Trends in Corporate Integrity

by Alice Winkler

As big business struggles to salvage its image, corporations are taking a closer look at their governance procedures to go above and beyond the requirements of Sarbannes-Oxley and ensure their corporate integrity. Corporate governance has made the news headlines over the past year, largely because of its failures. The meltdown at corporations previously thought to have epitomized the essence of American industry, i.e. Enron, Tyco, and WorldCom has largely been blamed on a lack of proper corporate governance. Therefore, in order to reassure shareholders, employees and consumers that these types of debacles are a matter for the history books, adequate governance procedures will have to be instituted.

Major companies are finding that they can expand upon the legislative standards implemented buy Congress in the Sarbannes-Oxley Act. As such, they are going above and beyond the requirements which they are obligated to follow and are implementing added controls to ensure the integrity of their internal procedures. The success or failure of these initiatives will shape the nature of corporate governance and impact the very essence of how companies will do business going forward.

In order to understand how to fix corporate governance, certain goals must be established at the outset. A corporation needs to be committed to an independent qualified board of directors. This implies that the individual directors not only have the skills they need to perform their duties, but that they have the authority to act freely within the constraints of their own experience.

Splitting the Role of CEO and Chairman of the Board

The Chairman of the Board is responsible for setting the Board's agenda and ensuring that directors receive the information they need to act. Therefore, a Board that is charged with overseeing the activities of a CEO simply cannot do its job properly if the very same CEO is also presiding as its chairman. Although some argue that splitting these roles will impede the Board's operation, it will clearly obviate an inherent conflict of interest that has become ingrained in American corporate structure.

A Blue-Ribbon Commission on Public Trust and Public Enterprise organized by the Conference Board in January 2003 recognized this contradiction in terms, recommending that the role of Chairman of the Board and CEO be divided, and that the position of chairman be held by an independent director. In situations where the chairman is not independent or the role of the CEO and chairman is not split, the commission advised that an independent “presiding” or “lead” director be appointed. Practically speaking, the lead director can control the information flow to the directors, the board agenda and preside over meetings of independent directors, making it easier for them to voice any concerns without undue pressure. This prevents the CEO from being raised to a heightened “super” status that is immune from challenges.

Shareholders are also pushing for this change. According to the Investor Responsibility and Research Center, as of November 2003, there were approximately 40 shareholder resolutions seeking a division of the responsibilities of CEO and chairman. This is in stark contrast to last year’s tally, when only 4 similar resolutions were filed for the entire year.

More notably, the transformation is more likely to come from within boards themselves. According to the *29th Annual Board of Director’s Study (2002*) published by Korn/Ferry, only 23% of respondents who had a CEO acting as chairman had a lead director. In sharp contrast, 61% agreed that when the position of chairman is held by an inside director, an independent lead director should be appointed.

According to statistics set out in a report by the Corporate Library in 2003 entitled *CEO/Chairman Splits in the Fortune 500: How Many and How Independent,* there are currently only fifteen Fortune 500 companies where the Chairman of the Board is an independent director, and 392 instances where he or she is also the CEO. Nevertheless, there is increasing pressure to restructure the traditional role of the CEO/chairman, especially due to legal troubles precipitated by poor governance practices.

For example, splitting the position of chairman and CEO at WorldCom was one of 78 directives issued by Richard Breeden, Corporate Monitor in the bankruptcy case filed by WorldCom. Similarly, Sprint created a lead director position as part of a legitimate settlement with its shareholders. Companies ranging from Charles Schwab to Pathmark have also elected to divide the duties of the CEO and chairman between two individuals in order to ensure the integrity of their board procedures.

Directors’ Responsibilities

But beyond the chairmanship of their boards, companies need to evaluate the processes by which their boards do their work. Directors must have the proper qualifications to evaluate the corporation’s performance, the personal commitment to challenge management when necessary and the time to devote to their responsibilities.

According to Sarah Treslik, Executive Director of the Council of Institutional Investors, “[a]s long as boards are chosen the people they’re supposed to oversee, oversight won't happen."[1] Board members that are hand picked by the CEO simply cannot be classified as "independent." They also cannot be independent if they work for companies that have extensive dealings with the company of board they serve.

In recognizing this basic fact, the Securities and Exchange Commission recently approved new corporate governance regulations which according to the Investor Responsibility Research Center, will require that approximately 70% of the S&P 500 corporations and 66% of the companies listed on the New York Stock Exchange make changes to their boards. These regulatory changes include the requirement that boards of directors be comprised of a majority of independent directors and have director nomination procedures that are controlled by the independents.

Notwithstanding the process involved in the appointment of a director, once an individual has accepted the responsibility of being on the board, he or she must have sufficient time to dedicate board duties. In 2002, the average director devoted 250 hours to board-related work, double the time spent in 1999. Independent board members are also spending more time meeting in executive sessions, outside the purview of the CEO, so they can assess board business in an objective manner. As such, some companies are limiting the number of boards on which their directors may serve. The National Association of Corporate Directors (NACD) recommends that board members who have full-time positions sit on no more than four boards. But some companies, such as General Electric, Home Depot, 3M and IBM, have imposed stricter limits, restricting their board members and/or chairmen from serving on more than three boards including their own.

Another element of ensuring that directors perform their duties successfully involves providing them with appropriate training. Clearly, members of audit committees require the necessary financial expertise to perform their duties, and are being trained in these functions. But a trend is evolving to ensure that the rest of the board receives training as well. This may range from a formal orientation program to requirements such as those implemented by GE and Home Depot that their directors visit their plants and offices a pre-specified number of times. Alternatively, this training can take the shape of attendance at formal training programs that teach the skills the directors need to successfully complete their duties. It is notable that the proxy advisor firm, International Shareholder Services, considers the formal training of board members as an element of its "corporate governance quotient," the measure of corporate soundness it utilizes to rate companies for its clients.

Moreover, in order to insure that board members are properly performing their duties, it is essential that their performance be adequately and consistently

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[1] *Corporate Governance (A Special Report) – Opening the Board The Fight is On to Determine Who Will Guide the Selection of Directors in the Future,*" Wall Street Journal, October 27, 2003.

appraised. According to Korn/Ferry's *29th Annual Board of Directors Study,* while 71% of respondents indicated that directors should be individually rated evaluated, only 19% do so, and less than half evaluate the board's performance as a whole. The emerging trend however, is for boards to initiate some form of peer evaluation that addresses directors' ability to perform their duties in an independent and committed manner, while making significant contributions to the board.

In exchange for this heightened level of scrutiny and liability, executive compensation is expected to grow. In fact, we can safely surmise that as directors serve on fewer boards, there will be a growing scarcity of qualified directors and a corresponding impact on director compensation. Executive compensation consulting firm Pearl, Meyer and Partners determined in its *2002 Director Compensation Survey* that directors' compensation remained flat that year with most companies taking a "hands off" position and waiting for the proposed regulatory changes to take effect.   However, the survey projects that compensation will have increased 20% by the end of 2003, and will ultimately increase 50% by 2005. Clearly this spike contrasts with the 10% increase over the last five years.

The Corporate Governance Officer

To top off these changes, note the rise of the Chief Governance Officer (CGO). Since the passage oif Sarbannes-Oxley, 33% of all companies surveyed by the American Management Association in its 2003 *Corporate Governance Survey* responded that they had hired a CGO. These individuals are charged with ensuring compliance with all internal controls and policies related to corporate governance and will drive the compliance element of corporate governance internally. They are entrusted with the role of "corporate watchdog" and are expected to have the authority to independently oversee board processes.

As more companies hire CGOs, employees and shareholders will have a well defined outlet for their complaints and allegations of abuse. These individuals in essence will be the final level of internal board review and the final level of corporate scrutiny implemented to protect shareholders from a repetition of the scandals and corporate excesses which have wreaked havoc on the American economy.

The current trend in re-evaluating the corporate governance process is just beginning. In order to present a cohesive governance program to shareholders, investors and employees, companies must be creative in evaluating current processes and developing new ones.

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