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Founded in 1974, Boardroom Consultants was the first firm to specialize in governance consulting and director selection. Since that time, the firm has become a recognized leader in succession planning and top-level management recruitment as well. Because Boardroom Consultants believes that the best and worst things that happen to a company start with the board of directors, our mission is to help companies improve their corporate governance. Services include counseling with chief executives and boards on such issues as board structure, committee charters and best practices; benchmarking for succession planning purposes; and providing in-depth board assessments involving top management and the entire board. The firm's Advisory Directors, seventeen former chief executives of major corporations, are an exceptionally valuable consultative and due diligence resource.

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his annual gathering provides an interactive forum for business leaders from around the world to share critical thinking, best practices and observations on changes in the advancement of leadership and governance. This year, 80-plus directors convened at the New York offices of TIAA-CREF, one of the nation's largest institutional investor and pension firms to discuss what's working and what's not. Our attention centered squarely on measuring the independence of boards and their committees, on the practical aspects of directorship today and the ideas that will lead to further constructive change tomorrow.

GOVERNANCE, FRONT AND CENTER

The most progressive companies and their boards realize that corporate governance is not just a matter of figuring out what is legally required – and weighing that against the price for non-compliance. Their objective is larger than that. Their focus is on living up to the ideals of our free enterprise system where effective leadership combines not only drive and ambition but also business savvy grounded in highly ethical principles and a long-term view.

To conform to the spirit behind existing and new rules, boards obviously need to consult regulations, listing requirements and best practices. But they must also seek their own answers to determine what works for them because there are no panaceas. And cosmetic improvements – at best – create a false sense of security.

The real issue behind governance is and always has been leadership. What follows is a summary of the events and lessons learned about leadership and governance at this year's Institute.

HONORING TWO PIONEERS OF GOVERNANCE

This year, the Institute on Board Committee Independence paid tribute to two leaders who, through their individual actions, helped inspire today's major shifts in board governance. "Both of these individuals acted with the courage of their convictions," said Roger Kenny, Managing Partner of Boardroom Consultants, in his introduction. "Both are

visionaries who created important turning points for independence and governance."

John Smale, First Non-Executive Chairman of a Major American Company

Today, executive sessions are mandated. But when John Smale, behaving as a true lead director, took the unprecedented step of gathering the independent board members together for the first time ever at General Motors, governance had finally reached a decisive moment. His action, supported by his fellow directors, led not only to the recovery of a great American institution but set a higher standard across the board for governance. General Motors, by adopting and communicating its now famous set of guidelines and utilizing a leadership structure – separating the roles of Chairman and CEO – that was strongly resisted in this country but provided the impetus of a new relationship between GM management and the board, became a beacon for a new era.

John Biggs, Champion for Investors and Advocate for Business

With an unwavering belief in the importance and value of governance, for years John Biggs has been encouraging companies to improve the independence of their boards. In looking for an effective way to approach management on this issue at the companies held by TIAA-CREF's various portfolio of funds, he established a rating system that would identify those most in need of some counsel on governance. But unlike other ratings systems, TIAA-CREF's has been designed by a committee of its board members, all of whom have

The First Annual Institute on Board Committee Independence

extensive experience serving as public company directors. Their understanding of how business really works sets TIAA-CREF's system apart from others that appear to have a more narrow social agenda or questionable data gathering techniques. Instead of using public media to gain the attention of management, Mr. Biggs favors a personal, low-key and private approach: he sends former chief executives to discuss any concerns that TIAA-CREF may have. He readily admits that these sessions often lead to a deeper respect and understanding on both sides and there have been many instances when TIAA-CREF has backed off after companies have been able to make a strong case for the actions in the context of their business issues. This willingness to find out what's really going on and an appreciation of both the challenges and the value of the free enterprise system, makes John Biggs an ideal champion for shareholders, and, at the same time, a true advocate for business.

THE SIGNIFICANCE OF INDEPENDENCE

At one time, the board at General Motors was not much different from the boards of most major American companies. Directors saw their role primarily as advisers or consultants; their major constituency was management; and their job was to try to help management in any way they could. The system seems to work adequately enough until, as happened at GM, the company becomes mired in trouble.

When a crisis occurs, directors are starkly reminded of their true role as representatives of the *owners* of the company. For GM, this epiphany resulted in a decision to overhaul the company's leadership and sparked a quest for independence that resulted in naming one of America's first non-executive chairmen, John Smale.

Once directors, and management, adopt the mindset that shareholders are the board's ulti-

mate constituency, a different culture emerges—one that can have a very deep and positive impact. At GM, this translated into a board with a fuller understanding of the company's business, a desire for more comprehensive and relevant information, and a willingness to work side-by-side with management to confront tough challenges.

It's easy to see how a board's focus can get derailed. Corporate ownership today is so broad, that stakeholders include not only the traditional large outside shareholder, but also management teams, employees who own shares, individual shareholders, and often the community at large. The only way to be responsible to all these diverse groups, it seems, is to have a long-term view that takes into account more than just share price, and to focus on oversight as much as guidance.

But is a more independent board and more diligent oversight the answer to corporate woes? According to John Smale, realistically speaking, it is very difficult for an independent board member to bring any kind of penetrating judgment to the operation of a corporation. "There's just no way board members can become familiar enough with the details of an operation to be able to have a significant voice in how that corporation runs outside of the context that management provides."

Ultimately, it seems, it all comes down to communication. "The most important role of the non-executive chairman," said Bob Weissman, the new lead director at State Street Corporation, "is one of communication that leads to positive results as opposed to simply creating tension."

The new Stock Exchange governance recommendations specify holding regular executive sessions—an idea that one member who worked on the project feels is the single most important new requirement. What formerly grew out of exasperation has become a disciplined and planned opportunity for directors to share their concerns among themselves and then to communicate with the CEO. Regularly

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their role primarily as advisers or consultants; their major constituency was management; and their job was to try to help management in any

scheduled executive sessions give directors a chance to discuss concerns before they boil over, and give CEOs a chance to bring up issues that they would like the independent directors to address. Both are legitimate uses of the board's time.

Whether a company goes as far as naming a non-executive chairman, or chooses instead to designate a lead or presiding director, heightened independence has become the touchstone for measuring governance—especially as it relates to how the board and its committees are composed and how they carry out their responsibilities.

In light of this, the Institute on Board Committee Independence paid careful attention to current trends among the board's three key independent committees: Governance and Nominating, Compensation and Audit. Highlights of these discussions follow.

THE GOVERNANCE AND NOMINATING COMMITTEE: PROVIDING PERSPECTIVE

The new Governance and Nominating Committee is charged with making sure the board is doing its job. Its name change—from Nominating Committee to Governance and Nominating Committee—has already worked some magic, making this committee one of the more exciting in contrast to its inoperative past.

Among its first responsibilities is to translate governance regulations and recommendations and put them in perspective for a particular company, because, noted Mercer Delta Consulting Chair Dr. David Nadler, “it is very easy to have good governance on paper but bad governance in practice.”

Compliance alone is not enough. Given the limited time directors have available for their work, there is also the issue of substance. The committee must ask: “Are we focused on the issues that are most important to the company?” Here are some suggestions to help the Governance and Nominating Committee fulfill its charter:

- *Review the board's statement of its role and responsibilities.* If the board has not articulated what is expected of management and individual directors, now is the time to do it. Specify how the board is going to add value.
- *Define the board's future criteria for membership.* Board succession is as important as CEO succession, although the former traditionally gets the lion's share of attention. Be wary of recruiting directors who are only adept at dealing with current hot issues. Those with a long-term strategic view and experience may better serve the company. Once the future direction of the company is established, look for directors with skills suited to those future needs.

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– Dr. David Nadler
- *Identify critical board agenda items.* Focus the board's attention and facilitate discussion of critical items such as strategy development, management development, succession, compliance and operational performance. This is how the lead director, or independent chair, can help maximize the directors' time.
- *Take the time to build trust.* To be effective, directors must trust that management is bringing them their problems, that benchmarking information is accurate, and that all other information—financial or otherwise—is delivered in a straightforward manner. Building this kind of trust, if it doesn't yet exist, takes time. Much depends on how the board reacts to information. Bob Weissman recounted the deal he struck with his board, promising that management would remove the “kabuki dance” quality to information they deliver, if the board would accept the fact that there are no easy answers. In fact, by working through the “high, hard” issues

together, the answers would evolve. A board that insists, and *allows*, the CEO to engage in free and open discussion about the difficult issues will find that this kind of culture leads to more informed decision-making and better outcomes.

- *Embrace board assessment.* Boards must evaluate themselves—the NYSE listing requirements demand it. When done well, board evaluation is a powerful process

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that can keep a board on track or move it in a more positive direction. Boards that rely on checklist methods, or who believe the issue is simply one of compliance are missing the point. Roger Kenny advises directors to dig below the surface to understand what’s really happening in the boardroom. “Directors need a platform to present their honest views on what’s working and what’s not. In our experience, the six or seven items that directors identify as being critical to their effectiveness as a board are the same items they have the least confidence in. Closing this gap is what board evaluation is all about.” It’s not an easy process, but it will result in a more highly functioning team, especially if you engage a third party in the process to ensure confidentiality and candor.

An added benefit to heeding these suggestions: companies that do so will have an easier time attracting the best directors, who are now looking for secure situations and more transparent business practices in the boardroom.

THE COMPENSATION COMMITTEE: BACK THROUGH THE LOOKING GLASS

For the last couple of years, to much of the public, the Compensation Committee appears to have been operating in some kind of Wonderland where the world was upside down. As compensation for senior executives and CEOs shot up, shareholders saw their own values steeply decline.

While executive compensation has always created an annual stir, it has now become a litmus test for governance and accountability.

Compensation is at the heart of what may become a milestone legal case on governance. In late May, the Chancery Court of Delaware received feedback from the Supreme Court when it denied a motion to dismiss the case against Walt Disney directors in connection with their proper knowledge and role—or lack thereof—in approving the company’s contract with Michael Ovitz. In this case, the board’s fiduciary duties of care and loyalty, known as the business judgment rule, will be tested on the issue of compensation. It is a cautionary note for directors. The Delaware Court (and other state courts are sure to follow) will be taking a careful look at the question of whether directors are acting in good faith when determining compensation.

The truth is, boards do have a responsibility to rein in management when they are indifferent to shareholders and employees by awarding themselves outlandish compensation packages, pension and perks. But Compensation Committees have been operating without guidelines and its members, unlike those of the Audit Committee, are not legally required to have any particular expertise.

New and emerging requirements for Compensation Committees are more demanding. Now, all directors will have to be more knowledgeable about and engaged in the activities of both the Compensation and Audit Committees. All directors will be held accountable—not just the official committee members.

On a positive note, directors are beginning to ask questions about the absolute compensation levels of CEOs and how CEO compensation relates to others’ within the organization. “Compensation Committees and managements of well-governed companies are voluntarily changing their key policies, procedures and disclosures in advance of potential new mandates and shareholder initiatives,” notes

Pearl Meyer, Chairman of compensation consultants Pearl Meyer & Partners. The major movement is on rebalancing pay packages to take into account not just stock price and annual performance, but also long-term performance and individual goals in order to motivate and reward people for real performance.

But what *is* real performance? “We’re talking about annual incentives that are geared toward running a business right every day, every week, every month, every year and getting people within the organization to commit to how that business should be run,” explained Pearl Meyer. “There is a shift toward focusing on individual responsibilities rather than playing the team game. Too many people have been allowed to hide behind the team and the stock price.”

The Compensation Committee should also be paying attention to broader compensation goals—with a focus on executive and senior management levels, of course, but also with a clear understanding of how these programs affect other levels within the organization. “Enterprise vitality relies on motivating and rewarding *all* participants. Compensation plans that undermine this fact also undermine board stewardship,” observed Nina Henderson, a board director and Compensation Committee member.

An Elephant in the Boardroom: Performance vs. Stock Price

There is an obvious disconnect when short-term performance outranks long-term vitality, and it is a direct result of focusing solely on stock price when evaluating management performance. It is the proverbial “elephant in the room” for any director. Institutional investors play a significant role in this. The fact is that the largest 100 mutual funds in America control 50 percent of the equity, and mutual fund managers get measured by how much stock values rise or fall over the time period of the fund’s average holdings (typically about 11 months) rather than on the management quality of their portfolio companies. This truncated view creates distortions that have been harmful.

IRS ruling 162m, effectively capping CEO salaries to \$1 million, only compounded the problem by serving as a catalyst for finding new ways to deliver rewards to senior management, the most pervasive of which has been the stock option, a cheap and abundant currency. Previously, CEOs were vocal

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campaigners against Wall Street’s obsession with short-term gains, but the rise of the stock option made management handmaidens to the process.

A Compensation Road Map

Issues at the center of compensation abound: Should stock price be thought of as a goal or merely the result of doing things right; performance rather than score? What about the quality of strategic implementation, cash flow, return on capital employed, EVA, market share and the value of global brand equity? Or, the effectiveness of management development and succession plans and programs? Every Compensation Committee should focus on improvements in these areas.

The ideal candidate for the Compensation Committee has a sophisticated background in business management. Ideally, he or she has been a CEO or senior operating manager who has delved into compensation issues. Of course, a committee dominated by CEOs may be perceived as co-conspirators in league with the CEO, but their experience and insight can be invaluable. Members of the Compensation Committee need a greater composite of skills than the Audit Committee’s which requires a specific expertise. Directors who serve on Compensation must expect to spend more time than simply attending board and committee meetings to fully understanding the business issues. In the end, CEO and executive salaries must be seen in the context of their perceived fairness by shareholders, employees and the general public. The final judgment, really, is one the

board has to make, and directors don't need to know as much as a compensation consultant to reach a judgment—but a dose of common sense helps.

THE AUDIT COMMITTEE: STRIKING A BALANCE

In the aftermath of what went on at Enron, Arthur Andersen, Tyco, WorldCom, Freddie Mac and others, most of the attention on governance during the last two years has been

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focused on audit procedures. Sarbanes-Oxley came about as the country was reaching a point of near panic. The government's analysis of what happened at Enron and other companies revolves around what the Audit Committee did or didn't do, and the majority of new requirements are directed toward the activities of the Audit Committee and the outside auditors. But the new mandates don't solve the fundamental difficulty of directors who serve on the Audit Committee: that they must rely solely on what someone else tells them.

Critics of Sarbanes-Oxley contend that the heightened scrutiny, longer hours and increased liability brought on by new regulation will discourage people from serving on Audit Committees, but others, like Kathleen Connell, California's former Comptroller, advise directors to get involved with the Audit Committee if at all possible because: “It's the best insurance package you have that the financial activities of the corporation are at a level where you don't have to worry about your personal liability.

Audit Committee members must be mindful not to get so mired in the process that they subjugate their primary duties of oversight through stewardship and as advisers. “The checking-the-box approach to governance will not inspire a true sense of ethical obligation,” Bill Donaldson, the new Chairman of the SEC, was quoted as saying.

To ensure the Audit Committee gets to the heart of the real issues, and strikes a balance between procedures and counsel, here are five steps to take:

- *Set high expectations and communicate them.* Be assured that the CEO, the CFO, the Controller and the internal auditor understand what the Audit Committee expects of them and that they are capable of performing to the Committee's—and no one else's—standard.
- *Create an environment that supports independence.* Make sure the lead partner of the outside audit firm has the specific industry knowledge necessary to do the job well. But this alone is not enough. Observe the working relationship between the audit firm and the company's financial management and be confident that both parties are willing to agree and disagree.
- *Spend sufficient time with the internal control team.* To reveal issues beneath the surface, it certainly helps to grill the CFO and be the entity that hires the outside auditor, but the great hope of the Audit Committee is the internal audit staff. This group provides access to the most critical information about what's going on inside the company. Like the outside auditor and the CFO, the internal auditors should understand that they are ultimately accountable to the Committee.
- *Invite people with strong operating experience, who may not qualify as “financial experts,” to serve on the Audit Committee.* Financial issues are not simply a rearrangement of numbers; they have a business context. Audit Committees need members who understand the operating aspects behind the numbers—in order to be effective.
- *Engage in more structured communications.* Audit Committee members have a significant role to play protecting and nurturing the ethical conduct of the organization. They must lead by example at all levels in the organization and they are beginning to see the need to communicate regularly, not only with the

financial staff of the corporation and with their fellow board members, but also with employees in general and with shareholders in appropriate venues.

Other issues remain to be worked through, not the least of which is the cost that companies must bear to create the structures necessary to support the new mandates. One estimate of the price tag to individual companies for Sarbanes-Oxley, including setting up stringent internal control mechanisms, reaches as high as \$900,000 a year. This may prove too great a burden for some. The consequences could likely include a reduction in the number of organizations willing to go, or stay, public—especially the small to mid-cap companies who make up most of the public listings.

MANAGING POTENTIAL LIABILITY

With all the things the Audit Committee has to cover, an area that seems not to have gotten the attention it deserves is risk assessment. One of the big fears directors have is that something will go wrong which, in retrospect, looks very obvious. Audit Committees (or some group of board members) will have to spend more time defining risk—financial, strategic and operational—for their particular companies in order to understand where the hot buttons are and how the company plans to respond should the situation warrant it. The outside auditor is not programmed to do this. Boards themselves will have to find a way to turn the idea of a risk assessment into a practical instrument for kicking off a constructive dialogue between the CEO and themselves.

Greater risks mean greater liabilities and one thing is certain: D&O insurance is going to cost more money. In fact, rarely has it been more expensive or harder to get. But it is absolutely essential that we protect directors because they are critically important to the future of American business. Without them,

our system won't work. Bill Seidman, former Chairman of the FDIC and publisher of *Bank Director* and *Board Member* magazines cau-

tioned directors about the potential downside saying, "If you don't want to take

the risk of getting sued, don't be a board member. No matter how innocent you are, it can be horribly unpleasant."

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NOTES FROM BOARDROOM CONSULTANTS

It is not business as usual in the boardroom. The bar has been raised, with more expected from directors and management in terms of governance, control, ethics and accountability.

Ultimately, that is what Sarbanes-Oxley is trying to achieve. But, like all sweeping legislation, there will be unintended consequences. It is now time for corporate America to step up to the plate—embrace the spirit behind the law and, in doing so, avoid further regulation.

As always, the answer can be found in individual character and in establishing an environment where candor and trust are valued. How do we know when this has been achieved?

When the CEO is willing to share the bad news with directors and

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when the board is willing to listen to it; when dissent is not viewed as disloyalty; when compensation goes down as well as up; and when every director recognizes that process alone won't do the job, but individual effort, time and commitment will.

Institute Speakers

Edgar W. Armstrong, Managing Director, Risk & Insurance Services - Pottridge & Associates, Inc.

Joseph E. Bachelder, Bachelder Law Offices

David Beck, Group Publisher - Kennedy Information, Inc.

John H. Biggs, Former Chief Executive Officer - TIAA-CREF

S. John Byington, Managing Partner - LegalLeaders, Inc.

Peter C. Clapman, Senior Vice President - TIAA-CREF

Kathleen Connell, Former Controller - State of California

Alfred C. DeCrane, Jr., Former Chief Executive - Texaco, Inc.

Nina R. Henderson, Former President - Bestfoods Grocery

Robert Holland, Jr., Former Chief Executive - Ben & Jerry's

Roger M. Kenny, Managing Director - Boardroom Consultants

Robert E. MacAvoy, President - Easton Consultants

Pearl Meyer, President - Pearl Meyer & Partners

Charles M. Modlin, Partner - Morrison Cohen Singer & Weinstein, LLP

David A. Nadler, Chairman - Mercer Delta Consulting

L. William Seidman, Former Chairman - FDIC

John G. Smale, Former Chief Executive Officer-P&G & Former Chairman - General Motors

Jeffrey A. Sonnenfeld, Associate Dean - Yale School of Management

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