Securities and Exchange Commission Historical Society
Interview with Joseph Grundfest
Conducted on June 20, 2013 by Robert Colby

RC: This is an interview with Joseph Grundfest for the SEC Historical Society's virtual museum and archive of the history of financial regulation. I'm Robert Colby. Today's date is June 20th, 2013 and our interview is taking place at the Stanford Law School, Palo Alto, California. Professor Grundfest, thank you for being with us today.

JG: Thank you, Bob and good morning.

RC: I find it's generally useful to start with early life and education. So, growing up, were you interested in economics and law?

JG: Growing up, I was interested in everything other than economics and law—baseball. I didn't get interested in economics and law really until college, and law not until really after college.

RC: You did your undergrad work at Yale.

JG: Undergrad at Yale and the London School of Economics.

RC: Where did you encounter economics for the first time?

JG: It was the first year at Yale. I entered Yale thinking that I'd take a shot at theoretical mathematics, that kind of stuff, and in the first week or two where you're in a seminar at Yale with real mathematicians I quickly learned that, even if I was good at math, I wasn't *great* at math. You'd have homework assignments, and you'd have to prove theorems. It would take me a bit longer to prove the theorem than the best kids in the class and my theorem would be a few lines longer than the best kids in the class.

In math you're either at the absolute very top or you're going to starve, so I figured I'd better find something else and economics worked well for me. I really enjoyed it. It had that mathematical orientation so I could apply the mathematical approach, and it was just filled with very interesting problems and challenges, so I really took to it.

RC: You pursued that further at the London School of Economics?

JG: I did a junior year abroad at the London School of Economics. And great thanks to the great training that I had at Yale because I showed up there and they had an undergraduate program and I had a terrific adviser. I explained to them that all the stuff you want to teach me I already know, and my adviser, a great guy, said, "All right hot shot, we're going to put you in the master's program for mathematical economics and econometrics." He just basically said, "I dare you to do this program."

So I did the program. It was great. The teachers again were absolutely fantastic. I took the exams. I got first-place distinctions, which was really wild, and they refused to give

me the degree because I hadn’t finished my bachelor’s degree at Yale. The requirement for getting the masters was you had to have a bachelor’s degree before they would give you the masters, and I said, “Well, you're going to make me go back to New Haven, finish my bachelor’s degree and then come back here?” And they said, “Yes, you go back, you finish your bachelor’s, you come here, we'll give you exactly the same exams again and then we can give you the master’s but we can't do it out of sequence”. I said, “Oh come on,” and so I never got the degree. I took the exams. I can't claim to have the master’s degree even though I completed the program. I just did it out of sequence.

RC: That’s wild.

JG: Rules are rules. Ask the SEC.

RC: (Laughter.) You ended up in law school after that, so was there anything in you–

JG: No. I'll tell you what pushed me to law school. After college I got a job at the RAND Corporation, and again, I have been fantastically lucky with my educational experience and with the training that I've received. At RAND, I worked on a range of projects. Typically we would do these consulting projects and all of the stuff that we did wound up being shipped to Washington on the domestic side, and it would always be reviewed by lawyers. The lawyers would make the decisions about how our research was going to be implemented.

Six months into my RAND experience, it looked to me like lawyers were running the world. Economists would whisper in lawyers' ears and lawyers would then make the decision. And my reaction was, "Damn it, if I'm going to whisper in somebody else's ear and have them make the decision, I'm going to make the decisions too." What's so hard about going to law school? So I decided to do the joint JD/PhD program here at Stanford and I got interested in law really only when I saw what the relationship was between economics and lawyers in the policy making process.

RC: That was an established program already, the joint JD and PhD?

JG: Yeah. Here at Stanford, even a century ago, in the Dark Ages, the university was very good about joint PhD programs. Today, being multi-disciplinary is really one of the differentiating factors of this university.

RC: What did you focus on in both degrees while you were here in law school/grad school?

JG: In law school there are a large number of courses that had a very strong economic content, whether it's Bill Baxter teaching anti-trust or the way Charlie Meyers taught property, it was really wonderful. It was, in a certain sense, very early on in the law-and-economics movement—we're talking 1974, '75, a bazillion years ago—and it was really just great. The law school was extraordinarily supportive of me doing work in the Econ Department. The Econ Department was very supportive of me doing work in the law school. On the econ side I focused on areas like finance, microeconomics, organization

theory, game theory, stuff along those lines. So it was very complementary, both areas of study.

RC: When you came out, what did you think that you would be doing when you came out of both programs?

JG: The main thing that I thought that I'd be doing would be following my wife. I came out of law school and got married the weekend after taking the Bar. We loaded up everything that we owned into Carol's Volkswagen Rabbit. We drove cross country in about three and a half days. That was our honeymoon. We figured that if we were talking to each other at the end of that road trip the relationship might last. So far so good. And I had a fellowship at the Brookings Institution where I continued to do some economic research and the like.

We didn’t really have a strong plan. We didn’t know whether we were going to stay on the east coast, whether we were going to come back to California. It turned out Carol wanted to stay on the east coast, she had some terrific opportunities, and I said, “Great, let me try to find a job.” And I had a bunch of friends who were working at Wilmer—then Wilmer, Cutler & Pickering—and went over and interviewed, and they said, “Yes, we’ve got some work for you,” and I said, “Great, let me help out.”

RC: Did you cover the range of legal topics at Wilmer, or did you focus on—

JG: Wilmer again was an absolutely spectacular learning experience, because at the time they trained lawyers in a way that was not specialized. I would be doing everything under the sun. There was a day where I'd be working on a major international anti-trust investigation with Don Turner and we had to work out litigation strategy. Then I was helping write a Supreme Court brief for another one of the partners. Then there was a trip-and-fall case for an elderly woman who used to be a secretary to Colonel Wilmer, one of the founders of the firm, and it was my job to prosecute that case. I learned all about trip-and-fall law in D.C. And we got a very, very nice payment out of a Chinese restaurant where this not so young lady happened to trip and fall on her way out. It was great. I discovered about underground vaults and did some very interesting discovery. It couldn't have been better—a great training experience because it was so eclectic.

RC: How did you go from there to the Council of Economic Advisors?

JG: Basically I got a phone call and the phone call said, "We're looking for somebody who's a lawyer and an economist. We have some big issues,"—then the problem was the S&L crisis—"and we also need to figure out how to handle this new takeover activity, which was then very new in the world." This was before poison pills. It was a bazillion years ago and the law was nowhere near as evolved as it is today. They said, "We heard that you understand all of this stuff and that you're being reasonably well trained at Wilmer." "I never got the PhD, let me be clear about that." "But you've got all this advanced economics training; come on over." So I come on over and sit down, have a great

conversation. But there's a problem, and that’s that I'm a registered Democrat and this is the Reagan White House.

They sort of said, “Well, you're a little unusual for a Democrat because you actually believe that markets can work.” And I said, “Yeah, I am an economically rational Democrat.” Sometimes I say a “free market Democrat,” but I think you say “free market” today, people think that means “unregulated,” which is certainly not what I believe. But they sort of said, “Well, gee, why are you a Democrat then?” And I said, “Well,”—and I remember this conversation with the people at the Office of White House Personnel—“because I really think your social policies are misguided.” That was at a time when AIDS was a major issue, and I thought the Reagan administration's policy on AIDS was profoundly harmful. There were a whole set of issues on which we were never going to see eye to eye. What did they think about gay rights? Again, we're going back thirty years here.

There were a whole set of social policy issues in which I just said, “I don’t agree, but when it comes to figuring out how to deal with the S&L industry, deal with takeovers, we are right on board.” I jokingly say that I'm the guy that invented Don’t Ask Don’t Tell. I said, “You guys don’t ask me what I think about all of these social policies and healthcare and other issues, and I won't tell you. I've got a responsibility in capital markets. I'm going to do capital markets.” But the thing that was really fascinating was they would always ask me about these other social policy issues, and I would always tell them I thought they were out to lunch. I didn’t leak to the press. We had a very professional

relationship along those lines and they discovered that from their view they had an economically rational authentic Democrat working in the White House.

RC: You were working on savings and loans and takeovers primarily?

JG: Yeah, those were the main capital markets issues at the time. There were many other issues but all of them were an order of magnitude less important.

RC: Were you studying the effects of regulation on these issues or just looking at them more broadly?

JG: It was a broader look from the Council of Economic Advisors. We would look at the effects of regulation, but you would also have to think about what the administration strategy should be. How do you work with Congress? What kind of legislation do you wind up pushing? How do you respond to the emerging issues in each one of these different areas? You've got to get all of the different branches of the executive branch working together. You've got to get the Commerce Department on board. You've got to get Treasury on board, primarily Treasury. You develop the political skills of taking a group of people within a large organization having twenty different opinions and saying, "Guys, we've got to come up with a consensus view that we can all sign on to." And one of my jobs was saying, "Okay, we're going to develop a consensus," and if there was somebody that wasn't on board you either had to persuade them or have somebody go tell them to get on board.

RC: Can you tell me about studying takeovers, because that seems like it would be particularly contentious?

JG: Yeah, it was very contentious and one of the reasons why it was contentious was it highlighted a split within the Republican Party. Let's oversimplify it. Let's say that there is a market-oriented wing of the Republican Party and a corporatist wing of the Republican Party. The market-oriented wing would say, "Let takeovers happen because if you structure them properly they can be a very efficient means to redeploy capital, to discipline management, to rationally give voice to shareholders." But then there's the corporatist wing of the Republican Party, which says, "Hey, wait a minute, we're the CEOs, these takeovers threaten our ability to run the companies the way we want to and we're the ones that set corporate policy and we're major supporters so we are actually opposed to takeover activity."

And you have an equivalent split in the Democratic Party as well, because there you had large groups who said, "We like takeovers." Why? Because they can actually be threatening to management. And then you had groups that say, "We hate takeovers." Why? Because after a takeover people tend to get laid off. So, with the takeover battles, there was a certain sense that they were simultaneously profoundly political, but political along dimensions that didn't give rise to clear Democrat/Republican lineups.

The challenge that I had was: "Look, there's a particular point of view." Mine was clearly on the markets-oriented point of view. You've got to have efficient capital allocation, and that's the view that we got the Reagan administration to back up and support over a lot of opposition from within the Republican Party. Here I was a fresh-faced, ridiculously young, bearded Democrat trying to persuade all of these Republicans, "Hey, guys, this is the way you've got to go." And they're looking at me and they're going, "Who are you to move us in this direction?" But we got it done.

RC: How did you make the case, through studies?

JG: No. I relied primarily on my remarkable good looks. Actually, it was a purely logical process. There was a tremendous amount of opposition, but I thought the economic data were very clear. By the same token, you couldn't let the process run amok in an extremely unregulated manner for a wide variety of reasons, including the fact that the political process wouldn't support it. So you had to come up with a rational, measured approach that would allow markets to evolve in a way that the political process would support.

RC: It's about this time that you move over to the SEC. Could you tell me about that process?

JG: Sure. What can I say? I was the luckiest bastard you'll ever meet. By statute the SEC can't have more than three members of the same political party as the President. So they had their Republican nominee, Ed Fleischman, and there was a Democratic opening and

they had to look around, and they said, "Where in the world are we going to find a Democrat that the Reagan White House could support for a seat on the SEC. And they looked around and they said, "You know that crazy bearded guy over at the Council of Economic Advisors? He's a Democrat. We all know that. He really is authentically a Democrat. All of this other stuff that we feel strongly about, he thinks we're nuts but on everything related to the SEC he's the guy that has helped pull our policy together. He's the one that's helped us herd the cats and we don't have to tell him how to think like a free-market-oriented regulator. That's what he thinks. That's what he does."

It's really only because the statute places a limit which is based on party affiliation, only because I was in the White House, or—can I say in a certain sense ironically—I hadn't compromised my principles. Had I said, "Well, okay, let me become a Republican so that I can advance in this environment," I never would have made it to the SEC. It was only because I was a Democrat, wasn't going to compromise on that, and, again, was entirely authentic in terms of my view about markets, and how they operate, and regulation, that I wound up, again, just being very lucky, the right person at the right time. Because you don't get on the SEC when you're thirty-three years old, which was my age at that time, without special circumstances.

RC: Had you dealt with the SEC at all while you were at the CEA?

JG: Oh yes.

RC: Can you tell me a little about that?

JG: I dealt with them very, very rarely and it really was only at the staff level and entirely informational. We were very careful not to do anything that could be perceived as the executive branch attempting to influence anything that an independent agency was doing. All the connections that I recall, number one, there were very few, and number two, they were all informational. The kind of stuff where today you would go to the Internet and you would get the documents and you would, say, clarify the sequence. We didn't have the Internet then so I'd have to call somebody up and I'd say, "Well, could you go through your files and find x, y, and z, and send over a copy?" And they were all public documents, that kind of thing.

RC: You didn't, say, look at what the Tender Offer Advisory Committee was recommending, or study that, or provide recommendations?

JG: Oh no, we wouldn't. They had their own committee. That was it. We would follow it, but they had their committee, and God bless them.

RC: So you are an economist coming to the SEC. Can you tell me a little bit about the state of economics?

JG: I'm an economist and a lawyer coming to the SEC, and I have background in both, and there was a debate at the time that I got on board. And there was a view by many

people—I'll be candid, that I wasn't qualified to be a Commissioner—that other people certainly knew more about the securities laws than I at the time. I'll be the first person to say that, yes, that's exactly right. At thirty-three I was not the most experienced securities lawyer. But on the other hand I was an economist, and I was a relatively newly trained economist, understood things like how futures markets operated, how derivatives markets operated, and understood what computerized trading meant for the markets.

If you look at computerized trading today and you compare it with what was happening then, it's night and day. The big deal back then was index arbitrage. How was it that you take price signals from the Chicago markets and actually trade equities so that you're able to make an almost guaranteed profit? It was really quaint. People would have these old IBM computers and they would be running this code, and it was very primitive compared to what people are doing now. But there were very few people at the SEC then who understood this stuff. It took a while to demonstrate to people that that kind of understanding, that being an economist and a lawyer, combined in one person, really was a value add to the process.

RC: Economic analysis in and of itself was a relatively new idea at the SEC.

JG: Well yes, economic analysis at the time was a relatively new idea. And not only was it a new idea, it was a new idea that wasn't really embraced by the organization. Let me tell you a story about how I got into trouble very early on. I gave a quote that wound up in *Fortune* magazine, and they featured it in one issue as, like, quote of the month. Some

people had asked me what it was that I had learned from my early service at the SEC that surprised me. I said, “It's interesting: there may be ten people in the whole building who have a real deep understanding of how markets actually work in the world today.” That’s a little bit like saying that the Food and Drug Administration only has ten doctors or ten chemists or ten biologists, because everybody else is a lawyer.” They're great lawyers, but they don’t have a deep understanding of how the markets actually work.

Boy, did I get in trouble with the staff. They let me know almost immediately that they did not appreciate my characterization of the staffs' skills along those lines. Number one, they let me know that they knew everything that they needed to know about the operation of the markets. And, in all candor, I bit my tongue because this was a part of the problem at the building, that you actually think that what you know is everything that you need to know. It's not. There's much more that we need to know, there's much more we need to do, and it's a certain sense of hubris.

I think the agency has evolved from that. I think it's much better today than it was then, but I think we still have a ways to go. The other thing I quickly learned was that if you were going to be a Commissioner you couldn’t perpetually be at war with the staff. You have to pick your battles, and the staff’s view was: Commissioners come and go, but we're here forever. They knew that I wasn’t going to be there twenty years. They knew that in four or five years I was going to be gone. So the staff can develop a strategy that says, “Okay, we have to follow a containment-in-management approach with regard to any Commissioner, or even any Chairman, because at some point they're gone. We're

career. We're here for the next twenty years; they're not." So I learned a good bit about Commissioner-staff dynamics and I learned to pick my fights. I learned strategies that could actually work and strategies that would just antagonize people and would fail.

RC: What were the sorts of things that you thought that they could improve?

JG: Without getting into specifics—and one reason I'm not going to get into specifics is this is like thirty years ago, I don't remember that many of them anymore—just the general view that incorporating market thinking, thinking about how actual markets work really would be essential to the success of the agency's enterprise. The way the agency worked then—and I fear it continues to work this way, and I hope it's changing—is that the staff and the commissioners would develop a policy view and that policy view could be rooted in a variety of things. It could be rooted in a political perspective; it could be rooted in ideology; it could be rooted in a particular legal view about how a statute should or shouldn't be interpreted. But it would rarely be rooted in terms of an economic analysis of, "Okay, what's the efficient result? What interpretation of this rule, what application of this rule, leads to the best market performance?"

The economic analysis was then always tacked on at the end. You would say, "All right, this is what we want to do and now let's have the economists write up why this is the smart thing." It would be relatively rare—it would happen, but it would relatively rare that you would bring in the economic thinking right at the beginning and say, "Let's

approach this problem like an economist and then make the rules fit the economic analysis."

There are many reasons for that. In particular, there were very few people in the building that had the skill set to do that. Most of the people in the building at the time were terrific securities lawyers and based their reasoning on a skill set that was very different from the traditional skill set that an economist would bring to the table if they looked at it differently. One of my colleagues, Charles Cox, was a pure economist, and Charles would tend to look at issues that way, as would I, and he and I would often have conversations where we'd share our frustrations. This is backwards, and it was backwards in many situations.

If you want to fast forward, clearly the D.C. Circuit's decision in *Business Roundtable* is extraordinarily controversial and many people will try to persuade you that the decision was wrongly decided, and what have you. Let's put that debate aside for the moment. You got to that decision, I think, because the D.C. Circuit looked at the rule, looked at the support for the rule and said that the agency really paid no attention to the underlying logic of what's going on here, that the agency had reached a political conclusion and they then were trying to pound a square peg into a round hole by suggesting that the data supported their conclusion.

I would have written the D.C. Circuit's decision quite differently but I would have come to the same conclusion. I don't want to stand up and say that I would agree with every

point made in the *Business Roundtable* decision, but I would agree with the conclusion that that rule was not based on an economically rational approach to the problem.

RC: Do you think that there are different views of what the SEC's role is in terms of investor protection versus market efficiency that causes that?

JG: Of course there are different views, but what's interesting is if you look at it again as an economist without an axe to grind, investor protection and market efficiency are really two ways of saying the same thing. How do you run a market most efficiently? How do you run a market in a way where buyers get what they're bargaining for at the lowest possible price, sellers get what they're bargaining for at the highest possible price, and you minimize the amount of friction in the process? You minimize also the cost of complying with the regulations because complying with these regulations is not free and at the end of the day it's investors who wind up paying for the compliance, so you have to think about that too. Part of the problem really is reflected in the way you ask the question, because that's how some people think about it. It's the battle between investor protection and market efficiency. No, it's not. It's the same problem, just looking at two different variables in the equation.

RC: You dealt with a number of different topics in your time at the Commission. There were a lot of things kind of coming to a head at that point. There are a number that I'm interested in, but you continued to deal with the issue of tender offers and takeovers at the Commission. Can you tell me about that?

JG: It was one of the hot issues at the time. How do you set up the takeover rules? Where do you set the different thresholds? Where do you set the different guidelines? What kind of disclosure are you going to require? Should the SEC be involved in Delaware's litigation on poison pills and the like? These issues came up everywhere. What do you say to Congress when Congress is thinking of amending the Williams Act and the like? The resolution of these questions, especially when they get to the level of Congress, is essentially political.

What I tried to do was develop an economically principled approach and say, “Look, here is my position and here are the economic and public policy reasons why this probably leads to the most efficient result for everyone and why it's good for investor protection, it's good for the macro-economy”—it minimized the cost of compliance with regulation. Regulation would seem to generate benefits higher than the cost and I would immediately recognize I'm going to have to compromise. There's no way that you're going to be able to get everything so let's try to figure out the best set of compromises. What will I give up? That’s the political process. Nobody ever gets everything they want, not even the President, so why would the most junior member of the SEC ever think that he's going to get everything he wants?

RC: Can you give me an example of that?

JG: Let me give you an example of a situation where that came up. The Delaware courts were then trying to figure out how to handle poison pills and we had the question as to whether we should write a brief supporting or rejecting poison pills. And it's my recollection that we wrote a brief arguing against poison pills. Again, you're asking me to go back more than thirty years and if it turns out that's wrong and I'm practicing revisionist history now, let's correct the record. But my recollection is we filed a brief and the Delaware courts disagreed with us.

We sort of sat back, we looked at it, and we said, "Well, let's monitor what's going on here." Instead of saying, "Gee, we need immediately to respond,"—because at the time I viewed this as inconsistent with a more free market approach to takeover activity—I said, "Let's not do anything rash. Let's not do something from a regulatory perspective at the SEC. Let's not try not to get any federal legislation in this area through Congress." There were people that wanted to do that. I said, "All right, let's run the experiment. Just because we disagree and just because we would things differently, this isn't a situation where we should be so cocksure that we're right. Let's see what happens, and if things wind up going off the rails there are a lot of things we can then do. Let's see what happens."

The world didn't come to an end. People learned how to evolve. You could have the view today that the world would be better off if there were no poison pills, but it's not like we're dead because there are poison pills. I think that's an interesting example responsive to your question.

RC: That sort of gets into the issue of the rights of shareholders versus the prerogatives in management. One of the things I remember seeing is different points: you early on argued that shareholders should be allowed to opt out of certain corporate regulations. Could you tell me some of what led you to argue that?

JG: Sure. A basic premise of corporate law in many ways is that the statute is a form of contract and then you could opt into and opt out of different provisions in the statute. And, provided people are appropriately informed, that kind of customization should lead to socially optimal results. That is in many ways a relatively non-controversial proposition unless people are going to wind up agreeing to terms with which you disagree. Or, if you think the process by which people reach these decisions is inherently inefficient, ill informed and unable to reach the social optimum, and you know better what the social optimum is than this imperfect process.

One of the problems that I see in government regulation across the board is that regulators tend to look at the markets and they tend to say, "Well, the markets, they make mistakes all the time." And I go, "Yes, of course they do. Look at all the decisions they have to make. They can't all be right—impossible—and in fact it's entirely conceivable that all of them are wrong. But that's not the question. The question is: can you as a regulator, or, at the time, can we as regulators in Washington, on average and over time, do better than the markets? Because we, as regulators, we're very, very human. We're

susceptible to a whole different set of influences, some of which are perfectly fine, others of which you don't want to talk about in public, and we make mistakes too.

So in the real world, the question is, which set of mistakes do you want to live with? Do you want to live with the imperfections that the market generates, or do you want to live with the imperfections that the regulators generate? Part of the art I think of being a really good regulator is to have humility and to say, "You know, I could be wrong about this, and if I'm going to try to push the market to a result different from the one that the market would generate on its own I have to have some confidence that I'm solving a market failure, that I'm contributing to the process in a way that on average and over time." You don't have to get it right every time—you can't get it right every time—but if you look at the decisions of the group we wind up in a better place.

RC: Sort of democracy is the worst form of government except for all the rest?

JG: Absolutely.

RC: The same idea.

JG: To me, a large part of the frustration is the number of people who go running around saying the market's got this wrong, the market's got that wrong, therefore we need to regulate, to which I go, "Whoa, whoa, whoa, whoa. Do you really think I'm that stupid?" Because you know that the regulators are going to get it wrong too. But to me the real

frustration is obviously if you're in the regulation business, and the government's in the regulation business, telling half the story is a very, very effective thing to do. We must act. Why? Because the market got this wrong.

"All right, I get it. Let's agree the market got it wrong. Now explain to me why you think consistently you're going to get it right." Now, there are situations where the government's got a great story to tell, and where regulators have a great story to tell, and where you need government regulation, you must have government regulation. You wouldn't want to live in a world without it. There are other situations where maybe the envelope is pressed a little too far.

RC: The converse of that is shareholder determination on things like takeover defenses and exclusionary tender offers. Did you hold the same view with regard to those, that shareholders should not opt in?

JG: My view basically was strongly in the area of self-determination, that to the extent you could get government out of the business of telling corporations how to run themselves, that would be a good idea. The challenge of course was that different people have different views about how corporations should run themselves. You have the battle between management and shareholders: to what extent does a corporate action require approval of management, and to what extent can shareholders on act on their own initiative?—a very complex issue.

There's a range of opinion about it in academia, and also among practitioners in the corporate governance world. You've got the extreme shareholder determinists, people like Professor Bebchuk at Harvard, and then you've got the extreme corporatists, people like Marty Lipton, and I consider both of them perfectly good friends. The two of them will never agree. I'm between the two of them. There are some situations where you want to let the shareholders decide the matter. There are other situations where you look at it as a question of representative democracy. The problem with letting shareholders decide everything, it becomes a little bit like the initiative process we have here in California which is crazy-making in many situations.

There's a reason why representative democracy tends to work well and there are many situations in which the corporate governance process is best understood as representative democracy, which with all of its flaws and with all of its foibles can often be better than direct democracy. But that's a contestable proposition and I appreciate that.

RC: One of the issues that gets into, that the Commission dealt with while you were there is the one-share-one-vote rule, and I was curious to get your perspective on that.

JG: One-share-one-vote, very interesting. I think my views at the time were very strongly fashioned by many other aspects of the policy debate as it was evolving. Again, I'm going back more than thirty years and the record will speak for itself. My present muddled recollection is that I was concerned that the trajectory was moving too far towards the management side of the spectrum and that these corporate voting structures,

other than one-share-one-vote, would be potentially damaging to the operation of a market process. It had tilted the scale too far towards management, and that view was fashioned by the fact that you had the emergence of poison pills. You had other factors that caused me at the time to believe that it was moving too much in the management-corporatist direction.

Looking back in hindsight, I say, "Gee, maybe I was wrong. I think that there are situations where if shareholders buy into the concept early-on appropriately and they understand what it is they're getting into, that having multiple classes of shares is an economically efficient result. The big debate here in Silicon Valley as we're talking now, is that there are a bunch of companies that have gone public with dual-class share structures. At Google the founders have their class-B shares, and there was just a settlement the other day about the issuance of non-voting class-C shares so you're going to have founder's shares with ten votes each, you have the publicly traded A shares with one vote, and you're now going to have C shares, which will have no votes.

At Facebook, the founder has his shares and clearly has voting control over the company that way. At Zynga, where the company is not doing well, the founder has control. In many of these situations what you're telling the stockholder is not only are you buying stock in the company, you're betting on this particular management team running the company, and, if they screw up, your ability to discipline them is going to be very limited. You have to ask whether you want to buy into that kind of a structure.

There was a time when I would have made that difficult to do. My views on that have evolved and I see a place in a robust market for having companies that have those structures. And, again, we're going to learn what the circumstances are where they make sense, and what the circumstances are where they don't make sense, and there will be situations where they don't make sense and they will unravel under their own weight. That's my prediction.

RC: One of the other things that is happening at this time in governance is that the activist institutional investors are becoming much more of a factor. Can you tell me what your perspective was on that from the SEC?

JG: My perspective was that shareholders have always had more power than they understood, and they weren't intelligently using the power that they had. That observation led me to write one of my early law review articles when I went into academia called "Just Vote No," where the premise was really very simple. And that is, sure, shareholders can't nominate their own directors, and you have nine slots on a board and the board nominates itself, but that doesn't mean that shareholders are powerless. You have the ability to withhold authority to vote for director and by withholding authority you in effect embarrass the directors. And semiotics can be very, very powerful. The symbolism of a director not getting a majority vote for their reelection is something that directors will care about. So there is that form of soft power that—I think it was 1990 or '91 that I wrote about this—that shareholders are not using effectively.

And you don't need to write any rules. It's a little bit like Dorothy in *The Wizard of Oz.* You've always had the ruby slippers; you just need to click your heels and you can wind up back in Kansas. At the time I was writing shareholders had much more power than you might realize. Use it intelligently. What's intriguing is it took the idea about twenty years to gain traction, so now everybody says we're going to run a "Just Vote No" campaign. We don't like compensation at this company, so we're going to vote against these directors. Look at J. P. Morgan. We're going to vote against the directors on the risk committee, and they're leaving. That's even though the shareholders don't have the formal authority to fire the directors.

My point was that you don't need that formal authority. You need to wield the soft authority that you have, and that you've had for decades, more intelligently and effectively. There's a sense in which I look at much of what's happening in the corporate governance area now and shareholder activism, and especially around the ideas of these "Just Vote No" campaigns, and I said, "Well, that's what I've been saying for twenty years." Again, it's a very imperfect process. In my own personal view, there are some situations where shareholders are acting quite stupidly and criticizing the wrong companies for the wrong reasons, and there are other situations where I think they've got it spot on. Again, the fact that this is an imperfect process that makes mistakes doesn't mean that it isn't the best available process.

RC: Why do you think the idea took so long to catch on?

JG: Because it came from an academic. No, I'm kidding.

RC: (Laughter.)

JG: (Laughter.) The short answer is I don't know. I actually think this was a tremendously missed opportunity that took them decades… This is an area where I just look at the institutional investors and I gave speeches: "I told you how to do it and it took you twenty years to make it effective." I don't know why. To me it seemed like low-hanging fruit.

RC: Do you think they were too focused on the hard-powered issues like the ability to nominate directors and things like that?

JG: I think that's a piece of it. I think that they say we need to have the ability to change directors, we need to have x, y, and z, to which my response is that you can do so much with the power you already have. I'm sure many of them felt like, "We don't want to do it because then we don't have an argument to try to get even more power. If we can actually use the power that we have effectively, then people can argue we don't need any more power than that." To which my response is, "Exactly." And their response is, "But we want more power." And I kind of go, "Wait a minute, why don't you use what you already—I mean, if you can solve the problem with this hammer and you don't need a screwdriver, why do you say give me a screwdriver?" But they want a screwdriver.

RC: Some of the other things that were happening, to go back to your time at the SEC, there's a lot of things like the insider trading scandals.

JG: Ivan Boesky, Michael Milken, all that other good stuff.

RC: The options listing, safe harbor rules. Were there things that stood out to you as the most significant?

JG: Let's talk about the insider trading because that's an issue that's still with us. I remember the Ivan Boesky situation, which was dealt with, and a very serious situation from the agency. Everybody was gob-smacked about the amount of trading and the extent to which people were violating confidences and what have you. One of the things that you immediately understood was that the existence of this kind of insider trading was corrosive in terms of confidence that people would have in the market.

You also had economists then who were arguing that insider trading shouldn't be illegal. I thought that's one of the dumbest economic arguments I've ever heard in my entire life, because if you think about material non-public information as being trade secret information, proprietary information—which it is. And if you're liable for insider trading only if you misappropriate that information, then if you believe there shouldn't be insider trading laws then let's get rid of intellectual property laws. You can never sue anybody else for disclosing a secret. You can never keep a secret. Clearly economists would say that's wrong. Well, same thing here.

The fundamental intellectual mistake that the finance economists made when they were arguing against regulation of insider trading was that they didn't understand that this was an intellectual property issue, not a pure finance issue. It's also a compensation issue, because if you have people in a company, and they know what your earnings release is going to be, well then whoever has enough money to buy the largest position is the one who's going to make the most money from it, not necessarily the employee who contributed the most to it.

At that point, management loses ability to set compensation in any rational way. The board of directors loses ability to say, "I want to reward this person, not the other person," because it's whoever can capitalize and steal the corporation's information most effectively who winds up getting the biggest gain. That's no way to run an efficient compensation mechanism. That's no way effectively to capitalize on the corporation's intellectual property. It's a prescription for chaos and disaster, so as an economist I never had a second's hesitation enforcing anti-insider trading regimes, especially built on a misappropriation theory. And I understand why many lawyers were concerned about the misappropriation theory. It's not an issue. It's great. Let's go for it.

RC: There was a while where it was kind of touch and go as to whether it would be allowed by the courts.

JG: Under misappropriation, that's exactly right. I always thought the misappropriation theory made a lot of sense, and there was a big issue around that. I know people were concerned. "Gee, is the economist going to support insider trading regulation?" The answer is this economist is ready to lead the charge for it on purely economic grounds. Put aside the fact that it's politically popular. That's a nice bonus under those circumstances, but that wasn't the reason why I was opposed to insider trading. That was not the dominant reason why I was opposed to it.

RC: There are a number of other areas where there are issues of trying to make the markets more efficient. I think of things like options lists, multiple listing of options, and the safe harbor rules. Can you talk about the other market efficiency issues that you dealt with?

JG: At the end of the day, the short answer is competition tends to be good, so allow multiple listings, have different marketplaces compete. Who can do the best job? There you go, that's the market that should prevail in that environment, unless there's an argument that says by fragmenting the markets you actually wind up hurting too many people. And that is a perfectly credible argument. There you have it. There are other situations where you want to say, "Look, we don't really know. Let's run an experiment. Let's see what happens."

RC: The market break kind of flies in the face of that, or sort of brought the desire for regulation to the fore again. Can you talk a little about the market break?

JG: The 1987 market break to me was fascinating for a wide variety of reasons. Where to start? One was to recognize there's a certain sense in which we were lucky in terms of how we got out of the problem. There were many mistakes that we came close to making that we didn't make. One of the biggest ones, I think, would have been to shut the markets down. There were many people in the building who wanted to do that. I was strongly opposed to doing that. There were also, I think, problems in the building that arose because—again, I'll go back to an earlier point that I made—many people did not understand how markets worked. They didn't understand that you had futures markets and that price discovery was occurring in the futures markets. They didn't understand mechanisms of transmission, and they had no idea about portfolio insurance. They had no idea that of all of a sudden liquidity can be extraordinary expensive. They didn't understand how clearing corporations worked, and that if you had questions about the solvency of clearing corporations that could send shivers throughout the entire marketplace. And you had some people who said, "Who cares about the clearing corporations? It has nothing to do with the stock market. That's the Chicago futures market. Why are we worried about that?" I'm kind of going, "Are you out of your mind?" It's a little bit like: "You want to cut off my left leg, that's okay. I've got a right leg." They're connected. You need to run a race. You're not going to be able to hop along. You lose a leg, you go down.

It was in a certain sense very frustrating to me to be in the middle of this kind of crisis and to hear lots of views where I'm sitting there, and I'm kind of going, "This is a problem, these people are not fully informed and you don't really have time to educate

people in the middle of a plane crash." That was an issue that I perceived at the time. Again, there were a small number of people who got it and fortunately the ball was passed to the small number of people who got it and I think we made the right decisions and we got lucky. Anybody who tells you it was just because of the right decisions, we knew what we were doing, they're either lying to you or they didn't understand what was going on. The situation was we did make the right decisions, but we got really lucky.

RC: Are there any other things from your time at the SEC that you feel like we should cover?

JG: I'm going to leave that totally up to you. I feel talked out on that point.

RC: I think we've hit the big ones. You left the SEC in 1990. So what brought you to Stanford?

JG: Have you seen the weather? (Laughter.) Why would you not? No, actually my wife's family was here in Palo Alto. Her father was a faculty member, taught fluid mechanics, and I sort of looked around and I said, "I've got three things I could do with my life at this point. I could go back and practice law. I could go to Wall Street and try to become a master of the universe—it's very interesting, computerized trading—and do hedge-fund stuff. Or I could try my hand at being a professor. And I was always interested in academia and teaching, and I said, "If I don't try this professor thing now, I'll never do it. I can try this professor thing and if I don't like it or if I fail at it, I can go to Wall Street or I can do a law firm."

Of the three big alternatives I saw only one was now or never, and that was academia. And I was always interested in it and I said, "Let's try it." There were a bunch of schools where I could have gone and gotten tenure immediately, and I said, "No, I'd rather do Stanford." And I came here, no tenure, and I said, "I'm going to earn my tenure the same way everybody else does, I'm going to earn my stripes, I'm going to do the writing, I'm going to do the research." And there you go. Now they can't get rid of me. (Laughter.)

RC: Were there particular topics that you came in wanting to study?

JG: Sure. We already talked about corporate governance. That was definitely a topic that I wanted to study. I wrote three articles relatively quickly, and got tenured very, very quickly. One of them was about corporate governance, and again the idea being shareholders have more voice. Then there was another piece which was purely legal, "Disimplying Private Rights of Action." The Supreme Court implied a private right of action under 10(b). Well, if you can imply a private right of action then there are things that the SEC can do, if it wanted to, under 10(b) to disimply the right. Because if you look at the statute, the statute is merely a delegation of authority to the SEC. Section 10(b) says it shall be unlawful to violate regulations adopted by the SEC. Well, if the SEC adopts a different set of regulations, then that which is illegal in violation of 10b-5 is different. And the SEC, if it wanted to, could say, "Look, private rights of action have to meet a higher standard." They can't lower the standard under what the statute requires, but, if the SEC wanted to, it could raise it. There's no legal requirement that the SEC

support an implication of the private rights to the fullest extent permissible by the statute. The SEC, if it wanted to, could always carve back. So that was a piece of pure legal analysis establishing a point that hadn't been in the literature until then and that the SEC has proceeded to ignore very pervasively and successfully. Politically, the agency is not about to say, "We're not going to prohibit fraud to the fullest extent of the law." So that's where that is.

The third piece that I did was, some professors at Harvard and Yale had written a piece on limited liability arguing that you could get rid of corporate limited liability and you could have unlimited liability for shareholders. I sort of looked at that and I said, "Well, that's just wrong, because once you understand how derivative contracts work you can in effect synthesize limited liability and these ideas about unlimited liability will generate stockholdings and certain patterns where it's all going to be held by bankruptcy-proof entities that aren't going to have any assets that you can attach." I looked at the idea and I said it would take me three seconds to engineer around this.

So I wrote a piece called "The Limited Future Of Unlimited Liability," which was I think a very nice application of derivatives and structuring, to say I understand these Harvard and Yale professors, I understand what they're trying to do and their heart's in the right place, I got it, but this is never going to fly. Let me tell you why this has to fail. And for a tenure piece, that's perfect. You have two giants in the field, they write and say this is going to be a great idea, and I write "not so much." And the "not so much" side of the argument has prevailed. So that was the immediate research agenda.

RC: Your second piece on private rights of action, the PSLRA passes in '95, are we talking about the same sorts of private securities litigation?

JG: Yes, that's exactly right. And then I did a lot of work around the PSLRA. I was involved with the debates having to do with the adoption of the PSLRA, and have done a lot of research around the PSLRA. You know we run the Securities Clearinghouse, which, when we launched it in 1995 or 1996, was path-breaking because nobody was doing anything in the legal space on the Internet, and it was an entirely new way of data collection and of doing open research on the Internet. Now here at Stanford we've got a variety of databases that are doing the same sorts of things. We have an intellectual property database. We're thinking about building and launching additional ones, so the whole area of legal research is being revolutionized and I think much to the benefit of the scholarly process.

The PSLRA was perfect from that perspective because all of the litigation is public and you had to file a notice every time you file a complaint. So we just set up a set of computerized screens. Again, in the early days of the Internet this was hot stuff, and we could just track every company that was being sued and you'd never had another area of law where you could go to a computer and… LexisNexis was tracking the decisions. Well, it's too late by the time a decision comes down. That's like saying, "Here's the death certificate." What you want to know is the birth certificate. Which are the new lawsuits and which complaints are being filed? And that was the novelty. We started

tracking the full life cycle of litigation. It a complaint is filed, we've got a copy of the complaint. Here are the motions, you can see everything. Today we have PACER, but this basically was PACER before there was PACER, and was ahead of its time. That's the perfect thing to do in Silicon Valley. That's one of the great things about being here and soaking up a little bit of the atmosphere of innovation and interest in computers.

RC: One of the things that I see you focused on is working with directors and looking at the role of directors on a board. Can you tell me about some of your work with directors?

JG: We run a Directors' College here at Stanford. Next year is going to be our twentieth anniversary, and we run the program in a very practical manner. We always ask ourselves, if you're serving on the board of a publicly traded company what are your high-profile problem issues, and what are some really good practical solutions? Examples for this year, our opening plenary session is on cybersecurity. Well this is a real problem, and it's a problem on many different levels including the fact that the vast majority of directors of publicly traded corporations have no frigging idea about cybersecurity problems or cybersecurity solutions. So, how do you deal with a situation where boards simply don't know what they don't know?

So we've got a panel with one of the leading cybersecurity people from the FBI, Mary Galligan, she's going to start, she's going to scare the bejesus out of the audience, she's going to give them real stories about real hacks and who's lost information and that stuff. Louis Freeh is on the panel. He's going to say, "You know, I used to run the FBI and the

whole bit and what Mary is saying is exactly right." He's now working with the private sector. Here's what we're doing. We've got Gordy Davidson who is one of the local lawyers who represents a lot of the cybersecurity companies and he'll talk about what he sees in the boardroom and the like. And then we've got this guy George Kurtz who is going to talk about a variety of different strategies that are very new and out-of-the box in terms of what corporations can do.

The pitch that I'm going to make is: "Look, there are many issues about which boards of directors themselves are not fully qualified and there are many things you can do. You can try to train some directors so that they have more knowledge, that's possible. Many directors aren't going to do that. You could try to put on your board a director who has cybersecurity expertise. Most boards are not going to do that. Or you could what most corporations do in situations where you need more expertise, you hire an expert, and boards do that all the time. You hire investment bankers, you hire special counsel to do internal investigations, you hire auditors to double check books, why not hire what I call cyber counsel? It doesn't have to be a lawyer. Hire an expert on cybersecurity, have that person report to the board, and have that person also responsible for testing the performance of the corporation itself on cybersecurity."

Because one of the problems that we run into is that many boards look to the IT department to brief the board on cybersecurity. Well, the IT department is in charge of making sure that you don't have any hacks, and putting them in charge of telling you how well they're doing is a little bit like having the CFO do his own audit. It's not the best

division of responsibility and that's the reason why I'm pushing toward the idea of cyber counsel or cyber expert, cyber advisor to the board. We'll see what happens. That's the kind of conversation that we tend to have at Directors' College.

RC: You said you started it twenty years ago. Was there something that was going on then?

JG: Independent directors of publicly traded corporations needed more information and shared knowledge about how to be a good director. Some directors were absolutely terrific, other directors were clueless, but there was a great opportunity for shared knowledge. At the time there was very little director education, and now every audit firm has in a certain sense copied us and they're doing it, and other universities have directors' education programs. We even let other universities steal our name. We said, "Look, you want to call it Directors' College and run it someplace else, fine, just go educate the directors." We're playing this cooperatively, not competitively. We've helped other universities start their directors' education programs. We believe in the mission. Let's go do it. Fortunately, we've got the most successful program out there. We work like banshees to make it work and we've got great people, Si Lorne and Dan Siciliano are absolutely spectacular, and we've been at this twenty years. One of these years we're going to get it right. We'll figure it out. We'll see what happens.

RC: One of the governance issues that pops up frequently in the '90s and in the 2000s is the proxy access issue. The SEC has dealt with it a number of times. Part of that is the issue

of nominating the directors and things like that. Can you tell me a little bit about your perspective, how that's developed as the SEC has pursued it?

JG: Sure. Again, I'm on the record. I have an article in *Business Lawyer*, so my views on this are transparent. There's a real simple logic to the process, and a lot of what the SEC has been talking about is profoundly illogical. Let's go to the basic premise. The basic premise is, shareholders are smart enough to figure out if they want to vote for or against a director, and they're also smart enough to figure out if they want to nominate other people to run for the board, so every proponent of shareholder access has to believe that.

Let's assume that's right. If that's right, why then aren't the same shareholders smart enough to figure out the rules by which they want to have shareholder access? Aren't the shareholders smart enough to say: "We want to have shareholder access with a trigger of 1 percent, 3 percent, 5 percent; 10 percent; we want shareholder access on an annual basis, on a bi-annual basis"?

If the proposal is, "Let's have shareholders and boards work together to set up protocols for shareholder access at individual companies, including the possibility we're not going to allow shareholder access at all," I'm all for that. That's logically consistent. But here's my problem. How is it possible to say that the shareholders are smart enough to decide who should be on the board, but they can't be trusted to govern the process by which they make that decision? I've never had a conversation with a person who can explain how you distinguish those two principles. The problem with the mandatory shareholder

access point of view is that it requires you to hold two totally contradictory ideas in your head at the same time, and that is these people are smart enough to vote for directors but they're not smart enough to set the rules by which they vote for directors. So, we have to set those rules for them.

If you can't explain why these people aren't smart enough to set their own rules but they're smart enough to vote for directors, that is fundamentally irrational. That's the basic reason why I think these mandatory proxy access rules shouldn't pass the simple rationality standard under the APA. It's arbitrary and capricious in my view to say shareholders are smart enough to do this thing but they're not smart enough to do that thing – when it's basically the same thing. Why do we have to tell them how to do that? That's my fundamental problem with it.

Now, the D.C. Circuit had other problems in terms of the evidence and how you analyze the evidence, and I respect the point of view that maybe the D.C. Circuit didn't get its critique of what the SEC did correct on every point. I don't think they were wrong about everything, but even if you put that critique aside I haven't heard anybody respond to my more fundamental problem with proxy access: "You're asking me to hold two conflicting ideas in my head at the same time, and that's one of the definitions of arbitrary and capricious. It's internally inconsistent." Can you explain it, Bob?

RC: No, I can't.

JG: Give it a shot. See, this is the thing. The best response I've heard typically is, "Well that's not the right way to think about the problem." I go, "Well, sure, because if you think about the problem that way you're not going to get the answer you want. But you want the answer you want and there you go."

RC: There's another issue in governance, and I would imagine that this has changed a great deal, is the issues of board composition and particularly the reforms that were called for for the board in the wake of the Enron and corporate accountability scandals. Can you tell me about what you saw as the issues at stake in the corporate accountability scandals, and then again with the reforms that were instituted for boards by the SEC?

JG: You've got to look at the environment surrounding Enron, WorldCom, a couple of other frauds at the same time, and I think what it underscored is that there was a lot of room for improvement in the internal governance process over basic blocking and tackling. The Sarbanes-Oxley response I think had a lot of good ideas. It also had a lot of bad ideas in it. Like any complex piece of legislation, if you're going to go back and do it all over again you would do it differently. On balance I think there was a lot of good, but it also caused a huge amount of money to be wasted.

Some of the expenses around item 404 are just absolutely preposterous, and there's nothing wrong with 404. It's a delegation of authority to the SEC and the PCAOB. But as soon as you saw what the rules coming out of the Commission were, my attitude was, "This is crazy. Why don't we just make a pile of hundred dollar bills and pour gasoline

and just light them on fire?" Because this is mandating so much process without any reason to think that it's actually going to solve the problem and make the world better. Billions of dollars were wasted in compliance with 404, and by the time the SEC and the PCAOB got around to recognizing that they had made fundamental mistakes in the way they wrote the implementing regulations it was too late because you'd spent all the money and now you just have the annual maintenance costs of complying with what was already in place. And there you go.

So there are large parts of Sarbanes-Oxley that are terrific, increasing the specialization of boards of directors on audit committees, great; getting more people involved on the board that really understand the finances of the company and that can intelligently ask probing questions and getting the audit firms to up their game—all of this is absolutely fantastic, but other items really went off the rails. You know, 404 is an example where Congress didn't do anything wrong in the statute. It was the way the SEC and the PCAOB implemented it.

RC: How so?

JG: That they wrote the rules in an overly expansive manner, that their definition of material weakness and significant deficiency was so broad and all of the tests that they in effect required, given the way the accounting firms were interpreting this, just led to massive expenditures of time and money for little or no improvement in the integrity of the reporting process.

RC: You may not be able to talk about it, but you served on public boards and I was wondering if you can talk a little about whether you’ve seen changes in the way that they function.

JG: I currently serve on the board of Financial Engines. That’s a company that I actually co-founded seventeen years ago, so we're an overnight success. We're now publicly traded. We are today the largest registered investment adviser in the world. As of our last quarterly announcement we managed $70.8 billion. I love the people there. Our senior management team, we've had one CEO for like sixteen years; average tenure of our senior management team is like eleven years. I jokingly say it’s because you guys are lousy, nobody else in the Valley wants to hire you. It's because I think they're wonderful people and they’ve been doing a great job. We've got a terrific board I think, extraordinarily competent, really understands the market, very active, always probing, always asking questions, always pushing management to do a better job. Management extraordinarily open I think with the board. I'm very happy the way that runs.

I'm also on the board at KKR, and that’s obviously a very different situation and there I'm chairman of the audit committee. That, in effect, is a controlled corporation because Henry Kravis and George Roberts, through an entity called Holdings, actually have the majority voting control and if they wanted to fire all the independent directors and bring new ones, they could. But they have been absolute princes. They say, “Let's run this the right way.” And they’ve got a terrific general counsel. In every situation they’ve always

taken the high road, and it's absolutely been a pleasure. And again, really competent people serving on the board, they know what they're doing, the former CFO at Wal-Mart, a former senior banker out of Morgan Stanley, Pat Russo who's been a CEO, John Hess, so it's an A team. We all roll up our sleeves, Dieter Rampl, a banking executive from Europe—I mean I've been very, very impressed and it's been terrific that way.

RC: Are there things that you've seen as you've served on these boards that you see as the critical elements of good governance by the boards?

JG: Yeah, it's information. You have to have a board that's smart enough to know what questions to ask separate and apart from anything that management wants to tell you. If a board is always depending upon management for all of its information, you're dead. You then have no independent ability to ask questions.

At KKR every board member has lots of information networks, and we all have a tremendous amount of information that's relevant to KKR, the private equity business, so we know how to question and probe appropriately. What are we doing? What's our strategy? Which funds are going out there? How are these funds performing? Do we need to shift resources from A to B? How is this initiative actually working? And we know more than what management is telling us.

The same thing at Financial Engines, where we've got a Harvard professor on the faculty, we've got another Stanford professor with me on the faculty, we've got CFOs from other

companies, we've got the former CEO at Barclays Index Fund Operations. These are people who really know the space. And management can come in and say whatever it wants. We've still got fifty questions based on things management hasn't told us. So having that kind of a really informed board in my experience has really been terrific. As I look around corporate America these are probably exceptions. And if you look at how informed boards are, my guess is these two companies are top decile, but that's where I'm comfortable playing. (Laughter.)

RC: I wanted to ask, we talked a little bit about recent governance reforms and some of the court decisions also. I was going to ask what's your perspective especially on the reforms coming out of Dodd-Frank, and then what do you see as the upcoming issues in corporate governance?

JG: Dodd-Frank—and, again, this is a prediction I've been making ever since the day Dodd-Frank was enacted—I don't know what Dodd-Frank really is going to be. I don't know when Dodd-Frank is really going to be implemented. If you look at the statute, it's really a massive delegation of rulemaking authority to the SEC, CFTC, Department of Treasury, and the like, and we still don't know how these rules are going to work in many situations. We still don't have a Volcker rule. What's fascinating is, we have investment banks changing their business strategy in anticipation of a rule that hasn't yet been written, which is one of the fascinating things. The threat of regulation is enough to cause real changes. But we don't know what the swaps rules are going to look like, and to me, as soon as I read the Dodd-Frank, I said that there's no exemption in the Dodd-

Frank Act from the Administrative Procedures Act. Every rule that comes out of Dodd-Frank is going to be susceptible to legal challenge by an aggrieved person.

If you just think about the timing calculus and the incentive to challenge, many of these rules are interdependent. Rule A depends on Rule B, what the SEC does rationally depends upon what the CFTC does, and you've got rationality tests and cost benefit tests, you've got all of these agencies working under the shadow of the *Business Roundtable* decision, so rules get passed, and they then are challenged. Do the rules get stayed while the challenge goes forward? Well, how long does it take the D.C. Circuit to rule on these matters? It takes at least a year, more likely eighteen months, so if you get a stay for a rule once it's adopted it's another eighteen months before it goes into effect, assuming that the rule passes muster. If the rule doesn't pass muster, you typically remand it to the agency and you say do-over, so what's the probability that all of these rules are going to pass muster? Not necessarily high, and when they fail to pass muster, then what happens?

So it's not immediately clear to me that Dodd-Frank is really going to take effect anytime soon, and it's also not clear to me that if you look at a rule that's adopted by one of the agencies that that's the way the world is actually going to work in the future.

RC: I wanted to leave a little bit of time for other topics that you'd like to talk about, if there's anything else that you'd like to talk about.

JG: I'm the luckiest bastard you'll ever run across. There you go. (Laughter.)

RC: Tell me a little about the Rock Center for Governance.

JG: Rock Center, absolutely terrific. Arthur Rock and Toni Rembe Rock, they've been coming to several of the programs we've been doing at the university, especially our Directors' College program, and they apparently were very big fans. Arthur calls me up one day and he says, "I'd like to give you $10 million."

RC: (Laughter.)

JG: I know. I kind of go, "Excuse me, is this a wrong number, Arthur?" He says, "No, no, I love what you guys at Stanford have been doing about corporate governance because you're doing research and you're in the real world at the same time. You're not writing these airy flights of fantasy that aren't connected to reality; you're trying to figure out what's the smart, right way to do this, how do we balance all of these issues?" I'd like to think that the style of what we do here at Stanford is simultaneously intellectually very rigorous, deeply rigorous, and useful, and that's a style that Arthur appreciates. And he said, "Well, come up with a proposal for what you would do if I actually gave you the ten million bucks," and here we are.

Arthur and Toni have just been absolutely terrific. And the gift, we're very entrepreneurial here at Stanford, we've used that gift to generate other sources of income.

So, basically we've grown that ten million. One of the mistakes that I think many organizations make is they say, “Okay, here's ten million. Let's spend it down and then let's go raise another ten million.” My view is, “Here's ten million. Let's turn it into thirty and do good things with the thirty.” So that’s basically what we're doing.

RC: One of the projects I saw discussed is analyzing the governance metrics. Can you tell me a little?

JG: That’s Dave Larcker. Basically he's looked at all of the metrics that places like ISS and other organizations generate and he's in effect demonstrated that they don’t tell you anything useful, that you have all of these governance scores, and if you try to invest based on these governance scores you're not going to do well, that if you look at the governance scores across different ratings organizations they rarely agree. I mean, the amount of disagreement is really extraordinarily large, and that there's no systematic reason to think that these groups, in Dave's view, know what they're doing.

So needless to say, this makes Dave and the Rock Center less than popular with the proxy advisory community, but on the other hand this is the great thing. If you approach these questions with intellectual integrity and you say, “Look, you can disagree with us but we're not cooking the books. We think we're asking the questions reasonably. For example, if it's clear what's good corporate governance and what's bad corporate governance, why do you advisors disagree so much?” That’s a tough question for them to answer. It's a simple question.

We went through a rocky phase, but now they understand that listening to our critique is actually good for them, so at Directors' College this year, our Monday morning breakfast, we have the CEO of ISS. He's going to be here, and Larcker is going to be here and we're going to engage. He knows he can't ignore the questions we're asking, and if we ask them honestly and rigorously without a political agenda, he's going to engage and we're going to engage with him.

We can't be in the business of doing research that makes people comfortable. That's not what we do. We've got to be intellectually rigorous, and if we've got issues about what management's doing, we'll write that up. If we've got issues about what shareholders are doing, we'll write that up. There are pieces that we've written that some people think are pro-shareholder. There are other pieces that we've written that people think are pro-management. Our view is, "Look, tell us what's wrong intellectually with any of these pieces and we'll listen to you. Now, you don't like the conclusion, that's not going to move my meter. You don't like the reasoning, you got my attention. That's the way we look at it. You can't do work in this area without pissing somebody off. If you try to make everybody happy you're never going to say anything useful.

RC: That pretty much covers everything I'd like to ask, unless there's anything else?

JG: No, that's great. We've covered much more real estate than I thought we would.

RC: Great.

[End of Interview]