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Corporate Governance Issues

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PANEL 2: CORPORATE GOVERNANCE ISSUES

Panel Chair

Honorable Peter Peterson[*]
Chairman, The Blackstone Group, and
Chairman, Federal Reserve Bank of New York

Panelists

John "Neel" Foster[**]
Board Member, Financial Accounting Standards Board

Professor Jeffrey Colon[***]
Fordham University School of Law

PROFESSOR RECHTSCHAFFEN: We are very honored to have Secretary Peterson here.

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[*] Peter Peterson is Chairman and Co-Founder of The Blackstone Group. He is Chairman of the Federal Reserve Bank of New York, Chairman of the Council on Foreign Relations, founding Chairman of the Institute for International Economics (Washington, D.C.) and founding President of The Concord Coalition. Mr. Peterson is the co-chair of the Conference Board Commission on Public Trust and Private Enterprise. He is the author of several books. Mr. Peterson has been awarded honorary Ph.D. degrees by Colgate University, Georgetown University, George Washington University, Northwestern University, the University of Rochester, and by Southampton College of Long Island University.

[**] John Foster is a Board Member of the Financial Accounting Standards Board. Prior to joining the Board, Mr. Foster was Vice President and Treasurer of Compaq Computer Corporation since 1983, the first year of Compaq's operation. Mr. Foster was a member of the Financial Accounting Standards Advisory Council ("FASAC") since 1992 and was a member of the American Institute of Certified Public Accountants ("AICPA"), the Texas Society of Certified Public Accountants and the Financial Executives Institute. Mr. Foster holds a B.A. degree in economics from Colorado College where he graduated with honors and was Phi Beta Kappa. He also studied accounting at the University of Colorado at Colorado Springs.

[***] Jeffrey M. Colon is an Associate Professor of Law at Fordham University School of Law, and teaches in the areas of corporate and tax law. Professor Colon completed his M.L.T. (Taxation) at Georgetown in 1993, his J.D. from Yale in 1987 and his B.A., summa cum laude, from Yale in 1983.

I am particularly honored to have Dean Treanor with us today, the Dean of my Law School, the Dean of the Law School where I went, the Dean of the Law School where I teach. He is going to introduce the rest of the program on corporate governance, including the panel with Secretary Peterson and Governor Bies's keynote address.

With that, I turn it over to the Dean of the Fordham University School of Law, Dean William Treanor.

DEAN TREANOR: Thanks very much, Professor Rechtschaffen.

Welcome, on behalf of the entire Law School community. I am here to welcome you to the International Symposium on Risk Management and Derivatives, which addresses the critical issues of corporate governance and responsibility.

I would like to thank all the distinguished panelists that we have today. If you look at the program brochure, it is a remarkable group. It is a congregation of people who are outstanding leaders in the field.

I would also like to extend a special welcome to the Symposium's keynote speaker, Governor Susan Schmidt Bies of the Federal Reserve System. Thank you very much for coming.

And I would like to recognize the chairs of the Symposium's various panels: Professor Steven Raymar of the Fordham School of Business—thank you for chairing a panel, Professor Raymar; the Honorable Peter Peterson, Chair of the Blackstone Group and Chair of the Federal Reserve Bank of New York, who will be presiding over this panel; and Howard Rubenstein, President of Rubenstein Associates, Inc.

In addition, I would like to thank Professor Carl Felsenfeld of our faculty, who directs the Fordham Institute on Law and Financial Services; Professor Jill Fisch, who directs the Fordham Center for Corporate, Securities, and Financial Law; and especially Professor Alan Rechtschaffen, who is the Symposium Chair and a member of our adjunct faculty. He originally envisioned the need for a conference like this seven years ago and has worked tirelessly since then to make this vision a reality.

The topics addressed by our distinguished panelists include accounting, corporate governance, and public relations, areas which have always been fundamental to the world of business and

the world beyond. Today, as we all know, these topics are more important than ever, as the securities industry tries to bolster investor confidence in a system that has recently been under siege from without and from within.

The issues which our panelists address today are equally important both to the financial industry and to the average citizen. Never before in our nation's history have so many members of the public been so invested in capital markets, and perhaps not since the Great Depression have so many individuals lost as much trust in the ability of the corporate and financial world to keep its own house in order.

The dialogue that is presented today is an important step in addressing the critical issues that will continue to challenge the business community in the days and years to come.

Again, I thank all of you for sharing your time and your talent on these issues of national significance, and I wish you a very successful Symposium.

Now I would like to introduce the panel on corporate governance issues.

The Panel Chair is the Honorable Peter Peterson, who is one of the best-known and most influential leaders in the business community of our time. In addition to currently serving as Chair of the Federal Reserve Bank of New York, he is also Chair of the Blackstone Group, a private investment firm, which he co-founded in 1985, and a Director of Sirius Satellite Radio.

Mr. Peterson served as Chairman and CEO of Lehman Brothers from 1973–1977, and after the merger with Kuhn, Loeb served as Chairman and CEO of Lehman Brothers, Kuhn, Loeb until 1984. Mr. Peterson is currently Chair of the Council on Foreign Relations and he is Founding Chairman of the Institute for International Economics. He is a former United States Secretary of Commerce and Chairman of the National Commission on Productivity during the Nixon Administration, and under President Gerald Ford he chaired the Quadrennial Commission on Executive, Legislative and Judicial Salaries.

Mr. Peterson has been named by the United States Junior Chamber of Commerce as one of the "Ten Outstanding Men" in the nation. Very early in his career, in 1972, he was named as one of the "Most Important Americans Under Forty," a recognition

whose accuracy would be proven time and time again over a long, distinguished career in the public and private sectors.

An author of numerous influential publications on economics, Mr. Peterson is a *summa cum laude* graduate of Northwestern University and holds an MBA with Honors from the University of Chicago. He also holds honorary doctorates from a number of universities, including his Alma Mater Northwestern.

Our panelists today are John "Neel" Foster, who is a member of the Financial Accounting Standards Board and a member of the Financial Accounting Standards Advisory Council; and Professor Jeffrey Colon of our faculty.

I bring you Mr. Peterson, who will then introduce and present the rest of our panel.

Again, thank you very much for coming.

MR. PETERSON: Thank you for that overblown introduction.

I am glad you did not refer to me, as I was once referred to, as a "powerful Secretary of Commerce," which started me in a career of collecting oxymorons, because anybody who has been in Washington knows there has never been a powerful Secretary of Commerce.

As far as my books are concerned, I specialize in worst-sellers.

The most unkind, but accurate, comment about my latest book, called *Gray Dawn*, was by Ted Sorenson, who said "*Gray Dawn* is a book that once you put it down, you won't be able to pick it up."

I guess the reason I am here is that, as some of you at least know, The Conference Board decided to set up a Commission on Public Trust and Private Enterprise and I was asked to co-chair it with John Snow, who used to chair The Business Roundtable. And, since I was also presumably educated at the University of Chicago, where our patron saint was Adam Smith—I am not old enough to have known him personally, but he tried to teach us the concept of comparative advantage.

Anybody asked to join commissions has to ask, "Well, what is different about this one?" I have seen the New York Stock Exchange ("NYSE") and The Business Roundtable reports. John Snow and I finally decided to take on this project on three grounds.

First, that it would not be just a business or a financial group,

because this problem in public trust is clearly metastasizing throughout the entire society. So, in addition to having former CEOs, we wanted highly trusted former government regulatory officials. We have Paul Volcker, we have Chuck Bowsher, Comptroller General, Arthur Levitt, former SEC Chairman, and Senator Rudman. We have a professor of business ethics, which some would also consider an oxymoron. She is Lynn Paine, Professor of Business Ethics at the Harvard Business School.

And, very importantly, because the investor community has been remarkably moot, or passive, or whatever you wish to call it on this, we have John Biggs of TIAA-CREF; we have Jack Bogle, a remarkably outspoken, free-thinking founder of Vanguard, and Peter Gilbert, the head of investments of the Pennsylvania State System.

Ultimately, we are going to try to make a difference in two ways: not only coming up with recommendations that we hope are sensible, but we are going to try to get the business community and the investor community organized. You will be seeing some advertisements in which we are going to ask for the support of these organizations.

I happen to be of Greek descent, so I always look for words of Greek origin. I do not know if you have seen "My Big Fat Greek Wedding," but you should if you have not. Anyone brought up Greek understands that everything began and ended with the Greeks. So when I see a word that has a Greek origin, I kind of go for it.

There is a wonderful word, called iatrogenic, which means caused by (*genic*) the doctor (*iatro*). One of the reasons we are very anxious to see the private sector start showing some leadership is I genuinely feel that when Congress gets involved in such delicate matters as executive compensation, you can almost be sure that the effect will be iatrogenic—that is, it will create symptoms and diseases that can be worse than the original problem.

Now, public trust. It has been customary for people with my kind of business background to utter a cliché—"there are just a few rotten apples." I think it does not matter what those of us in business think. If we are dealing with the public, we have to think like the public thinks.

I have been appalled at the extent and level and depth of public anger, fear, and disrespect that exists. Forty-three percent of the Americans in a recent survey said they believed all executives engaged in these shenanigans. Another 36 percent believe "many or most" do. And only 15 percent buy our "few rotten apples" idea.

Humor is useful in life. I do not know if you saw this cartoon. It was unkind and unfair, but I think it conveyed a public attitude. It shows one of Saddam Hussein's deputies coming up to him and saying: "Mr. President"—or whatever they call him—"those Americans have gone too far. They are now beginning to call you a CEO."

So there is a pervasive public view that I think something has to be done. The reasons we should care are obvious. Ours is a country—we have Governor Bies here of the Federal Reserve Board—where we spend much time talking about our abysmally low savings rate, our outsized current account deficit and how we need to get $500 billion a year from abroad. We know how terribly important trust in our capital markets is, and we think that reason argues very persuasively at the macro level for doing something about it.

Now, I am going to talk for a few minutes about one subject. We probably violated the antitrust laws, but I have assigned each of our panelists a different market sector so we did not compete with each other. I am going to talk about the issue we have tackled first on the Commission because it is the toughest issue, it is the most toxic issue, and it is the one most people have not talked about, but which I believe is at the absolute root of the breakdown in confidence, and that is executive compensation.

You are probably familiar with the fact that growth of CEO compensation in the last ten years has been ten times faster than that of the average worker. And we can understand if we step back from our illusions or our clichés, why the average American might say, "You know, you business types talk about productivity and the importance of linking productivity to wages. Are you saying that your productivity has grown ten times faster than ours has?"

The media has covered this subject, shall we say, very extensively. We see *The Financial Times* pointing out that

executives made $3.1 billion in companies that went bankrupt, referring to it as "the stunning payoff for corporate failure."[1] You probably saw the *Fortune* cover which said: "You bought, they sold: How hundreds of greedy executives sold $66 billion worth of stock."[2] So there is a pervasive attitude out there that we really need to understand.

We got the help of Simpson Thatcher and Towers Perrin who at least reduced my level of ignorance. I had not understood, frankly, what the main drivers were of this huge growth in compensation and the major role of stock options.

Between 1990 and 2000, stock options went from 8 percent of total equity to over 16 percent. And you combine that with the stock market "bubble," or whatever you wish to call it, and the combination of huge quantities—unprecedented quantities—of stock, a bull stock market, very limited holding periods, very limited ownership requirements—which gave rise to what I think is really bothering the American people, which is executives making hundreds of millions of dollars in some highly publicized cases while they presided over failed or failing companies.

Now, one of the iatrogenic effects of congressional involvement in executive compensation was the 1993 limit on the deductibility of cash compensation above $1 million. That, plus the accounting treatment of stock options, where they did not have to be expensed even though they were very large tax deductions for stock options, the latter I have found in my speaking around the country the public does not appreciate. When I tell them that Microsoft got a $3.1 billion tax deduction in 1999 or Cisco got a $2.5 billion tax deduction in the year 2000, most people are very surprised.

So the combination of not expensing these options and getting a big tax deduction created the feeling that these options were more or less free. And they were given in overwhelming quantities.

One of the delicious ironies of this problem that I have discovered is that one kind of option that is not expensed is the

1. Ien Cheng, *Survivors Who Laughed All the Way to the Bank*, FIN. TIMES (London), July 31, 2002, at 10.

2. Mark Gimein, *You Bought. They Sold.*, FORTUNE, Sept. 2, 2002, at 64.

fixed-price option, which is about 99.5 percent of the total options. Options that try to relate compensation to performance—for example, restricted stock grants that say "you will get X grants of stock if corporate earnings go up this much for Y years"; or performance-oriented options that say "if you earn a rate of return higher than the cost of capital, or higher than the Dow Jones, then you get stock"—all of those performance-based stock options are expensed.

So, unintentionally I think, what has happened is we have had this tremendous de-linkage between performance, on the one hand, and compensation, on the other, and in the aggravated cases it is really de-linked because we have negative performance and huge compensation, which I think is at the root of this problem.

Now, another thing I discovered is that to say that the West Coast high-tech industry's enthusiasm for expensing options is restrained would be an understatement. What I did not know until we looked into this was the immense variability in the role that expensing options would play on reported earnings, which, combined with the huge number of options, has tremendous impact.

For example, in a very interesting study done by Merrill Lynch, they took the entire S&P 500 and they broke it down by industry. What they found was that if you expense options in most of the industries, the effect on reducing reported earnings is typically somewhere between 3 and 10 percent. In the case of the information technology industries, it is 70 percent.[3] So you can understand how the combination of huge numbers of options with this substantial effect on decreasing reported earnings would create a problem of earnings comparability.

The executive compensation philosophy of the Commission, if I can summarize it, on compensation is as follows:

- A true focus on long term;
- Secondly, a focus on operating performance, not just stock performance; and
- A true focus on long-term ownership.

3. Lou Dobbs, *The End of the Era of Excess*, U.S. NEWS & WORLD REP., Sept. 30, 2002, at 54.

Now, over the long term, the experts tell me, there is a high correlation between stock prices and performance. It is over the short term that there are these deviations.

Now, had there been a high correlation between compensation and performance, I think we would have had a very different public mindset than we do at the present time.

We make a number of recommendations. I will try to rush through some of the more important ones. The fact that we achieved actual unanimity on twenty-two of them and unanimity-minus-one—Andy Grove of Intel—on the expensing of options is some indication that a group of respected Americans can achieve some consensus when they really look at this situation.

First, the compensation committee, in our view, has to take charge, which they had not taken in many cases, and in particular, take charge of retaining any outside compensation consultants. If we have time, we can talk about it. I think this assumption that outside compensation consultants, outside law firms, outside auditors, are truly outside is one of the fundamental issues that has to be explored in corporate governance.

I am afraid in too many cases, and most certainly in compensation consultants, these outsiders came to see the management, not the independent directors, as their client. As their management-generated fees go up, we should not be surprised if they would be restrained in their enthusiasm to bite the hand that they perceive as feeding them. In 2000, consulting fees were about three times the auditing fees. Compensation consultants got a wide variety of fees that were not directly related to executive compensation. So we think it is essential that the independent directors pick the compensation consultants and they both hire them and fire them.

I have become a great booster of Warren Buffet, not that he needs it. He has been highly supportive of our effort. He appeared at our press conference recently. He referred to compensation consultants as being named "Ratchet, Ratchet & Ratchet," on the grounds that there is a tendency to keep ratcheting up compensation. Having been on eight compensation committees, I do not ever recall a case where a compensation consultant said, "You guys are getting paid too much."

Second, the compensation committee, in our view, should be

unconstrained by industry averages and statistics and by current levels, which in some cases may be excessive.

Garrison Keillor in "Lake Wobegone" talks about a wonderful place where everybody was above average. In our approach to compensation, we almost assume everybody must somehow be above average.

If current levels are excessive—and certainly, in certain companies I think they are—we want to avoid any notion that "last year the guy got $11 million, so let's start from there and figure out how to pay him more." We ought to go back to baseline-zero-based budgeting.

Third, we think, obviously, as you can tell, the options should be expensed. I have heard all the arguments for and against. Perhaps we will have some time to discuss it. But we think FASB and the International Accounting Standards Board should have a uniform system to get comparability.

Fourth, we think senior management and directors should do two things with options. First, they should have a substantial holding period. Secondly, the senior officers should have very substantial long-term ownership requirements, even until they retire if they wish, to achieve this unity between long-term corporate interests and executive compensation.

Fifth, we believe that companies should assiduously avoid the use of special-purpose entities to enrich executives. I read a most illuminating, but melancholy, report by the Dean of the Texas Law School on the special entities in the case of Enron, and it is indeed very sober reading when you realize the immense conflicts of interest it created between the employees and the corporation.

Sixth, we support very conspicuous disclosure of all employment agreements, all arrangements—and we mean conspicuous.

One of the circular arguments we ran into for why this should not be disclosed and that should not be disclosed is "it is in the footnotes." The argument seems to be: "Well, they already know it; it is in the footnotes." Well: "If they already know it, why are you objecting to making it conspicuous?" Given what has happened recently on retirement perks and so forth, we come out very strongly for full and conspicuous disclosure.

Seventh, we think that stockholders should approve any and

all aspects of stock equity compensation, and most certainly in terms of re-pricing of options. The most controversial recommendation that we made, but, ironically enough, we did achieve unanimity, for whatever that is worth, is the notion of adverse notice of the intention to sell stock.

As we look at what bothers the American public in all these headlines that I mentioned, it is the notion that somehow somebody must have known something before they sold the shares; otherwise, how could they have made this much money and then the stock soon tanks by over 75 percent, as in the case of the *Fortune* story. We, therefore, suggest that new techniques be developed for advance notice of the intention to sell stock, because we think that gets at what is truly bothering a lot of people. The combination, we think, of a substantial holding period and long-term ownership, plus advance notice would have alleviated a lot of what we have now observed.

I have gone on too long. Let me now ask Mr. Colon if he will talk about independence of directors, including investment bankers.

MR. COLON: Thank you very much.

I want to briefly talk about the current proposals that have been put forth by both the NYSE and NASDAQ regarding corporate governance.

The NYSE's report grew out of a request by Harvey Pitt to have the Exchange review its corporate governance standards. As a result, there were meetings and testimony was taken, and the proposal that was submitted to the SEC on the 16th reflects the findings of these meetings.

I am going to briefly describe what I believe are the most important points, critique them, and then raise some questions. I think it would also be very instructive if persons with actual experience of serving on boards of directors were to give their views as to the possible or probable effects that these listing standards have on corporations.

First, some procedural background. The NYSE has submitted its report to the Securities and Exchange Commission ("SEC"). It has not yet been published for public comments, and the SEC is probably reviewing it. When it is published for public comments, interested parties can weigh in with their views. And then, it will

hopefully be enacted relatively quickly.

The NASDAQ proposal has not yet been submitted to the SEC. Apparently, it is being reviewed now by SEC personnel.

There are three parts of the report that I am going to focus on.

The first is the requirement that the board of directors of NYSE listed companies be comprised of a majority of independent directors. Currently, there is no such requirement by either NASDAQ or the NYSE. There is currently a requirement of the NYSE that each listed company have three independent directors.

From my observations, most large companies—the Intels and Microsofts of the world—have boards of directors that are largely independent, including Enron, which everyone recognized had purportedly a supermajority—a large majority—of independent directors.

The requirement that a majority of directors be independent is being proposed by both NASDAQ and the NYSE.

In addition, the NYSE is also proposing requiring a regularly convened executive session of the independent directors. They will be required to regularly convene without the participation of the inside directors.

Finally, the NYSE is proposing that each listed company have an audit committee; a nominating committee—it could be called a corporate governance committee; and a compensation committee—three separate committees. Currently, there is no required nominating or compensation committee.

Each of the committees will have to go through a couple of procedural hoops, including promulgating corporate governance standards, written charters, and conducting yearly evaluations. They have to, in essence, grade themselves. They will have certain discretion in how the committees are named, but basically, all companies will have to have audit, nominating, and compensation committees.

There really is no definition in the NYSE listing requirements of who constitutes an "independent" director. Currently, the only definition of independence is found in the rules for the audit committee, but that definition does not apply to other areas.

If the NYSE proposals are enacted, the board of directors is going to have to affirmatively determine that a director has no material relationship. I think this is very important. As Mr.

Peterson alluded to, that someone is truly independent is really a question of fact, and the board of directors will have to affirmatively determine that there is no material relationship.

There are increased restrictions for deeming a director independent. There will be a cooling-off period for former employees of auditors for five years. Right now, it is three. I think it has always been a concern when former auditors end up being on the board of directors. One must question whether they are truly independent. The requirements also cover immediate family. I do not think anyone would object to that.

So we have the tightening of the definition of independent directors, both by NASDAQ and the NYSE; the requirement that the majority of directors be independent, and then the requirement for the three separate boards—the nominating, audit, and compensation committees—that have to be composed of wholly independent directors.

Now, bad corporate governance is somewhat like crime—everyone is opposed to it, but the solutions for eradicating it are where reasonable people disagree. I do not believe that enacting these proposals would be a panacea for a lot of the abuse we saw last year with WorldCom and Enron. Take Enron as an example. They had a supermajority of independent board of directors. Almost all large corporations in the United States have a majority of independent board of directors. The NYSE report claims that having a majority of independent board of directors "will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest." Well, I think the last statement is certainly clear.

But I am not so sure about the first—what do we really mean by "increasing the quality of board oversight?" There have been some recent academic studies published within the last two years focusing on board independence and return to shareholders. I think ultimately that is what everyone is concerned about. By having a board that is, in essence, controlled or captured by the CEO or management, there is the potential for a lot of self-dealing and for the shareholders to end up getting the short end of the stick.

These studies have actually found to the contrary; they have found that there is no relationship between independence and

shareholder returns.

There are some questions as to how to measure independence, and that is obviously a debatable issue, but the studies seem to have found a negative correlation: the more independent the directors, the less the shareholders have benefited. So I think that these studies should give us some pause before jumping on the independence bandwagon.

Since most large corporations already have a majority of independent directors, corporations that are going to be the most affected are the smaller, more specialized companies. For them, I think the costs of having the three separate committees and having a majority of independent directors may be substantial.

The report did not cite a single authority supporting their finding that having a majority of independent directors would increase shareholder return and increase the quality of board oversight. This seems to be somewhat of an over-reliance on anecdotal evidence. If a majority of independent directors is good, why not a supermajority? Again, nothing in the report suggests that a supermajority would be better or worse.

Another issue that has not been addressed is the relationship between independence and compensation. Should we have the directors' compensation consist solely of cash? Should we have it tied to the performance of the stock? A lot of people have argued that we should have some kind of alignment of the shareholders' and directors' interests. But then, I think we end up facing some of the similar issues that Mr. Peterson mentioned regarding compensation in general, especially options. When you have options, you create asymmetric payoffs: "good results—I get rewarded"; "bad results—well I just have to find a new board to serve on"; "something terrible happened—act of God; it is not my fault."

The proposals may focus somewhat too narrowly on the monitoring function—overseeing management—of the board, which is probably its most important function. But there are a lot of other aspects to being on a board—I think Mr. Peterson could probably give us some insight on this.

Being a director not only involves monitoring, but also developing relationships and assisting in strategic planning. I believe here independent directors may be at a very significant

disadvantage to quality insiders. Who is going to know the business of a corporation as well as someone who has been up through the ranks, knows the competitors, and knows the business risks, better than an insider? Will companies be better off, especially smaller companies, if they are forced to go out and recruit independent directors, and have to rely on people who do not have as much information and relevant human capital as the current insiders have?

We have to be concerned with the requirement of separate executive sessions. A board has to be an institution of collegiality; it has to act by consensus. By requiring separate executive sessions of the board, the proposals may create divisions between the independent and executive directors. Query, what is going to be the results of the decisions taken at these executive sessions? Will the insiders be forced out of the decision-making process if the decisions have already been made by the independent directors in these executive meetings? I don't know. I think some distrust and divisions could certainly develop among boards.

I have spoken enough. I want to conclude by saying that many of these ideas or proposals are well intentioned but many of them are already followed by most large corporations—in fact, they were followed by many of the corporations that suffered disastrous blow-ups—so I think we should not look at them as a panacea to prevent future Enrons.

Furthermore, I think that they will cause significant problems for smaller, more specialized companies that will be forced to find independent directors. This may not be easy, given the potential greater liability and risk that they may incur. Also, it will not be easy for smaller companies with specialized operations to find the person with the requisite knowledge.

I think that these proposals should be viewed with some amount of caution, and perhaps some flexibility should be considered, such as exempting small cap companies from some of these requirements. That is it.

MR. PETERSON: Thank you.

John Foster is a member of the Federal Accounting Standards Board, which has some fascinating history. I was telling John I read much of Arthur Levitt's book. If we have time, I would be interested in whether his recollection of history is roughly the same

as yours, Mr. Foster.

MR. FOSTER: It is pretty close.

MR. PETERSON: Thank you.

MR. FOSTER: I am pleased to have the opportunity to return to this conference this year. In the past, I have mostly discussed the accounting for derivatives, and, since I was addressing lawyers about accounting issues, I felt pretty comfortable. I am not sure why I was not on the accounting panel this morning, but here we are.

This year I am going to discuss the role of the audit committee, which, with the recent passage of the Sarbanes-Oxley Act ("Act"), has become a legal issue. I do not feel quite as comfortable addressing lawyers about legal issues, so I am not going to give you an in-depth analysis of the law or the listing requirements of the exchanges as they relate to audit committees. I assume that most of you are lawyers or law students and much better than I at reading and interpreting the law. Rather, I am going to focus on the role of the audit committee and what I believe are the necessary requirements for an audit committee to function efficiently and successfully.

However, before I do that, I would like to focus on at least some aspects, the fundamental aspects, of Sarbanes-Oxley, perhaps the most important of which is making the audit committee responsible for a company's relationship with its independent auditors. In that respect, the audit committee is directly responsible for the appointment, the compensation, and the oversight of the auditor, and is also responsible for pre-approval of all audit services and non-audit services.

Moreover, as has been discussed, the Act does require that each member of an audit committee be independent. Sarbanes-Oxley does define what is "independent." It means that audit committee members "cannot accept any consulting, advisory, or other compensatory fees from the company, or be an affiliate of the company."[4]

The Act also requires the SEC to issue rules respecting disclosure as to whether the audit committee includes at least one

4. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745 (2002).

financial expert; and, if not, why not. This provision, along with specific exchange requirements that have been proposed, will almost force companies to have someone on the audit committee that has some financial expertise.

That completes my summary of the legislation, obviously from 50,000 feet. I leave the rest of the legislation and its interpretation in your capable hands.

Before I go on, I have a standard disclaimer. The views that you are going to hear today are my views, they are not the views of the Financial Accounting Standards Board ("Board"). Those views are only set through due process and long deliberations. So keep that in mind.

Also, I have got a lot of notes, and I will make reference to my notes during my remarks, but I hope you will excuse me and not think, as Winston Churchill once did when he was asked by a young Member of Parliament how he had liked his speech: "First of all, you read it; secondly, you read it poorly; and thirdly, what you read was not worth reading."

Audit committees of boards of directors have been in existence for a long time. However, until recent years, I think the role of the audit committee was often unclear. In fact, back in the late 1970s and early 1980s, I was practicing public accounting, and most of the audit committees of my clients thought that their principal responsibility was reducing audit fees. I would doubt that today members of audit committees share that belief.

Even before the recent failures in financial reporting and the recent passage of Sarbanes-Oxley, the SEC and the stock exchanges began to focus their attention on the duties of the audit committee.

In 1999, the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, which was set up at the behest of Arthur Levitt, who was then Chairman of the SEC, issued recommendations to approve the independence, operations, and effectiveness of audit committees.

In response to that report, the stock exchanges, including the NASDAQ stock market, adopted new listing requirements that were applicable to all listed companies, and the SEC issued a rule for new disclosures about audit committees.

In response to Sarbanes-Oxley, those listing requirements

have been strengthened. But, as I said, since most of you are familiar with those requirements, I am not going to get into them today. Even if you are not familiar with them, I suspect you will get much more from reading them yourselves than having me recite them.

I believe the most important responsibility of the audit committee is to oversee financial reporting. The other key responsibilities, evaluating the audit process and assessing the company's internal control system and risk management capabilities, are directed toward and support the primary goal of quality financial reporting.

Many believe that financial reporting is the responsibility of the auditors. But while the auditors assume responsibility for attesting that the financial reports prepared by management fairly present the financial condition and the results of operations of companies, it is management, and ultimately the board of directors, that have responsibility for preparing the company's financial reports. Implicit in this responsibility is management's assurance that the information is not only complete and accurate, but that it can be relied upon by investors and creditors when they make decisions.

I believe that much of the cause of what happened at Enron and the other recent failures can be attributed to the short-term focus of the entire financial community and the resultant pressures on companies for reporting steady increases in quarterly earnings. Companies that can achieve steady growth in earnings are rewarded with handsome price/earnings multiples, and managements that achieve steady growth are also rewarded with what in my view are grossly inappropriate amounts of stock options.

I have nothing against stock options. In fact, in the interest of full disclosure, my personal financial situation was greatly improved as a result of options that I received at Compaq Computer Corporation. But I thought, along with everybody else, I better get my two cents in about stock options, since I did not get to be on the accounting panel.

My views are very similar to Mr. Peterson's. I would observe that it was originally thought—and in some circumstances, it is clearly true—that options align the interests of management with

the shareholders. Recently, however, we have seen a lot of companies re-price employee stock options when the share price declines, and some have questioned whether management's interests are truly aligned when the shareholders lose when the stock price goes down.

Some might argue that, rather than aligning interests, there is a clear conflict. Management, because it will benefit greatly by increases in stock prices but has little down-side risk, has incentives to enter into risky ventures that might result in spectacular returns but might also result in significant losses. If a risky venture fails, they will have lost nothing, having paid nothing for their options; but they will win big if the venture succeeds. And generally, even if the venture fails, management will get new or re-priced options.

Moreover, the volumes of options that are granted to management are so large in many cases that management is given almost perverse incentives to maximize profits in the short term with little regard for the long term, and this tendency is exacerbated by the fact that the average tenure of a CFO or a CEO is roughly four years.

So we have a situation where management has tremendous incentives to maximize reported earnings in the short term, and these incentives have also resulted in management's pushing the accounting envelope, and sometimes companies have actually strayed from the requirements of existing standards.

The recent focus on the role of the audit committee, and the new requirements imposed on it, are the result in large part, I believe, of this tremendous pressure to meet Wall Street's expectations. In the current environment, after the fallout from several cases of financial fraud that led investors to broadly view financial information with skepticism and to new legislation aimed at improving financial reporting, a prudent audit committee would be wise to assume the following responsibilities:

- Most importantly, the audit committee should understand and evaluate whether corporate management has set a tone that encourages quality financial reporting.
- It should identify, through discussions with various operating and financial managers, the risk and related financial reporting issues that the business presents.
- It should also understand the company's critical accounting

policies and assess the appropriateness of management's selection of the accounting principles used in preparing financial statements.

- Estimates are a necessary part of financial reporting, and the audit committee should understand how those estimates and the related assumptions have been developed.
- The audit committee should review with management and the independent auditors significant or unusual transactions, particularly those transactions that occur near the end of a reporting period.
- And, of course, the audit committee should review all earnings released and quarterly financial statements to assess whether the financial statements, including disclosures, are complete, accurate, and fairly presented.
- In addition to direct financial reporting responsibilities, an audit committee and its members should have a clear understanding of the quality of the company's internal control systems and the oversight of that system. Many, if not most, companies have an internal audit department, and that department focuses principally on the performance of the company's internal controls and processes. To ensure that the internal auditors are properly focused, the audit committee should be involved in developing the internal audit department's goals and missions.
- In addition, the director of internal audit should report directly to the audit committee, and both the audit committee members and the director of internal audit should have unfettered access to each other.

The 1992 Report of the Committee of Sponsoring Organizations of the Treadway Commission ("COSO Report")[5] defined internal control as "a process effected by an entity's board of directors, management, and other personnel designed to provide reasonable assurance regarding the achievement of objectives and effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations."

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5. Committee on Sponsoring Organizations of the Treadway Commission, *Internal Control—Integrated Framework* (1992), *available at* https://www.cpa2biz.com/CS2000/Products/Product+Detail.htm?cs_id=%7B1DC6F23C%2D70C6%2D4816%2DA3CD%2DAE70236B7992%7D&cs_catalog=CPA2Biz (last visited Jan. 28, 2003).

An audit committee should not only be familiar with that report, which is called the "COSO Report," but could use that definition to assess the quality of the company's internal control systems.

While it is clear in legislation and other rules that the audit committee has responsibility for relations with the independent auditors, this is a relatively recent development. Prior to the report of the Blue Ribbon Committee—and, unfortunately for some companies, even after—the principal relationship between the independent auditor and the company has been with management. Yes, the auditors usually meet with the audit committee, but I think in many circumstances those meetings are perfunctory and that the auditors were very judicious in what was said about the critical accounting issues and the management of the company. Sarbanes-Oxley makes it clear that the auditors are the client of the audit committee, not management.

In that regard, the audit committee should ask for—and receive—frank assessments of the competence of financial management, as well as the auditor's opinion on the quality of the company's critical accounting policies and the accounting treatment for unusual transactions. Only an informed board can make appropriate decisions.

I want to return to an earlier observation, and that is the tone at the top. It has occurred to me that one of the key elements in each of the recent failures in financial reporting was the proverbial "tone at the top." While the audit committee is not directly responsible for tone at the top, it should ensure that the company's culture prescribes appropriate conduct in preparing financial information.

The National Association of Corporate Directors identified four basic principles for protecting shareholders against fraud and other illegal acts. I am not going to discuss all of them because they are not directly on point.

But the first—and, in my view, the most important—principle is setting the tone at the top through conduct and communications. That is, establishing a corporate culture that is committed to lawful and ethical behavior that begins at the highest level and permeates the rest of the organization.

In closing, I would like to emphasize that in the current

environment audit committees must be diligent and proactive, and they must be willing to devote the time to develop relationships with the independent auditors and with management responsible for financial reporting to understand the company's business and the risks it faces, including complex transactions that it enters into, and to understand the company's critical accounting policies and the effect of those policies on reported information.

Audit committee members cannot accept what is put before them. They must ask questions. Moreover, as Bob Herdman, the Chief Accountant at the SEC, said in a recent speech, "Asking a good question is only half of the equation. Obtaining an understanding of the answer is equally, if not more, important."

That wraps up my prepared remarks. I look forward to any questions that you might have, or observations.

MR. PETERSON: Thank you very much to both of you.

We have about fifteen minutes or so for questions. Let me ask you the first one.

Expensing of options is clearly the most public controversy—Arthur Levitt calls the decision to back off his biggest mistake in the book—and that the FASB members were, by and large very much in favor of that. To what extent is that your version of history and what does that tell you about the appropriate way of monitoring and maintaining the independence of FASB?

MR. FOSTER: That is a difficult question. I cannot crawl into his mind as to whether he regrets that. I presume, since he said so. But this was in 1993–1994, and there was tremendous pressure brought on the Congress—in particular, by the high-tech community, but it was pretty much universal—that expensing options was inappropriate and the wrong answer—universal on the part of the business community, that is.

I think that many people, including Chairman Levitt, believed that the very existence of the FASB was threatened by this pressure. There were resolutions passed in Congress and there were other threats to undermine the independence of the Board.

My personal opinion is that the Board should have stood its ground. In fact, I dissented to the statement because I believe that political pressure is an inappropriate reason not to stand your ground and that you give up your independence by folding. But

the majority of the Board concurred that the Board was threatened and agreed to a compromise which required disclosure of stock compensation expense in the financial statements as well as its effect on earnings but did not require it to be reflected in the basic financial statements.

MR. PETERSON: What then was the fundamental leverage on Arthur Levitt and on the rest of the Board members? Budgetary, that Congress would not finance you? Or what? What was the threat, in other words?

MR. FOSTER: The biggest threat was a bill that was introduced by Senator Lieberman that would have required every decision of the FASB to be approved by the SEC, so essentially taking standard-setting responsibility out of the private sector.[6] That was the real threat.

QUESTIONER: Any comments on the exemption from independence for a company that is controlled by 51 percent of the shareholders and the period allowed for the independence to take place after that situation changes?

MR. FOSTER: You mean with respect to independent directors?

QUESTIONER: Yes.

MR. COLON: Actually, he is alluding to in the report or in each of these proposals there is an exception for controlled companies, so the parent/subsidiary situations are where you have a substantial majority shareholder.

Again, the report notes this affects, incredibly, very few—less, I think, than 1 percent—of the companies that are listed. It will be interesting to see whether these companies' stock performance will be better than the companies that are now going to be governed by these. I think it will be somewhat interesting.

Yes, I think that is a good idea. But that was only put in after there was significant pressure by parent/subsidiary corporations or ones where there was a significant shareholder. So again, those companies, control companies, are exempted from these requirements that I mentioned.

But I think, again, it gives flexibility. It realizes that this kind of "one model fits all" is not appropriate for all companies. I hope

6. Accounting Standards Reform Act of 1994, S. 2525, 103rd Cong. (1994).

that they give more consideration in the public comment-and-notice period to exempting, or perhaps providing some safe harbors for, smaller companies.

QUESTIONER: Do you think the SEC will go along with the two-year period?

PROFESSOR COLON: He is also alluding to the fact that you have twenty-four months before the independent requirement becomes effective, so the boards that currently are not in compliance have twenty-four months.

That I do not know. I do not have any particular inside information. If any of the participants here or any of the attendees do, please feel free to volunteer.

MR. PETERSON: I want to admit to a profound conflict of interest here. We are one of the larger buyout funds. We have a number of situations where we are the control shareholder.

We take the point of view—you may think of it as self-serving; I do not know—that if we are talking here about alignments of owners and management, we think there is a very close alignment, at least in the companies we own, because when we do a deal with management in the company we always insist that they put a substantial amount of their own net worth into long-term ownership of the business and that there is an up-front understanding on the exit strategies, as it were, and typically they do not exit except proportionately when we the owners exit.

So I think in those cases, at least the theoretical argument is there is much more of an alignment of interests when a substantial owner is involved in this matter compared to anyone else. But others may disagree with that. I do not know.

QUESTIONER: Secretary Peterson, you made a point of expressing disappointment that large stockholders, such as mutual funds or insurance companies, accumulators of interest, really had been relatively quiet on this issue. It seems to me that these are asset holders, or stockholders, who in many cases exceed the size of the companies that they are holding stock in. And yet, they have really done nothing to force accountability, to do the sorts of things an audit committee ought to be doing. They have just been lackadaisical, if you want to use that expression, and have defeated their fiduciary interest representing the people that rely on them for investing.

Can you make a comment about that and propose some solution?

MR. PETERSON: Well, it is among my areas of ignorance to understand what the dynamics might be that explain this phenomenon. There are a couple of explanations that I have heard.

One, while we talk at great length in America about long-term owners, apparently there are relatively few such owners, because the turnover, I am told, in stock—on the mutual funds, for example—is 122 percent a year. So that there is perhaps a shortage of people who are long-term owners. This does not diminish the fact that our country as a whole has a deep public interest in the viability of a company long term, for all sorts of obvious reasons.

The second reason I think they have not been involved has to do with a kind of special conflict of interest that in my level of naïve ignorance I had not understood. Some of the biggest holders of stock in companies are also asset management firms, and they are soliciting business from the corporations that they are asked to vote against in some cases.

In quite a few cases, we have been told in our inquiry that the corporations contact them. I do not know whether you would call it implicit linkage or explicit linkage. The implication is that "if you really want our asset management business, we hope you will remain friendly with us." So there is that conflict that results.

Third—and I would hope this is one of the reasons—there has not really been a vortex or an axis around which such an effort could be organized. We now have these three major representatives who, believe me, are passionate about what we are doing.

I have already written one hundred of the largest public pension funds, and John Biggs and I and others are speaking to them. We are going to suggest the following to them: that if there is such a thing as democratic capitalism, it depends on the notion of votes in a free society. We are going to propose that you review our best practices and that you write to companies in which you have ownership positions, and simply ask them before you vote which of these best practices they currently have, which they intend to have; and, if they do not, why not. Then, express whatever displeasure you have by how you decide to vote.

I used to be a CEO of a Fortune 500 company, and I can tell you we used to track negative votes very carefully. At least in those days, which was many years ago, when a negative vote on a given issue had three percent or four percent or five percent, we got very concerned about it.

You have a situation now where a small handful of institutions control over half their stock. If only a small percentage of those would get organized around a given set of best practices, I am naïve enough to think that it would make a huge difference.

The other thing that has to happen here, frankly, on the corporate side is I think there has to be some private-sector CEO leadership. If you think I am boring on this subject, you should hear me on budget deficits.

But I have started budget efforts of this type in the past, when I was concerned by the Reagan fiscal policy in the 1980s and what it led to ultimately. What I found there was that if you go to a large business trade organization, they are very much like any large organization—they operate by consensus basically. Leadership and boldness is not about consensus.

There is a brilliant piece written by Shepherd Mead that I read once, called "The Glob." He pointed out that any important new ideas have edges to them, and if you present that kind of an idea to a group, they start filing off the edges and you end up with a glob.

What we discovered on the budget deficit was if we could get six or eight or ten leading CEOs, men of real conscience and boldness and so forth—like Jeff Immelt at GE, who is a classic example—that others will decide maybe it is politically correct, or socially correct.

But I think it is going to take some combination of private-sector leaders in business and in the investor movement organized around some best practices. And I think we are going to have to persuade particularly the CEOs that this is appropriate not only for positive reasons but for defensive reasons.

For example, in Congress today, there are proposals roaming around there that, much like that million-dollar cap created all kinds of effects, could have some very unfortunate effects.

There is one proposal being talked about, for example, that an executive could not sell a single share of stock while he was there. I am not smart enough to predict what the iatrogenic effects are,

but you can be sure there would be some such effects. And there are several other such ideas.

I gave a talk the other day, and Ralph Nader, of all people, who is not one of my normal colleagues in life, said, in all good conscience, "Well, Mr. Peterson, I would like to hear your reaction to the proposal that all compensation plans would have to be approved by a stockholder vote." Well again, I just cannot imagine what all the implications of that would be.

So I think there is both a positive reason why the private sector ought to get involved and there is a defensive reason why they ought to get involved. We are going to find out whether we can be successful in doing it. But I am a great believer in volunteerism on the particular subject of executive compensation.

QUESTIONER: I was taken a little bit by your comments about the asset managers, particularly where they might be seeking other business but not want to be very active in helping on the corporate side of the activities. With the proliferation of index funds, I would be curious as to when, if ever, a Vanguard or a Fidelity or the other mutual funds—and, indeed, the pension funds—ever bought these index fund's holdings. For example, they would have, let's say, four or five percent of that index fund holding a Royal Dutch or Exxon, et cetera. It seems to me that it is easy to escape taking a position.

Yet, these funds who have that fiduciary duty do not seem to be stepping out and saying, "I will not be passive," even though the investment is passive, and actually take an active role: "I will be proactive in managing the activities of a corporation where I hold shares in my fund." What would be your reaction to that?

MR. PETERSON: Well, I am sure you all know who Jack Bogle is, of Vanguard. He is going to be one of the leaders of our effort to get the investor community organized. He is extremely upset about the passivity of investors. And, as you know, they are major players in the index business. So I am hopeful that they will get involved.

QUESTIONER: Coming back to the questions that are being raised, I think this is a situation where you just need to have fewer laws, laws that are unambiguous, as opposed to leaving it up to the shareholders.

For instance, the $1 million limitation for management, about

which I asked the Wall Street people, and they kind of snickered and said they did not pay any attention to that and there were all kinds of ways to get around it. Now, one way to have effect is to have limitations that are meaningful.

And then, a second question. There is perhaps something wrong with a situation in which CFOs can retire with $50 million salaries, $50 million retirement contracts, a couple of weeks before they get sued, and then it is almost impossible to get the money back without going through civil suits.Is there any way to get the money back, aside from civil suits and criminal suits?

PROFESSOR COLON: That is our legal system. There is not really any self-help in this area. For me, I am somewhat happy that we have a system like that. I think we will see how this all plays out. I mean, if there is fraud, there is fraud, violation of fiduciary duties, there is a panoply of laws. Apparently, New York State Attorney General Elliot Spitzer is invoking the Martin Act[7] here to go after these people if there were abuses.

I think what we are looking for in the future, though, is to have something in place that prevents this—having different incentive structures, different compensation structures, to prevent just the "being able to take the money and run" possibility.

But I think we still have not seen the end. There will be many years of litigation for these somewhat unfortunate fellows. I think we have not really seen the end of that yet.

Regarding the compensation, I think we have a system here, a free market system, where companies should be able to pay what they think is appropriate to get the best talent. Now, you and I can disagree about how much is too much—you know, is Michael Jordan worth that much; any of the baseball players, any of the CEOs? I think here part of the problem is we want to make sure that if they do get this compensation that they have earned it, that they have added long-term value for shareholders. I think as long as everyone else is thriving, people will have a lot less concern about paying.

There is a competitive market out there, as I think someone like Mr. Peterson could probably tell you, about good-quality, reputable CEOs.

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7. N.Y. GEN. BUS. LAW § 352 (2002).

QUESTIONER: I am hearing a level of complacency about the corporate governance reforms that are on the table. It seems to me that they are mostly corporate governance reforms that have not worked very well in the past and would not do very much help to prevent a future Enron.

Professor Colon talked about outside directors. Yet, a recent academic study just says that there is no correlation between the percentage of outside directors and the firm's profitability. The proposals and the refinements to audit committees have been on the table, and this Blue Ribbon Committee Report is years old and certainly predates Enron, and it did not seem to have any effect on the audit committee's practices there.

We can expense stock options, but we know, and we have known for a long time, that the top executives get paid a lot of money. That information is disclosed in the annual reports, and it does not seem to provide us with a basis for reducing that compensation

So isn't the idea of getting these best practices on the table and getting institutions on-board really a kind of superficial response if we really are in a crisis of corporate governance right now?

MR. FOSTER: I would make one observation. The data that Professor Colon presented relative to independent directors and returns—the notion that an independent director is just somebody who does not work for the company. I think that under Sarbanes-Oxley, if their definition of independent director is extended and applied broadly, a lot of those directors would not be considered independent—again, if that definition is applied broadly. Perhaps there will be some change relative to that.

MR. PETERSON: Might I say, to add at least a slightly optimistic note in this rather melancholy discussion, aside from believing deeply in getting leadership in both sectors—and I think you are going to begin to see some real progress—let's not minimize the almost sea-change that is already taking place in boards of directors that does not get widely reported.

I must tell you that I do not know whether it is a combination of shame, pride, or even fear, because I think you are going to find in some cases, that some guys will be going to jail.

If you can stand a little bit of levity, our President, for all his other virtues, engages in malapropisms every once in awhile, as we

all know. The other day, he reportedly said, "I think it is terribly important that we get these guys in cufflinks."

That may indicate a certain social class or orientation. I do not know.

I do not know—where there have been these egregious cases of inattention, indifference, conflict of interest, self-serving—whatever you wish to call it—I do not know whether directors are going to get sued on a personal liability basis or not, whether you think that is a possibility under American law.

But what I am trying to suggest is the board members I have talked to in the last month or two—I can tell you that it is not just a question of whether they are independent or not; it is a question of how involved they have been. In too many cases, they have been too uninvolved. I can tell you they are a hell of a lot more involved today than they were two months ago in reviewing all of their responsibilities.

Finally, so much has been said about auditors and compensation consultants, and most certainly investment bankers, and their conflicts, but I have had two or three experiences as a major director of a major corporation where I have been less than enthralled with the performance of outside law firms when it came to investigating alleged improper practices of their regular clients. In at least three cases, I have seen major law firms who were also the beneficiaries of major fees for Mergers and Acquisitions ("M&A") and all sorts of other services.

I have been in private firms. I understand your compensation is related to your revenues. I do not know that enough attention has been focused, if I may, on what the ethics and the appropriate practices are for outside law firms in the event of a truly independent investigation.

I can tell you in two cases—and I do not want to go into details here—of major corporations that, in the presence of an investigation, used their regular law firm. I found their "investigation," to characterize it most benignly, to be extraordinarily passive, and in each case I hired my own law firm, and in each case they came up with very different findings as to the problem.

So I do not know whether this falls into the ethics of law firms or the practices, but I do not think we ought to kid ourselves.

So, having ended on a highly offensive note, I want to thank our fellow panelists very much for their contributions. Thank you.

PROFESSOR RECHTSCHAFFEN: Secretary Peterson, thank you very much for being here and sharing your thoughts, which are exciting, and at the end controversial as well.

Once more, I want to thank Secretary Peterson. I think he deserves one more round of applause.