Board Governance Series

VOLUME IV 2004

A KEY EDUCATIONAL RESOURCE FOR TODAY'S BOARDS OF DIRECTORS

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CORPORATE BOARD MEMBER MAGAZINE | NASDAQ®

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CORPORATE
BOARD MEMBER
MAGAZINE

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In the wake of what many consider a time of most profound change in the rules governing board operations in the last century, it's back to board basics. With most of corporate America having addressed their all-important governance foundation through compliance with the new regulations, boards are shifting their focus to more substance and less form.

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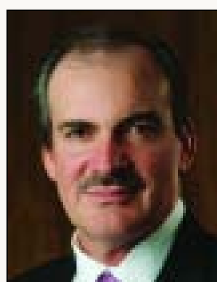
Our previous editors were received with great enthusiasm and we believe volume 4 will be of equally great interest to directors seeking guidance in these challenging times. We invite board members to access the websites and webcasts featured in this publication as part of their continuing education.



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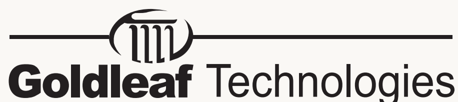

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Refocusing from Form to Substance… How Can Boards Become More Effective?

Trends in Director Compensation

Blair Jones, senior vice president and practice leader, Leadership Performance & Rewards, Sibson Consulting, discusses changes in the structure and levels of board compensation, as well as trends in committee pay.

Blair Jones
Senior Vice President and Practice Leader, Leadership Performance & Rewards
Sibson Consulting

In the wake of corporate scandals, increased regulation, and heightened institutional investor interest in board activity, we have seen a commensurate change in both pay levels and pay structure. This change reflects the greater time and effort required of board members, as well as the greater risk these individuals face. Board compensation generally has three components: retainer, meeting fees, and, typically, equity pay. We are seeing the greatest changes in the two cash components–retainer and meeting fees–both of which have increased.

A prospective Sibson study shows that board retainers appear to be rising by about 15% at the median. The study also found an increase in meeting fees. This trend is interesting because many companies previously had been moving toward eliminating meeting fees and using a larger retainer to cover all board requirements with the aim of reducing the complexity of their board compensation programs. But given the new environment, different boards will have different time requirements at different points and meeting fees–while not perfect–are one way to recognize the various levels of time activity that boards demand.

We haven't seen as much of an increase on the equity side of the equation, but we have seen more attention paid to the design of equity compensation and the features wrapped around it. Traditionally, companies have used stock options as the primary equity vehicle for boards, but now many companies are considering restricted stock as well. This trend is similar to what is happening in the executive pay arena where we see companies reexamining their use of options. The reexamination stems from both the public's distaste for options and the concern that options may influence boards to make short-term decisions that are not in the long-term best interests of shareholders. From an internal standpoint, companies must also consider that board members have to come up with cash to exercise their options. To counter these factors, some companies have turned to restricted stock as a better vehicle. Since restricted stock doesn't have to be exercised, it can, in some ways, provide a more stable type of equity feature for a board. In addition, restricted stock avoids any unintended signals that might be sent by stock option exercise transactions related to stock options. That said, there are a number of boards that don't want to receive any compensation from their equity component unless the company's stock price increases. At the end of the day, which long-term vehicle is most appropriate represents a key philosophical decision.

A number of companies have introduced stock ownership guidelines for their board members similar to what we might see in the executive ranks. Typically, the guidelines are expressed as a multiple of the retainer similar to what a CEO would have–if a CEO has to hold five times his salary as an ownership guideline, then board members would need to hold five times his or her retainers. Another guideline is to require directors to hold shares until they retire from the board. Companies choose that option for different reasons, but the primary message they are trying to send is that they want board members to be committed to the company and ride with shareholders for the long term. So again, overall pay is increasing primarily in the cash component, but the structure is changing through more meeting fees, different forms of equity, and the introduction of stock ownership requirements.

Just as there have been changes in the structure and levels of board compensation, we've also seen trends emerging in committee compensation. Like board compensation, committee compensation has different components.

Some committees have retainers, which are flat yearly fees paid for committee service; some committees have meeting fees, and some committees have both components. One trend is that the prevalence of committee retainers is increasing, particularly for committee chairmen. The retainer is intended to recognize increased time commitment. The audit committee has most frequently offered a retainer to the chairman, because the audit committee has, at this point in time, received the most attention and has required the greatest additional time. The retainer is intended to recognize that increased time commitment. Now that a year or two of heightened governance attention has passed, we are starting to see retainers appear for the chairmen of the compensation committee, the finance committee, and the governance committee as well. Companies are realizing that any of these committees could have more or less work over time, and, regardless, the chairman has to do more prep work for their committee meetings.

That said, there is a recognition that the audit committee carries the heaviest burden right now, so the audit committee chair is often getting 50% more to double what other committee chairs receive. For instance, if an audit committee chairman receives $15,000 as his or her committee chair retainer, then the other committee chairs will receive somewhere between $7,500 and $10,000 for their retainers. Committee member retainers are less prevalent for committees other than audit, but of the others, the compensation committee has received the most attention.

Another trend is the increase in committee meeting fees. Whereas meeting fees might have been $1,000 or $1,500 in the past, we now see those fees increase to $2,000, $2,500, even $3,000 per meeting. This increase recognizes that not only do directors have multiple meetings to attend, requiring significant time, but a lot of prep work required outside of the meetings.

As companies consider the mix of retainers and meeting fees for committee works, and also for their board in general, they need to examine how they are asking board members to spend their time. Retainers are a good reflection of the basic requirements of the board and committees. Meeting fees allow companies to add a flexible component to recognize different time requirements and appropriately compensate a director for the number and level of meetings the board, or a given committee, may demand over time.

We encourage companies to take an inside-out look as they think about how to structure board compensation going forward. First, consider what the company is trying to accomplish and the role that director compensation should play. Then, determine whether there is guidance from the external marketplace, perhaps in the form of a company that is in a similar situation or a broad group of peers that could be used to help gauge director compensation levels. Boards should also use guiding principles for director compensation similar to those they've developed to guide executive compensation, as a reference to examine the role of pay in attracting and retaining directors and influencing their decision making.

It is important to note that pay is not the only reason that directors join a board. Directors join boards for the development opportunity, to network, and for the chance to make a difference. They are going to join boards that have good reputations and sound governance. Pay is only one element in the attraction equation. So the question is: What role does pay need to play in that equation? At some level, pay is not going to be the reason people join a board. But if a director candidate is deciding between two boards with different compensation packages, a variance in pay could put one company at a competitive disadvantage with regard to recruitment. Or, if you have standing board members who sit on several boards and they see their compensation changing elsewhere, pay could become a point of discontent.

PRINCIPLES FOR STRUCTURING BOARD COMPENSATION

- What is the company trying to accomplish with board compensation?
- Do you want a unique plan or one that follows a peer group?
- Where do you position pay levels relative to the market?
- What mix of cash versus equity is best?
- What are the expectations regarding director stock ownership over time?

So balancing the role pay plays in attracting and retaining board compensation is the first principle.

The second principle a board should consider is how much it wants to follow the market. Does the board want a director compensation package that is specifically responsive to its needs, or does it want to emulate what a broad group of peers is doing? For instance, if a board is in a post-scandal situation such as those involving Enron, MCI, or Tyco, its circumstances may require it to structure its compensation differently. A board in that position might pay higher retainers to reflect the tremendous time requirement of its board members, or the board might want to structure its equity differently because of certain sensitivities.

"It is important to note that pay is not the only reason directors join a board. Directors join boards for the development opportunity, to network, and for the chance to make a difference."

The third principle for a board to consider is where to position pay versus the market. Should pay be at the median of the market, or higher or lower? That decision depends on how prominent the board wants pay to be in the overall equation. For example, a board that lacks a great reputation and has a hard time recruiting directors may need to offer higher pay than a board with a great reputation.

Next, boards need to consider the mix of cash and equity. The median practice in the marketplace is about 50/50 cash and equity, but boards must decide if they want to structure their cash and equity mix differently. There are a variety of elements that go into that decision. For example, a board may wish to parallel its executive compensation policy, or it may structure the cash/equity mix to send a specific message to the marketplace.

The final principle relates to a board's expectations regarding director stock ownership. Does the board want its directors to hold shares over a period of time, and, if so, what is the expectation relative to that?

These principles help put stakes in the ground as boards start to design their director compensation programs. In turn, these decisions also send an explicit message out to the marketplace about what a company is trying to accomplish with its director pay.

Boards must also decide how frequently they want to update director compensation. At a minimum, companies generally evaluate executive compensation every two to three years. In the current environment, compensation programs have been changing more frequently than in years past. Companies should set a principle to specify the timeframe for examining director compensation, as well as to define when and under what circumstances they would change the program.

Clearly director pay is changing in the marketplace. As companies look at their internal situation, it is important that they determine how board pay fits into their director values proposition and then design their director compensation program based on what best serves the directors, the company, and its shareholders.

An Audit Committee's Most Frequently Asked Questions about Section 404

Garrett L. Stauffer, partner and U.S. leader for corporate governance at PricewaterhouseCoopers LLP, reviews a hot topic for audit committees–internal controls over financial reporting.

Garrett L. Stauffer
Partner and U.S. Leader for
Corporate Governance
PricewaterhouseCoopers LLP

Internal controls over financial reporting is a topic every audit committee is discussing. Likewise, implementing the new Sarbanes-Oxley Section 404 requirements is at the top of the list of concerns for every audit committee. I'd like to summarize four of the more frequently asked questions that we receive from audit committees in connection with these issues. The first question is, "Where is the company in the process of evaluating its internal controls over financial reporting, and how does it compare to other companies?" The second area that has created a lot of interest among audit committees relates to the new requirement for auditors to evaluate the audit committee's effectiveness in its oversight of internal controls over financial reporting and external financial reporting. Thus, the question we are hearing from audit committees is, "What does that mean; what are auditors going to do to assess us?" The third question is, "What role does the audit committee need to play in this overall internal controls evaluation?" And finally, "How can the company sustain this process to make it a long-term effort that works?"

Where is our company in the process, and how do we compare?

While each company will be at different points in the process–because of its size, its resources, the complexities of its systems, and its geographic location–I believe most 12/31 companies should be well along the way by the end of the third quarter. Ideally, a company should have completed the documentation of its controls, including all five components of COSO. In addition, it should have the initial testing of controls to evaluate operating effectiveness pretty well under way and close to completion. And finally, the company should be in a remediation state to address any control deficiencies that were found as a result of its testing to ensure controls are operating effectively. That said, I don't believe many companies are actually at this point. The majority of companies we're seeing have had some slippage along the way and will need to make a concerted effort between now and the end of the year to complete the process. We are continuing to see workload estimates increase over the original estimates. Keep in mind this is a significant task. 404 compliance is a first-time effort, and it's taking considerable resources and putting considerable strain on companies. I believe companies need to be completed with their initial testing process by or around the end of the third quarter. Why do I say that? Because if it's not completed by the end of the third quarter, companies will not have allowed enough time to do remediation. Companies are most likely going to find deficiencies when doing their testing, so they need to allow enough time to remediate–or correct–those deficiencies and see the new controls operating correctly for a sufficient period of time. In addition, companies will have to update testing and allow time for the external auditor to complete an evaluation.

What will external auditors be doing to evaluate audit committees?

This question relates to the PCAOB standard on 404, requiring that an auditor evaluate the effectiveness of the audit committee's oversight of internal controls, financial reporting, and the external reporting process. First, the standard emphasizes that it is the board's responsibility to evaluate audit committee effectiveness. The standard does not require the auditor to do any separate and distinct evaluation. Rather, it recognizes that the audit committee plays a vital role in the control environment and the monitoring

components of internal controls over financial reporting.

So what is required of the auditor? There are four areas for review. First, the auditor will need to be satisfied that audit committee members are independent of management. Second, the auditor will want to understand the audit committee's responsibilities and how they are articulated, and be satisfied the committee understands them. Generally these are spelled out in an audit committee charter and include many things, such as the new stock exchange listing requirements that are now in effect and all the Sarbanes-Oxley requirements. Third, the auditor will want to see whether the committee is fulfilling those responsibilities and review committee members' knowledge, background, and understanding of financial reporting and internal controls. Finally, the auditor will want to evaluate the committee's involvement with the external auditor, as well as its involvement with key management, such as the chief financial officer or the chief accounting officer and the director of internal audit. The auditor will want to know how the committee evaluates the capabilities of these key management members. The audit committee also needs to ensure internal audit reporting responsibilities are appropriate. The days of internal audit not having direct involvement with the audit committee and not attending every meeting are long gone. Internal auditors need to be involved in every meeting with the audit committee and report on their process and any problems.

The last point I want to make is that the standard clearly states that an ineffective audit committee is a significant deficiency and a strong indicator of a material weakness. So if the auditor concludes that the audit committee is ineffective, that very likely will result in a material weakness, which would then result in the conclusion that the company has an ineffective system of internal controls.

What role does the audit committee play in overseeing the internal controls process?

Simply put, the audit committee should play an active role in the process. It needs to be involved in all key aspects, including the scope of the process, the depth and the breadth of the process, and who in management is accountable for the process. Committee members need to be apprised of ongoing results so that they know where the company stands in relationship to plan completion. They also need to understand any deficiencies coming out of the process. Finally, the audit committee needs to be involved in action taken to remediate any problems. That is an important part of the process, and management and the audit committee need to be comfortable that remediation is taking place so that they can eliminate any year-end problems around control deficiencies. A successful effort in this 404 process requires heavy senior level involvement, oversight, and sponsorship, and the audit committee must take an active role.

How do we sustain the Section 404 process over time?

First of all, compliance with 404 is more than a one-time goal. Treating the evaluation of internal controls as a one-off method on an annual basis will slowly but surely sap the energy out of the company's management and staff. The process must become embedded in the organization. Leadership's commitment must be sustained and that includes involvement by the audit committee.

That sustained commitment can best be demonstrated if the company puts together a senior executive steering committee that's involved in long-term evaluation. The process should be built into the daily routines and operations of the company. Many believe a continuous self-assessment process will allow the company to sustain the effort long term, making it the most effective and efficient way to achieve the 404 reporting objective. In order to build a sustainable process, the company needs to evaluate and improve the training of its staff, the effectiveness of its business processes, and its ability to create and leverage a strong IT environment.

In conclusion, internal controls over financial reporting is a hot topic with audit committees. Audit committees need to understand the substantial effort companies must be investing in order to complete this process; they need to understand the depth and the breadth of the process and the results it's generating. And, finally, they need to be involved in overseeing the process, and ensuring it gets done.

“The days of internal audit not having direct involvement with the audit committee and not attending every meeting are long gone.”

Board Involvement in an Effective Compliance and Ethics Program

In light of the November 1 deadline for new guidelines, Holly Gregory, partner at Weil, Gotshal & Manges LLP, provides an overview of effective compliance and ethics programs.

Holly Gregory
Partner
Weil, Gotshal & Manges LLP

The enactment of the Sarbanes-Oxley Act and related listing requirements have caused public company boards to review their ethics and compliance programs to ensure that they have adequate whistle-blower procedures, protections against whistle-blower retaliation, effective codes of ethics that apply to senior financial officers, as well as good internal controls generally related to compliance issues. Recent amendments to the Federal Organizational Sentencing Guidelines have brought this issue to the board agenda.

As of Nov. 1, 2004, new sentencing guidelines take effect that emphasize the role boards play in these kinds of compliance programs. Therefore, this is a good time for boards and managements to once again discuss the effectiveness of these programs to make sure that they are fully satisfying the new requirements.

While companies should be aware of the November 1 deadline the Blakely Supreme Court decision has caused some to question whether or not these kinds of sentencing guidelines are constitutional. Whether or not the new guidelines are eventually struck down or amended, this is a good time for companies to look at what the new guidelines require as a matter of best practice.

It's also important to keep in mind that a corporation can be held criminally liable for the wrongful acts of employees. The amended federal sentencing guidelines give guidance to sentencing courts about when they should lower the penalties for corporations for wrongful acts of an employee or agent due to actions the corporation has taken that show an overall culture of compliance.

The amended guidelines set forth seven factors that courts are to look at to determine if a corporation has an effective compliance and ethics program in place. If a sentencing court determines that a compliance and ethics program is effective, significant mitigation of criminal penalties can be had. There's also another benefit to an effective compliance and ethics program. Recent Department of Justice and SEC internal publications make clear that in the decision to prosecute a corporation, the prosecutor can look to the organization's compliance culture. Therefore, an effective compliance and ethics program may even help to avoid prosecution against the corporation in a case where something does go wrong.

The first factor for an effective program is that standards and procedures the corporation has established to prevent and detect violations of law. While the standards and procedures must be "reasonably capable of reducing the likelihood of criminal conduct," they should not be limited to the deterrence and detection of criminal conduct. In order to adequately deter and detect criminal conduct, the standards and procedures should be designed to address a broader range of unacceptable conduct. As an action item related to this factor, the board, or an appropriate board committee, should direct management and counsel to review the corporation's code of conduct and related procedures, assessing in particular whether the standards and procedures adequately address areas that pose the most significant risks of unlawful and unethical behavior for that corporation.

The second factor is directors and senior management should engage in the design, implementation, and maintenance of the compliance and ethics program. While senior management is responsible for the program, the board must be

knowledgeable about the content and operation of the program and exercise reasonable oversight as to both its implementation and its effectiveness. A senior manager must be assigned overall responsibility for the program.

The third factor for an effective compliance and ethics program is regular screening of new management personnel for past illegal or unethical conduct. While the careful vetting of CEOs and other senior managers is already best practice, this requirement expands the universe of managers who should be screened to include, at a minimum, all high-level personnel, all employees with substantial supervisory authority (such as plant managers or sales managers), and all employees who have been delegated substantial discretion (such as employees authorized to negotiate material contracts or set material pricing terms). The board and senior management should discuss what methods are being used to screen senior-level personnel. In addition, the board should actively review the screening of potential candidates for CEO and other senior managers.

The fourth factor is that there must be compliance and ethics training of all corporate personnel. This training should communicate, in a practical and straightforward manner, the corporation's standards and procedures, as well as other relevant aspects of the compliance and ethics program. Such training should include directors, officers, employees, and even agents and should be discussed by the board and management.

Another area that sentencing courts will consider is whether efforts have been made to encourage and monitor compliance with, and to evaluate the effectiveness of, the compliance and ethics program. A corporation must take reasonable steps to ensure that its compliance and ethics program is being followed and is effective in detecting and deterring prohibited conduct. Anonymous and confidential systems for employees and agents to report concerns and seek guidance with respect to any questionable conduct without threat of retaliation for whistle-blowing is a necessary component, as are steps to audit, monitor, and evaluate the program. A reporting system that provides a means for anonymous and confidential reporting of accounting and auditing concerns (as required by Sarbanes-Oxley) but not for the similar reporting of other types of concerns may not be deemed sufficient.

The sixth factor that sentencing courts will look to is whether incentives and discipline are used to promote compliance. The board and management should review the sanctions for misconduct under the compliance and ethics program. This review should also encompass consideration of possible incentives for compliance and ethical conduct that may be appropriate to the corporation's business and operations. For example, the board may wish to consider making performance under the compliance and ethics program a component of performance evaluations and bonus compensation.

As the seventh and final factor, a sentencing court will look to see whether or not the corporation responds appropriately if and when criminal conduct occurs. The corporation should be prepared to address both specific instances of misconduct as well as any systemic shortcomings that may compromise the effectiveness of the compliance and ethics program. The board and management should discuss the creation of procedures to ensure a prompt and appropriate response to specific violations, as well as a mechanism for regularly reviewing at the board (or board committee) level the causes and conditions that led to any potential system failure and for the evaluation and approval of systemic improvements as necessary.

> "Spending real time and effort monitoring the company's compliance programs has become part of a director's duty of care."

In summary, directors need to be aware of the impact mitigating the Federal Organizational Sentencing Guidelines can have on criminal penalties should employees or agents be found to engage in criminal conduct. Mitigation requires board involvement in ensuring an ethical and compliant culture. This isn't a new role, however. Spending real time and effort monitoring the company's compliance programs has been recognized as part of a director's duty of care. Since 1996, the Caremark case and the revised sentencing guidelines are an opportunity to review how the board manages its compliance program. Corporate directors will serve their company well if they pay attention to developments in the compliance area because, as the federal sentencing guidelines underscore, corporate directors are in a unique position to help protect the company from criminal penalties when things go wrong.

How Effective Boards Utilize Sarbanes-Oxley Information

Martin Bienenstock, partner at Weil, Gotshal & Manges LLP, discusses the optimal board agenda as directors digest the data created through compliance with Sarbanes-Oxley.

Martin J. Bienenstock
Partner
Weil, Gotshal & Manges LLP

What additional data does the corporation obtain as a result of the Sarbanes-Oxley Act?

Compliance with Sarbanes-Oxley creates all kinds of data, some of which is reported and some of which stays in the company. But to break it down into these broad categories, one must first look at the procedures developed to obtain the data. The CEO and CFO are jointly responsible for making sure the corporation has disclosure controls and procedures in place to uncover the important data for the company's financial statements, which also includes nonfinancial information that's material. So a company's internal records today will include material information about risks the company faces, off-balance-sheet debt, compliance with its code of ethics, and the CEO's assessment of the company's disclosure controls and procedures that are in effect at least 90 days before the statement date. All this is designed to enhance both the quality of data for the public investor as well as for the company, which will enable management and the board to address what's material to the corporation. It's a wealth of data, and the challenge is how to make use of it.

Corporations are now going to obtain immense quantities of data in their files, a subset of which will be included in their publicized financial statements and reports filed with the SEC. This emanates from the new requirement that the CEO and CFO certify that they have established adequate disclosure controls and procedures designed to make sure public investors, but, equally important, management and the board, have access to all material information, both financial and nonfinancial. Boards will also receive data concerning the company's code of ethics and, as this is now an area of emphasis, will become more sensitive to the notion of making sure that code is followed.

What should a board do with all that data?

The first thing the board must do is make sure it understands the data so it can act on it. This data goes to the viability of the company, its prospects, and how it might perform, as well as the risks that could prevent it from performing according to its business plan. So the board has to make sure the right people, be it management, outside professionals, or directors themselves, digest the data. For instance, if the company has a huge amount of off-balance-sheet debt, somebody has to keep track of the debt terms, the consequences to the corporation if that debt can't be refinanced, and how that might affect the company's ratings. All of that has to be digested and understood. And if there is nonfinancial information that could create a financial impact, such as a risk from a key supplier or an ingredient for a key product, the company must have a contingency plan. It's important to remember that because plaintiffs' lawyers can now access this data in a company's files for discovery proceedings, the board is more vulnerable in terms of being accused of having the data at its fingertips and not taking the right steps to protect the corporation or not using the data to help the corporation. So now that more data is available, the board must make sure management has the right people assigned to digest it and come up with contingency plans so directors can say they acted on the information in a reasonable timeframe. Also, Sarbanes-Oxley goes to great lengths to avoid finger pointing by having both the CEO and CFO certify that they have disclosure controls and procedures in place and then by having the auditor certify that indeed they are in place. That way, they are locked into the notion that there shouldn't be any

surprises for the corporation, and they can't point their fingers at each other for not telling one another. In this environment, the CEO and CFO–whether they are on or off the board–have a particular interest, as does the auditor, in making sure that the controls work and that the corporation has an early warning system that will enable the board to head off trouble before it must be reported in a financial statement.

How can chairmen, CEOs, general counsels, board advisers, and corporate secretaries help board members carry out their duties?

In light of Sarbanes-Oxley and all this additional data being supplied to the company through its employees, outside auditors, and, potentially, outside experts, the board and the CEO are now required to make sure there are corporate employees and officers in charge of understanding that information and recommending action plans. For example, if a company is highly leveraged and needs to periodically roll over debt that's coming due, it will no doubt have people in charge of looking at its refinancing options. This, frankly, is so obvious that it was done well before the passage of Sarbanes-Oxley. But for other risks that are not as obvious, such as a lawsuit that might be filed based on an accident, whether someone finds a contaminated product on a drugstore shelf or a company delivery truck carrying contaminated waste crashes and contaminates a river of drinking water, companies need to detect the bad things that might happen and develop broad contingency plans to deal with them to minimize harm to the company. These situations can be divided into internal and external risks. Internal risks to the company include issues with key employees, the patent duration for key products, and the protection of its secret know-how. Then there are external risks–what might happen in the credit markets and capital markets, new competition, and new products, among lots of other things. The company needs to assign each of these risk categories to various employees and officers to keep tabs on them and, where possible, to invest money in either eliminating or mitigating them. This task is not driven primarily by a need to comply with the law; this task is driven by a need to increase share value by minimizing the company's level of risk to its ability to continue operating as a going concern.

How can management and the board collaborate to develop the optimal board agenda?

It's important, first of all, that this be a collaboration. Corporations don't work well if there is an adversarial relationship between directors and corporate officers, such as the CEO. So this must be a collaboration with everyone looking to increase share value as the ultimate goal. Yet under Sarbanes-Oxley, there is heightened scrutiny and sensitivity with regard to a company's code of ethics. In fact, any deviations have to be promptly reported, and it's unlikely boards post-Enron are going to waive their code of ethics. So on one hand, you have a very important policing function that prevents corporate officers and directors from taking advantage of their corporation. On the other hand, they are required to collaborate to make sure that they do the right things for their company.

The best method for the CEO and the board to put together the optimal agenda is to start out with some categorizations of what they are trying to achieve. They are trying to look at company revenue drivers and all factors critical to the company's ability to continue as a going concern. They are certainly trying to avoid the known risks and to uncover unknown risks. They are trying to protect one another by making sure they look at each task affecting the corporation in a way that would pass the scrutiny of the Delaware Chancery Court. Part of this agenda has to be to give the CEO and the board the protection of the business judgment rule by making sure they get the right advice and by providing the right amount of time and analysis to each problem that must be resolved. This includes, for instance, having the general counsel or another expert review the new federal sentencing guidelines with the board and corporate officers. This not only emphasizes how important it is to make sure the corporation is in compliance with the law, but also goes to show that the board and corporate officers have a

HANDLING COMPLIANCE DATA

- Make sure the appropriate people are assigned to assess the data.
- Have management make recommendations to the CEO, CFO, and the board.
- Create contingency plans.
- Categorize internal and external risks.
- Collaborate with management to identify appropriate board agenda items.

joint interest in protecting one another as they jointly protect the company. So the optimal board agenda is a wide-ranging, complex item.

Notably, the agenda should include having management prepare contingency plans to deploy in a crisis. The company must be prepared to reach out quickly to all its lifelines including financers, employees, vendors, customers, the public, and the stock exchanges.

"The board has to make sure that the right people, be it management, outside professionals, or directors themselves, digest the data."

In summary, after the passage of Sarbanes-Oxley, which resulted largely from the Enron scandals, many board members are asking why they should continue to be board members. A large part of the answer is that they can enhance share value in compliance with laws that create heightened scrutiny over a corporation and its constituents, including its officers and employees. To pass that heightened scrutiny, the board and management need to discuss the optimal board agenda that will keep management honest and the board looking solely after the rights and benefits of shareholders and creditors, where necessary. Bottom line: If nothing else, boards need to make sure they are completely aware of their business, its risks and what they've done about those risks, and are in compliance with the law.

A Reflective Look at the Evolution of Corporate Boards

Edward Knight, executive vice president and general counsel of The NASDAQ Stock Market, reviews companies' changing cultures in this era of profound board governance changes.

Have there been any regulatory actions or events that will ultimately impact corporate directors or their efforts to be part of an effective board?

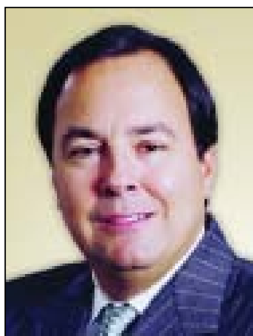
We're in the implementation phase of what many would consider the most profound changes in the rules governing board operations in the last century. These changes were very detailed and, in some cases, very controversial. So the focus now is not so much on the new rules, but based on our discussions with Congress and the SEC, on the interpretation of these rules–trying to get people to understand how to follow them practically, identifying best practices, and refining points as we go forward. For instance, in the case of NASDAQ's rules and their effect on foreign issuers, we had caused companies to apply for exemptions when all they needed to do was give us assurances that they were complying with their home country rules. So we smoothed out that process, and you'll find that the SEC and other regulatory agencies and SROs that have a role in this transition are making efforts to smooth out their processes as well.

What are you seeing with respect to companies' efforts to change their organizations to more ethical cultures?

It's really a translation process of taking a rule, a set of words, and giving it life. It is putting the rule into the words and actions of a company and its culture so that it is ingrained and employees understand it is a priority for the company. Each company will have a different way of doing that, but in the end, what is most reliable is having written policies and procedures that give life to these rules and remind people of their obligations. So it's all about taking these rules and turning them into procedures and policies that people understand, and really making it part of the company culture.

NASDAQ does not mandate board evaluations in its listing requirements. What is NASDAQ's attitude toward evaluations?

Generally, it's part of the phenomenon of companies wanting to take extra precautions to ensure that they're doing the right thing, and obviously, that is a very good development. It's in the same category as private companies that are not subject to Sarbanes-Oxley applying those rules even though they are not required to do so. So it is going beyond the law and taking extra precautions because the company is committed to compliance and to performing at a high level for its investors. Nevertheless, it may not be for all companies, and it is not something that we at NASDAQ think should be part of our rules. It needs to be translated into the company's culture and what its priorities are in terms of its directors, but it's certainly something boards should consider, perhaps in the category of best practices.



Edward Knight
Executive Vice President,
General Counsel
The NASDAQ Stock Market

Refocusing from Form to Substance... How Can Boards Become More Effective?

Our board governance experts discuss how corporate directors can enhance their effectiveness and contribute to their company's success.

TK Kerstetter
President
Corporate Board Member
Moderator

Martin J. Bienenstock
Partner
Weil, Gotshal & Manges LLP

Holly Gregory
Partner
Weil, Gotshal & Manges LLP

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Sibson Consulting

Edward Knight
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Garrett L. Stauffer
Partner and U.S. Leader for Corporate Governance
PricewaterhouseCoopers LLP

With many companies having addressed their all-important governance foundation through charters, guidelines, policies, etc., and as boards shift back to focus on more substance and less form, what issue, process, or activity would you suggest corporate directors refocus on to enhance their effectiveness as a board and positively contribute to the organization's success?

Holly Gregory: As boards move their focus from compliance with the new governance regulations back to board work focusing on helping a corporation grow and prosper, the most important thing they can do is engage in a serious dialogue with management about where they can add value. Boards have great freedom to define their own agendas, and this is a wonderful time to talk with management about the important issues facing the company and how the board can best help management address the areas of performance, competition, and risk. Usually this discussion centers around the corporation's strategy and the aspects of that strategy for which board members can bring particular insight. This discussion is most helpful if it focuses on the drivers of the business, management's assumptions about risks to the strategy that the board may want to question, and the information the board needs on a regular basis to be assured that this is the right management team with the right strategy.

Edward Knight: One of the principles at the heart of our securities system is transparency and truthfulness. If you had a relative thinking about investing in a company for which you were a director or senior officer what would you tell them? It should be the same thing that appears in the disclosures of the company. If it isn't in those disclosures, it needs to be, because they protect a company and its investors. Investors can take bad news, but they can't be lied to. Being open, transparent, and truthful with investors will serve companies, directors, and investors well.

Martin J. Bienenstock: With the passage of the Sarbanes-Oxley Act, for boards to become more effective and comply with the law, they must make sure their corporation obtains the benefit of all the additional data generated by complying with the act, some of which goes into the financial statements filed with the SEC. To do so, the board has to develop a process with specific components. Corporate officers and employees have to assess all of the material information uncovered by the company's disclosure controls and procedures. They will then make recommendations to the CEO, CFO, and board on a periodic basis as to what might be done to mitigate, eliminate, or leave some of these risk factors alone, although the corporation still needs to conduct contingency planning to deal with additional risk factors as they arise. The board, meanwhile, has to make sure that the wealth of data it's responsible for uncovering through the auditor and other experts is used, because directors will most certainly be confronted with this data if they're ever sued. It must also sure that this is a company project. It might be designed with the help of outside governance experts, but it is still the company's responsibility to build into its systems ways to uncover material information and act on it. The board can then say that it has done its job.

Blair Jones: My suggestion is that boards focus on their membership. At the end of the day, the board is only as good as its own directors. A focus on membership should have several components. First, make sure board

members have the right talent, the right performance standards, and the right competencies. Next, make sure the board is developing its competencies and expertise. All of that feeds into creating better dynamics. The right people, with the right skills, talents, and expectations will engender robust discussions that add value to the company. Companies and boards should take advantage of the information obtained through the policies and practices developed during its phase of redesigned governance, such as conducting performance reviews of board and committee members, and use that information to assess skills and also to remove any impediments to generating good conversation.

Garrett L. Stauffer: My advice in today's environment would be that nonmanagement directors need to meet without management to discuss management and board performance. That discussion should include how the board is discharging its responsibilities; what issues is it dealing with and are they the right issues; are directors adding value; does the board have the right directors; is the right mix of people and skill sets involved in the committees and on the board; management's strengths and weaknesses; leadership skills; and ethical values. The ultimate success of a company is going to be based on management. So it's imperative that the board evaluate management's strengths and weaknesses. Another area to look at is board meetings. How long are they and how often are they held? Board members should also challenge the atmosphere of meetings. Are they open? Can there be candid dialogue on the processes and issues of the day? And finally, directors need to evaluate the information they are receiving. Are they getting the right level of information on a timely basis needed to be effective? After directors have completed their evaluation, they need to designate one or two of the key members of the board to discuss the evaluation with management, listing the areas that the board believes warrant improvements and then tracking those improvements as they move forward.

"At the end of the day, the board is only as good as the people who are on it."

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