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**Working Paper**

## Economics Of Corporate Governance Reform

Working Paper, No. 191

**Provided in Cooperation with:**

George J. Stigler Center for the Study of the Economy and the State, The University of Chicago  
Booth School of Business

*Suggested Citation:* Kroszner, Randall S. (2003) : Economics Of Corporate Governance Reform, Working Paper, No. 191, The University of Chicago, George J. Stigler Center for the Study of the Economy and the State, Chicago, IL

This Version is available at:

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## **ECONOMICS OF CORPORATE GOVERNANCE REFORM**

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December 2003

### Introduction

The reforms that are occurring in U.S. corporate governance, following the revelations of large scale frauds in 2001 and 2002, arose from calls for more than just changes in the structures of corporations as they affect managerial decision-making. News of financial scandals among major U.S. corporations fueled demand for relatively wide-ranging reforms that would be locked into place through legislation and other forms of commitment by public and private regulators. It will take time to fully document the responses of private and public policymakers to concerns about investor confidence following recent financial reporting scandals. Table 1 identifies some of the options recently considered by private self-regulatory organizations, a number of which are being implemented through the Sarbanes-Oxley Act of 2002.<sup>1</sup>

The recent reforms are the latest in a series of calls for corporate governance reform that corporate managers have seen over the past century. These include changes associated with merger waves (including those of the 1980s and 1990s), the introduction of the SEC in 1934, the imposition of constraints on institutional stock ownership through the Investment Company Act

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<sup>\*</sup> An earlier draft was presented at the Federal Reserve Bank of Chicago Conference on Bank Structure and Competition, May 2003, while the author was Member, President's Council of Economic Advisers. I am deeply indebted to Cindy Alexander, without whom this could not have been written.

<sup>1</sup> Parts of this discussion of corporate governance reform derive from "Corporate Governance and its Reform," Chapter 2 of the Economic Report of the President, transmitted February 2003 to the President by the Council of Economic Advisers, United States Government Printing Office, Washington. <http://w3.access.gpo.gov/eop/>

of 1940 and other legislation, and the continuing modification of regulations (and their interpretation) by regulators, legislators and the courts.<sup>2</sup>

The nature of the concerns leading up to the Sarbanes-Oxley Act and related reforms is outlined in a speech given by the President on March 7, 2002. That speech sets forth a “Ten Point Plan to Improve Corporate Responsibility and Protect America’s Shareholders,” calling for a concerted response to the emerging news that some of the Nation’s largest corporations had not truthfully reported their earnings and that this would harm investors, including employees whose pensions were invested in the company’s stock. The reforms suggested in the Plan and embodied in the Sarbanes-Oxley Act involve three core principles of effective governance: 1) accuracy and accessibility of information, 2) management accountability, and 3) auditor independence. These principles are useful guides toward a closer alignment between the actions of managers and the interests of shareholders and other investors. This is known to economists as the goal of reducing agency costs in the corporation.

### Market Forces Promote Strong Corporate Governance

In order to obtain access to well-developed financial markets, corporations must win and maintain investors’ confidence. What this means is that managers must commit their corporations to provide investors with enough information about the firm’s prospects to assuage concerns about adverse selection and agency costs that can undermine the corporation’s ability to obtain external financing on good terms. Managers, as insiders, generally know more than outside investors know about the corporation, the managers’ competence, and their likely

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<sup>2</sup> For merger wave’s effect on corporate governance, see A. Shleifer and R. Vishny, “The Takeover Wave of the 1980s,” in D. Chew, ed., *Studies in International Corporate Governance* (New York: Oxford University Press, 1997) 98-105, and B. Black, “The First International Merger Wave (and the Fifth and Last U.S. Wave),” *University of Miami Law Review* (2000) 54, 799-818.

diligence in managing the investors' funds. Facing this informational disadvantage, investors demand reliable information about the corporation and its management. They seek assurance about the quality of the corporations' management and investment prospects and that managers will act diligently so that agency costs will be low.<sup>3</sup>

One solution is for managers to create systems of checks and balances that shape the conduct of their corporations and that are readily observable by outsiders. Checks and balances governing the choices of managers and projects, for example, can commit the corporation, through rules and incentives, to employ more talented managers and to pursue more promising investment prospects. Transparent systems for setting management compensation and procedural safeguards on managers' actions can reduce the agency costs of delegating decisions to management. By creating strong systems of corporate governance, managers can thus improve the efficiency of their firms and the terms on which financing is available to them.<sup>4</sup>

Strong corporate governance generally involves some form of publicly revealed commitment to whatever checks and balances have been instituted. This can be critical to meeting investor demand for assurance. Typically it is not enough for managers simply to claim that they have instituted certain systems and procedures and promise to maintain them; investors must be able to verify that those systems and procedures are actually in place and that the commitment to maintain them is real. This assures investors that those arrangements are not likely to unravel when they are not looking.

The standards for strong corporate governance are thus high. Fortunately, managers of U.S. corporations have a solid foundation on which to build. Nationwide markets for capital and for management talent, together with a strong legal system and a long tradition of sound internal

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<sup>3</sup> M. Jensen and W. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure," *Journal of Financial Economics* (1976) 3, 305-360.

corporate governance, provide managers with incentive to innovate and powerful tools for communicating credibly with outsiders.<sup>5</sup>

Research over the past decade has focused attention on how stronger legal protections for minority investors and other reforms can significantly reduce corporations' costs of obtaining outside financing, thereby improving corporate performance and capacity for growth.<sup>6</sup> The legal and regulatory foundation for corporate governance in the United States is already among the strongest in world, according to this research. In the U.S., the value of reform to derive from the fact that obsolescence tends to limit the effectiveness of longstanding laws and regulations. It thus makes good sense for public officials – regulators and legislators – to update their rules either after the conditions that led to those rules have changed or after unforeseen weaknesses in the rules' effectiveness become known. The financial reporting scandals that came to light during 2001 and 2002 surely exposed unforeseen weaknesses, or limitations, in the system of laws and regulations that supports U.S. corporate governance. As explained below, federal initiatives introduced during 2002 seek to address these limitations.

### Corporate Governance Reforms during 2002

The corporate governance reforms initiated by the Federal government during 2002 are among the most far-reaching reforms to federal laws and regulations affecting U.S. corporate governance since the establishment of the Securities and Exchange Commission. It will take time to know the full scope of the effect and the magnitude of the public and private sector costs

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<sup>4</sup> A. Shleifer and R. Vishny, "A Survey of Corporate Governance," *Journal of Finance* (1997) 52, 737-783.

<sup>5</sup> J. Coffee, "The Rise of Dispersed Ownership: the Roles of the Law and the State in the Separation of Ownership and Control," *Yale Law Journal*, (2001) October.

<sup>6</sup> R. La Porta, F. Lopez-de-Silanes, A. Shleifer, "Corporate Ownership Around the World," *Journal of Finance* (1999) 54, 471-517, and R. La Porta, F. Lopez-de-Silanes, A. Shleifer, and R. Vishny, "Investor Protection and Corporate Governance," *Journal of Financial Economics* (2000) 58, 3-27, and R. La Porta, F. Lopez-de-Silanes, and A. Shleifer, "Investor Protection and Corporate Valuation," *Journal of Finance* (2002) 57, 1147-1170.

incurred in achieving it. It is possible, however, to characterize the potential effects – and indeed benefits – of the reform initiatives for U.S. corporate governance by considering how they implement each of the three principles underlying the President’s plan for reform. In this light, the most dramatic effects of the recent reforms are being achieved through regulations being promulgated by the Securities and Exchange Commission under the Sarbanes-Oxley Act.

### *1) Information Accuracy and Accessibility*

A primary goal of U.S. securities regulation is to ensure that investors receive good information in a timely manner. Managers with strong investment prospects benefit from the existence of institutions that make it easier to communicate with outside investors credibly and at low cost. They accordingly have strong private incentives to develop and maintain such institutions. The private costs of doing so can be lower for the government -- and for large private self-regulatory organizations -- than it is for individual managers and investors, acting alone. In recognition of this, enforcement of accurate and timely disclosure is one of the primary roles of the Securities and Exchange Commission.

The Sarbanes-Oxley Act promotes accuracy and timeliness in corporate financial reporting in several ways. First, the Act introduces new disclosure requirements. Directors, officer and principal investors must disclose their transactions in company stock more quickly than before – by the end of the second day after the transaction, rather than 10 days after the close of the calendar month as previously required. This enables investors to react more quickly to the information contained in such disclosures. Indeed, more rapid disclosure strengthens the capacity of outsiders generally to act on news of insider trading. The act further requires that corporation make more information available about the quality of their internal governance

statutes, including whether they have special ethics rules in place to guide the actions of senior financial officers, and whether the audit committees of their boards of directors include any financial experts (and if not, why not).

Financial analysts and auditors also must make certain disclosures under the Act. Each must publicly disclose to investors whether any conflicts of interest might exist to limit their independence from influences other than the desire to serve the interests of shareholders. This provides an additional check against any conflicts that might remain after the other provisions of the Act, and the other reforms accompany the act, are taken into account.<sup>7</sup>

Second, the act seeks to improve the effectiveness of the many existing U.S. securities disclosure regulations by dramatically increasing some of the sanctions for violating them. The incentive implications are similar to those of rules designed to increase the expected sanctions for management misconduct, which will be discussed below. The Act provides for a fourfold increase in the maximum prison term for criminal fraud – to 20 years rather than 5 years – and an even higher maximum term of 25 years for securities fraud. Both of these increases in prison terms are in addition to fines and other, nonmonetary sanctions. Recognizing that penalties cannot be imposed without evidence that a violation has occurred, the Act also increases the maximum sanction for destroying documents allowing courts to impose fines and terms of imprisonment of up to 20 years for this offense. The most severe penalties, such as imprisonment, tend to apply only to violations found to have occurred knowingly, with the stiffest sentences reserved for violations that are both knowing and willful.

Finally, the Act creates new rules and institutions for shaping managers' and auditors' choices concerning the accuracy and timeliness of corporate financial reporting. In doing so, the

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<sup>7</sup> See R. Michaely and K. Womack, "Conflict of Interest and the Credibility of Underwriter Analyst Recommendations," *Review of Financial Studies* (1999) 12, 653-686.

act promotes compliance with existing disclosure rules, in addition to strengthening managers' and auditors' incentives generally to act in the interest of investors. (These provisions apply the principles of management accountability and auditor independence and so will be discussed in more detail separately, below).

In requiring disclosure, securities regulations supplement both the law and market forces in creating incentives for corporate managers to provide timely and accurate information to investors.<sup>8</sup> Corporate managers have incentives to supply favorable information because, in doing so, they can distinguish themselves and their corporations from others who lack favorable information to report. Enforcement of anti-fraud laws can beneficially strengthen this signal.<sup>9</sup> That said, it is too early to measure the actual effect of disclosure rules under the Sarbanes-Oxley Act.<sup>10</sup>

## *2) Management Accountability*

The second underlying principle of recent corporate governance reforms recognizes the importance of managers sharing in the benefits and costs of their actions. Federal corporate governance reforms have placed special emphasis on holding managers accountable for costs. This is not surprising in the wake of recent allegations of accounting fraud. The concern is that managers have not been held adequately accountable for costs their lack of timely and accurate reporting may have imposed on others. Economists recognize two distinct means of discouraging – or deterring – managers from taking actions against the interests of shareholders.

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<sup>8</sup> For evidence on the relevant market forces, see M. Gerety and K. Lehn, "Causes and Consequences of Accounting Fraud," *Managerial and Decision Economics* (1997) 18, 587-599.

<sup>9</sup> P. Dechow, R. Sloan, and A. Sweeney, "Causes and Consequences of Earnings Manipulation: An Analysis of Firms Subject to Enforcement Actions by the SEC," *Contemporary Accounting Research* (1996) 13, 1-36.

<sup>10</sup> For an example of disclosure laws with unintended consequences, see G. Jarrell and M. Bradley, "The Economic Effects of Federal and State Regulations of Tender Offers," *Journal of Law and Economics* (1980) 23, 371-408.



One is to step up detection efforts, so that managers face higher probabilities of getting caught in the act of wrongdoing and thus sanctions. The other is to increase the total sanction that the manager receives for an offense upon detection. The level of deterrence depends on the would-be offender's expected sanction – the product of the probability of detection and the size of the total sanction.<sup>11</sup>

Under recent corporate governance reforms, managers likely will face significantly higher probabilities of detection in association with financial reporting fraud. This is being accomplished by three different types of reform. First, more money is being spent on the enforcement of laws against management and auditor misconduct, especially financial reporting violations. See Table 2.

The government has not just spent more money on enforcement, however. It also has sought to use its enforcement resources more efficiently. In July of 2002, the Corporate Fraud Task Force was established to better coordinate the efforts of the Securities Exchange Commission, Justice Department and other institutions engaged in detecting misconduct and imposing sanctions where it occurs.

Finally, managers are being confronted with higher detection probabilities through measures to clarify liability for wrongdoing within the corporation. One example of this was the requirement of the SEC to require CEOs and CFOs to certify the accuracy and completeness of their companies' financial reports. Without such a requirement, accountability for inaccuracies or missing information might be viewed a public good within the firm, with each of several parties having some small chance of being held accountable for misconduct if it is detected.

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<sup>11</sup> G. Becker, "Crime and Punishment: An Economic Approach," *Journal of Political Economy* (1968) 76, 169-217, A. Polinski, and S. Shavell, "The Economic Theory of Public Enforcement of Law," *Journal of Economic Literature* (2000) 38, 45-76.

Requiring CEOs and CFOs to certify financial statements alleviates concerns and confronts at least two officers within the firm with high detection probabilities in the event of misconduct.

The Act also clarifies the roles and responsibilities of other corporate officers, in addition to CEOs and CFOs. It expressly charges corporation's audit committees with responsibility for overseeing the selection and compensation of the company's outside audit firm. As already mentioned, audit committees must reveal whether any of their members are financial experts, and if not, why not. A corporations' attorneys are expressly held responsible for reporting any evidence they might receive of a violation of the Act, a breach of duty, or other violation to the chief legal counsel, to the CEO, or to the audit committee or other independent directors (if other parties appear not to respond to the information in a timely manner). This too increases the probability that misconduct will be detected by outside enforcement authorities and subjected to sanction when it occurs.

Reforms designed to increase the magnitude of sanctions that managers receive upon detection are more straightforward. In addition to clarifying the roles and responsibilities of various corporate officers, the Sarbanes-Oxley act introduces new sanctions for managers who fail to live up to those responsibilities. For example, the Act makes it a criminal offense, subject to fines of up to \$1 million, to knowingly engage in false certification of financial reports. In the extreme case where a CEO or CFO knowingly and intentionally provides false certification, the maximum sanction climbs to \$5 million. In case this is not enough to deter false certification, CEOs and CFOs who falsely certify financial reports are required to forfeit any bonuses, incentive compensation, or other gains that they might have received from the company during the year after the issuance of a false report. This limits the ability of other corporate participants to offer side-payments to a CEO or CFO to encourage complicity in misconduct.

### *3) Auditor Independence*

The objective of auditor independence is to limit outside auditors' tolerance of false (or careless) financial reporting on the part of corporate managers. This can be accomplished by altering the structure of the market, or specific transactions, through which auditors sell their services.

Structural reforms can limit some of the temptation audit firms and their partners face to tolerate false reporting by making it more costly for managers of public corporations to express their demand for tolerance. Supply-side reforms can make it more costly for public accounting firms to provide tolerance by confronting audit firms and their partners and employees with higher expected sanctions for tolerating false reports. The Sarbanes-Oxley Act introduces both demand- and supply-side reforms that will together limit the amount of tolerance that managers of audit firms can realistically obtain. Reforms promoting auditor independence thus reinforce initiatives designed to promote management accountability in limiting the occurrence of false reporting.

The Sarbanes-Oxley Act limits the demand for auditor tolerance by making it more difficult for managers who might benefit from that tolerance to play a role in the selection and compensation of outside auditors. Under the Act, a corporation's choice of auditor must be made by a committee of independent directors who are not employees of the company and have no relationship with the company other than as directors. Recognizing that some managers might subsequently find ways to influence auditor compensation in the course of their subsequent dealings with specific representatives of the audit team, the Act requires that accounting firms periodically assign a new audit partner to each client account. As a further

possible obstacle to compensating the audit firm for tolerance, the Act prohibits public accounting firms from compensating the audit firm for some non-audit services.

On the supply side, the Act increases the expected cost to auditors of showing tolerance for false reporting by creating a special new agency – the Public Company Accounting Oversight Board – to monitor and enforce the diligent supply of outside audit services. To increase the probability of detection of misconduct by auditors, each public accounting firm must register with the Oversight Board and submit to periodic reviews of its performance. The Oversight Board is given the authority to act upon any evidence of auditor misconduct by undertaking investigations. Upon registering with the board, each public accounting firm agrees to cooperate with the board's investigations. Such cooperation includes retaining audit work papers and other documents for a minimum of 7 years and providing those records to the board on request.

When the Oversight Board discovers evidence of misconduct, it has the power under the Act to impose sanctions. It can impose fines on individual auditors and the accounting firms that employ them. It also can bar auditors from supplying their services to any U.S.-listed corporation, temporarily or permanently. The combined effect of this new monitoring effort and these newly instituted sanctions is to increase the expected cost of misconduct to any registered accounting firm or employee. This reinforces the demand-side constraints on auditor selection to limit the supply of tolerance to any manager or corporation that might continue to seek it out.

### Financial Service Firms

The changes in the regulatory climate discussed above are confronting financial institutions with new challenges, primarily in two of three primary areas of reform: information accuracy and accessibility, as well as management accountability. Not only are financial institutions called

upon to comply with new regulations as corporations, they also must re-evaluate their relationships with corporations – as suppliers and board members. Just as regulators are working to implement new rules, financial institutions and the researchers who study their practices are examining these relationships more closely than ever before. Following more general findings on the nature of corporate governance over the past two decades, recent research has begun to focus on the nature of financial institutions' contributions to corporate governance. Evidence on the role of bankers as board members provides one illustration of this point. In work with Philip Strahan, I have investigated the frequency of connections between banks and non-financial firms through board linkages and whether those connections affect lending and borrowing behavior.<sup>12</sup> Our results suggest that avoidance of potential conflicts of interest explains both the allocation and behavior of bankers in the U.S. corporate governance system.

### Opportunities for Further Reform

Recent reforms have sought directly to affect managers' and auditors' influence in public corporations. Yet non-management shareholders also can have an important influence on corporations. During the 1970s and 1980s, institutional investors were accumulating unprecedented equity ownership stakes in U.S. corporations. As their ownership has grown, so has their role. In the 1980s, institutions were often seen as passive participants in corporate governance, with evidence from research supporting this view. This changed during the 1990s. Some constraints on the role of institutional ownership have remained in place, however.

The Investment Company Act of 1940, for example, substantially constrains the ability of institutions to discipline corporate management on behalf of households and other investors.

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<sup>12</sup> Randall S. Kroszner and Philip E. Strahan, "Throwing good Money After Bad? Board Connections and Conflicts in Bank Lending," NBER Working Paper No. 8694, December 2001, and A Bankers on Boards: Monitoring,

This restriction appears to have arisen from a desire to promote diversification of institutional holdings and to limit institutions' influence over corporate managements. Modern financial economics research has helped to clarify what conditions must exist for diversification to occur. The evidence is that the Act's restrictions go far beyond what is required to ensure diversification. In their current form, the Act thus imposes costs on investors – and on modern corporate governance – without countervailing benefits to investors or to the functioning of the market generally.

Modern research also has brought to light the critical role that the prospect of shareholder intervention into the corporation can play in disciplining management. This valuable discipline can be obtained without actual intervention. The necessary condition is that managers recognize the presence of a threat by an acquirer or other external investors to intervene. In its current form, the Investment Company Act of 1940 assures managers that the ability of institutions to step in and take direct disciplinary action against any misconduct will be limited. Other legal and regulatory constraints on the role of institutional investors are reviewed in Table 3.<sup>13</sup> This constitutes an updated listing of potentially inefficient constraints on institutional investors' participation in public corporations that has been highlighted in previous research. These rules represent good opportunities for future reforms. Recent SEC proposed rules on expanding the ability of large shareholders to have their nominees for directors be included in proxy materials – so-called shareholder access initiatives – simply add a complex set of new regulations of dubious

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Conflicts of Interest, and Lender Liability,@ *Journal of Financial Economics*, December 2001, 62(3), 415-52.

<sup>13</sup> Table 3 provides an up-to-date listing of laws and regulations that appear to unduly limit the value of institutional investors' participation in U.S. corporate governance, following M. Roe, "Political and Legal Restraints on Ownership and Control of Public Companies," *Journal of Financial Economics*, (1990) 27, 7-41. The recent reforms have not fully exploited the U.S. potential for improvement in the legal and regulatory foundation for U.S. corporate governance.

merit rather than focus on the primary task of reducing the existing regulatory barriers to active participation of large shareholders in the governance process.<sup>14</sup>

A key issue to consider in the wake of recent reforms is appropriate scope of and interaction between private and public efforts to promote strong corporate governance. Just as the efforts of one country's enforcement authority might duplicate those of another -- and the duplication of enforcement efforts might adversely affect the efficiency of targeted corporations -- the efforts of government legislators and regulators might in some instances duplicate private sector efforts to promote strong corporate governance.<sup>15</sup> The recent reforms in the U.S. have drawn attention to the importance of striking the right balance between public and private efforts to promote strong corporate governance. In light of the role that self-regulatory organizations have played in responding to the call for reform, similar issues may arise in the balancing of efforts by individual corporations with those of private-sector regulatory organizations. The practical importance of these remaining issues will become clearer with the passage of time, as evidence becomes available on the longer-term consequences of the recent reforms.

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<sup>14</sup> For an explanation and critique of the SEC shareholder access proposals, see Randall S. Kroszner, "Comment on U.S. Securities and Exchange Commission Proposed Rule on 'Security Holder Director Nominations'" AEL-Brookings Joint Center for Regulatory Analysis, Working Paper 03-13. Dec 2003.

<sup>15</sup> See H. Demsetz and K. Lehn, "The Structure of Corporate Ownership: Causes and Consequences," *Journal of Political Economy* (1985) 93, 115-1177, and Clifford G. Holderness, Randall S. Kroszner, and Dennis P. Sheehan, 1999. AWhere the Good Old Days That Good? Changes in Managerial Stock Ownership Since the Great Depression,@ *LIV Journal of Finance* 435-469.

Table 1. – *Some Corporate Governance Initiatives of NYSE and Nasdaq*

Principle	Initiative
Information accuracy and accessibility	NYSE and Nasdaq proposals require that listed companies publish a code of business conduct and ethics and guidelines for corporate governance. NYSE proposal further requires disclosure of board-approved exemptions.
	Nasdaq proposal requires that a press release immediately disclose a going-concern qualification in an audit opinion.
	NYSE and Nasdaq proposals required disclosure of any permissible exemptions to their corporate governance requirements by non-U.S. issuers.
Management accountability	NYSE and Nasdaq proposals required independent director approval of director nominations and of CEO compensation.
	NYSE and Nasdaq proposals required shareholder approval of all equity-based compensation programs. NYSE further disallowed a broker from voting on such plans without customer instruction.
	NYSE and Nasdaq proposals required that a majority of directors be independent (except at "control" companies) and set a more stringent definition of "independence," which excludes persons with <i>any</i> financial or personal relationship with the company.
	NYSE proposal required CEOs of all companies to certify annually that they know of no violation of NYSE governance standards.
	NYSE would have ability to issue public reprimand letter for companies in violation of its governance requirements.
	Nasdaq proposal required independent director approval of all related-party transactions.
	NYSE and Nasdaq proposals required that nonmanagement directors meet regularly without management.
Auditor independence	NYSE and Nasdaq proposals required that the audit committee have responsibility to hire and fire the auditor.
	NYSE and Nasdaq proposals required audit committee approval of all nonaudit services of auditors.
	NYSE and Nasdaq proposals entailed heightened standards of independence for audit committee members in that compensation would be allowed only for board or committee service.
	NYSE and Nasdaq proposals required financial literacy of all audit committee members and accounting or financial management expertise of at least one.

Sources: New York Stock Exchange (NYSE) and Nasdaq Stock Market (Nasdaq).



TABLE 2. – *SEC Enforcement Actions*

SEC activity	FY 2000	FY 2001	FY 2002
Financial fraud and issuer reporting actions filed	103	112	163
Officer and director bars sought	38	51	126
Temporary restraining orders filed	33	31	48
Asset freezes	56	43	63
Trading suspensions	11	2	11
Subpoena enforcement actions	8	15	19
Disgorgement ordered (millions)	\$463	\$530	\$1,328
Penalties ordered (millions)	\$44	\$56	\$116

TABLE 3. – *Legal Rules that Shape the Roles of Institutional Investors*

Institution	Restriction	Source
Insurers		State Law (New York example)
Life insurers	<ul style="list-style-type: none"> <li>No more than 2 percent of assets may be in the common stock of a single company; no more than 20 percent of assets may be in equity interests.</li> </ul>	NY Insurance Law (for insurers doing business in NY)
Property and casualty insurers	<ul style="list-style-type: none"> <li>No more than 2 percent of assets may be in a single company's preferred or guaranteed stock; at most, 10 percent of assets may be in common stock.</li> </ul>	Same
Mutual funds	<ul style="list-style-type: none"> <li>For half of portfolio: no more than 5 percent of fund's assets can go into stock of any one issuer and fund may not purchase more than 10 percent of voting stock of any company, otherwise tax penalties apply.</li> <li>Must get SEC approval prior to joint action with affiliate, e.g., a fund needs SEC approval before acting jointly to control a company of which it and its partner own more than 5 percent.</li> </ul>	Subchapter M of the Internal Revenue Code  1940 Investment Company Act
Pensions	<ul style="list-style-type: none"> <li>Must manage assets prudently, and generally requires that assets be diversified. The "prudence rule" has been interpreted to require that a person responsible for a plan retain experts when appropriate, and is a significantly higher standard than the business judgment rule.</li> <li>Must act for the exclusive purpose of providing benefits to participants and beneficiaries.</li> <li>Traditional pension plans may not acquire any stock or bonds issued by the company that sponsors the plan if such acquisition would cause the plan to hold more than 10 percent of its assets in such securities.</li> <li>These rules are supplemented by rules that specifically prohibit potentially abusive transactions with the plan.</li> </ul>	ERISA: 29 U.S.C. § 1104 (a)(1)(B) 29 U.S.C. § 1104 (a)(1)(C)  29 U.S.C. § 1104 (a)(1)(A) 29 U.S.C. § 1107 (a)(2)  29 U.S.C. § 1106 (a); 1106 (b)
Bank holding companies (BHC)	<p>Bank holding companies generally cannot acquire direct or indirect ownership or control of any voting shares of any company that is not a bank. Several important exceptions exist which, for example, permit a BHC to hold shares of a company:</p> <ul style="list-style-type: none"> <li>That do not exceed 5 percent of the company's outstanding shares, if the ownership does not constitute "control"</li> <li>Engaged in activities closely related to banking.</li> </ul>	Bank Holding Company Act of 1956  12 U.S.C. § 1843(c)(6)  12 U.S.C. § 1843(c)(8)
Bank trust funds	<ul style="list-style-type: none"> <li>For pension accounts, no more than 10 percent of assets may be in employer securities.</li> <li>Active bank control could trigger liability to controlled company.</li> </ul>	ERISA: 29 U.S.C. § 1107 (a)(2) Bankruptcy case law

Sources: United States Code, Department of Labor, Federal Deposit Insurance Corporation, Securities and Exchange Commission, and National Association of Insurance Commissioners.