



The Conference Board

# Commission on Public Trust and Private Enterprise

**A PERSONAL POSTSCRIPT**

by Commission Co-Chairman  
Peter G. Peterson



**The Conference Board Commission on Public Trust and Private Enterprise** was convened in June 2002 to address the circumstances which led to the corporate scandals that were widely reported during 2001–2002 and the subsequent decline of public and investor confidence in companies, their leaders, and American capital markets.

The Commission’s work\* articulates a series of principles and “best practice suggestions” in three major areas—executive compensation, corporate governance, and audit and accounting issues—as they relate to publicly held\*\* corporations.

The 12-member Commission—co-chaired by Peter G. Peterson, Chairman of The Blackstone Group and Chairman of the Federal Reserve Bank of New York; and John W. Snow, Chairman and CEO of CSX Corporation and former Chairman of The Business Roundtable—included prominent leaders from business, finance, public service, and academia. Although the Commission was sponsored and supported by The Conference Board, it enjoyed absolute independence and authority in its findings and recommendations, and was financially supported by The Pew Charitable Trusts.

The full text of the Commissions reports and recommendations can be found on The Conference Board’s Web site at [www.conference-board.org/PublicTrust.htm](http://www.conference-board.org/PublicTrust.htm)

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\*The Commission issued its first set of findings and recommendations, Part I: Executive Compensation, on September 17, 2002. Subsequently, Part 2: Corporate Governance and Part 3: Audit and Accounting were released on January 9, 2003.

\*\*While these issues are also of concern to privately held companies, such companies are often financed through a sophisticated investor base. Use of money from the general public, however, necessarily subjects publicly held companies to higher scrutiny and, therefore, to the attention of this Commission.

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**Peter G. Peterson** is Chairman of The Blackstone Group, the private investment banking firm he co-founded in 1985. Mr. Peterson is also Chairman of the Federal Reserve Bank of New York, Chairman of the Council on Foreign Relations, and founding Chairman of the Institute for International Economics (Washington, D.C.). Mr. Peterson is the Co-Chairman of The Conference Board's Commission on Public Trust and Private Enterprise.

Mr. Peterson was CEO of the Bell and Howell Company (1963–1971). He was Assistant to the President for International Economic Affairs (1971–1973), and in 1972 became Secretary of Commerce. He was Chairman and CEO of Lehman Brothers (1973–1977) and, after the merger with Kuhn, Loeb, became Chairman and CEO of Lehman Brothers, Kuhn, Loeb, Inc. (1977–1984). Mr. Peterson was formerly a Director of Sony Corporation, Minnesota Mining and Manufacturing Company, Federated Department Stores, Black & Decker Manufacturing Company, General Foods Corporation, RCA, The Continental Group, and Cities Service.

The views expressed here are the personal reflections of Commission Co-Chairman Peter G. Peterson. The Conference Board, which maintains a policy of non-advocacy, has not endorsed these reflections, nor do they necessarily reflect the individual views of the other Commissioners.

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# Commission on Public Trust and Private Enterprise

## A PERSONAL POSTSCRIPT

I am often asked: Why would John Snow<sup>1</sup> and you be willing to take on the daunting task of co-chairing The Conference Board Commission on Public Trust and Private Enterprise? Did the two of you realize that enthusiasm for your recommendations would, at the very least, be restrained—perhaps from many of your best friends in the business world? Of course we did.

While I was honored by the opportunity to serve, quite frankly I also had some reservations. As someone who has enjoyed a long, fortunate, and not unsuccessful career in both business and government, my faith in the American system of free enterprise is rock solid. From personal experience, I know that the vast majority of CEOs are good and honest people. Moreover, experience has taught our nation that serious consequences can emerge from well-intentioned attempts to over-regulate the way corporations do business.

As a result, before I could wholeheartedly dedicate myself to developing any recommendations for reform, I needed to be convinced that American business was suffering from a systemic problem that went far beyond the presence of “a few bad apples” with whom the justice system would soon be dealing on its own. Armed with mountains of research, a tireless staff,<sup>2</sup> and thoughtful colleagues, I set out to answer the following questions:

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<sup>1</sup> John resigned his Co-Chairmanship of this Commission on January 28, the day of his confirmation as the nominee for U.S. Secretary of the Treasury. He has been a great partner and contributor throughout the period during which we developed our recommendations, and has authorized me to state that he supports them all.

<sup>2</sup> In particular, I want to especially recognize the great work of Carolyn Brancato and Alan Rudnick from The Conference Board; Scott Olsen of Towers Perrin; and Pete Ruegger, Ken Edgar, and A.J. Kess of Simpson Thacher & Bartlett, who generously contributed their impressive talents and energies to this project.

## Is There a Real and Enduring Problem?

First, I needed to be convinced that the breakdown of public trust in American business was broad and deep. As an alumnus of an opinion survey firm in my early career, I read many recent public opinion surveys, and was saddened and indeed shocked by the melancholy sameness of the results. It is now perfectly clear to me that the public emphatically rejects my somewhat comforting theory of “only a few rotten apples in the barrel.” I needed to be reminded that this Commission was charged with increasing the level of trust of the *American public* in corporate America, regardless of how we business leaders felt about ourselves.

Study after study show that substantial majorities of Americans now believe that most of us at the senior levels of business are—in the broadest sense—presumed guilty until proven innocent. Perhaps the most discouraging statistic I came across was that 74 percent of Americans believe “you can’t be too careful” when dealing with those of us in big business (interestingly, small business owners are widely trusted by the public). This put us distressingly near the very bottom of a long list of professions.

Some business leaders have told me that they feel these negative perceptions are media-inspired and, as a result, likely to diminish in the months ahead. While it is true that the corporate scandals probably received more than their full share of coverage over the past year, I do not believe that we can or should blame the breakdown in public trust simply on a media cycle. Mistakes were made and the damage is real. Thus, I believe it would be unwise simply to hope that the memories will fade on their own: A Chicago research firm that regularly tracks the public’s trust of big business over time concluded that any change in the public’s perception will occur only at a “glacial” pace. As we all know, destroying a house does not take much time or effort, but building one does. I am afraid that the same holds true with regard to the public’s trust: Losing it is easy to accomplish, but restoring it takes a great deal of time and effort. Furthermore, I believe that if any significant additional cases of corporate malfeasance come to light in the near future, any gains made with respect to the public’s negative feelings about business will quickly be lost.

On the question of whether we are faced with an enduring problem, I am therefore confident that the entire Commission, after intensive analysis of much data, shares my view that the public’s lack of trust in corporate America is a real problem that is not going to “go away.” It is a problem that must be addressed promptly, thoughtfully, and comprehensively.

## Does It Matter?

Second, I needed to be satisfied that this erosion in public trust truly mattered. In my role as Chairman of the Federal Reserve Bank of New York, I have been made painfully aware of America's dismal savings rate; the presence of resurgent budget deficits that once again stretch as far as the eye can see; and an unprecedented current account foreign deficit—about 5 percent of GDP, or \$500 billion, annually—that leaves America's economy hugely dependent on importing unequaled—and some would argue unsustainable—amounts of foreign capital. When thinking about the foreign deficit, the immortal words of Herbert Stein come to mind: "If something is unsustainable, it tends to stop." I know of no other precedent for such extraordinary dependence on foreign capital by such a strong and mature economic power.

Leading experts in America's capital markets tell me that the public's loss of confidence in American business has *already* slowed the inflow of foreign equity capital and has been a major contributor to the prolonged weakness of the financial markets. Any added loss of confidence by foreign investors in America's capital markets could result in a number of profound effects that could quickly spread throughout our economy. Now that we have the substantial additional market uncertainties created by the contentious geopolitical environment, we cannot afford any more loss of confidence in our capital markets.

There is no question in my mind that rebuilding public trust and restoring confidence in the integrity of our markets matters a lot.

## Who Would Join Us?

Third, I wanted to be sure that we could attract an outstanding, broad-based group of credible Americans from various professional backgrounds to join this effort. On this score, I was frankly astonished and most certainly reassured that virtually everyone we asked to join this Commission accepted immediately. It would be hard for me to imagine a more respected group of outstanding Americans from among the business sector, the investor community, the highest levels of the U.S. government, and the distinguished minds of the halls of academia than the group that comprise the Commission.

## *A Personal Reason for Joining*

I also had a very personal reason for accepting the kind invitation to co-chair this Commission. My parents came to this country from Greece when they were teenagers, in search of more opportunity and a better life. I consider

myself the luckiest and most grateful beneficiary of this greatest of all economic systems. If I could make even a small contribution to help heal the wounds that have afflicted our system, I felt it would be my honor as well as my obligation.

### **What Would Be Our Objectives?**

Finally, I asked myself what this Commission might reasonably hope to accomplish. It seemed evident that voluntary private sector leadership was both desperately needed and far preferable to the alternative, namely, legislation and the unintended consequences that often accompany it. In the particular case of executive compensation, I believe attempts to regulate such compensation is a thoroughly bad idea. Why? Because history teaches us the sad fact that Congressional action often has serious unintended negative (and sometimes ironic<sup>3</sup>) consequences and rigidities. We observed these negative consequences when Congress placed a cap of \$1 million on cash compensation deductibility, inadvertently setting off an explosion in awards of fixed-price stock options and inflating senior compensation in the process. This kind of unfortunate Congressional involvement is the political equivalent of what the medical profession calls the iatrogenic effect, a side effect or disease caused by the “iatro,” the doctor.

When faced with the facts, I decided that restoring faith in our free enterprise system and recapturing public confidence in our business leaders do matter a great deal. Based on that decision, as well as other deeply personal reasons, I accepted the challenge and the honor of serving as Co-Chair of this distinguished Commission.

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<sup>3</sup> One can safely assume that Congress did *not* have in mind the large increases in executive compensation that many experts believe resulted from the 1993 legislation capping the deductibility of cash compensation.

What follows are recommendations in the areas of executive compensation, corporate governance, and auditing and accounting that we believe will serve the public interest and help restore the public's trust in private enterprise.

My work for the Commission provided me with a valuable learning experience, and I would like to articulate a few of the basic findings that shaped my understanding of the underlying causes of the corruption to which I have referred and the cynicism that followed. I would also like to discuss some basic themes that I hope will give our specific recommendations some additional context.

### The Causes of Private Corruption and Public Cynicism

Because this Commission had an open and independent charter to move in whatever direction the evidence and our good sense took us, we decided to start our work by reviewing the toxic subject of *executive compensation*. It was our perception that excessive compensation was perhaps the major contributor to the dramatic loss of confidence in the governance of America's publicly held corporations. When we started our work in this area, I assumed that the widely reported, generic increases in executive compensation would present the major problem to the public. All of us on the Commission had read the *BusinessWeek* report showing that, over a 10-year period, compensation had risen about 9½ times faster for CEOs than for rank-and-file employees. We also knew that *BusinessWeek* had reported that in 1980 CEO compensation was 42 times that of the average worker, whereas in recent times it was roughly 500 times that average—far higher than in Japan and Europe.

We were also aware of critics who questioned management claims that employees' compensation should reflect their productivity. These critics asked: Has management's productivity grown that much faster than the average worker's productivity? William McDonough, President of the Federal Reserve Bank of New York, gave his direct and widely publicized answer to this question in a speech to the Trinity Church of New York, discussing the morality of the excesses of executive compensation: "I'm old enough to have known both the CEOs of 20 years ago and those of today. I can assure you that the CEOs of today are not 10 times better than those of 20 years ago."

Clearly, this imbalance of pay between executive management and workers has contributed to the malaise in public trust. But as we delved further into this issue, I came to believe that the more dominant contributor to the loss of the public's trust was the highly publicized reports of excessive and, indeed, egregious compensation of CEOs in *failing* or *failed companies*. A *Financial Times* headline read, "A Stunning Payoff for Corporate Failure." A cover of *Fortune* magazine featured a story titled, "You Bought, They

Sold.” The *Fortune* story reported that executives at certain companies whose stock prices had declined 75 percent or more from their peak in a relatively short period had nevertheless reaped billions of dollars of gains from stock sales. As the headline shouted, “Since 1999, Hundreds of Greedy Executives in America’s Worst Performing Companies Have Sold \$66 Billion Worth of Stock.” In effect, the *Fortune* article seemed to be asking the Watergate question: What did they know and when did they know it?

These kinds of public suspicions led us to recommend full, conspicuous, and readily understandable—“plain English,” “plain sight”—disclosures of executive compensation arrangements. In addition, to reassure the public that senior management is not involved in stock transactions involving the company in advance of material information being available to the public, we recommended that executive officers give advance notice of their intention to dispose of the corporation’s equity securities.

Now, why do I believe that excessive compensation at these failed or failing companies—rather than simply the overall increase in executive compensation—is the more dominant explanation of the precipitous decline in the public’s trust?

So called “class warfare” no longer seems to be as powerful a political message as it may once have been in America. Many Americans believe that the American dream is a real possibility for them: Witness the interesting statistical anomaly that 20 percent of Americans believe that they are in the upper 1 percent in terms of income, and another 20 percent believe that they will be. Moreover, \$20 million sports star salaries do not seem to engender anything comparable to the criticism or anger engendered by executive compensation. Perhaps their success is seen more as something to be admired, along with the hope that they or their kin can someday achieve that success.

In many of the recent scandals, the public witnessed certain executives reap unprecedented gains just prior to a time when their shareholders suffered huge losses, and many of their employees lost their jobs and at the same time saw their retirement savings suffer irreparable damage.

This was most visibly demonstrated and most highly publicized in the case of Enron. Dan Yankelovitch, the well-known public opinion expert, reported that Americans were particularly outraged and frightened by widely publicized reports that the restrictions placed on Enron employees selling their company stock held in retirement accounts during periods of rapidly falling stock prices were far greater than those placed on Enron’s executives. Employees and the public alike saw this phenomenon as still another example of a rigged system that favored executive over non-executive employees.

## Five Themes of Our Recommendations

### 1 A TRIAD OF EFFECTIVE EXECUTIVE COMPENSATION PRACTICES

After the Commission’s extensive study and analysis, I came to believe in the following triad of principles for establishing effective compensation systems:

- a) A renewed focus on the *long-term* success of a corporation;
- b) A renewed focus on *corporate operating performance*—not simply on stock price performance, which can obviously be capricious. With this in mind, the Commission recommended that independent Compensation Committees should be unconstrained by industry median compensation statistics or by the company’s own past compensation practices and levels. Instead, we recommended that the Compensation Committee, with the concurrence of the Board, should establish performance-based incentives that reinforce the corporate performance goals approved by the Board (for example, return on equity, revenue and profit growth, cost containment, cash management, and non-financial objectives, such as quality goals); and
- c) A renewed focus on substantial *long-term stock ownership*, which, in turn, can validate operating performance; help serve as a driver of long-term corporate performance; and more truly align the long-term interests of shareholders and management.

History teaches us that stock prices do tend to reflect operating performance over the long term. But it also teaches us that stock prices and operating performance often deviate over the short term. Therefore, we believe that, whereas managing for stock price gains too often means managing for the short term, managing with an eye towards long-term operating performance is in the best long-term interests of the corporation and its shareholders, as well as its other constituencies, such as employees, communities, and customers—all of whom have a decided interest in the long-term success of the corporation. That is why I believe it is critical to focus executive incentives on the long term.

Our recommendations for longer holding periods for equity-based compensation and for substantial stock ownership requirements for senior management and independent directors fit directly into this context. Indeed, had *just these two best practices* been in place, we may have avoided a number of the recent corporate collapses that were accompanied by egregious short-term gains by executives of those failing companies.

You might ask: How, then, does our recommendation of uniform expensing of equity-based compensation fit into this context? In approaching the highly contentious issue of expensing options and other equity-based compensation,<sup>4</sup> I was both ignorant of many of the facts and an agnostic. I had known, of course, that long-term *cash* incentives are expensed, but I had not known that most so called performance-based equity awards and grants are also expensed on income statements. By performance-based equity awards and grants, I mean: (1) restricted stock awards and/or option grants that tie the vesting of such awards and grants to the achievements of certain performance goals; (2) stock options whose strike-price is increased by a “risk-free” rate of return (e.g., the treasury rate); and (3) stock options whose strike price is increased or decreased based on the return of either a general market index or a peer group of companies. I also learned that so called fixed-priced stock options came to dominate the stock option field—over 99 percent of options granted, as some compensation experts told me. Significantly, these fixed-price options are treated differently than the other equity-based incentives and are *not* expensed on the income statement.

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<sup>4</sup> Personally, I must say, I felt there were more important issues than the issue of whether to expense options.

I came to believe that the elimination of the bias towards fixed-price options, which I felt led to an inadequate focus on corporate operating performance, is one of the most powerful reasons to favor the uniform expensing of all forms of equity-based compensation.<sup>5</sup> In the best of worlds, the Financial Accounting Standards Board and the International Accounting Standards Board would adopt a uniform standard, thereby increasing transparency and comparability among companies on an *international* basis. The uniform expensing of equity-based compensation would also, I believe, improve the comparability of earnings *among companies operating across different industries* (I was surprised to learn that, whereas the expensing of options in S&P companies would decrease reported earnings by an average of about 10 percent, in the information technology industry the

expensing of options would reduce earnings by approximately 70 percent).<sup>6</sup>

I believe that a more level playing field would result in a far greater use of long-term compensation incentive programs that are more closely tied to the corporation's *actual operating performance*. If all forms of compensation—cash and equity-based awards—were treated similarly in terms of their impact on profitability, it seems to me that companies would be more likely to choose programs that offer real, balanced incentives to help create long-term value.

Indeed, in talking to companies that have recently decided to expense stock options, they report that they have been “surprised” or even, in one case, “exhilarated” by the creative opportunities to tie new methods of compensation to actual long-term operating performance. (Given the uncertain outlook of stock markets generally, I would expect more companies to turn to long-term performance cash incentives.) Also, I believe the public's attitude towards executive compensation would be improved markedly if they saw that much of this compensation was truly related to long-term performance.

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<sup>5</sup> Some observers believe that there are other perverse effects of not expensing fixed-price options. One of these perverse effects is to discourage companies from paying dividends. This is true for two principal reasons. First, companies often offset the dilution resulting from the exercise of stock options by repurchasing their shares in the open market, thereby decreasing the amount of cash available for dividends. Second, there is little incentive for management to pay, or increase the amount of, dividends when such payments may have little impact on—or may even decrease—the stock price. Furthermore, cash may be distributed to shareholders in the form of stock buy-backs, which may in fact increase the stock price and, in addition, would result in capital gains treatment for shareholders. Some argue that another perverse effect of fixed-price stock options is the incentive it provides management to increase the amount of the company's leverage. This increased leverage obviously increases the risk profile of the company, but the potential payoff to senior management with a substantial number of options can be enormous. In addition, with fixed-priced options, it is arguable that management is not sharing in any of the downside risk associated with the increased leverage.

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<sup>6</sup> Although many argue that options are too difficult to value, the market seems quite capable of valuing options in other contexts. In the first place, so called put-and-call options are widely bought and sold. In the second place, it is interesting that when it comes to the reporting—some would say, inflating—of revenue options, management's tolerance for ambiguity seems high, as some recent and rather flagrant cases in the telecommunications industry have shown. Yet when it comes to expensing of stock options that reduces earnings, such tolerance for imprecision is substantially lower. Finally, speaking of imprecision, as Chairman Greenspan has pointed out, an estimate is surely more accurate than valuing options at zero.

Fixed-price options were not expensed and did not reduce reported earnings. Nonetheless, they conferred substantial tax deductions on the employer that granted the options at the time that employees exercised the options. As a result, the perception arose in some circles that these particular options were either “free” or low-cost. This led to an explosion in the number of stock options that were granted. In the period following the 1993 legislation capping the deductibility of cash compensation, stock options—which were viewed as performance-based and thus not subject to the deductibility cap—roughly doubled as a percentage of total equity and came to dominate the compensation of many executives. The combination of a huge number of options granted; a bull market; and short holding periods proved, in some cases, to be highly seductive and led, in some instances, to the practice of “managing” short-term earnings. This phenomenon also led to unprecedented short-term gains by some executives, gains unrelated to corporate operating performance—or, if you prefer, too de-linked from operating performance.

## 2 KEEP “INDEPENDENT” FIRMS INDEPENDENT

Effective corporate governance requires not simply a substantial majority of unconflicted, independent directors, but a variety of “independent,” “objective,” “outside” professional organizations (i.e., auditing firms, legal firms, compensation consultants, stock analysts, etc.) acting in the corporation’s best interests. These professional organizations must view the corporation (and not management) as their client. Instead, we have found a troubling number of examples where these “outsiders” tended to view their de facto client as management.

Why? In this connection, law firms, auditors, and compensation consultants had launched drives to increase revenues by participating in higher growth and higher margin businesses. Often, these firms are awarded the largest portion of their fees by *management* for services unrelated to their monitoring functions (e.g., consulting fees for auditing firms,<sup>7</sup> etc.)

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<sup>7</sup> In the year 2000, fees for non-audit services were reported to represent more than three times the amount of fees paid to auditors for audit services.

From personal experience in a private firm, I can assure you that partners are typically rewarded for the *total* fees from the “client.” So we shouldn’t be surprised if these human beings are reluctant to bite the hand that feeds them. René Descartes once commented sardonically that “A man is incapable of comprehending any argument that interferes with his revenue.” In a number of cases, had these outsiders been truly independent, these scandals could have been prevented.

Given this, our Commission felt that a number of proactive steps needed to be taken. To begin with, we suggest that the independent directors take charge. For example, in certain circumstances, the independent directors should hire and fire these advisory firms. In the case of compensation, we believe the consultants should be hired and report directly to the Compensation Committee with regard to executive compensation issues, rather than management hiring these consultants on the Board’s behalf. Beyond this, we think Boards of Directors should consider restrictions on certain services performed by these outsiders that might present a conflict of interest (for example, independent investigations by the regular law firms; or putting auditors in an advocacy position, i.e., designing income tax shelters using novel and debatable strategies, including using special-purpose entities and extensive offshore partnerships or affiliates).

### 3 TOWARD AN OWNER NATION, NOT A TRADER NATION

Effective corporate governance theory also requires that Boards of Directors focus on building *long-term* values for shareowners—emphasis on *owners*. Modern theory also emphasizes serving the interests of employees and affected communities, which are also quite obviously focused on the long term.

As we have suggested, these theories can be realized, in part by emphasizing long-term operating performance in management compensation incentives. But what are we to make of the fact that the annual turnover rate during 2001 on the New York Stock Exchange was more than 100 percent and on NASDAQ nearly reached 300 percent? To a large extent, we have become a nation of traders, not owners. If that is true, what does it mean to act in the *long-term* interest of shareowners?

Given our view that this long-term focus nevertheless remains crucial, we suggest a variety of proposals intended both to increase the number of true owners—for example, by significantly increasing the tax differential between long-term and short-term holding periods—and to facilitate shareowners becoming proactive in the governance process.

These proposals are our attempt to address another anomaly of corporate governance, namely the passivity on the part of the vast majority of America's shareowners. The 100 largest managers of pension funds and mutual funds now represent the ownership of one half of all U.S. equities. Yet, as my fellow Commission member, Jack Bogle, put it, "these managers possess an awesome, yet largely unexercised, power." We believe that, if shareowners were to get actively and thoughtfully involved, they could exert a substantial and constructive influence on the conduct of a corporation. Indeed, if the corporate owners don't care, who should?

## 4 BALANCE OF POWER

In today's media, the so-called "imperial CEO" has become a new cliché.

Beyond this cliché, critics raise rhetorical questions: Isn't the CEO an employee of the corporation? Doesn't every employee need a boss? If the CEO sets the Board's agenda, controls the information flow to the Board, and sets (or even packs) the Board's schedule, isn't it quite possible that he or she will minimize the critical, if troublesome, issues being placed on the agenda and limit the time for open and unstructured, but vital, dialogue?

The specific question du jour that seems to dominate the debate on corporate governance structure is: Should there be a non-CEO Chairman or not?

Before getting fixated on that one alternative, it seems to us that it might be wiser to ask some questions: How do we avoid having an "imperial CEO?" What is it we are trying to achieve when we say we want more balance of power and checks and balances?

I would have thought we should be creating a structure and an open, honest, constructive environment that permits the board to perform its crucial oversight role effectively. To achieve that, we presumably need to have an open process for determining the issues to be reviewed, an open flow of required information, adequate time for discussion, and a setting where important issues can be openly and honestly discussed.

At the same time, I believe we also should ask ourselves: What should we try to avoid? Clearly, it seems to me, we should avoid turf battles and, more generally, an adversarial climate, except, of course, in certain limited and special problem situations.

To minimize this risk, it seems to me that specific procedures must first be developed. What will the lead or presiding director or non-CEO Chairman do, and how will he or she do it? It would seem essential that these procedures should be agreed to up front, memorialized by each Board, and reviewed regularly. I believe we are in the *very early stages* of an evolving process in which the goal is to develop an open and constructive relationship between the CEO and the independent directors. As this process unfolds, a large measure of mutual respect, understanding, sensitivity, and patience will be required.

With this approach and mindset, it should be possible *over time* to achieve the ultimate objective of the CEO focusing his or her energies on managing the business and the lead independent director ensuring that the independent directors are able to effectively fulfill their oversight responsibilities.

Since releasing our report, I'm often asked: Why did you recommend three different structural approaches? To be sure, we had Commission members who felt strongly that one approach or another was the best. Yet, as we pressed for evidence for which approach—the non-CEO Chairman, for example—was most effective, the evidence presented appeared to be highly equivocal.

What we did all agree on was that there are at least three approaches, any one of which would represent a significant step forward—*if* we define carefully how the Board intends to exercise its independence and responsibilities with respect to agenda, information flow, regular meetings of independent directors, etc.

I believe the one indispensable element in any revised governance structure is to have one independent director—whatever you may wish to call him or her—designated to take the lead on these matters. As the old saying goes, “If everyone is responsible, no one is responsible.” This strikes me as particularly true when

a company faces real problems, such as major transitions or daunting financial challenges. I feel a designated independent director—whether he or she is the non-executive Chairman or is called the Lead Director or Presiding Director—must be able to, for example, call and arrange regular and special meetings of independent directors, approve the agenda and information flow, and the like. In addition, other directors would be able to turn to this director to ensure that a particular concern gets addressed, including any concerns relating to the agenda and information flow.

## 5 PREVENTIVE THERAPY: THE CRITICAL IMPORTANCE OF AN ETHICAL CULTURE

It should bother all of us that in many investigations of actual improper corporate behavior, employees stepped forward to say: “I knew they were doing that.” Why, then, didn’t they step forward sooner? How much better would it have been if these employees had interceded earlier!

It should also bother all of us that virtually all of the companies that were involved in the recent scandals had written codes of conduct that were obviously being ignored or overruled. Why? What management and cultural signals were being seen in actual practice that implied—in effect—that other things are just more important than ethical conduct? What values were those executives really valuing?

It is perfectly obvious that prevention of these abuses in the first place is, by any standard, ultimately the most important objective. We turned to the Commission members who are genuine experts in this field: Lynn Paine, Professor of Business Ethics at Harvard Business School; and Ralph Larsen, former Chairman and CEO of Johnson & Johnson, widely recognized as one of the most ethical companies in America.

Lynn Paine shocked John Snow and me when she first reviewed with the two of us the result of a large and anonymous study of employees indicating widespread awareness of violations of codes of conduct *that occurred at their own companies* during the past year. For example, one recent survey found that 37 percent of employees in selected U.S. industries had in the previous year observed misbehavior that they believed could result in a significant loss of public trust if it were to become known. We asked Lynn if there were any other studies. Indeed, there were, and the results were distressingly similar. I would urge readers to do three things:

- a) Review the employee survey data in our report and see if it does not motivate you to explore the practices at your own institution. (It has certainly led me to do that in our firm.)
- b) Then, I suggest you review carefully the specific suggestions in our report discussing the importance of making it clear that ethical conduct is a critical element in assessing performance; making it easy *and safe* for employees to report misconduct; and conducting regular studies within your institution to assess employee understanding of, and compliance with, your institution’s code of ethics.
- c) Finally, I sincerely hope that Boards of Directors, when picking the CEOs of the future, will put character and integrity at the top of the list of “must” job specifications—that is, the capacity to know what is right and what is wrong, to do what is right, and to be able to convey these values throughout the corporation.

If these recent scandals are not simply to be just another episode of corporate misconduct, we will need business leaders with a steady moral gyroscope and business leaders with personal, internal, self-imposed, and, yes, absolute standards.

Many of the recent highly publicized actions taken by certain corporate executives were just plain wrong. Indeed, neither technical compliance with laws, rules and regulations, nor best practices and processes would have prevented the recent scandals. Nothing is more important than tone at the top.

**I** bring these personal reflections to a close on a positive and sincerely felt note.

Already, I sense a sea change in corporate governance. I have never seen Boards of Directors and CEOs as diligent and as proactively involved as they are today on the issue of corporate governance. Although this renewed diligence on the part of Boards of Directors and CEOs may be due in part to pride, shame, fear, recently enacted regulations, the prospect of additional and potentially destructive legislation, or a combination of these factors, I believe that the primary driver motivating the vast majority of directors and CEOs is simply their desire to do what is right.

America is displaying its usual response to new problems—openness, directness, self-correction, and resilience.

Adding to all this is my continuing conviction that the vast majority of our CEOs and directors are good and honest people. I am confident that, by a year from today, we will witness major progress in corporate governance in America.

A handwritten signature in black ink, appearing to read "Pete Steiner". The signature is fluid and cursive, with a long horizontal stroke extending from the end of the name.

*March 12, 2003*



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