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"RESTORING PUBLIC TRUST IN AMERICAN CAPITALISM - WHAT SHOULD BOARDS OF DIRECTORS DO?"
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REMARKS AS DELIVERED

Thank you, Geoff for that most gracious introduction. I am honored to be here to participate in this week's discussion of "The Ethics of Capitalism." Chautauqua has a grand tradition of bringing together spirituality, intellectual activity, the arts, and fellowship. Congratulations to this community, and good wishes for many more centuries of these inspirational gatherings.

Restoring Public Trust in American Capitalism – What Should Boards of Directors Do?

Belief in the American system of capitalism

Let me begin by saying first and foremost that I believe in the American system of entrepreneurial capitalism. It is this system, coupled with our democracy and rule of law, which has made the U.S. economy the largest and most dynamic in the world and brought our country unprecedented prosperity. It is this system which makes the American dream a reality.

Entrepreneurship is embedded in our society. It is part of our culture. Entrepreneurship was brought by those early settlers who landed on our shores. They were self-selected individuals with adventure in their bones, courage in their hearts, and a desire to create a better life for themselves and their children. They were risk takers and innovators and they believed in uprightness, fairness, and justice.

Those early settlers created a new world, a new country, and today centuries later, the United States of America is still the shining city on the hill and still the attraction for millions who come here for a better life, to live in freedom, and to pursue the American dream through our system of entrepreneurial capitalism.

But is our capitalist system perfect? No. No economic system is.

Capitalism, and the industry it has spawned, has caused degradation of our planet. Workers are sometimes displaced by trade or competition. The gap between rich and poor seems to grow. Yet to paraphrase Winston Churchill's famous quote about forms of government: "…that democracy is the worst form of government except for all those other forms that have been tried from time to time." The same can be said of capitalism. It is the worst economic system except for all the others that have been tried from time to time.

Other systems have arisen. Communism – with its state ownership and central economic planning – has been tried and has failed. Socialism – in varying styles and degrees – is practiced in some countries. Economic systems other than capitalism, while they might seem appealing on the surface, are not part of U.S. culture and heritage. And I truly believe that the American way has made us a great and good nation, and therefore, we should stick to it, build on it, and improve it.

I will leave to others a discussion about what is good and bad about capitalism. But I want to be clear that I believe capitalism is the best economic system and only want to make it perform better.

Capitalism has been questioned over the years.

At various times in our history, the U.S. capitalistic system has been attacked or questioned, and generally out of this questioning has emerged new ideas and fixes to remedy what went wrong. We Americans seem to believe that old adage, "Trouble is only opportunity in work clothes." We are good at recognizing problems and then acting to solve them. This is one of our greatest strengths. We want to make our capitalistic system work better and more equitably.

Through our recent history, some examples of concern about our system stand out. The Great Depression caused deep concern, and out of this traumatic era came Federal governmental action, new regulatory approaches, such as creation of the Securities and Exchange Commission (SEC), and new safety nets, such as Social Security.

Earlier in this decade, the scandals involving Enron, WorldCom, and others caused questions about our system. Illegal and fraudulent activities were at the root of these scandals – plus a huge helping of greed. In response to the public outcry, corporate governance became a political issue, and the Federal government stepped in. The Congress passed and the president signed the Public Company Accounting Reform and Investor Protection Act of 2002, commonly known as Sarbanes-Oxley, named for the two major sponsors in the Senate and the House. It aimed at fixing those things that went wrong and provided stiff criminal penalties for fraud by company management.

The current economic turndown is causing questioning again.

Today, once again, corporate governance and capitalism are being questioned. This time it is because of the financial meltdown and the severe economic downturn touching every corner of the world. And public trust in our system is at the lowest ebb I can recall. In the most recent annual Gallup Honesty and Ethics poll, business people reached a new low, even with Congress, and a bit above car salesmen, telemarketers, and lobbyists.

This current financial crisis and economic downturn was decades in the making and there is plenty of blame to go around – public policy which overly stimulated home ownership, bad loan underwriting resulting in subprime mortgages, clever but risky financial instruments, too much leverage, and too little supervisory oversight which

failed to see the linkage among financial institutions -- plus greed on the part of some businesses and some consumers.

But at this moment, much blame is being leveled at Chief Executive Officers (CEOs) and boards of directors, as well as the way in which companies are governed – or not.

Today I will focus on boards of directors and their role and responsibility for corporate governance. I speak as one who has observed and participated in the evolution of corporate governance. Since 1980 – except for the time I was Secretary of Commerce – I have served on the boards of fourteen public companies and currently serve on two. Most of these companies are large but my experience also includes some smaller ones, including a start-up. These fourteen represent a variety of industry sectors – chemicals, retailing, insurance, banking, biotechnology, consumer products, and heavy machinery.

Corporate Governance is based on checks and balances.

I'll begin by sketching a bit of background about corporate governance. The U.S. corporate governance framework is based on a system of checks and balances, just as the U.S. government is. The Chief Executive Officer (CEO) is responsible for managing the enterprise. The board of directors hires and fires the CEO, makes policy, oversees company performance, approves major capital expenditures, and sets compensation for the CEO and the management team. The owners of the company – the shareholders – elect the board of directors. It is a tripartite balance.

Good corporate governance is one of the legs on which American capitalism now stands, and its practices have been evolving over the years.

An early defining work was the book entitled, *The Modern Corporation and Private Ownership,* by Adolf Berle and Gardiner Means, published in 1932. In the earlier days the owners of a company were also the managers, and in many smaller firms today, that is still the norm. But with the development of large corporations with many thousands of shareholders, Berle and Means described – with concern – the separation of ownership and control. That was because professional managers, led by the CEO, rather than owners, were controlling the destiny of the company. Many of the corporate governance reforms being suggested today, which I will discuss later, are aimed at increasing the control of the owners, the shareholders, over the direction of the company.

Still, in the decades following the Berle and Means treatise, professional managers dominated, and CEOs populated their boards of directors with friends and golfing buddies. By the 1970's the idea of "independent" directors began to take hold. Independent directors, by definition, are not part of or related to management, and can, therefore, be a "check" on what management does.

By the 1980's, shareholders – owners – began to wake up. Large institutional shareholders – such as pension and mutual funds – which own many shares in U.S. companies, began to recognize their latent power. One milestone was the formation of

Institutional Shareholder Services (ISS, now Risk Metrics) to advise these funds about how to vote their shares at the annual meeting. Another milestone was the formation of the Council of Institutional Investors. Also at work were the so-called “raiders” who engaged in hostile takeovers, forcing boards, under pressure, to make faster decisions about what to do. The most prominent fight was for control of RJR Nabisco, chronicled in the book, *Barbarians at the Gate.*

Moving into the 1990’s, boards became more assertive and removed CEOs more frequently. Shareholder activists pressed for equity ownership by managements in their companies in order to align their interest with that of the owners. Stock options were favored. But when stock markets boomed and options were exercised, the payouts seemed huge and the pay gap between the CEO and the employees at the bottom of the ladder grew dramatically, triggering public concern about excessive CEO compensation. The SEC promulgated new rules of disclosure about executive compensation. These disclosures were intended to deter excessive compensation but instead became a “scorecard” as CEOs looked around to see what others were making. The SEC also allowed shareholders to submit pay-related resolutions to be included for a vote on proxy statements.

Even though boards became more assertive during this era, the “rock star” CEO reached a zenith. “Why shouldn’t we be paid like professional football players?” one such star was heard to say.

Boardroom change has accelerated in this decade.

This decade, beginning in 2000, has seen even greater change. A majority of U.S. households now own stock in U.S. companies; institutional investors own an estimated 75% of public company stock. So, many Americans have “skin in the game,” and company and stock performance is more avidly watched and reported about by the media. The Sarbanes-Oxley era, mentioned earlier, ushered in new requirements for boards, some by law, some by regulation. I’ll cite four of these:

- Public companies now must have a majority of independent directors.

- The board must have its own independent leadership – a lead director or an independent, or non-executive, chairman of the board.

- Regular executive sessions of the independent directors without the CEO present are required and are presided over by the lead director or the non-executive board chairman. In earlier days, there were no board meetings without the CEO present. In fact, CEOs would get very upset if they thought board members were meeting without them. And so, if something were amiss in the company that board members wanted to discuss with each other, they had to do it surreptitiously on the phone or in private gatherings. Now, during each board meeting, the board meets in executive session. This gives directors, without parsing words, the opportunity to let our hair down, speak frankly about possible concerns, strategy, performance, CEO compensation, CEO succession and

anything else. Often one comment by a director sparks another director's thinking and triggers a productive group exchange and consensus. This is the way a good collegial process is supposed to work. Following this, the lead director or non-executive chairman conveys the substance of the discussion, where appropriate, back to the CEO. A wise CEO takes such comments to heart.

This is one of the best reforms. It reinforces both director independence and the ability of the board to function as a group and it brings out of the shadows the opportunity for directors to speak candidly with each other about the company. Such conversation is now a routine board process. I have seen a lot of good come from these sessions.

- The outside audit firm now reports directly to the audit committee of the board of directors. Previously, the auditor in theory reported to the audit committee but in reality worked for management. Now, according to Sarbanes-Oxley, the audit committee hires and fires the outside auditor, approves the scope of the audit, pre-approves fees, and chooses the lead audit partner. These changes have strengthened the auditor's independence, brought the audit committee and auditor more closely into alliance, and have improved the "check" on management's judgments, accounting policies, financial statements, and the ethical culture of the company, or "tone at the top," as it is called.

Please note that in addition to the evolutionary changes I have described, over the years there were a number of court cases which further defined the fiduciary duty of directors – for example, the Van Gorkom and Disney cases – and have contributed to increasing the expectations for the work of boards. I do not pretend to be an expert on the law and so will defer further explanation to those in the legal profession. But, needless to say, this body of case law is an important part of the corporate governance environment.

Many of the aforementioned changes enlarged the power of the board and its "check" on the CEO. And incidentally, a "check" on the CEO need not be confrontational; it can take the form of critical, constructive questioning and comment, and/or taking a stand, where needed, against something management proposes. In any case, a good board process will sharpen management's thinking. In many instances I have witnessed, this process has brought forth useful information, new insights, and even new directions.

Another positive change is that boards now engage more actively with the CEO and the management team on corporate strategy. They engage more actively about the "tone at the top," and they engage more actively about how business risk is managed. Boards focus more on succession planning, especially for the CEO. Choosing the CEO may well be *the* most important thing boards of directors do.

In other words, as corporate governance has evolved and because of law and regulation and a desire to do the right thing for investors, directors are working harder,

doing more, and doing it better. At the same time, during this decade shareholder activists tabled a number of new ideas to enhance the role of shareholders in the governance equation.

Another realignment of boardroom power is coming.
And now, another sea change in corporate governance is ahead. This one is triggered by this severe economic downturn and the questioning and decline in public trust that has come with it. Once again, the U.S. government has stepped in, but this time, on a scale not seen since the Great Depression, to rescue our financial system, shore up our economy, and mitigate further loss of jobs.

I remember the famous quote of Illinois Senator Everett Dirksen from years ago, “A million here, a million there, and pretty soon we’re talking about real money.” Times have changed. Today billions – or rather trillions of dollars – are being poured into the U.S. economy through stimulus packages and the Troubled Asset Relief Program (TARP). As a result, the U.S. government now owns shares – in some cases controlling shares – in banks and financial services firms (such as Citigroup), insurance companies (such as AIG), and automobile companies (such as General Motors and Chrysler). Government has taken over Fannie Mae and Freddie Mac to stabilize the unraveling home mortgage market.

In an unprecedented and visible action, the White House has fired the CEO of General Motors, is replacing its board, and has orchestrated the company’s bankruptcy filing and re-emergence. In the cases, where firms have taken bailout funds, there are by law restraints on executive compensation, and the president has appointed a White House “pay czar” to approve compensation decisions in those firms. This is all new territory.

My hope is that the U.S. government’s intrusion into the private sector will be temporary. If it lasts too long and is too deep, I fear that our society will alter its expectations about what government should and should not do, and will welcome government control too eagerly. If this happens, I believe it will constrain the very entrepreneurial spirit and innovative capability which are cornerstones of our economy’s greatness and dynamism.

Hand in glove with the government intervention is the current rush to increase the power of shareholders and in turn, to “check” boards of directors and hold them more accountable. A variety of actions are moving ahead.

- One is “say-on-pay,” which means that shareholders would have an advisory vote on a company’s pay plans. The firms receiving government bailout funds already have this, and the expectation is that the Congress will pass a bill making it apply to all public companies. Last week the Treasury Department sent the Obama Administration’s version of this legislation to Capitol Hill. Executive compensation is a sensitive issue on Capitol Hill and around the country. The pay and bonuses awarded to some executives in firms receiving government funds is a particularly sore point when many employees are losing their jobs. And we recall the fun the

late night comedians had with the AIG executives who went to a spa for a business retreat.

- In another action, the SEC has put forth a proposal, now out for public comment, called for short, “proxy access.” If enacted, this would allow shareholders owning a certain percent of a company’s stock for a specific time period, to place their director nominees on the company’s ballot for vote at the annual meeting. Now, in order to do that, a shareholder must run a separate slate of directors and engage in a proxy contest with the company’s proposed slate. A new rule would make such a challenge much easier.

- Already, most large companies have a “majority voting” standard, which means that a director must receive a majority of votes cast to be elected. Earlier, a director could be elected with a plurality of the votes cast.

- Earlier this month the SEC approved a stock exchange rule indicating that brokers, who hold shares of stock for their customers, would no longer be allowed to vote these shares unless their shareholder customers agree. It is thought that brokers and their representatives generally vote in favor of the company slate. This new rule would change that.

- The SEC has proposed other rules which would require board members to tell investors more about their qualifications and experience and would mandate more disclosure about executive compensation.

- Besides, these actions there is a “shareholder bill of rights,” embodied in various pieces of legislation which have been introduced in the Congress. We are not sure which, if any, of these will be enacted into law.

What is the implication of these new powers, if enacted?
Use of these new powers by shareholders – in combination – can realign the power balance among the board, the CEO, and the owners. This can change the dynamics in the boardroom. The bottom line is that shareholders, as owners, desire to assert more power in corporate boardrooms and hold directors and management accountable for performance. This is what Berle and Means were aiming at in their early work.

It is difficult to see the future clearly. But quite possibly there will be more competition, perhaps even “campaigns”, for board seats. There will be more focus on compensation and probably more “no” votes for members of compensation committees and boards if executive compensation seems excessive or if the pay plan process does not seem rational. And because of the majority vote standard, it is possible that more directors could be voted out.

Shareholder activists foresee that directors will be pressed to communicate directly with the company’s shareholders. This sort of communication happens now but it is usually

between the management and shareholders. Most boards have not yet focused on this possibility.

We hope these changes will be constructive and will enhance corporate governance and company performance.

But there are possible down sides and unintended consequences. These changes favor large institutional shareholders – state pension funds, labor union pension funds, mutual funds, and other large holders, such as activist hedge funds – while leaving small investors out in the cold. The interests of many small investors may not coincide with those of the large institutional owners. Some large shareholders may want to make a fast buck, and that may not align with the objectives of other shareholders who want a longer term building of value. A further concern is that some shareholders may have special interest agendas which run counter to the well-being of the company, its employees, and other shareholders.

What should boards do?
This brings me to the crucial question – what should boards of directors do now? Although I believe boards are performing better, it is time for another step up in vigilance and performance. If we are to restore public trust in corporate governance and in American business, we as directors must be part of the solution. That need is urgent.

Here is what I believe we, as directors, must do. I am talking to myself as well as to colleagues on other boards.

First, renew efforts to understand fully the business or businesses of the company and know what the drivers of success are. Answer these questions: how does the company make money? Does the company make money by also doing good, in other words, providing products and/or services which are needed and useful? Does the company do no harm? If such questions cannot be answered, it is impossible for directors to do an adequate job of overseeing performance.

In addition, we should rededicate ourselves to the qualities of character all of us, as directors, must have – integrity, good judgment, a commitment to excellence, and courage. And each director should know what he or she brings to the board table through expertise and experience. The nominating committees of boards today are giving more attention to all of these things and are working to bring onto the board individuals who have experience and insight to contribute to the company's strategic direction.

Second, re-evaluate how board members work together. A board is usually a group of 6-12 people, so it must do its work as a group, by consensus. A key dimension of board effectiveness – often overlooked, I believe – is the group dynamic at work around the board table and the way the group interacts with the CEO. There are a variety of cases where person for person, the directors sitting around the board table are excellent

people. Yet somehow, apparently, the group process didn't work well enough or quickly enough when action was needed. Boards should look at themselves and be honest about how things are working. Do board members respect and trust each other? Are they willing to challenge management? How do they deal with an overpowering CEO? Is board leadership – lead director or independent chairman – working well? These and many other questions should be examined and answered. Where different behavior is called for, the board should make that happen.

Third, accept the challenge to boards launched by the National Association of Corporate Directors (NACD) in March. (For full disclosure here, I note that I am the chairman of that group. NACD was formed more than 30 years ago and is the only membership organization of corporate directors.)

NACD is providing tools for boards to use in evaluating their corporate governance structure and performance in order to increase their effectiveness. The basic tool is the "Key Agreed Principles to Strengthen Corporate Governance for U.S. Publicly Traded Companies." This document is unique. It was a year and a half in preparation and represents the distillation and articulation of a variety of governance principles on which we believe there is agreement from business, directors, and shareholders. There are 10 principles, quite logical, really: (1) board responsibility for governance (2) corporate governance transparency (3) director competency and commitment (4) board accountability and objectivity (5) independent board leadership (6) integrity, ethics, and responsibility (7) attention to information, agenda, and strategy (8) protection against board entrenchment (9) shareholder input in director selection and (10) shareholder communications.

We ask each board to evaluate its practices against these ten principles – and where it needs to strengthen its practices, do so – and then to repeat the evaluation process every year. The NACD is giving recognition to those boards which accept the challenge. Some of those are: Aetna, Home Depot, United Health, and Becton Dickinson. I want to emphasize that these principles are not prescriptive – they are not a "cookie cutter" one-size-fits all list of do's and don'ts. We are challenging each board to evaluate and enhance its performance in whatever way it sees fit.

NACD further challenges boards to pay special attention to four key areas of their activity: executive compensation, risk oversight, strategy, and transparency. A white paper is provided to guide the board discussion. These four issues were chosen because they seem to be the ones which need focus most urgently. For example, the oversight of risk was an area of underperformance by both managements and boards that lay at the heart of the current financial crisis. There were creative financial instruments in use which no one understood well enough and so did not consider the risks associated with them. A good example is subprime mortgages. The situation was compounded by packaging them into securities and then selling those securities around the world. Also, no-one, regulators in particular, seemed to clearly understand the interrelationships among financial institutions which, if there was trouble, could put the entire financial system at risk.

Executive compensation, as we said earlier, is a political issue, which boards must step up to solve. We must work to make sure compensation practices are rational, fair, and that rewards are for performance – not for non-performance. Too often in the past, CEOs who failed to deliver walked away with fat severance packages, which were part of contracts negotiated before they stepped into the CEO role. These contracts guaranteed these payouts – no matter what the performance was. Compensation committees and boards must put a stop to such practices. Just say no.

Succession planning is another key area. Boards must ensure a good answer to the age old question: "What if the CEO gets hit by a bus?" Another NACD white paper is in the works to challenge boards on this aspect of its work.

Boards must step up to the challenge and improve performance.
I urge boards to step up to the challenge. These are difficult times, and boards should reach to be the best they can be to serve the company and its shareholders -- and thereby deter the need for further government intervention into the process of corporate governance, which is essentially a private sector activity.

An obvious question: will such a voluntary effort on the part of boards be enough? Can this help to head off another economic crisis? Will it stop future fraudulent activity?

Of course, there can be no guarantees. But I truly believe that more effective governance and more vigilance can contribute significantly to better financial and ethical performance. And I earnestly believe we must try. It is in the interest of everyone – taxpayers, workers, shareholders, managements, boards, and our government – that we succeed in proving that corporate governance can be effective and that our entrepreneurial system of capitalism really is the best.

We are in a global world.
Here is a further thought. We are in a fast-paced global world. There is no turning the clock back. And if ever there was doubt about the interconnectedness of economies around the world, this current global recession should have put those doubts to rest.

Economies are intertwined. So, if we are to head off another global downturn and develop better early warning capabilities, we should press for more worldwide collaboration in several areas: global standards of corporate governance, global regulatory convergence, and global accounting and auditing standards.

We in the U.S. should actively continue to press for these things and engage with others around the world so that when the current economic storm passes – and it will – we can move ahead together. If we succeed, our actions will strengthen corporate governance and capitalism globally. This, in turn, will help to bring prosperity, create jobs, fight poverty, enhance health, deliver innovation, and preserve our planet. These objectives are worth working for here in America and around the world. I truly believe that making a profit must also serve the public good, and that is what we must strive for.

Let me conclude with the profound yet simple words of Ralph Waldo Emerson, “Doing well is the result of doing good. That’s what capitalism is all about.”

Thank you.

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