EFFECTIVE CORPORATE GOVERNANCE PRACTICES

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It's a great pleasure to be with you today to share thoughts and experiences about corporate governance. I am speaking as a director of many public companies in the United States during the past twenty-five years.

First, let me give you a bit of background.

The US system of corporate governance is based on a regime of checks and balances. Management runs the company. The shareholders own the company. And the board – composed of a majority of independent directors – is responsible for policy and direction and represents the interests of the shareholders.

But that presents an interesting question: who are the shareholders directors are to represent? Shareholders are not a monolithic group. There are large institutions; there are individual investors. Some shareholders are willing to stay invested in the company for a long time, others stay only for the short term. And some shareholders may be activists (or "raiders") who want to change the strategy of the company to bring higher returns.

There are also stakeholders – employees, customers, and communities. I personally take them into account, too, but the shareholder interest, as I perceive it to be, comes first under most state incorporation statutes.

Under the US system**,** corporations are incorporated under state statutes. But the regulatory regime, mainly under the Securities and Exchange Commission (SEC), is federal**.** The SEC came into being in reaction to the US stock market crash of 1929. It is an independent agency, headed by five commissioners appointed by the President with the consent of the Senate for a fixed term of years. The commissioners do not come and go with the change of Administrations. One of the commissioners is designated chairman by the President.

The SEC has a budget of over $800 million and has 3,500 people. The agency has jurisdiction over "registrants" (public companies whose stock is sold through the stock exchanges). The SEC also has regulatory authority over US stock markets and their function. The agency is empowered to require various disclosures and reports, to investigate, and to enforce.

The stock exchanges (New York Stock Exchange, NASDAQ, and American) have requirements that companies must meet in order to be listed. The SEC approves those requirements.

I appreciate that your culture and your business establishment may not work exactly as ours does in the US. I'm not here to tell you how to run things, but to relate how the US system works in the hope that some of my experience will be useful to you.

The US has had a rash of recent scandals. The first major one involved the Enron Company in 2001. This was followed by World Com and various others.

At Enron**,** dishonesty and collusion among the management caused the reporting of misleading and fraudulent financial results. The auditor, Arthur Andersen, did not provide the proper check on management through its audit process. The board of directors seemed asleep. When the truth became known, the company's stock declined sharply and the company collapsed. The audit firm was indicted by the Department of Justice and also collapsed. Investors suffered big losses. So did the employees – one of the stakeholders – many of whom were heavily invested in Enron stock. Meanwhile the top people at the company walked away with millions of dollars. That caused corporate governance to become a political issue. Trust in corporate managements, directors, auditors, and stock market research analysts fell to a new low.

The President and the Congress stepped in quickly. The result was the Sarbanes-Oxley Act (2002) – called SOX for short. There were new regulations by the SEC and new listing requirements by the stock exchanges. All of this was aimed at creating a future in which there would be clearer accountability, more transparency, and a stronger system of checks and balances. The reforms seem to be working. So far so good.

There are a variety of reforms, but I'll discuss the five that I think are the most meaningful.

(1) Standards for director independence have been raised.
All directors are to be individuals of professional accomplishment, good judgment, and high integrity. But, in order to list on the stock exchanges, a majority of directors must be independent. Standards for independence have been raised by SOX, the SEC, and the stock exchanges. This is intended to give directors more backbone and courage to challenge management when necessary. This is one of the checks. The ultimate check within the purview of the board is to choose the CEO and when necessary, change the CEO.

But the real value of independent directors is that they bring other viewpoints and relevant experience to deliberations about strategy and performance. Obviously, in order to do this effectively, they must also understand the dynamics of the business – how the company makes money.

So, today US boards are constructed to have a mixture of expertise and experience represented around the board table. One example is Aetna, Inc, which is in the health care insurance business. Besides the company's CEO, there are the following people who are independent directors:

- Four CEO’s from other companies, **not** in the health care insurance industry;
- a retired CEO from another industry;
- a Harvard professor who is the country’s expert on health care economics;
- an eminent physician;
- an entrepreneur; and
- a former government Cabinet member who brings public policy experience and expertise in audit and corporate governance.

I can say absolutely that the collective mixture of different viewpoints among the independent directors sharpens management’s strategy and operational excellence. In some cases this can make a crucial difference between success and failure. The process of board deliberation can bring out issues that management may have overlooked.

There are now a variety of criteria regarding independence mainly designed to ensure that the director does not have a sizeable financial relationship with the company. For example, a director is **not** independent if he/she or a family member is a part of another enterprise which makes or receives payments from the company that exceed 2% of the other enterprise’s revenues. To be deemed independent, a director cannot have been an employee of the company for the past 3 years or worked for the company’s auditor for the past 3 years.

But independence is also a mindset. A director must be willing to ask the tough questions of management and keep asking until he or she gets good answers. In other words, the director should not just agree with management because he or she is a friend or golfing partner of the CEO. A strong message was sent when the directors of Enron and World Com had to pay out of their own pockets to settle lawsuits against them.

This is working – directors have become more vigilant, more intellectually engaged, and more willing to challenge. This does not mean that they are attempting to micro-manage company affairs. It means that they are far more active in doing their job of oversight, challenge, and advice. It also means that there is increased emphasis on promoting a culture of ethics in the company. This starts with the CEO and is known as the “tone at the top.” We hope that over time there will be ample proof that good governance equates to superior company performance.

Today’s directors are not chosen by the CEO as they were in the old days. Now the CEO in involved but the board’s nominating committee, composed of independent directors, makes the choice.

(2) Board Executive Sessions are required.
There is a new requirement that the board hold executive sessions of the independent directors regularly without management present. They must be presided over by a presiding director, lead director, or a chairman of the board who is not also the CEO. These sessions are scheduled into the agenda of the meeting and are designed to give the opportunity for candid discussion. A director can bring up any issue and that is what happens.

The presiding director presides and afterward relates the consensus back to the CEO. I have seen very constructive suggestions and comments emerge from these sessions, which are then implemented.

This is one of the best reforms. It reinforces the independence of the board as well as helping it work together as a group. And this is an important point: a board functions as a group, so the group must work well together to be effective. Members must respect and trust each other, and there should be candor and openness. But any group needs a leader and that is why this reform has created a leader of the board – the presiding director, who is chosen by the other independent directors – as differentiated from the leader of the management, the CEO.

> Example: I was in two executive sessions last week. In one company, we discussed the CEO's compensation. In the other company, the session focused on an aspect of the company's strategy that the board thought too risky.

(3) SOX requires that the CEO and CFO certify quarterly to the truthfulness of the financial statements.

In order for them to certify, there are sub-certifications required from business unit heads, the controller, internal auditor, functional heads, and others. In other words, the process is pushed down in the company. The sub-certifications come up, and that gives comfort to the two at the top who must certify to the board, the regulators, and the shareholders.

The audit committee – which must review quarterly the earnings release, financial statements, and SEC filing – also reviews the certifications. If a certification is missing or is hedged in some way, that would be a concern. In other words, increased discipline has been brought to the reporting of financial results, and there is clearer accountability.

SOX has also spelled out stiff penalties if fraud is found later. If the CEO and CFO certify wrongly, there is a maximum penalty of $1 million and/or 10 years in jail. If the certification is found to be willfully misleading, the maximum penalty is $5 million and/or 20 years in prison.

This has gotten everyone's attention.

(4) The responsibility of the Audit Committee has been increased.

The audit committee is the only board committee which monitors what management does all the time. This is part of the system of checks and balances. The work of other board committees ebbs and flows – but vigilance is demanded of the audit committee all the time. Audit committees must be composed of independent directors and are responsible for helping to ensure the integrity of the financial statements and the process that produces them.

Independent auditors also are important to the system of checks and balances. SOX requires that the audit committee be responsible for the appointment, compensation, and oversight of the work of the outside auditor.

This strengthens the reporting relationship of the outside auditor to the committee. The audit firm does not report to management. It did not before but often acted as though it did. This is a change. So, now the audit committee not only selects the audit firm but chooses the lead engagement partner who manages the audit.

The audit committee, especially the chairman, must carefully and wisely use the checks and balances built into the audit committee system. There is inherent tension among the roles of those who are around the table – management, the outside auditor and internal auditor. The latter two are checks on management. The audit committee plays one off against the other – gently, not confrontationally -- to get the most insight and information. And the purpose is to become aware of problems before they become crises and to work with management to head them off. From my long experience with audit committees, I can say that this process can work very effectively and can be a great help to management.

The audit committee also ensures that the management has a process in place to manage risks to the company. That is a new requirement. I have long felt that audit committees should set the agenda for their work according to the areas where there are the biggest risks to the company. Now, we are using a process called enterprise risk management. That entails identifying a comprehensive list of risks, indicating the probability of that risk occurring and noting the probable impact on the company. Each risk area has an "owner", a person in management who is responsible for managing that risk. Identified also is the board committee (or the full board) which is to oversee whether the risk management process is working. A good director will be conversant with the key risks confronting the company.

(5) The Public Company Accounting Oversight Board (PCAOB) to regulate the accounting profession has been created.
The new requirement is that each public accounting firm which audits public companies must register with the PCAOB and the PCAOB periodically inspects the firm's work. Previously this review was done by the American Institute of CPA's, a professional association in the private sector. The PCAOB is a private sector regulatory body, but it is under the jurisdiction of and reports to the SEC. In addition to the work described above, it also writes the standards by which auditors are to do their work. This new regulatory apparatus is aimed at causing the auditors to be more independent and to rebuild trust in our accounting firms.

I believe the PCAOB is doing a commendable job. However, there is an unresolved issue, and it relates to the auditing standard which implements section 404 of SOX. This requires management to represent that the system of internal controls is effective, and then the auditor must attest to this. This requirement has caused a lot of complaints and many in corporate America believe it is costing too much and not providing enough benefit to justify the cost. New guidance to ease this process was given about a year ago by the SEC and PCAOB and the situation is about to be reviewed by the regulators once again. I believe the requirement should be less for small companies.

The Bottom Line
I continue to believe that most corporate managers, directors and auditors are honest. But if some people in management work together to deceive the board and the investment community, it is difficult for the directors to know. However, I think the new reforms make it more difficult today to do what those at Enron, World Com, and Fannie Mae did.

I also believe that the US corporate governance system is working reasonably well and that trust is returning. But as a director, I believe in the old adage, "Eternal vigilance is the price of liberty." In this case, eternal vigilance on the part of the board is the price of profitability.

The Vision
Our capital markets are global and moneys move around the world with lightening speed. What happens in one market can have ripple effects in others, as the financial crisis of 1998 has aptly demonstrated. So, to one degree or another, we are all in the same boat. Therefore, the vision for the future is to have a truly global system of capital markets, so that an investor in one country can trust the financial statements provided by a company in another country. One necessary element is the need for international accounting standards that all countries will adopt and enforce the same way. We need assurance that auditors in every country are independent. We need a more common global regulatory system or at least, an effective regulatory regime in each country. And we need a more common system of best practices in corporate governance.

This may be a pipe dream rather than a vision. But I believe the goal of a truly international financial world is a vision worth working toward.