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Keynote Address

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KEYNOTE ADDRESS

*Governor Susan Schmidt Bies**
Member, Board of Governors of the
Federal Reserve System

PROFESSOR RECHTSCHAFFEN: We are very honored this year once more to welcome a Member of the Board of Governors of the Federal Reserve System.

* Susan Schmidt Bies took office on December 7, 2001, to a full term as a member of the Board of Governors of the Federal Reserve System ending January 31, 2012.

Dr. Bies received a B.S. in education from the State College of New York at Buffalo in 1967 and an M.A. (1968) and a Ph.D. (1972), both in economics, from Northwestern University. Dr. Bies has served as a Fellow at the Federal Reserve Bank of Chicago (1969-70) and as a Fellow at the Northwestern University Center for Urban Affairs (1968-69).

Before becoming a member of the Board, Dr. Bies was Executive Vice President for Risk Management and Auditor at First Tennessee National Corporation, Memphis, Tennessee (1995-2001). From 1979 to 1995, she served in various other positions at First Tennessee, including Executive Vice President and Chief Financial Officer, Senior Vice President and Chief Financial Officer, Senior Vice President and Treasurer, Vice President for Corporate Development, Tactical Planning Manager, and Economist.

Before joining First Tennessee, Dr. Bies was Associate Professor of Economics, Rhodes College, Memphis, Tennessee (1977-79); Assistant Professor of Economics, Wayne State University, Detroit, Michigan (1972-77); and Chief Regional and Banking Structure Economist at the Federal Reserve Bank of St. Louis (1970-72).

Dr. Bies has been active in leadership positions for various organizations, including the Emerging Issues Task Force of the Financial Accounting Standards Board, the Committee on Corporate Reporting of the Financial Executives Institute, the End Users of Derivatives Association, the American Bankers Association, and the Bank Administration Institute.

She has also served with numerous other organizations including the American Economic Association, Institute of Management Accountants, International Women's Forum, American Economic Association, Economic Association of Memphis, University of Memphis, Memphis Area Chamber of Commerce, Memphis Youth Initiative, and Memphis Partners.

The most important thing I want to emphasize about Governor Bies is that she has been on both sides of the fence. She has served as an officer of a major corporation and now as a regulator, as a Member of the Board of Governors of the Federal Reserve System.

We are very honored to have Governor Bies with us today. With that, I would like to introduce a Member of the Board of Governors of the Federal Reserve System, Governor Susan Schmidt Bies.

GOVERNOR BIES:¹ I want to thank Dean Treanor and Alan Rechtschaffen for the invitation to participate in this timely symposium on corporate governance issues. When I joined the Federal Reserve Board of Governors last December, I knew I would be doing more than helping to set short-term interest rates. While the general public and market focus on the decisions of the Federal Open Market Committee, Board members spend much of their time on various operating committees, focusing on payment and settlement systems, and the safety and soundness of financial institutions and markets. But the rush of current events has meant that I have spent less of my time dusting off my economics Ph.D. and more time using my experience as a corporate chief financial officer, auditor, risk manager, and accountant, to consider the policy issues of recent corporate control failures.

Today I want to focus on the role that risk management can play in strengthening corporate governance from the point of view of boards of directors, management, and internal control functions.

I. MANAGING RISKS

The last decades of the twentieth century were, without a doubt, a period of dramatic change in financial engineering, financial innovation, and risk-management practices. Enterprise-wide risk management has been evolving as financial theory has advanced, new technology has made modeling of risks more

1. Governor Susan S. Bies, *Remarks by Governor Susan S. Bies*, Annual International Symposium on Derivatives and Risk Management (Oct. 8, 2002), at <http://www.federalreserve.gov/boarddocs/speeches/2002/20021008/default.htm> (last visited Jan. 28, 2003).

feasible, and innovation has helped to find better ways to mitigate risk. Some types of risk are further along in the evolutionary process.

While there are many ways to categorize risk, I will use three broad categories for illustration—market, credit, and operating. Operating risk is the least developed, as conceptual frameworks, metrics, and databases are still in preliminary stages. I will come back to the issues surrounding operating risk in a few moments.

Market risk arguably has evolved the furthest because of the transparency of markets, frequency of transactions, and financial engineering that can parse the various forms of risk exposure so that appropriate financial instruments can be developed to hedge the specific components of risk. The treasury functions of corporations routinely use models to assess and manage price, interest rate, liquidity, and foreign exchange risk. As a result, managers can better anticipate changes in revenue and expense due to these factors and develop responses to their specific circumstances.

One tool for managing risk is securitization. Many of the assets on a firm's balance sheet, such as receivables and customer leases, can now be securitized—that is, grouped into pools and sold to outside investors. Securitization helps a firm manage the risk of a concentrated exposure by transferring some of that exposure outside the firm. By pooling a diverse set of assets and issuing marketable securities, firms obtain liquidity and reduce funding costs. Of course, moving assets off the balance sheet and into special-purpose entities, with the attendant creation of servicing rights and high-risk residual interests retained by firms, generates its own risks.

Derivatives are another important tool for managing risk exposures. In the ordinary course of business, firms are exposed to credit risk and the risk of price fluctuations in currency, commodity, energy, and interest rate markets. For example, when an airline sells tickets months before a flight, it becomes exposed to fluctuations in the price of jet fuel. A higher price of jet fuel translates directly into lower profits and, perhaps, a greater risk of bankruptcy. Firms can now use derivatives—options, futures, forwards, and so on—to mitigate their exposure to some of these risks. The risk can be transferred to a counterparty that is more

willing to bear it. In my example, the airline could buy a forward contract or a call option on jet fuel to hedge its risk and thereby increase its financial stability.

Another major category of risk is credit risk, which also has become much more quantified. Models analyze a corporate customer's or borrower's probability of default, the loss in the case of default, and the borrower's likely exposure at the time of default, taking into consideration future draw-downs. The greater use of credit models in retail transactions provides a stronger framework to assess risk and ensure that pricing reflects credit quality. For consumer credit, however, models are less proven, since data collection and loss estimates generally evolved after the 1990-91 recession and so have not been proven under stress conditions or for subprime borrowers. Because many of these borrowers did not have significant access to credit in previous recessions, their ultimate default rate in the current cycle should help to validate the strength of the new statistical models.

For example, the health of financial institutions today reflects the improvement in the risk management process that has been ongoing at banks for many years. Increasingly, the entire risk management process has become more quantitative, reflecting not only the enhanced ability and lower costs of collecting and processing data, but also improved techniques for measuring and managing risk. The banking industry has been able to report record earnings in the first half of this year, despite rising loan losses for large corporate credits and credit cards. Banks have diversified their revenue streams to mitigate the impact on earnings during credit cycles. And by improving risk management processes, bankers have learned to identify risk exposures that exceed the target return on capital and sell, hedge, or use controls to mitigate risk exposures.

II. RISK ASSESSMENT

As corporations grow larger and more diverse, it becomes more difficult for executive management and boards of directors to monitor activity across the company. Directors, particularly, do not have the time to understand all of the transactions occurring. Thus, a key issue for boards and audit committees is how to focus their

attention to the appropriate areas. This is where a sound risk management and internal control framework can be very helpful.

The Sarbanes-Oxley Act requires management to issue a report about the quality of internal controls. A similar requirement was put into effect for banks in the Federal Deposit Insurance Corporation Improvement Act of 1991.² Since then, bankers have adopted approaches along the lines of the Committee of Sponsoring Organizations' of the Treadway Commission (COSO) Internal Control Integrated Framework.³ This requires all managers, at least once a year, to step back from other duties, and evaluate risks and controls. Each manager considers current and planned operation changes, identifies the risks, and determines appropriate mitigating controls and the effectiveness of those controls.

Managers then report their assessment up the chain of command to the chief executive officer, with each new level of management in turn considering the risks and controls under their responsibility. The external auditors attest to the results of this self-assessment in banks, and results are reported to the audit committee of the board of directors. Thus, the process helps management communicate among themselves and with the board about the dynamic issues affecting risk exposures, risk appetites, and risk controls throughout the corporation.

Risk assessments such as the one outlined in COSO's internal control framework presumably could be useful in assessing the relative risk and returns from various lines of business when formulating business strategies. But not all corporations and boards consider risk as a part of their annual strategic planning or other evaluation processes.

A study conducted this year by the Institute of Internal Auditors and the National Association of Corporate Directors showed that directors are not focusing on risk management.⁴

2. Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (1991).

3. *Internal Control—Integrated Framework Executive Summary*, available at http://www.coso.org/Publications/executive_summary_integrated_framework.htm (last visited Jan. 28, 2003).

4. Institute of Internal Auditors and National Association of Corporate Directors, *After Enron: A survey conducted by The Institute of Internal*

Forty-five percent of directors surveyed said their organization did not have a formal enterprise risk management process—or any other formal method of identifying risk. An additional 19 percent said that they were not sure whether their company had a formal process for identifying risks.

Sound corporate governance is an essential element of a strong risk management process. Governance involves many players, each with specific assigned responsibilities to ensure that the system as a whole is sufficient to support the business strategy and ensure the effectiveness of the systems of internal control.

Directors are not expected to understand every nuance of every line of business or to oversee every transaction. They can look to management for that. They do, however, have the responsibility to set the tone regarding their corporations' risk-taking and to oversee the internal control processes so that they can reasonably expect that their directives will be followed. They also have the responsibility to hire individuals who they believe have integrity and can exercise a high level of judgment and competence. In the light of recent events, I might add that directors have the further responsibility to periodically determine whether their initial assessment of management's integrity was correct.

Indeed, beyond legal requirements, boards of directors and managers of all firms should periodically test where they stand on ethical business practices. They should ask, for example, "Are we getting by on technicalities, adhering to the letter but not the spirit of the law? Are we compensating ourselves and others on the basis of contribution, or are we taking advantage of our positions?"

III. RISK MANAGEMENT AND INTERNAL CONTROLS

Boards of directors are responsible for ensuring that their organizations have an effective audit process and that internal controls are adequate for the nature and scope of their businesses. The reporting lines of the internal audit function should be such that the information that directors receive is impartial and not

Auditors and the National Association of Corporate Directors (Jan. 31, 2002), at <http://www.theiia.org/iaa/publications/newsletters/caebulletin/directors-enron.ppt> (last visited Jan. 28, 2003).

unduly influenced by management. Internal audit is a key element of management's responsibility to validate the strength of internal controls.

Internal controls are the responsibility of line management. Line managers must determine the level of risks they need to accept to run their businesses and to assure themselves that the combination of earnings, capital, and internal controls is sufficient to compensate for the risk exposures. Supporting functions such as accounting, internal audit, risk management, credit review, compliance, and legal should independently monitor the control processes to ensure that they are effective and that risks are measured appropriately. The results of these independent reviews should be routinely reported to executive management and boards of directors. Both executive management and directors should be sufficiently engaged in the process to determine whether these reviews are in fact independent of the operating areas under review and whether the officers conducting the reviews can, indeed, speak freely.

In many of the recent corporate and audit firm failures that have received public attention, basic tenets of internal control, particularly those pertaining to operating risks, were not followed.

Recent events should remind boards of directors, management, and auditors that internal controls and sound governance become even more important when firms' operations move into higher-risk areas. Indeed, when changes are happening, control failures often increase significantly. Rapid growth, merger of operation centers, and introduction of new products and delivery channels are examples of situations that put stress on the control environment.

When these types of changes occur, "people risks" rise. These are risks that are related to training employees in new products and processes. Employees who join the organization need to learn the culture of the company and the control environment. Employees unfamiliar with their new responsibilities—the systems they use, the services they provide customers, the oversight expected by supervisors and members of internal control functions—are all more likely to create control breaks.

Rapid growth and change also modify the relative risks to an organization. New lines of business may require different

customer-qualification tests to meet the expected levels of customer risk exposure. Further, the pressure to beat a competitor to market with new products may shortcut the design-review process and omit an important control or allow a programming error to adversely affect the software used to deliver the services.

Many of the companies that have been the center of recent governance failures demonstrate some similar characteristics. They were lead by hard-charging entrepreneurs whose ability to think outside the box pioneered advances in new lines of business. But the personalities of these individuals, in many cases, led to a focus on sales growth and support and inadequate time spent building the control infrastructure.

Another form of people risk is internal fraud. When expectations of the market and supervisors, or pressures of personal life become overwhelming key officers may step over the ethical and legal boundaries and cover up errors or purposely steal from the corporation. While executive fraud is very difficult to detect, it is eventually discovered. Obviously, during the past year, we've seen severe reactions to observed failures within corporations—not only from investors and creditors, but also from lawmakers and regulators.

Although risk management has become much more quantitative, considerable management judgment must be applied to the risk management process. Frequent, small losses can generally be absorbed in the operating margin of the product or service. It is the low-probability, large losses that provide the greatest challenge. And, it is just such risks—the ones that can severely damage, if not kill, an organization—that too many enterprises do not formally take into consideration.

When one looks at the extreme loss events for many types of operating risks, for example, executive frauds, it is easy to recognize that the normal bell-shaped probability distribution does not fit. Rather, the extremely long-or fat-tailed distributions emphasize that risk management and internal control judgments must be applied. What is even more difficult, is that some exposures can better be classed as uncertainties than as risks. That is, patterns of losses, and risk drivers, are very hard to identify. Terrorist attacks, technology breakthroughs, and other events that cannot be defined ahead of time often have significant implications

for the loss exposures of corporations.

Indeed, recent events have demonstrated that the complexity and size of modern corporations create significant market risk exposures that give management and the board of directors little time to react after serious breaches in internal controls become known. Reputation risk, especially in a trust business like banking, can lead to loss of liquidity, cancellation of major new contracts, and indictments, which bring the ultimate corporate loss—failure of the firm. And as we have seen, the market's response can be harsh.

IV. RISK MANAGEMENT AND DISCLOSURE

The intended or unintended consequences of the opaqueness that comes with complexity raise serious issues for financial reporting and corporate governance. Effective governance requires investors and creditors to hold firms accountable for their decisions. But they must first have the information necessary to understand the risks that the firm is bearing and those it has transferred to others. Here again, enterprise risk management can provide a framework through which management and boards can convey appropriate information that will allow outsiders to understand the company's risk exposures and how the company limits and manages those risks.

Public disclosures by corporations need not follow a standard framework that is exactly the same for all. Rather, we should insist that each entity disclose the information it believes its stakeholders need to evaluate its risk profile. Each business line in a complex organization is unique, and—to be most effective—the specific disclosures of its risks should be different, too. Even in smaller organizations, disclosures should be tailored to reflect the activities of the organization. A summary of the information that executive management and the board of directors need to monitor the health of the enterprise is an excellent place to start when tailoring the information that would be useful to investors and customers. Disclosure rules that are too rigid may become incompatible with risk management processes that continually evolve.

Disclosures should clearly identify all significant risk exposures—whether on or off the balance sheet—and their impact

on the firm's financial condition and performance, cash flow, and earnings potential. With regard to securitizations, derivatives, and other innovative risk-transfer instruments, traditional accounting disclosures of a company's balance sheet at a single point in time may not be sufficient to convey the full impact of a company's financial prospects.

For example, if a firm securitizes receivables through commercial paper conduits, those receivables are no longer on the company's books under current accounting standards. Yet the aging of receivables is a key indicator that investors and lenders use to assess the quality of sales and operations. If the receivables move off the balance sheet, information about the aging of the receivables should continue to be part of the firm's disclosures.

Equally important are disclosures about how risks are being managed and the underlying basis for values and other estimates that are included in financial reports. These disclosures should identify key risk drivers and describe the range of possible outcomes. Unlike typical accounting reports, information generated by risk management tends to be oriented less to a point in time and more to a description of the risks and the variability of results.

To take an example from the world of banking where the discipline of risk management is relatively well developed, an accounting report might say that the fair value of an investment portfolio is \$300 million and has dropped \$10 million from the last report. However, the bank's internal risk report would show much more extensive information, such as the interest rate, maturity, and credit quality of the assets and the range of values the portfolio would take under alternative future scenarios. The user of a risk-management report could determine whether changes in value were due to declining credit quality, rising interest rates, portfolio sales, or payoffs of underlying loans.

Corporate risk officers have developed other types of reports that provide information on the extent to which the total return in a particular line of business compensates for the line's comprehensive risk. On an enterprise basis, a reader of covariance reports can determine whether the growing lines of business have risk exposures that tend to offset those in other business lines—thereby resulting in lower volatility for the earnings of the

corporation as a whole. If the lines of business have high correlations, investors would expect management and the boards of directors to have in place more significant processes to monitor and mitigate those risks.

Complex organizations should continue to improve their risk-management and reporting functions. When they are comfortable with the reliability and consistency of the information in these reports, they should begin disclosing this information to the market, perhaps in summary form, paying due attention to the need for keeping proprietary business data confidential. Not only would such disclosure provide more qualitative and quantitative information about the firm's current risk exposure to the market, it would also help the market assess the quality of the risk oversight and risk appetite of the organization.

A sound risk-management system in a complex organization should continually monitor all relevant risks, including credit, market, liquidity, operational, and reputation risks. Reputation risk, which recent events have shown can make or break a company, becomes especially hard to manage when off-balance-sheet activities conducted in a separate legal entity can affect the parent firm's reputation. For all these risks, disclosures consistent with the information used internally by risk managers could be very beneficial to market participants.

In conclusion, an effective enterprise-wide risk management process can provide executive management and the board of directors with a framework to strengthen the governance process. Risk management can identify where exposures exceed the risk-tolerance limits and determine where investments in enhanced controls can most effectively mitigate remaining risks. The evolution of risk management can provide metrics for management and the board of directors to assess the relative returns from various forms of risk exposures and can help shape strategic decisions. For companies undergoing rapid growth and those engaged in relatively new business processes and practices, risk management can provide a method for developing an internal control infrastructure to support the success of the business strategy.

Further, the risk management framework can improve the transparency of disclosures to help investors and customers better

understand the operations of the firm. I particularly want to emphasize that disclosure need not be in a standard accounting framework or exactly the same for all organizations. Rather, each entity should disclose the information its stakeholders need to best evaluate the entity's risk profile. Companies should be less concerned about the vehicle of disclosure and more concerned about the substance of the information made available to the public.

No business can afford to remain static, and firms of all sizes should continually pursue better ways to manage risk. The discipline of risk management is still relatively young. Investments in better forms of risk management processes often reduce losses and provide a more robust framework for evaluating business alternatives. Following sound risk management, governance, and disclosure practices consistently is also crucial to maintaining the confidence of capital and financial markets. Boards of directors and executive management are responsible for ensuring that the corporate governance process is conducted with competence and integrity. If they do, our economic system should grow stronger.

That is the end of my formal remarks, but I would be glad to take any questions from the floor.

PROFESSOR RECHTSCHAFFEN: Governor Bies, you talked about directors' lack of focus on risk management and the concept of reputational risk. I think that shareholders now are focused on risk management. Who is going to sound the "all clear" for shareholders? Who is going to make people more confident so America can continue to fetch the America premium? What is going to occur for me to go invest the money I have in the bank so I would feel comfortable that now corporate governance rules are in place that are going to make people act honestly when you cannot legislate others?

GOVERNOR BIES: I think we are still in a repair phase of the recent events. Clearly, confidence is lacking in markets today, and investors are right in waiting to see what is really going to happen as an outcome of all of this.

One of the things I find the saddest in this whole episode is that the groups who should be leading the charge and strengthen the focus of their responsibilities—mainly the outside and internal accounting and audit professions—have generally been very silent,

particularly the American Institute of Certified Public Accountants (“AICPA”).

You know, one of the things—as was said earlier today, public accountants are there not for management, not for the boards, but to attest to investors, to attest to customers who enter into long-term contracts with companies, that “this is a sound, reputable company I can do business with.” But those outside auditors, we have learned, are much more interested in cross-selling additional services than in what their framework is for really servicing their true calling.

We would not really need outside auditors if we lived in a world of management reporting. Any company can do their internal books any way they want. We only have them to display information to the world.

I sat with a group of corporate financial officers a few years ago, and we were all concerned at the time because we were not getting enough good talent in the colleges and universities in auditing and accounting, so we were having difficulty recruiting enough students. The AICPA very proudly showed us this videotape they wanted us to take along on our visits to campuses to help recruit students into the exciting world of accounting.

When you looked at this recruiting tape, it talked about how you too can be an accountant and work on strategic issues, shoulder-to-shoulder with the CEOs of the companies, and how you are going to be able to look at new technologies and new products and help design business processes.

Nowhere in this ten-minute video did it say:

Folks, you are entering into a profession that is at the core of the foundation of the American capitalist system, which relies on full, open, transparent disclosure to investors. You play a critical role in that. You have got to make sure that these reports fairly reflect what is going on in companies. And your life is going to be tough, because you, as a young person particularly, are going to have to stand up to CEOs and tell them when controls are broken, and you are going to have to stand up to business line managers and tell them when the way that they want to account for a particular transaction is not appropriate. It is going to build your character very quickly.

The real-life experience of what young folks will go through as

they enter the profession of accounting and auditing were not described in this film. And I think it is because the whole AICPA profession is just focused on cross-selling, cross-selling, cross-selling, and not the core values.

And until we get back to the core values, I worry about how we are going to restore confidence. Maybe the market will say, "Gee, we have not had a breakdown that has been publicly announced in the last six months; that is behind us."

But, long term, we are not going to get at it until all of these things that were talked about in earlier panels do — boards really look at risk management, really have management involved in looking at risk — and do not use internal controls as a way to cut expenses when earnings are tough, because that is when you need them the most. Control stress breaks happen more when earnings are weaker.

QUESTIONER: Governor Bies, you brought up the fact that two-thirds of the corporations do not have central risk management departments. This is really horrible to hear. Through my experience of about six years in the financial industry with a number of global investment banks, I have noticed that we have department-specific control rooms for compliance officers or risk management controls.

Do you have any data on corporations having the department-specific controls while not having the central risk management, company-wide risk management group?

GOVERNOR BIES: I do not have that, but I would say that is one of the concerns we have, and I have as a bank regulator, because if the control oversight is only within the business unit, where is the independent judgment coming in? It compromises. Very often, we will find control units part of the business unit, where the individuals do not feel empowered and are not effective in getting the senior management in that business line to make the changes necessary to enhance controls.

That is one advantage of having enterprise control functions, is that the individual—whether it is a compliance officer, a risk manager, a credit underwriter—can go to a similar function in the corporation as a whole and say, "Look, I am not getting anywhere."

And, likewise, if you have an enterprise system, you can look

at the effectiveness. Maybe to cut cost they downplayed it, put a rookie in. For example, one of the recent publicly known breakdowns occurred because the young auditor who was told to look at foreign exchange controls had never seen one before. You know, it would be a miracle if that young person could have found it in his first engagement.

So I am leery that you can really say you have got an effective system of internal controls and governance if you do not have an ability to have an independent oversight outside of that line of business.

QUESTIONER: Thank you, Governor Bies. In your remarks you indicated that growth industries are most at risk for these kind of audit problems. Other than maybe the high-tech industries, which everybody is familiar with, do any others come to mind?

GOVERNOR BIES: I would say any company around. And just think about it. If you have got stable management, stable products, stable systems, stable people, you know what you are doing. Risk happens when you have breakdown in processes, and so you have systems changes, you have people without the knowledge, you have got unanticipated sales volumes, and there is pressure on management to make those numbers.

Change itself is an important driver of control issues. If you look at the framework on COSO, or if you look at basic texts in audit, you will find that is a theme that recurs all the time. It is true for big companies and small companies. It is true for even what you might consider a stodgy industry. I mean, if you look at banking, for example, we see control breakdowns in fast-growing banks, just because — you know, it may only be a \$50 million bank, but it is a young enterprise that is growing very quickly. Well, you have got people trying to do multiple things at the same time; they are trying to learn to work together. They say, “Oh, I thought you were going to do that.” “No, you were going to do that.” Your responsibilities are moving, and whenever the dynamics are that intense, you have a greater likelihood for breakdowns to occur.

PROFESSOR FELSENFELD: Governor Bies, thank you very much for coming.

GOVERNOR BIES: Thank you.

Notes & Observations