

Board Governance Series

VOLUME I

2003

A KEY EDUCATIONAL RESOURCE FOR TODAY'S BOARDS OF DIRECTORS



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Corporate
BOARD MEMBER
magazine

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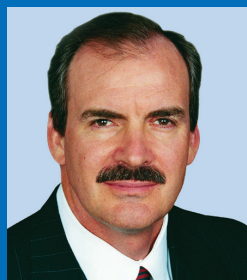
Dear Corporate Director:

It has become clear that the responsibility for good corporate governance has been placed squarely on directors' shoulders. Having the authority to monitor corporations mandates that all board members be educated on best boardroom practices.

To that end, *Corporate Board Member* magazine, in cooperation with The NASDAQ Stock Market, is proud to offer corporate boards the Board Governance Series.

This resource is a series of informational webcasts designed to educate corporate directors on governance issues and trends that are important to today's and tomorrow's public companies. The webcasts feature top board advisers from some of the country's most prestigious companies offering best practices and expert advice on corporate governance. This Board Governance Series supplement is a written collection of the inaugural webcasts.

More webcasts, supplements, and guidance will follow, as the series is designed to cover a myriad of critical board topics. We believe it will be of great interest to those who choose to use the series as a resource.



A handwritten signature in black ink, appearing to read 'TK Kerstetter'.

TK KERSTETTER
President
Corporate Board Member



A handwritten signature in black ink, appearing to read 'Hardwick Simmons'.

HARDWICK SIMMONS
Chairman and CEO
The NASDAQ Stock Market

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Corporate
BOARD MEMBER
magazine

Corporate Board Member is a leading information resource for senior officers and directors of publicly traded corporations, large private companies, and Global 1000 firms. The bimonthly publication provides readers with decision-making tools to deal with the corporate governance challenges confronting their boards. *Corporate Board Member* extends its governance leadership through conferences, director training programs, roundtables, an extensive database, and timely research.

The magazine maintains the most comprehensive, up-to-date database of directors and officers serving on boards of publicly traded companies listed with The NASDAQ Stock Market, New York Stock Exchange, and American Stock Exchange. Headquartered in Brentwood, Tennessee, with editorial offices in New York City, *Corporate Board Member* is published by Board Member Inc. and is the sister publication of *Bank Director* magazine, a leading information resource for officers and directors of financial companies. For more information, visit www.boardmember.com.

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What Is Good Governance and Can It Be Shaped?

Board Governance Series partners discuss the defining qualities of good corporate governance.

TOM NEFF: Good governance is about independence. Many companies and boards have figured this out, but what has been considered best practices will now be mandated because of new rules and regulations. First, the majority of the board must be independent of management, meaning not a former employee within the last five years, not a member of the audit firm, and having no material commercial or even social or charitable relationship with the company. Independence is key. Then each main committee must be composed entirely of independent directors. Many companies have already done this, but all listed companies will eventually be required to do so. This means that boards will need an audit committee, a compensation committee, and a nominating or governance committee composed of independent directors only—no members of management and no one else who is not viewed as independent. This structure will allow good governance to take place.

HOLLY GREGORY: In thinking about what effective corporate governance is, it's important for us to realize what it is not. In today's environment, our expectation of corporate governance is very high. But the board of directors was never intended to be, nor is it positioned to be, the bulwark against intentional fraud by management. The board of directors is dependent on management, the CFO, the general counsel, and the CEO for information. It can't do its job without that information. So if those people are involved in intentional fraud, it's difficult, if not impossible, for a board of directors to ferret it out.

There are three important components to effective corporate governance: attention, information, and objective judgment. Unfortunately, these things are not amenable to the kinds of checklists we see when we look at best practices. Believe me, I'm a fan

of best practice, but best practice has its limits. First of all, you need directors who are going to pay attention to the right issues and devote the time needed to ask the right questions and get the right information.

That brings us to the second requirement, information. Information is key to the board's role, yet most directors are outsiders. That means they are very dependent on corporate management to get the information they need. In some ways, this is the biggest barrier boards face. We are going to see boards spending a lot more time and effort to make sure that they have the systems in place that will bring the information to them.

And finally, there's objective judgment—the ability to bring judgment distinct from management's judgment and directors' personal interest to the important issues that come before them. That's why we see the strong focus on director independence in the current reform effort.

RICHARD STEINBERG: Good governance is a number of things. In order to have good governance, a board must have the right structure in place. By structure, I mean the independence of board members in form and in mind. Boards need to have the right composition, with the right people, the right skill sets, and the right knowledge base. They need to be the right size, with the right committee structures and the right commitment from board members. I call these components enablers. You must have the right structure that enables the board to carry out its responsibilities effectively. These responsibilities include oversight of the strategic development of the company, that is, the development of the strategic plan. They also include oversight of risk management, not just making sure that management brings the most important risks to the board and manages them



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“Boards need to have the right composition, with the right people, the right skill sets, and the right knowledge base.”

- RICHARD STEINBERG

effectively, but also making sure management has the right processes in place to identify emerging risks before they become problems. Directors must focus on CEO and top management performance and compensation and succession planning. They must focus on making sure that the ethics and the integrity, not only of senior management but going all the way down through the organization, are right. Furthermore, they must have the right performance metrics. They need to make sure management has the right measures in place and the right focus on mergers and acquisitions and on financial reporting. All of these comprise the core responsibilities that the board needs to carry out effectively. That is good governance.

JOHN KEOGH: Good corporate governance comes in all shapes and forms. We need to understand our companies, their history and their culture, the track record of inside management in terms of leading the company, and what kind of value they've created for their shareholders. That's just as important as how many independent directors they have sitting on a nominating committee, or how many they have sitting on the board.

On the question of whether corporate governance can be shaped, we are witnessing that today. The market, in terms of the value it's putting on companies that are publicly traded, is looking to corporate governance as something that is valued and is implicit in the stock price. Second, we are witnessing on the nightly news and the front page of

the *Wall Street Journal* the consequences of poor corporate governance, whether that's people being taken away in handcuffs or tremendous liability in securities class-action suits. This will change the way corporate boards behave. I don't know how it will play out, but certainly the responsibility of board members will be taken much more seriously than ever before. The consequences of not paying attention, not being involved, and not understanding what's happening on the boards on which one serves could be devastating personally, from a financial and a reputational point of view. That alone should shape change in the boardrooms of America.

NEFF: The focus on boards is intense from investors, obviously, and from the media. Board decisions are watched very carefully. If it is perceived that a board is not making the right decisions with regard to, for example, executive compensation, it will hear about it. Directors need to justify what they are doing in the proxy statement to shareholders, not only with regard to their philosophy of compensation, but also their reporting must be much more specific to rationalize decisions made. The report should take into account how the company has performed against its peers and how the executive team has measured up against its objectives. Because of the focus on the board's role and responsibility, when boards make decisions they are going to be thinking about not only what the right decision is, but also the potential perceptions of that decision.



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Group, Inc.**

What Effect Will the New Corporate Governance Reforms Have on Today's Board Members?

Board Governance Series partners take part in a conversation about how the new corporate governance reforms are affecting today's boards.



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Senior Partner
Weil, Gotshal & Manges LLP



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IRA MILLSTEIN: That's probably the key question with respect to the new legislation and the New York Stock Exchange rules. If you add up the new NYSE and NASDAQ rules, Sarbanes-Oxley, and the SEC changes, these reforms shift a great deal of power in the corporation from management to the board. Sarbanes-Oxley is an enabling piece of work that says to the board, "You have the authority and power to do the right thing vis-à-vis management, vis-à-vis the lawyers, vis-à-vis the auditors." It creates an independent board and tells them, "You are supposed to be independent, you are supposed to go to work, you can't be passive any more. We are looking to you for good corporate governance—for controlling the accountants, monitoring management, and overseeing all the things that may have gone wrong during the recent corporate governance debacles." Directors are taking these reforms quite seriously and are beginning to think through how they will exercise their new responsibilities. It's a watershed piece of work, and boards have a lot to do to execute the responsibilities they have been given.

JOHN KEOGH: Looking at recent corporate reform, whether that's the Sarbanes-Oxley Act or the NYSE and NASDAQ rules, clearly the intentions are positive. The intent is to make sure that directors are more actively engaged in understanding the businesses of the companies whose boards they serve. As an underwriter, however, I am concerned. A lot of emphasis and added responsibility being placed on the independent directors, which could manifest itself in increased liability. Traditionally, the target of securities class-action suits has been inside management. Independent outsiders

have been brought into those lawsuits, but the focus of the litigation and of the alleged damages has really been on the insiders, be it the CEO, CFO, or other senior members of the management team. I think we may witness a sea of change in terms of how the plaintiffs' bar treats securities class-action suits, with more attention paid, and perhaps more accusations and allegations made, against independent board members.

RICHARD STEINBERG: Given the attention surrounding Sarbanes-Oxley and the NYSE and NASDAQ proposals, it's clear these reforms will have a positive effect and bring out best practices. For some boards and directors, the reforms are not going to have much impact because they are already doing much, if not all, of what is being called for. But for those boards that are not doing those things, the reforms are going to have a positive effect, especially with respect to independence. The new call for nominating, compensation, and audit committees comprised solely of independent directors will be positive. The call for private meetings without management is also a positive reform. Directors on the audit committee, especially, will be paying much closer attention and will be holding auditors' feet to the fire in terms of understanding their testing plans and related accounting and reporting issues.

JULIE DAUM: What we know best is board recruiting and composition. The new regulations will have a huge impact on board composition for several reasons. First of all, the strict definition of independence will prevent many current board members from serving on committees. Second, the requirement that there be three independent committees – audit,

“It creates an independent board and tells them, ““You are supposed to be independent, you are supposed to go to work, you can’t be passive any more.”” - IRA MILLSTEIN

compensation, and nominating – is a huge change. If you look at just the S&P 500, 25% of those boards don’t even have a nominating committee, let alone worry about whether it’s made up of independent directors. And if you look at the audit committees of the S&P 500, only 5% of the members are CPAs or CFOs. That is a huge pool of audit committee members, some of whom will have to be replaced. So the reforms are going to have a tremendous impact on composition as boards begin to bring in new people. On the other hand, it’s going to be difficult to recruit directors because people are very leery about joining corporate boards at this time. They are worried about liability. They are worried about the time directorship requires. Furthermore, many boards are restricting their executives from serving on boards or telling them they can serve on only one. So there is a real disconnect between the huge demand for new directors and a very small supply of people who are qualified and interested in serving.

KEOGH: An unintended consequence of these reforms, again though they are well intentioned, is that corporate America needs quality board members more than ever – talented, experienced

people to sit on boards and be actively involved. But with the advent of these reforms and the potential for increased responsibility and liability for board members and after witnessing cases where D&O insurers do not respond, we are probably in a position that nobody intended us to be in, which is, “Why would anyone sit on a board today?”

STEINBERG: It’s clear that the pendulum has swung in the sense that most directors have been focusing on their responsibilities to add value in terms of providing good, insightful, seasoned advice and counsel to senior management. And that’s an important responsibility. But now the pendulum has swung toward their monitoring roles, with the board serving as a check and balance on management. The challenge is to maintain a balance between the two. Ultimately, you can’t legislate good corporate governance. Directors know that. They are going to focus on the things they need to do inside the boardroom. They’ve got to have the commitment, the diligence, and the courage to carry out their responsibilities effectively. At the end of the day, that’s good corporate governance.



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Audit Committees – Managing Critical Relationships

**Richard Steinberg,
U.S. leader for corporate
governance at
PricewaterhouseCoopers LLP,
discusses the key
responsibilities of the
audit committee.**

An audit committee has four key relationships: first, with the board itself, and then with management, internal audit, and external audit. The expectations put upon an audit committee are tremendous. If you take into account Sarbanes-Oxley and SEC requirements, institutional investors and New York Stock Exchange and NASDAQ requirements, audit committees have huge responsibilities. Boards sometimes tend to throw more responsibility on top of those, such as compliance with federal sentencing guidelines, oversight of internal control beyond finance reporting, and corporate social responsibility issues. So the board needs to make sure that the audit committee is not overloaded.

The charter is key. The audit committee's charter needs to say exactly what the committee is responsible for and no more, because you certainly don't want more in the charter than a committee can, in fact, carry out. Also, an audit committee should report to the board. Some observers of Sarbanes-Oxley are suggesting that an audit committee is almost a separate entity, or has a higher level of liability. That remains to be seen. But certainly the audit committee needs to bring key issues to the full board level. And the members themselves need to ensure that their committee has the right composition. In addition to a financial expert, the audit committee needs to make sure its members have the right knowledge base, dedication, seriousness, and time available to carry out their responsibilities.

Another important relationship, and among the most critical, is with management. It's management that provides the vast majority of the information that the audit committee needs to fulfill its duties. The audit committee must have information in sufficient depth and with sufficient analysis to enable it to have a full understanding of the operations of the

business and how that's reflected in the financial statements. And committee members need to get this information well in advance of meetings – not just a day or two before – so that they have ample time to go over it. Importantly, there needs to be an open channel of communication between the audit committee chair and the CFO or chief accounting officer. There is often information that the audit committee requires that is not in that package, so the channel needs to be open to enable effective information flow. The audit committee should focus on the capabilities of management personnel involved in financial reporting – their background, education, and integrity. Those issues are crucial. Internal control is another critical area. The audit committee must understand the financial reporting controls, which are established by management. The committee should focus especially on the control environment, including the tone at the top, and the ethical values of the company and management.

Setting meeting agendas is also a very important issue. All too often, audit committees have found that a member of financial management, usually the CFO, sets the agenda. I think audit committee chairs now have a better understanding of their responsibility. It's their meeting, and they need to make sure the issues that they think should be addressed are on the agenda. The meetings should be free flowing, allowing for full discussion. Committee members should be able to probe issues and to challenge management. It's not a case of simply asking a question; it's a case of following up and making sure that the information is forthcoming from management to the audit committee.

Another important relationship is with internal audit. First, a member of the audit committee, normally the chair, should review the internal audit charter. The charter might include



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The Audit Committee's Four Critical Relationships

- 1 The Board of Directors
- 2 Management
- 3 Internal Auditors
- 4 External Auditors

operational issues, compliance with laws, internal consulting with management, and internal controls. Experience shows that an audit committee often thinks that the internal audit function has more to do with, for example, controls over financial reporting than is, in fact, the case.

Another question to consider: Is internal audit being pulled off to do special projects? That might or might not be an issue, but it could indicate that internal audit is not able to carry out its audit testing plan.

audits' findings and recommendations, making sure that they are being tracked and actions are being taken appropriately on follow-up.

The final crucial relationship is with the external auditor. Under Sarbanes-Oxley, now there is no doubt as to who the external auditor reports to: the audit committee. The auditor still needs to interact with management, but it's the audit committee that makes the final decisions on hiring, retention, dismissal, scope, fees, and so forth. The audit committee needs to focus

"The expectations put upon an audit committee are tremendous."

Next, the audit committee needs to review the qualifications of the chief internal auditor and his or her staff – their experience, background, and knowledge base. Do they have the right resources and overall internal audit budget to carry out those responsibilities? Can they do their jobs without undue interference? This is perhaps the most important issue. In my mind it's not as important whether there is a solid line or a dotted line between the chief internal auditor and the audit committee. What is important is that there be unrestricted access. Is the audit committee ready to deal with potential conflict issues between management and internal audit, and is it prepared to either approve or reject changes in responsibility, staffing, or even job security? Private meetings with internal audit are as important as anywhere else. People are a bit more forthcoming in private meetings, and those are essential. Finally, the audit committee needs to understand and review internal

carefully on the audit team and its members' qualifications, capabilities, experience, and background, not only those of the engagement partner, but also of the second partner and other partners involved, be it tax, IT, or internal control, and perhaps the senior manager.

Independence is a key area of audit committee focus. The committee should consider any relationships that the auditor may have with the company or management, as well as the issue of non-audit services. The audit committee needs to consider, for those services that are allowed under Sarbanes-Oxley and the SEC, the capabilities of who is performing those services, cost issues, positive or negative effect on audit quality, and safeguards that the firm and the profession have in place.

Finally, the audit committee needs to focus very carefully on the audit scope. There can be a tendency on the part of management to restrict scope in certain areas. The audit committee

should have, and normally does have sufficient knowledge of the company, the business, and the industry to ensure that the external auditor is focusing its testing plans on issues of audit risk identified by the audit committee. At the end of the day, the audit committee wants to make sure there is free-flowing communication between external audit and the committee, and that the auditor is forthcoming and has the courage to do the right thing with regard to financial reporting.

To sum it up, the audit committee should avoid a checklist mentality. It's substance over form; the committee should not be just going through the motions, it should be making sure it's doing its job well. If it does its job well, the audit committee will go a long way toward ensuring a reliable financial reporting process.

Rules for Recruiting the Right Director

Julie Daum, North American leader of the Board Services Practice at executive search firm Spencer Stuart, reviews guidelines for nominating committees as they focus on board membership and recruitment.

Never has there been more of a demand for directors, and never has the supply been smaller. This is because the traditional pool of candidates for boards has been active CEOs; people who are the heir apparent of the CEO or president, or someone who is about to step into the CEO's suite; and women and minorities. These people already serve on one, two, and possibly three boards. They are not going to take on additional directorships, because boards now require so much more time. Many people estimate that board service takes twice as much time as it did a year ago. In addition, a lot of directors are doing a risk/reward analysis, and many don't believe that the rewards are adequate for the amount of time and the exposure that's involved in board service. They are concerned about professional liability – no one wants to see their name on the front page of the *Wall Street Journal* – as well as the potential financial liability that's now associated with serving on a board.

With this disconnect between supply and demand, what can you do if you are a CEO or the head of a nominating committee? As a CEO, the first thing you must do is create a nominating committee, if you don't already have one, that's charged with worrying about board membership and recruitment. The nominating committee has three responsibilities: to review the current board, to identify the kinds of skills and people needed for the company going forward, and to design the board recruitment process.

The first thing the nominating committee needs to do in terms of reviewing the board is to look at each board member and determine if he or she meets the new independence requirement. That assessment will have significant impact on who can stay on the board, who can serve on the committees, and how the board's work gets done.

The second thing that's important is to look at each board member and

decide what skills he or she brings to the board. Some of that comes from the resumé; for example, one director may have a marketing background, but some of it also comes from service on your board. Perhaps another director is the person who brings the group together at the end of every meeting. It's really important to see what skills you have on your board, as well as determining strengths and weaknesses.

And finally, you have to know when you are going to have openings on the board. The easiest thing to do is look at who is approaching retirement age, or who is at the end of his or her tenure. You also need to have individual conversations with your directors to see if any are considering going off the board, and, if so, when they are thinking of doing so, or if someone is interested in coming off one of the committees. We are seeing a tremendous movement away from the audit committee. People are starting to say, "I would prefer not to stand again for the audit committee."

When you are finished with all of this, you should step back from your existing board and look at the company and what its needs are for the next couple of years. Look at the company's strategy and ask, "What skills do we need over the next year, what skills do we need over three years, what skills do we need over five years to get us where we need to be?" Then overlay onto that the skills of your existing directors, and you can begin to identify gaps. When advising a client, we make a chart of the existing board members and list all the skills we think are important across the top. We also track age and insider versus outsider. We look at things such as do they have financial skills, do they have marketing skills, have they taken a company public (if that's important to the board), and do they have previous governance experience from other companies? Whatever is deemed important we lay out and compare to



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existing board members, so it's very easy to see gaps. Then you prioritize those gaps as either mandatory, or "nice to haves." Out of that, you develop a position specification in writing that says, "These are the kinds of skills and backgrounds that we would like to have in the next directors we recruit." This document is your road map.

You should begin to scout and see who is considered the best in the areas you are seeking and take that pool of candidates and do a fair amount of due diligence on all of them before speaking with any of them. It's important to look at someone who appears to have the perfect resumé, but then you need to find out what kind of board member he

"People are starting to say, 'I would prefer not to stand again for the audit committee.'"

The next guideline for the nominating committee is to design a process that will be used consistently with director recruitment over the next couple of years. Many companies find it beneficial to hire an independent, impartial consultant to help them do this, perhaps even to help them identify the kinds of skills they need, but certainly to help them identify potential candidates. Taking that road map of the position, the first thing that the consultant and the nominating committee should do is to solicit input from the board: "You know the company, you know our strategy, you know how this board works as a group. Is there anyone who meets these specifications?" It must be understood that anyone who is suggested is going to be compared to these specifications. It is important not to overlook the other board members, because they have the best interests of the board in mind and they may also have a network that you want to tap.

The second thing you must do is go into the marketplace and find people who meet some of these criteria without identifying what company you work for

or she is. This person may be the world's best CEO, but cannot operate in a room of his or her peers. They can't listen; they want to be the leader. So it's important to understand not only what someone has accomplished professionally, but also what he or she is like when seated at a boardroom table and how they work with others.

Most potential board members will want to meet at least one person from the board and at least one person from management. They will want to meet privately with a board member because they are going to want to know whether the CEO listens to the board and what the boardroom dynamic is really like, and they won't feel comfortable asking that of management. We find that many board candidates are now asking to meet with the CFO, and perhaps with the outside auditors or outside counsel. You need to decide what due diligence you are willing to allow potential new board members to do on the company. You also need to think about what kind of due diligence you are going to do on the potential final candidates. You've already evaluated them to see what people have

Six Nominating Committee Guidelines

- 1** Determine if each board member meets the new independence requirement.
- 2** Decide what skills each director brings to the board.
- 3** Be aware of board openings.
- 4** Look at the company's strategy and determine what skills directors will need to bring to the boardroom table.
- 5** Design a process that will be used consistently with director recruitment.
- 6** Find people who meet your directorship criteria.

to say about their performance on other boards, but you need to make sure that there is nothing in their history that will embarrass the company. So at the end of this process, as they are doing their due diligence, it's very important that the board do its as well. If you follow these guidelines, you are much more likely to identify and recruit a director who will be a competitive advantage to your company.

What Every Director Needs to Know About D&O Insurance

With interest in D&O insurance escalating, John Keogh, president and COO of National Union Fire Insurance Company of Pittsburgh, PA, a member company of the American International Group, Inc., outlines questions directors should ask about their coverage.

Today, more than ever, the D&O policy is an important protection for directors. With the escalation in securities class-action suits over the past five years, both in terms of frequency and severity, many people who are being asked to sit on boards, and those who already do, are questioning their insurance coverage, should they become party to a securities suit.

Furthermore, with the advent of Sarbanes-Oxley and the increased responsibility and expectation for vigilant corporate governance, board members are asking how their D&O policy could and should respond. They are also asking how much insurance they have and who it's with. One could argue that they should have been asking these questions two or three years ago, but, quite frankly, the D&O claims and litigation environments have changed considerably over the past several years. Much of this is playing out on televisions across America and on the front page of the *Wall Street Journal*, thus the escalating interest in not only the D&O carrier, but how the coverage works and how much coverage you have to protect your personal assets and all the work you've put into your business. The fact that your net worth could be lost in a securities class-action suit is a potential risk board members are starting to recognize. As a result, the D&O policy is arguably one of the most important assets of a director.

One concern our company has regarding the new reforms is that well-intentioned reform sometimes has unintended consequences. We witnessed that with the Private Securities Reform Act of 1995. We learned a lesson there. The plaintiffs' bar is very capable of taking new legislation not intended to create more civil litigation and finding new avenues in that legislation for litigation. This might mean pressing litigation that otherwise would not have been pressed before based on the statutes or creating increased damages

and increased settlement values based on violations of the legislation. In today's uncertain times, therefore, board members should be even more inquisitive about their D&O policy and actively involved in its purchase.

To that end, directors should ask five questions about their D&O policy. One, is there enough coverage? Given the skyrocketing escalation of settlement values with respect to securities class-action suits, what may have been adequate in terms of limits a year ago may not be adequate now. So, first and foremost, how much insurance do we buy, and is it enough?

Second, who's covered by the policy? Often, D&O policies cover not only the directors and officers, but many others who will share the limits, most notably the corporate organization itself. That leads to dissolution of those policy limits. This is a question that should be raised. A policy that's limited at \$100 million and available only for the individual directors and officers is much different than a \$100 million policy that's being shared with the corporate entity and potentially has other coverages built into the form.

Third, who's your carrier? This may seem straightforward, but it's something that most directors don't know, and there is a difference among carriers. There are cases being settled today for millions of dollars where one large D&O carrier is insolvent and not responding and thus incapable of paying those claims. The financial strength of the carrier needs to be well understood.

Fourth, what's the history of this carrier in D&O? Does it have a history, or is the carrier new to this product? Is it committed to D&O? What is its claims-handling capability? Unfortunately, securities class-action suits are very complicated and very difficult to handle on the claims side. A carrier with a long and proven history in D&O is much more valuable



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President and COO
National Union Fire Insurance
Co. of Pittsburgh, PA
Member Company of the
American International
Group, Inc.

Five Questions Directors Should Ask About Their D&O Policy

than one without a history.

Furthermore, how the policy responds to fraud is more important today, perhaps, than it was in years past. There have been several cases that have resulted in D&O carriers not responding because of allegations of fraud. So how does the D&O policy respond if an insider is accused of committing fraud? Will you be protected?

Last, what new products does this carrier offer? Has the company looked at products that have become available in the past year that protect directors and officers during catastrophic events when the traditional D&O policy may not respond or be enough in terms of policy limits?

Those are just five quick questions directors should ask with respect to D&O insurance. They should pay as much attention and be as involved in the purchase of this insurance as they are in their other corporate duties as directors of publicly traded companies.

1 Is there enough coverage?

2 Who is covered by the policy?

3 Who is your carrier?

4 What is the history of this carrier in D&O?

5 What new products does this carrier offer?

“...the D&O policy is arguably one of the most important assets of a director.”

Risks You Can Avoid Through a Governance Audit

Weil, Gotshal & Manges LLP partners Martin Bienenstock and Robert Messineo discuss the importance of governance audits and how they help boards minimize risk while maximizing profit.

MARTIN BIENENSTOCK: The premier question for a board, and its mission, is how to increase shareholder value. Yet it must do so in a way that carries out its legal responsibilities to avoid exposure. Before anyone had heard of Enron or Sarbanes-Oxley, we were advising boards on how to conduct a governance audit so that they could concentrate on increasing shareholder value while satisfying their legal responsibilities. A governance audit enables the board to identify the material risk factors affecting the corporation and to act on them in order to minimize risk while maximizing profit. When people speak about reviewing governance, they are usually talking about making sure the board is composed of enough independent members to make the right decisions. The governance we are talking about has been developed so that boards can direct management and employees to effectuate a reporting system of all material transactions.

An important benefit for directors is the mandatory information they receive on a regular basis. If we've heard one thing loud and clear in the context of WorldCom, Enron, and Adelphia, it's that "the board didn't know." In many cases, there were fine directors involved who didn't know and are embarrassed about not knowing, but it wasn't necessarily their fault. A governance audit packages the risks for various company enterprises. The complex ones will be explained, and when these initiatives are laid out, the directors will gain an understanding of transactions that they may not otherwise have understood, and that will lead to more questions about the risks they create. It will enable board members, without having to do the due diligence themselves, to assess the material transactions the company is undergoing and to recommend which ones should be continued and which ones should be discontinued.

ROBERT MESSINEO: In developing a governance audit, we identify goals the company and board want to achieve. The first and primary area we focus on is risk avoidance. In dealing with risk avoidance, we seek to have a governance system that complements the company's internal risk management and internal control systems, as well as its system for preparing SEC files. The governance system is intended to identify risks to the company's business and point out those matters in which the company can mitigate its risks. There are a variety of risks; some are financial, some are internal, and some are external. External risks include problems with funding in the capital markets, dealing with competition, the macroeconomic environment, the regulatory environment, relationships the company may have with suppliers or for research and development, and other key relationships. Internal risks include arrangements with key compliance, the status of key employees, legal compliance relationships, dealing with subsidiaries (particularly where they are not wholly owned), and managing internal control systems. Most companies have made arrangements for dealing with these situations, but they also need to bring pertinent information about these items to the attention of the board and executive management. Second, we consider the board's ability to prioritize and manage its time.

Applying its time to the company's top issues is a primary operational aspect of managing the board's affairs. Having this sort of risk assessment done on a systematized basis helps the board choose the areas it wants more information on. What operations does it need to know more about? What does it need background on from professionals or experts in order to deal with the risks?

A third area that can benefit from a governance audit is better board



MARTIN BIENENSTOCK
Partner
Weil, Gotshal & Manges LLP

decision making. How the results of the audit will translate into a particular decision obviously depends on the circumstances. But for the board to be able to put into context the various risks the corporation faces is a distinct advantage. When a proposal comes before the board, particularly on a major issue such as an acquisition or a financing, the directors will be better

governance audit process is rooted in the company and that there are people within management who will own the process and the reporting of it. It may be necessary to bring in some experts, whether they are from legal or accounting or from an engineering or marketing perspective, as part of the initial process of assessing and identifying risks and choosing

“If we’ve heard one thing loud and clear in the context of WorldCom, Enron, and Adelphia, it’s that ‘the board didn’t know.’” - MARTIN BIENENSTOCK

positioned to assess the issue along all the gradients of risk that should be addressed, and they will be able to ask the right questions and make sure the correct information is provided to help them make the best decision.

The board needs to make a couple of commitments to get the governance audit process started. The first is to completing the process, even if it takes a number of weeks or months for several directors to do it. The idea is to have a systematic and comprehensive review. This is not something that will be finished overnight or in one board meeting. So the first step is a willingness to see the process through and despite the admittedly scarce amount of board time available, make sufficient time over a period of two or three meetings to complete the process. The second step is to make sure that the

appropriate metrics. The reporting process should clearly identify who’s responsible for preparing the reports and when they are going to be delivered on a regular basis.

BIENENSTOCK: By undertaking and implementing a governance audit, the board will accomplish several important objectives. First, from the viewpoint of an outside investor, the board will be looking at the company and identifying virtually every material factor that’s important. Second, it enables the board to concentrate on shareholder value while simultaneously satisfying its legal obligations. And third, when board members and the CEO are asked, “What have you done in the face of Sarbanes-Oxley?” they’ll be able to answer in a sound bite, “We did a governance audit.”



ROBERT MESSINEO
Partner
Weil, Gotshal & Manges LLP

Understanding the Benefits of the New Listing Requirements

Edward Knight, executive vice president and general counsel of The NASDAQ Stock Market, gives an overview of the benefits of the new listing requirements.

Our listing standards are really the expression of a stock market's character and values. In dealing with post-Enron issues, we found some gaps in our listing standards where we had not foreseen issues that could cause investors to lose confidence in the companies listed on our market. We decided not just to consider best practices, but to establish rules: rules dealing with the critical issues the public was concerned about; rules for disclosing more information to the investing public; rules about empowering shareholders to have more of a voice in the governance of companies, particularly with regard to stock options; rules giving audit committees more power, authority, and resources; and rules instilling confidence in the public that companies are generally being run according to the highest standards. One way of doing that was to give independent directors a larger role in the governance of companies at the board level.

We also wanted to ensure that these rules were clear, objective, and easy to apply so that not only would we be able to enforce them, but companies wouldn't have to spend a lot of time interpreting them. And we tried to build some flexibility into these rules because one size does not always fit for every company. We have a diverse mix of companies in our markets. Therefore, it's not always possible for them to have the resources and the capability to, for instance, recruit a large number of new directors. We thought there should be options in that circumstance and we built that into our rules.

Last, we wanted to make sure that we didn't violate the law of unintended consequences. We did not want to be so prescriptive that we inhibited the risk-taking that companies must undergo at the board level and throughout a company. So those were the principles we looked at in establishing our new rules in response to the events of 2001 and 2002.

Will boards have a transition period to meet the new listing requirements?

The new governance standards have a good deal of necessary complexity. They will require many boards to be reconstituted in significant ways. The question is how much time is fair to allow companies to adopt these new standards? We think there should be considerable time built into the rules to allow companies to recruit the directors they need and make changes in terms of the processes the board follows and the advisers it needs. As the SEC finalizes its views on our rules and the other markets' rules, we have encouraged the adoption of a generous transition rule that would allow, for instance, changes that affect boards and their population not to go into effect until the annual meeting in 2004.

What can investors expect from NASDAQ-listed companies?

It may sound like a cliché, but this is not a sprint, it's a marathon. It will take a long time to see the fruits of reforming corporate governance in America. It took us a while to get here. It will take us a while to sort through it. We have, in essence, rewritten the constitution for corporate America and that needs to be interpreted and applied. It's not just rules. It's all the institutions associated with those rules and then applying them in such a way, through enforcement by the stock markets, that gives the public confidence that these rules have meaning. I have no doubt from my conversations with corporate leaders throughout the United States that they are fully committed to this and that they will not only apply the letter of the rule but the spirit of the rule and go beyond and adopt the best practices whenever they can. There's a considerable amount of focus and enthusiasm in corporate America. They understand the problems we face and that this is something we



EDWARD KNIGHT
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need to address collectively.

It's important in approaching these issues that the public understand that the markets had a certain plan and vision in mind and principles that they've tried to apply uniformly in adopting these new rules, and that the rules are only a first step. Everyone needs to pull together, make these rules theirs, and go beyond them whenever necessary. We need to adopt standards that reflect the culture of companies around the country, which I have found have the highest standards and want to do the right thing. We need to take our rules as a point of departure, embrace them, and move forward to restore the confidence that the American people need to have in our equity markets.

“We tried to build some flexibility into these rules because one size does not always fit for every company.”

Conducting a Self-Assessment of the Audit Committee

Richard Steinberg, U.S. leader for corporate governance at PricewaterhouseCoopers LLP, outlines the key areas audit committee self-assessments should cover.

The audit committee is under the brightest spotlight in terms of corporate governance. Self-examination is considered best practice now, and many audit committees are assessing their own performance. There are a number of areas we need to focus on in that regard.

SETTING A STANDARD

Determining the standard to which it will hold itself accountable is the first step in a self-assessment for the audit committee. It might be subject to Sarbanes-Oxley, the New York Stock Exchange requirements, or NASDAQ rules. But it needs to supplement those with best practice and that's what most audit committees conducting self-assessments have decided to do. These are the benchmarks they measure themselves against.

COMMITTEE COMPOSITION

The next area is the composition or makeup of the audit committee, and that normally starts with the independence of its members. You need to consider whether they are adhering to the strict requirements of the new rules as well as to the spirit of the rules. Audit committee members must ask themselves whether they meet those requirements. If not, or if they have any doubts, they should discuss them with the audit committee chair, or the chair of the nominating or corporate governance committee.

Committee size is important as well. Most audit committees are composed of three to five individuals. I've worked with audit committees with nine members or even membership representing the full board, however I've found this approach to be highly ineffective. Audit committee members have to look at their attributes and those of the committee as a whole. Are they demanding? Are they challenging? Do they bring the right judgment to bear? And do they have the right knowledge, not only of accounting,

reporting, and internal controls and all of the other areas required by the new rules, but also of the industry, business, and company issues, because they must have this knowledge to be positioned to determine whether the financial statements properly reflect the company's performance.

Then there is the issue of the financial expert, which has received a lot of media attention. In an assessment it is important that the audit committee ask itself whether its members are relying too heavily on that individual. They all need to be involved. Interestingly, members without an in-depth knowledge of accounting and auditing can be invaluable. In a sense they are probably the people best positioned to determine whether the financial statements are understandable and meet investors' needs.

COMMITTEE RESPONSIBILITIES

Another critical area is the responsibilities the committee has identified for itself. The expectations on the committee are enormous. Time doesn't permit us to cover them all, but I'd like to touch on a few. Certainly the financial statements and related information such as management discussion and analysis are first and foremost. Information that goes to the media and analysts and other agencies also is critical. Likewise, internal control and the certification processes of the CEO and CFO should be a focal point of the audit committee. The new rules also call for focus on compliance with laws and regulations, risk management issues and ethics, and protocols for employees to bring forth complaints. Some committees focus on corporate social responsibility, health and safety, and a myriad of other issues. During the assessment, audit committee members should ask themselves whether they have identified the right responsibilities. One of the most important things they



RICHARD STEINBERG
U.S. Leader for
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PricewaterhouseCoopers LLP

can do is to reach consensus with the board that the committee has the right items on its plate, and not too many.

COMMITTEE EXECUTION

Another very important area is how the committee carries out its responsibilities. It should focus on such things as whether it receives the correct information, whether it is timely, and whether it is in the proper form, with the right analysis and identification of issues. Is it looking at matters that are truly important, or is it getting bogged down in immaterial issues?

Getting behind the numbers, the committee needs to ask itself if it is simply questioning management and the auditors as to whether everything is OK, or is it truly challenging, debating, and probing management and internal and external auditors about the issues? Are members pushing until the audit committee itself feels comfortable that the numbers are appropriate?

or soon will be? Or is there more there than the committee can carry out? A committee certainly doesn't want more in its charter than it can deliver.

Then, there's meeting protocols. Is the committee holding private meetings with internal and external auditors, and is it avoiding the trap of establishing a meeting schedule and then trying to shoehorn its responsibilities into it? Or, is it determining the responsibilities and the time they'll take and then setting the schedule around that?

Communications are crucial. Are committee members comfortable with the communications about the committee's activities going in the proxy statement? Of course, the audit committee is still a committee of the board and it needs to make sure it communicates important issues to the full board.

The assessment process is also very important. I advise committees to avoid yes/no and on/off questionnaires.

The attention has been given mostly to the mechanics and the structure of audit committees, and those are certainly important and can be extremely helpful if a committee is accused of wrongdoing. But the best possible defense is to ensure reliable financial reporting. If that's done, there will be no need to defend yourself in the first place.

Overall, carrying out a meaningful assessment of the audit committee can be a great step toward ensuring effective performance.

“There are probably no audit committee members who have not thought about personal liability.”

COMMITTEE GOVERNANCE

Another key area is how the committee governs itself. First is the agenda. Who's controlling the agenda? Does management control it or is the committee chair making sure that he or she controls the agenda setting?

Next, there's the charter. Does the charter include all the requirements under Sarbanes-Oxley and the exchange proposals that are in place

You really want qualitative assessments on the responsibilities and how they are carried out. Most audit committees that do this successfully find it can be very helpful to have a facilitator involved in the process.

PERSONAL LIABILITY

A final word: There are probably no audit committee members who have not thought about personal liability.

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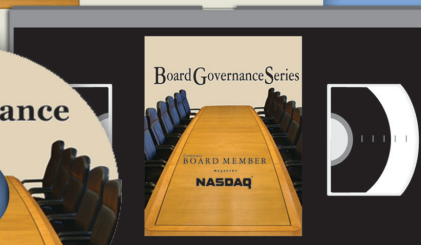
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