STATEMENT

OF

THE BUSINESS ROUNDTABLE

ON

THE CORPORATE AND AUDITING ACCOUNTABILITY,
RESPONSIBILITY AND TRANSPARENCY ACT OF 2002
(H.R. 3763)

FOR THE
COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

MARCH 20, 2002

The Business Roundtable submits the following discussion regarding the collapse of Enron and analysis of the Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002 (H.R. 3763).

The Roundtable is an association of chief executive officers of leading corporations with a combined workforce of more than ten million employees in the United States and $3.5 trillion in revenues. The chief executives are committed to advocating public policies that foster vigorous economic growth, a dynamic global economy and a well-trained and productive U.S. workforce essential for future competitiveness.

The Roundtable is recognized as an authoritative voice on matters affecting American business corporations and as such has a keen interest in corporate governance. Indeed, as leaders of some of our nation's largest businesses, the Roundtable has the strongest interest in corporate governance practices that secure the confidence of stockholders, employers, policymakers and other constituencies.

The Roundtable has issued publications on corporate governance issues since 1978. In 1997, the Roundtable published its Statement on Corporate Governance, which suggests best practices in areas such as the functions of the board of directors, board structure and operations, and stockholders' meetings (attached). We are pleased that a number of practices recommended in 1997 have been increasingly adopted by large corporations as best practices.

In light of recent events, the Roundtable has undertaken an expedited review of its 1997 statement regarding corporate governance, and we expect to issue a new statement on the subject later this spring.

INTRODUCTION

The Roundtable has issued a public statement regarding issues related to the bankruptcy of Enron, in which we expressed our views of Enron's collapse and a set of principles we believe should guide the discussion of proposed changes in practices, regulations, and laws (attached).

With respect to Enron, the Roundtable believes that a number of the actions and behaviors that are revealed in the report of the special committee of the Enron Board of Directors and that contributed to the collapse of the company, are unacceptable.

The report of the special committee describes a pervasive breakdown in the norms of ethical behavior, corporate governance and corporate responsibility to external and internal stakeholders. The Enron situation appears at this point to derive fundamentally from a massive breach of trust.

The United States has the best corporate governance, financial reporting, and securities markets systems in the world. These systems work because of the adoption of best practices by public companies within a framework of laws and regulations.

The collapse of Enron is a profound and troubling exception to the overall record of success. Other less dramatic exceptions may also exist among the thousands of U.S. public corporations. But they are exceptions in systems that have generally worked very well.

Indeed, demonstrating the inherently self-correcting nature of our market system, American businesses already are responding to the lessons learned from Enron's collapse. Companies are strengthening their financial controls, giving critical review to the clarity and transparency of their financial reports. Corporate boards of directors are taking steps to assure themselves, stockholders, employees and the public that Enron-like failures will not occur at their companies. Directors also are insisting that corporate managers and outside auditors carefully review the quality of corporate financial disclosures and the effectiveness of internal controls.

In the last several months, the Securities and Exchange Commission ("SEC") has issued several statements guiding public companies to more complete and forthcoming disclosure, and companies of the Roundtable, and many others, are already heeding that guidance. The annual reports filed with the SEC and sent to stockholders this month by most of our companies contain expanded disclosures and greater transparency in accordance with the SEC guidance and our own strong commitment to provide stockholders with clear and complete information needed to make informed investment decisions. Our most demanding regulators -- investors and the market -- require no less.

In the wake of Enron, the Congress, the Administration and the SEC have proposed new laws and regulations to address perceived breaches of trust, failures of responsibility and lack of candid disclosure at Enron and other companies. The Roundtable welcomes the personal involvement of the President and his "Ten-Point Plan to Improve Corporate Responsibility and Protect America's Shareholders." We also applaud the efforts of leaders in the Congress, including those of Chairman Oxley, to address the issues raised by Enron and related events.

The Roundtable will work closely with policymakers to help ensure that any necessary changes to laws and regulations are effective and efficient, taking care that our responses to the unusual circumstances presented by Enron do not inhibit U.S. public corporations' ability to compete, create jobs and generate economic growth.

It is in that spirit that the Roundtable submits the following analysis and discussion of the provisions of the Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002 (H.R. 3763).

OVERSIGHT OF THE ACCOUNTING PROFESSION

The Roundtable shares the widespread recognition that independent oversight of the accounting profession is necessary. We believe H.R. 3763's creation of a new "public regulatory organization" offers a responsible and thoughtful approach. In particular, we support H.R. 3763's provisions for effective oversight by the SEC and a self-funding mechanism that would ensure that the new organization is not solely dependent on the accounting profession for funding or operations.

The proposed legislation would establish a framework for the SEC to recognize one or more public regulatory organizations to oversee the accounting profession, under the oversight of the SEC. The organizations recognized by the SEC would have the authority, among other things, to punish accountants who violate the securities laws and standards of ethics, competency or independence.

This approach appears to be broadly consistent with the President's Ten-Point Plan, which calls for the establishment of a regulatory board under the supervision of the SEC. We understand that the SEC is in discussions with the Congress, the Administration and other interested parties concerning the appropriate structure and responsibilities of the regulatory body. We believe that these parties should continue discussions in order to develop a consensus as to the structure and operation of the regulatory body prior to engaging in specific legislation and/or rulemaking.

AUDITOR INDEPENDENCE

The Roundtable strongly believes that it is critical to take steps to promote and maintain auditor independence, in fact as well as in appearance. H.R. 3763 would direct the SEC to establish rules prohibiting an accountant from providing certain non-audit services -- financial information systems design or implementation services and internal audit services -- to an audit client.

We note -- and applaud -- H.R. 3763's careful approach, designed to focus on the issue of auditor independence. If legislation is warranted in this arena, H.R. 3763 has drawn the line on prohibited non-audit services precisely where it should be. Companies must be allowed to purchase from auditors valuable services that do not raise real questions of independence in fact or in appearance.

The SEC has taken the position, after an extensive rulemaking process, that financial information systems design or implementation services and internal audit services are not consistent with auditor independence. In 2000, the SEC conducted a rulemaking proceeding with respect to its auditor independence rules, including a review of non-audit services provided to audit clients. The final rules, adopted in November 2000, are still being phased in, and prohibit a number of non-audit services and impose restrictions on others, including financial information systems design and internal audit services. At the same time the SEC amended its auditor independence rules, it also adopted new rules requiring disclosure to stockholders of the fees companies pay to their outside auditors for audit and non-audit services.

The fee disclosure rules, accounting industry recommendations such as those in the August 2000 report of the Public Oversight Board Panel on Audit Effectiveness (also known as the "O'Malley Panel")[1], stockholder proposals dealing with non-audit services and the events surrounding the collapse of Enron have caused audit committees throughout corporate America to review carefully their policies and procedures with respect to all services provided by outside auditors. The issue is clearly posed and the American corporate and investor communities are addressing it. Change is occurring at a rapid pace.

In his testimony before this Committee on March 13, 2002, Barry Melancon, President and CEO of the American Institute of Certified Public Accountants, indicated that the accounting profession will not oppose prohibiting auditors of public companies from providing financial information systems design or implementation and internal audit services. The Roundtable is pleased that the accounting profession endorses such a ban and agrees that the ban is appropriate.

Other legislative proposals contain long lists of prohibited non-audit services. Many of these services are considered inconsistent with independence and were either prohibited or strictly limited by SEC rules adopted in late 2000 that are still being phased in. Other useful non-audit services are most efficiently provided by a company's outside auditors, such as pre-acquisition due diligence, tax analysis, statutory audits, assistance with governmental filings, and the provision of comfort letters. These services do not raise real questions of independence in fact or in appearance. Prohibiting them would impose significant unnecessary costs on public companies and their stockholders.

Accordingly, if the Committee concludes that it is necessary to adopt legislation to regulate auditor independence, the Roundtable believes that any limits on the scope of services provided by auditors should go no further than the ban on financial information systems design and implementation services and internal audit services. The provision of other non-audit services could be regulated through existing or additional SEC rules and audit committee oversight.

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[1] Report and Recommendations of the Public Oversight Board Panel on Audit Effectiveness, Shaun F. O'Malley, Chair (August 31, 2000), *available at* http://www.pobauditpanel.org/download.html.

PROMPT DISCLOSURE

The Roundtable agrees that, in an age of instant communication, there is an increasing need for corporations to disclose material information closer to the time it becomes available. H.R. 3763 would require the SEC to establish rules mandating that public corporations disclose "on a rapid and essentially contemporaneous basis" certain information, as determined by the SEC, about their financial condition and operations.

The SEC has the authority to prescribe, and has announced that it intends to propose, rules in this area.[2] These rules would expand the types of information that companies must provide on current reports and accelerate the deadline for reporting. The Roundtable supports a standard that would provide investors with disclosure as promptly as possible, consistent with the need to allow companies sufficient time to prepare disclosure that is meaningful and accurate.

In this regard, the Roundtable has concerns about whether it would be feasible for companies to disclose information on Form 8-K "on a[n] . . . essentially contemporaneous basis," as proposed in H.R. 3763. Before a company files a Form 8-K, there are normal and prudent internal procedures that need to be followed, including verification of facts, notification of affected parties, and internal and external legal and accounting review of the applicable disclosure. If companies do not have adequate time to follow through on these procedures, there is a danger that disclosures may not be accurate and that the market will be misled rather than better informed.

TRANSPARENT DISCLOSURE

The Roundtable supports H.R. 3763's goal of enhancing the transparency of corporate disclosures, and we agree that the SEC should proceed with rulemaking in this area. We note that the SEC has ample existing authority to prescribe rules and regulations governing the content of the disclosures that companies make to investors, and is already using that authority.

Among other things, H.R. 3763 would have the SEC require disclosure of off-balance sheet transactions and relationships with unconsolidated entities that are "reasonably likely to materially affect the issuer's financial condition." The proposed legislation would also mandate new SEC rules for disclosure of relationships and material transactions that are not arms-length. Finally, the bill would require the SEC to consider additional disclosures concerning key accounting principles and non-exchange traded contracts, as well as the use of "plain language" in disclosure documents.

With respect to the specific topics that H.R. 3763 targets for improved disclosure, the SEC has already issued several important interpretations and has indicated that further rule proposals are imminent. In December 2001, the SEC issued guidance to companies about the

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[2] SEC Press Release, SEC to Propose New Corporate Disclosure Rules (Feb. 13, 2002), *available at* http://www.sec.gov/news/press/2002-22.txt.

information it expects to see in their Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") about critical accounting policies.[3] The SEC also notified companies about three areas in which they should consider providing better disclosure: liquidity and capital resources, including off-balance sheet arrangements; non-exchange traded contracts accounted for at fair value; and relationships and transactions on terms that would not be available from clearly independent third parties.[4] The annual reports being filed this month by most public companies reflect this guidance. More recently, the SEC indicated that it would propose amendments to its MD&A rules to require disclosure about critical accounting policies.[5] In the area of "plain language," the SEC has initiated successful efforts with respect to prospectus disclosures and SEC Chairman Pitt has expressed an interest in making financial statements more understandable to investors.[6] The SEC has also suggested proposing rule changes that would obligate companies to post their periodic reports on their websites at the time of filing with the SEC.

Given the SEC's existing statutory authority and the steps that the SEC has already taken in the areas covered by the proposed legislation, the Committee may wish to monitor the progress of the SEC's rulemaking efforts before deciding whether additional legislative steps are necessary.

OVERSIGHT OF FINANCIAL DISCLOSURES

The SEC needs flexibility so that it can react to changing market and regulatory conditions. When unexpected events occur, the SEC must be able to reallocate its resources quickly and shift focus to address these conditions. For example, over the past decade, the SEC has had to devote significant resources, at various times, to microcap/penny stock fraud, abuses in connection with real estate roll-up transactions, and derivatives, along with monitoring new rules, such as the executive compensation rules promulgated in the early 1990s. At any given time, the SEC must be able to exercise its judgment as to where its regulatory focus should be targeted. Prescribing by statute the particular kinds of companies, or issues, that should receive SEC attention would unnecessarily constrain the SEC's flexibility. Thus, we do not support statutory minimum periodic review requirements. We believe a better approach would be to

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[3] Cautionary Advice Regarding Disclosure About Critical Accounting Policies, Release Nos. 33-8040 & 34-45149 (Dec. 12, 2001), *available at* http://www.sec.gov/pdf/33-8040.pdf.

[4] Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations, Release Nos. 33-8056 & 34-45321 (Jan. 22, 2002), *available at* http://www.sec.gov/rules/other/33-8056.htm.

[5] SEC Press Release, SEC to Propose New Corporate Disclosure Rules (Feb. 13, 2002), *available at* http://www.sec.gov/news/press/2002-22.txt.

[6] Harvey L. Pitt, Remarks Before the AICPA Governing Council (Oct. 22, 2001), *available at* http://www.sec.gov/news/speech/spch516.htm.

require the SEC to disclose the amount and types of reviews it conducts in greater detail in its annual report.

ELECTRONIC DISCLOSURE OF INSIDER TRANSACTIONS

The Roundtable agrees that the existing disclosure system is inadequate because of the length of time between the date a transaction occurs and the date it must be reported. We agree that more timely disclosure of insider transactions would benefit investors. We also agree that transactions in the open market and sales of securities back to a company should be reported promptly.

The Roundtable does not oppose legislation directing the SEC to promulgate rules governing the disclosure of transactions by officers and directors. We are concerned, however, about legislation that would set rigid deadlines. Even relatively straightforward transactions by insiders may not lend themselves to immediate reporting. Transactions that investors are likely to consider significant -- such as large sales -- are often effected in a series of transactions over the course of one or two days. Because brokers currently have three days to settle transactions, even basic information -- such as the price at which shares were sold -- may not be available for several days after a transaction occurs. Moreover, there is a wide range of non-open market transactions that involve reportable changes in ownership, and the rules currently applicable to insider transactions are, accordingly, very complex. We believe that any changes need to be considered carefully to ensure companies and their officers and directors have sufficient time to prepare reports that accurately reflect the substance of their transactions.

We note that the SEC is considering new rules that would require issuers to report transactions by officers and directors on an expedited basis.[7] The Roundtable welcomes the opportunity to work with the Congress and the SEC to develop a workable system for timely reporting of insider transactions.

PROHIBITION OF IMPROPER INFLUENCE ON AUDITS

H.R. 3763 would also make it unlawful to violate new SEC rules that would prohibit any officer, director, or affiliated person of an issuer to "willfully and improperly influence, coerce, manipulate or mislead any accountant performing an audit for the purpose of rendering the financial statements being audited materially misleading." The bill further provides that the SEC would have exclusive civil enforcement authority for this prohibition, making clear that a new implied private right of action is not intended – a position the Roundtable strongly supports.

Current SEC rules forbid the type of conduct that is the subject of the prohibition in H.R. 3763. Some years ago, the SEC adopted two rules under Section 13(b)(2) of the Securities Exchange Act of 1934 ("Exchange Act") that prohibit the conduct covered by this prohibition.

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[7] SEC Press Release, SEC to Propose New Corporate Disclosure Rules (Feb. 13, 2002), *available at* http://www.sec.gov/news/press/2002-22.txt.

Rule 13b-1 makes it unlawful for any person to "directly or indirectly, falsify, or cause to be falsified any book, record or account subject to Section 13(b)(2)(A) of the…[Exchange] Act," and Rule 13b-2 provides that "[n]o director or officer shall, directly or indirectly, make or cause to be made a materially false or misleading statement, or omit to state, or cause another person to state, any material fact necessary in order to make the statement made…not misleading to an accountant in connection with (1) any audit or examination of the financial statements of the issuer…or (2) the preparation or filing of any document or report required to be filed with the Commission." In addition, the Congress amended the Exchange Act to add Section 13(b)(5), which provides that "no person shall knowingly circumvent or knowingly fail to implement a system of internal accounting controls or knowingly falsify any book, record, or account described in paragraph (2) [regarding internal accounting controls and maintenance of books, records and accounts]."[8]

The Roundtable believes that the Committee should consider the extent to which the proposed legislative provision may duplicate this existing SEC authority.

TRADING DURING PENSION FUND BLACKOUT PERIODS

The Roundtable supports proposals designed to ensure that company executives do not engage in improper trading during a period of a blackout. Any such limits on trading should provide that, first, the definition of a "blackout" should be consistent with that used for other purposes, such as advance notice requirements. Second, the rules should not apply where a blackout affects only a relatively small part of an employer's workforce (e.g., a small plan merging into a much larger plan). Third, the trading limits should be applied to an appropriately narrow group of top decision-makers in a company and would only apply during periods where the blackout affects the ability of plan participants to trade in company stock.

LITIGATION-ORIENTED PROPOSALS

While not addressed in H.R. 3763, the Roundtable also has concerns about other legislative proposals that would eliminate some of the central limitations on abusive litigation enacted as part of the Private Securities Litigation Reform Act of 1995 ("PSLRA").

The Congress passed the PSLRA to accomplish two principal policy objectives -- encouraging disclosure of more forward-looking information because of its value to investors, and discouraging frivolous lawsuits. The Roundtable strongly advocated the inclusion in the PSLRA of a safe harbor for forward-looking statements. Since 1995, we believe that this safe harbor has significantly improved the content and transparency of corporate disclosure. The safe harbor has encouraged management to share internal projections, strategic goals and other important forward-looking information with the marketplace. Many companies now provide "outlook" sections in their SEC filings to afford investors greater insight into management's

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[8] The conduct targeted by the new provision may also be prosecuted by the SEC under Exchange Act Sections 20(a - c, e), 21B and 21C.

views about where a company is going. Removing the protections afforded by the statutory safe harbor could make companies reluctant to provide valuable disclosure.

The Roundtable believes that doing away with the PSLRA's safe harbor would usher in a new era of litigation abuses and turn back the clock on reforms that have yielded positive results for companies and investors alike. For these reasons, the Roundtable opposes the provisions of other bills that would weaken the protections of the PSLRA.

CONCLUSION

The Roundtable supports the goal of stockholder protection embodied in the provisions of H.R. 3763. As the Congress considers proposed changes to current laws and regulations, we urge the Committee to consider SEC and private sector initiatives already underway. Notably, these include initiatives of the stock exchanges and organizations such as the National Association of Corporate Directors and the Financial Executives Institute, as well as the Roundtable's current project to update its 1997 Statement on Corporate Governance.

The Roundtable is committed to taking forceful and effective steps to prevent further failures from occurring in the wake of Enron's collapse. While new legislation may be required, it is also important to ensure that the statutory and regulatory tools already in place are enforced. But at the end of the day, there is no substitute for the commitment by business leaders to responsible and ethical leadership. As chief executive officers of some of America's largest businesses, the members of the Roundtable have made that commitment.

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THE BUSINESS ROUNDTABLE

Statement of The Business Roundtable
On Corporate Governance Principles
Relating to the Enron Bankruptcy

February 11, 2002

The Business Roundtable (BRT) believes that the actions and behaviors, revealed in the report of the special committee of the Enron Board of Directors, which contributed to the collapse of the company, are unacceptable. The report describes a pervasive breakdown in the norms of ethical behavior, corporate governance and corporate responsibility to external and internal stakeholders. The Enron situation appears at this point to derive fundamentally from a massive breach of trust.

The United States has the best corporate governance, financial reporting, and securities markets systems in the world. These systems work because of the adoption of best practices by public companies within a framework of laws and regulations. The collapse of the Enron Corporation is a profound and troubling exception to the overall record of success. Other less dramatic exceptions may also exist among the thousands of United States public corporations - but they are exceptions in systems that have generally worked very well.

Since 1990, the BRT has been an authoritative voice on issues of corporate governance. Most recently in 1997, the BRT published its Statement on Corporate Governance, which suggests best practices in areas such as the functions of the board of directors, board structure and operations, and stockholders meetings. Over the years large corporations have increasingly adopted these practices. In light of recent events, the BRT will expedite an updating of the Statement to deal with many of the issues currently under discussion.

In light of the public interest in issues growing out of the Enron situation, we believe it is necessary to restate here our understanding of some guiding principles of corporate governance that should form the basis for considering any proposed changes in practices, regulations and laws.

First, the paramount duty of the board of directors of a public corporation is to select and oversee competent and ethical management to run the company on a day-to-day basis.

Second, it is the responsibility of management to operate the company in a competent and ethical manner. Senior management is expected to know how the company earns its income and what risks the company is undertaking in the course of carrying out its business. Management should never put personal interests ahead of or in conflict with the interests of the company.

Third, it is the responsibility of management, under the oversight of the board and its audit committee, to produce financial statements that fairly present the financial condition of the company and make sufficient disclosures to investors to permit them to assess the financial and business soundness of the company.

Fourth, it is the responsibility of the board and its audit committee to engage an independent accounting firm to audit the financial statements prepared by management and to issue an opinion on those statements based on Generally Accepted Accounting Principles. The board, its audit committee and management must be vigilant to ensure that no actions are taken by the corporation or its employees that compromise the independence of the independent accounting firm.

Fifth, it is the responsibility of the independent accounting firm to ensure that it is in fact independent, is without conflicts of interest, employs highly competent staff, and carries out its work in accordance with Generally Accepted Auditing Standards. It is also the responsibility of the independent accounting firm to inform the board, through its audit committee, of any concerns it may have about the appropriateness and quality of significant accounting treatments, business transactions, and about any weaknesses in internal control systems. The firm should do so in a forthright manner and on a timely basis, whether or not management has communicated to the board or the audit committee on the same matters.

Sixth, the company has a responsibility to deal with its employees in a fair and equitable manner. Employee benefit plans, once established, should be operated in a manner that is fair and equitable to all employees.

These responsibilities, and others, are critical to the functioning of the modern public corporation. No law or regulation alone can be a substitute for the voluntary adherence to these principles by corporate directors and management and by the accounting firms retained to serve American corporations.

Many proposals will no doubt be offered to create new regulations or laws to deal with what appear to be breaches of trust and failures of responsibility at Enron. We must all take care that responses to the unusual circumstances presented by Enron do not inhibit U.S. public corporations' ability to compete, create jobs and generate economic growth. The Business Roundtable is reviewing corporate governance principles and procedures and will work closely with policymakers to help ensure that any necessary changes to laws and regulations are effective and efficient.

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The Business Roundtable is an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees in the United States and $3.5 trillion in revenues. The chief executives are committed to advocating public policies that foster vigorous economic growth and a dynamic global economy.

Statement on Corporate Governance

September 1997

The Business Roundtable
An Association of Chief Executive Officers Committed to Improving Public Policy

Statement on Corporate Governance

A White Paper from The Business Roundtable

Foreword

The Business Roundtable is recognized as an authoritative voice on matters affecting large corporations and, as such, is keenly interested in a proper understanding of the purpose of corporate governance. Past publications of The Business Roundtable that have addressed corporate governance issues include The Business Roundtable's statement on Corporate Governance and American Competitiveness (March, 1990), Statement on Corporate Responsibility (October, 1981) and The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation (January, 1978). In the current publication, The Business Roundtable summarizes its current views on governance issues, thus updating and building on the work of the past.

The Business Roundtable notes with pride that, in the seven years since its last publication on corporate governance, many of the practices suggested for consideration by The Business Roundtable have become more common. This has been the result of voluntary action by the business community without new laws and regulations and reflects the positive impact of interested stockholders. The Business Roundtable believes it is important to allow corporate governance processes to continue to evolve in the same fashion in the years ahead.

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I. Introduction

The Business Roundtable wishes to emphasize that the principal objective of a business enterprise is to generate economic returns to its owners. Although the link between the forms of governance and economic performance is debated, The Business Roundtable believes that good corporate governance practices provide an important framework for a timely response by a corporation's board of directors to situations that may directly affect stockholder value. The absence of good corporate governance, even in a corporation that is performing well financially, may imply vulnerability for stockholders because the corporation is not optimally positioned to deal with financial or management challenges that may arise.

… the substance of good corporate governance is more important than its form; adoption of a set of rules or principles or of any particular practice or policy is not a substitute for, and does not itself assure, good corporate governance.

Many discussions of corporate governance focus on questions of form and abstract principle: Should a corporation have a non-executive chairman of the board? Should the board have a lead director? Should there be a limit on the number of boards on which a director serves? The Business Roundtable considers such questions important. Indeed, much of this Statement is devoted to discussing them. However, The Business Roundtable wishes to emphasize that the substance of good corporate governance is more important than its form; adoption of a set of rules or principles or of any particular practice or policy is not a substitute for, and does not itself assure, good corporate governance.

Examples of this point abound. A corporation with the best formal policies and processes for board involvement may be at risk if the chief executive officer is not genuinely receptive to relevant board input or if knowledgeable directors hesitate to express their views. A corporation can have excellent corporate governance structures and policies on

Corporate governance is not an abstract goal, but exists to serve corporate purposes by providing a structure within which stockholders, directors and management can pursue most effectively the objectives of the corporation.

paper, but if the CEO and the directors are not focused on stockholder value, it may be less likely the corporation will realize that value. Directors can satisfy the most demanding tests for independence, but if they do not have the personal stature and self-confidence to stand up to a non-performing CEO, the corporation may not be successful. On the other hand, a corporation that lacks many of the so-called "best practices" for corporate governance, or that does not memorialize its practices in formal documents, may nonetheless perform well if its directors and management are highly able people who are dedicated to advancing the interests of stockholders.

One of the reasons why people focus on the formal, structural aspects of corporate governance is that doing so permits evaluations that appear to be objective and verifiable. Formal attributes of good corporate governance can be tabulated to compare corporate governance practices across the spectrum of companies. Such comparisons do have value, but it would be a mistake to lose sight of their limitations. The "soft," subjective factors in corporate governance — such as the quality of directors and the personalities of CEOs and directors — receive less attention from scholars and journalists but are critical in the real world of corporate behavior. Boards and management should not feel that they have discharged their responsibilities in regard to corporate governance just by putting in place a particular set of structures and formal processes. They must also periodically review these structures and processes to insure that they are achieving good corporate governance in substance.

Corporate governance is not an abstract goal, but exists to serve corporate purposes by providing a structure within which stockholders, directors and management can pursue most effectively the objectives of the corporation. There has been much debate in corporate governance literature about the parties to whom directors owe a duty of loyalty and in whose interest the corporation should be managed. Some say corporations should be managed purely in the interests of stockholders or, more precisely, in the interests of its present and future stockholders over the long-term. Others claim that directors should also take into account the interests of other "stakeholders" such as employees, customers, suppliers, creditors and the community.

In The Business Roundtable's view, the paramount duty of management and of boards of directors is to the corporation's stockholders …

The Business Roundtable does not view these two positions as being in conflict, but it sees a need for clarification of the relationship between these two perspectives. It is in the long-term interests of stockholders for a corporation to treat its employees well, to serve its customers well, to encourage its suppliers to continue to supply it, to honor its debts, and to have a reputation for civic responsibility. Thus, to manage the corporation in the long-term interests of the stockholders, management and the board of directors must take into account the interests of the corporation's other stakeholders. Indeed, a number of states have enacted statutes that specifically authorize directors to take into account the interests of constituencies other than stockholders, and a very limited number of state statutes actually require consideration of the interests of other constituencies.

In The Business Roundtable's view, the paramount duty of management and of boards of directors is to the corporation's stockholders; the interests of other stakeholders are relevant as a derivative of the duty to stockholders. The notion that the board must somehow balance the interests of stockholders against the interests of other stakeholders fundamentally misconstrues the role of directors. It is, moreover, an unworkable notion because it would leave the board with no criterion for resolving conflicts between interests of stockholders and of other stakeholders or among different groups of stakeholders.

Good corporate governance is not a "one size fits all" proposition ...

While The Business Roundtable favors certain broad principles as generally contributing to good corporate governance, not all of these broad principles are necessarily right for all corporations at all times. Good corporate governance is not a "one size fits all" proposition, and a wide diversity of approaches to corporate governance should be expected and is entirely appropriate. Moreover, a corporation's practices will evolve as it adapts to changing situations.

II. Functions of the Board

The business of a corporation is managed under the direction of the board of directors, but the board delegates to management the authority and responsibility for managing the everyday affairs of the corporation. The extent of this delegation varies depending on the size and circumstances of the corporation. In a large corporation that is performing well and has strong management, the board may delegate more; in a smaller or closely-held corporation, or one facing critical challenges, more detailed involvement by the board in the business of the corporation may be appropriate. In a large publicly owned corporation that is not facing extraordinary difficulties, in addition to reviewing and approving specific corporate actions as required by law (e.g., declaration of dividends), the principal functions of the board are to:

(i) Select, regularly evaluate and, if necessary, replace the chief executive officer; determine management compensation; and review succession planning;

(ii) Review and, where appropriate, approve the major strategies and financial and other objectives and plans of the corporation;

(iii) Advise management on significant issues facing the corporation;

(iv) Oversee processes for evaluating the adequacy of internal controls, risk management, financial reporting and compliance, and satisfy itself as to the adequacy of such processes; and

(v) Nominate directors and ensure that the structure and practices of the board provide for sound corporate governance.

Management Selection and Compensation

- The selection and evaluation of the chief executive officer and concurrence with the CEO's selection and evaluation of the corporation's top management team is probably the most important function of the board. In its broader sense, "selection and evaluation" includes considering compensation, planning for succession and, when appropriate, replacing the CEO or other members of the top management team.

- The performance of the CEO should generally be reviewed at least annually without the presence of the CEO and other inside directors. The board should have an understanding with the CEO with respect to the criteria according to which he or she will be evaluated, and there should be a process for communicating the board's evaluation to the CEO.

- Boards have a responsibility to ensure that compensation plans are appropriate and competitive and properly reflect the objectives and performance of management and the corporation. Incentive plans will vary from corporation to corporation and should be designed to provide the proper balance between long- and short-term performance incentives. Stock options and other equity-oriented plans should be considered as a means for linking management's interests directly to those of stockholders.

Providing advice and counsel to management is a key element of the board's role.

Approval of Major Strategies And Financial Objectives

- Approving major strategies and financial objectives and tracking results is related to the function of selecting and evaluating the CEO. Insofar as the corporation develops and successfully executes sound long-range plans, the CEO and the corporation's management team will generally be deemed to be doing a good job. There may also be circumstances in which the CEO is deemed to be doing a good job even though financial results fall short of plans.

- A corporation may achieve its near-term financial objectives but may ultimately fail if it has not developed an appropriate business strategy. Accordingly, boards should consider financial objectives and results in the context of the wider business strategy of the corporation.

- When a corporation falls significantly short of its important objectives or when plans appear to be inadequate, more intensive board oversight of management is warranted. This kind of circumstance requires the best judgment of people highly experienced in business and management. Alternatives must be considered carefully and appropriate action taken.

Advising Management

- Providing advice and counsel to management is a key element of the board's role. It is fulfilled both in formal board and board committee meetings and also in informal, individual director contacts with the CEO and other members of management.

- A board member who effectively fulfills his or her role of advising the CEO provides an important service to the corporation.

Risk Management, Controls and Compliance

- The Board must assure that an effective system of controls is in place for safeguarding the corporation's assets, managing the major risks faced by the corporation, reporting accurately the corporation's financial condition and results of operations, adhering to key internal policies and authorizations, and complying with significant laws and regulations that are applicable to it.

- In performing these functions, the board generally relies on the advice and reports of management, internal and external counsel, and internal and external auditors. The board's role should be to review reports from such experts, to provide them with guidance and to assure that management takes appropriate corrective actions when significant control problems are reported.

Selection of Board Candidates

- It is the board's responsibility to nominate directors. The board nominates a whole slate, which should encompass individuals with diverse talents, backgrounds, and perspectives who can work effectively together to further the interests of the corporation's stockholders, while preserving their ability to differ with each other on particular issues as policy is developed. Men and women of different ages, races and ethnic backgrounds can contribute different, useful perspectives.

Each director should represent the interests of all stockholders, not those of any single individual or group of stockholders or any single interest group.

- Each director should represent the interests of all stockholders, not those of any single individual or group of stockholders or any single interest group. Cumulative voting is generally not recommended for large publicly owned corporations because it may lead to the election of directors who represent particular groups of stockholders, which can in turn create factionalism and undermine the effectiveness of the board.
- Effective boards are composed of individuals who are highly experienced in their respective fields of endeavor and whose knowledge, background and judgment will be useful to the corporation. Directors must have the ability and willingness to learn the corporation's business and to express their personal views.
- Each person serving as a director must devote the time and attention necessary to fulfill the obligations of a director. Service on other boards often broadens and deepens the knowledge and experience of directors. In addition, CEOs who serve on other boards frequently gain valuable insight and experience which prove useful in the running of their own companies. However, service on too many boards can interfere with an individual's ability to perform his or her responsibilities. Before accepting an additional board position, a director should consider whether the acceptance of a new directorship will compromise the ability to perform present responsibilities. Similarly, it is advisable for an inside director to consult with his or her own board before accepting a new directorship on the board of another corporation. Because time demands from board to board and capacities of individual directors will vary, The Business Roundtable does not endorse a specific limitation on the number of directorships an individual may hold.

- Each nominating/governance committee should develop its own process for considering stockholder suggestions for board nominees. Should a stockholder desire to suggest a nominee to the board, most corporations request that a letter be written to the secretary of the company providing a resume of the suggested nominee.

Board Evaluation

- The board is responsible for its own evaluation from time to time. Such evaluations will provide the basis for the board's recommendation of a slate of directors to the stockholders. Boards also implicitly evaluate individual directors by endorsing them for re-nomination. Some boards formalize this process through evaluations of individual directors. Other boards formally address individual director performance only when it appears that a particular director is not contributing sufficiently to the performance of the board as a whole. While no particular approach to individual director evaluation is best for all companies at all times, each board should have a process, formal or informal, for discharging its responsibility to nominate good directors.

- The board should from time to time review its own structure, governance principles, composition, agenda, processes and schedule to consider whether it is functioning well in view of its responsibilities and the evolving situation of the corporation.

III. Structure and Operations of the Board

There are, and should be, diverse approaches to board structure and operations. In the following sections we describe approaches that The Business Roundtable considers generally useful for good corporate governance. However, these should not be regarded as rigid rules applicable to all corporations at all times.

It is important for the board of a large, publicly owned corporation to have a substantial degree of independence from management.

Board Composition

- Boards of directors of most large publicly owned corporations typically range in size from 8 to 16 individuals. Optimal board size will vary from corporation to corporation and industry to industry. In general, the experience of many Roundtable members suggests that smaller boards are often more cohesive and work more effectively than larger boards.

- It is important for the board of a large publicly owned corporation to have a substantial degree of independence from management. Accordingly, a substantial majority of the directors of such a corporation should be outside (non-management) directors. The degree of independence of an outside director may be affected by many factors, including the personal stature of the director and any business relationship of the director with the corporation or any business or personal relationship of the director with management. Directors, or firms in which they have an interest, are sometimes engaged to provide legal, consulting, accounting or other services to the corporation, or a director may have an interest in a customer, supplier or business partner of the corporation, or may at an earlier point in his or her career have been an employee or officer of the company. Depending on their significance to the director and to the corporation, such relationships may affect a director's actual or perceived independence. The Business Roundtable believes that, where such relationships exist, boards should be mindful of them and make a judgment about a director's independence based on his or her individual circumstances rather than through the mechanical application of rigid criteria. This would involve consideration of whether the relationships are sufficiently significant as to interfere with the director's exercise of independent judgment. If a particular director is not deemed sufficiently independent, the board may nevertheless conclude that the individual's role on the board remains highly desirable (as in the case of an inside director) in the context of a board composed of a majority of directors with the requisite independence. The overall result should be a board that, as a whole, represents the interests of stockholders with appropriate independence.

- For certain functions, such as membership on an audit or compensation committee, more specific standards of independence should be used. For example, Section 162(m) of the Internal Revenue Code prescribes certain standards that the compensation committee must meet to permit the deduction for federal income tax purposes of performance-based compensation exceeding $1 million paid to the CEO and the four other highest paid executive officers. There are other examples of prescribed standards for members of the compensation committee under Section 16 of the Securities Exchange Act of 1934 and for members of the audit committee under rules of the New York Stock Exchange. In addition, more particularized rules apply in certain industries, such as banking. It is recommended that the board, or a committee such as the nominating/governance committee, periodically confirm that the composition of the relevant committees meets the applicable requirements as well as any other criteria determined by the board.

Most members of The Business Roundtable believe their corporations are generally well served by a structure in which the CEO also serves as chairman of the board.

- Inside directors will ordinarily include the chief executive officer and may also include other officers whose positions or potential for succession make it appropriate, in the judgment of the board, for them to sit on the board.

- There has been considerable discussion of mechanisms for providing board leadership independent of management. Such leadership is particularly important when a CEO dies or becomes incapacitated or when there are questions concerning the competence or conduct of management:

  - ▲ Most members of The Business Roundtable believe their corporations are generally well served by a structure in which the CEO also serves as chairman of the board. They believe that the CEO should set the agenda and the priorities for the board and for management and should serve as the bridge between management and the board, ensuring that management and the board are acting with common purpose.

  - ▲ Some corporations have separated the roles of CEO and chairman of the board, often in response to particular circumstances, such as to provide a smooth transition from one CEO to another.

  - ▲ Some other corporations have employed the concept of a lead director. The role of a lead

> director is sometimes designed with specific duties, such as consultation with the CEO on board agendas and chairing the executive sessions of the board. In other cases, the lead director has no special duties in ordinary situations, but assumes a leadership role in the event of the death or incapacity of the CEO or in other situations where it is not possible or appropriate for the CEO to take the lead.

Each corporation should be free to make its own determination of what leadership structure serves it best, given its present and anticipated circumstances. The Business Roundtable believes that most corporations will continue to choose, and be well served by, unifying the positions of chairman and CEO. Such a structure provides a single leader with a single vision for the company and most Business Roundtable members believe it results in a more effective organization. Where these positions are unified, The Business Roundtable also believes that it is desirable for directors to have an understanding as to how non-executive leadership of the board would be provided, whether on an ongoing basis or on a transitional basis if and when the need arose. In some boards, the presence of one strong figure might provide the natural leader. In other circumstances, there could be an understanding that leadership would fall to the committee chair responsible for the subject matter that gave rise to the need. In still others, it could be the responsibility of the committee chairs to recommend whether non-executive leadership is required, and if so, in what form. Whether the board's understanding of the process would be codified as a formal board action should be a matter for individual boards to determine.

A wide diversity of approaches in committee structure and function responds to the specific needs of companies facing different business challenges and having different corporate cultures, and reflects the need to allow organizational experimentation.

- It is now common practice to establish rules for the retirement or resignation of directors. These may, for example, include a mandatory retirement age for directors or a requirement that a director submit his or her resignation at such time as the director no longer occupies the position he or she held at the time of election, unless the change in position is as a result of normal retirement. Even in the absence of such provisions, a board should plan for its own continuity and succession — for the retirement of directors and the designation of new board members. Because the composition and circumstances of boards will vary, so too will the retirement policies of different corporations.
- The Business Roundtable recognizes that certain corporations may have histories or circumstances that make term limits desirable for them. However, The Business Roundtable generally does not favor the establishment of term limits for directors. Such limits often cause the loss of directors who have gained valuable knowledge concerning the company and its operations and whose tenure over time has given them an important perspective on long-term strategies and initiatives of the corporation.

Committee Structure

- Virtually all boards of directors of large publicly owned companies operate with a committee structure to permit the board to address certain key areas in more depth than may be possible in a full board meeting. A wide diversity of approaches in committee structure and function responds to the specific needs of companies facing different business challenges and having different corporate cultures, and reflects the need to allow organizational experimentation.

- It is recommended that each corporation have an audit committee, which is required under New York Stock Exchange rules, a compensation/personnel committee, and a nominating/governance committee and that membership in these committees be limited to outside directors. The board may also wish to establish other committees with other specific responsibilities. Other common committees include an executive committee to act for the board between meetings and to handle other specifically assigned duties, a finance committee, and a social responsibility or public policy committee. In some cases a board may wish to establish ad hoc committees to examine special problems or opportunities in greater depth than would otherwise be feasible.

- The number of committees will vary from corporation to corporation. Boards should also be conscious of the limitations inherent in having too much of their business handled in committees. Boards working as a whole on important strategic issues allow the corporation to take advantage of the collective wisdom of the board.

- The primary functions of the audit committee are generally to recommend the appointment of the public accountants and review with them their report on the financial reports of the corporation; to review the adequacy of the system of internal controls and of compliance with material policies and laws, including the corporation's code of ethics or code of conduct; and to provide a direct channel of communication to the board for the public accountants and internal auditors and, when needed, finance officers, compliance officers and the general counsel.

- The compensation/personnel committee is generally responsible for ensuring that a proper system of long- and short-term compensation is in place to provide performance-oriented incentives to management. The compensation committee will also evaluate the CEO's performance for compensation purposes and report on this subject to all of the outside directors, if this function is not performed by the entire board. Likewise, it authors the report on executive compensation required under the proxy rules. This committee is also often responsible for assuring that key management succession plans and managers are reviewed periodically. In some companies, succession planning and review of key personnel issues are handled by the nominating/governance committee. When CEOs serve on each other's boards, it is generally inadvisable for them to serve on each other's compensation committees because of the potential for conflicts of interest.

- The nominating/governance committee is typically responsible for advising the board as a whole on corporate governance matters, developing a policy on the size and composition of the board, reviewing possible candidates for board membership, performing board evaluations, and recommending a slate of nominees. The board should have the benefit of the CEO's involvement in the selection process, but the responsibility for selection of board nominees remains that of the board.

Board Compensation

- Board compensation should be competitive in view of industry practices and the extent of burdens placed on board members. The form of such compensation will vary from corporation to corporation and may depend on the circumstances of the directors that the board may be seeking to attract and retain.

- Boards should consider aligning the interests of directors with those of the corporation's stockholders by including some form of equity, such as stock grants or options, as a portion of each director's compensation.
- Some corporations may wish to establish a specific goal for equity ownership by directors; however, the desirability of setting such a goal is company specific and may depend on the circumstances of its directors. For example, some directors whose principal occupations are in public service or academic settings may prefer current cash compensation.
- Although there has recently been a trend away from retirement programs for directors, The Business Roundtable believes that the focus should be on the appropriate level of total compensation, rather than on the timing of payments.

Operations

- Boards must meet as frequently as needed in order for directors to discharge properly their responsibilities. According to surveys, the typical board of a large publicly owned corporation meets about eight times per year. Depending on the complexity of the organization, the degree of business success and stability, and the desires of the board, greater or lesser frequency may be appropriate. Many directors prefer to have fewer but longer meetings where subjects can be explored in depth.
- There should be an opportunity for the board to meet periodically, at least annually, outside the presence of the CEO and other inside directors. This may be a portion

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of a normally scheduled board meeting, and the CEO's annual performance evaluation is a good opportunity for such a meeting.

Board members should have full access to senior management and to information about the corporation's operations.

- A carefully planned agenda is important for effective board meetings, but it must be flexible enough to accommodate crises and unexpected developments. In practice, the items on the agenda are typically determined by the chairman in consultation with the board, with subjects also being suggested by various outside board members. A CEO should be responsive to a director's request to add a specific subject to a future agenda.
- To ensure continuing effective board operations, the CEO should periodically ask the directors for their evaluation of the general agenda items for board meetings and any suggestions they may have for improvement. In particular, the board should ensure that adequate time is provided for full discussion of important corporate items and that management presentations are scheduled in a manner that permits a substantial proportion of board meeting time to be available for open discussion.
- The board must be given sufficient information to exercise fully its governance functions. This information comes from a variety of sources, including management reports, personal observation, a comparison of performance to plans, security analysts' reports, articles in various business publications, etc. Generally, board members should receive information prior to board meetings so they will have an opportunity to reflect properly on the items to be considered at the meeting.
- Board members should have full access to senior management and to information about the corporation's

operations. Except in unusual circumstances, the CEO should be advised of significant contacts with senior management.

- Because the information and expertise relevant to the board's regular decision-making will normally be found within the corporation, the main responsibility for providing assistance to the board rests on the internal organization. There may, however, be occasions when it is appropriate for the board to seek legal or other expert advice from a source independent of management, and generally this would be with the knowledge and concurrence of the CEO.

- In general, the corporation's management should speak for the corporation. Communications with the public at large, the press, customers, securities analysts and stockholders should typically flow through, and be coordinated by, the CEO or other management. From time to time outside directors may be requested by the board or management to meet or speak with other parties that are involved with the corporation.

- It is important that each board consider its policies and practices on corporate governance matters. Whether or not a board will formalize its board practices in written form will vary depending on the particular circumstances. Some corporations have found that over-formalization leads to a rigid structure which emphasizes form over substance, while others have found that insufficient formalization leads to lack of clarity.

IV. Stockholder Meetings

… matters brought to stockholder attention through the proxy statement should be matters of significance to the business of the corporation and to stockholders as a whole.

Meetings of stockholders provide an important forum for the consideration of management and stockholder proposals. An orderly discussion of the corporation's affairs is facilitated by following a specific agenda and by adhering to a code that governs the conduct of the meeting.

Agendas and Conduct of the Meeting

- To facilitate an orderly meeting of stockholders, it is desirable that there be a written agenda made available to all attendees.

- Principal rules for the conduct of the meeting should be set forth in writing and also made available to every attendee. The rules may address matters such as the procedures for moving resolutions and asking questions of the chair, and include any limits on time or number of speakers for matters under discussion.

Management and Stockholder Proposals

- The consideration of management and stockholder proposals and board nominations is largely conducted through the proxy process rather than through proposals raised at stockholder meetings. This gives all stockholders, rather than only those who attend the meeting, the opportunity to consider relevant matters. Although the rules governing inclusion of stockholder proposals in proxy statements have changed over the years and are likely to continue to evolve, certain underlying principles should govern the process. Most importantly, matters brought to stockholder attention through the proxy statement should be matters of significance to the business of the corporation and to stockholders as a whole. Other matters, such as those relating to personal grievances and political or social issues are more appropriately discussed in other forums. Matters pertaining to the conduct of the ordinary business operations of the corporation should be governed by management and the stockholder-elected board of directors.

- Reasonable notice of topics permits all interested parties to participate in the process in a considered way. As a result, The Business Roundtable recommends that corporations consider advance notice requirements in by-laws because such requirements generally promote good corporate governance.
- Adequate measures to assure the integrity, accuracy and timeliness of the voting tabulation process are highly important.

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