

# American Bar Association Task Force on Corporate Responsibility

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## Testimony of Financial Executive International

### Introduction

Hello. I am Dean Krogman, Vice President of Technical Activities and Conferences for Financial Executives International. I would like to thank this task force of the American Bar Association for this opportunity to discuss its proposals on Corporate Responsibility. I am here as a member of Financial Executives International or FEI. FEI is the leading advocate for the views of corporate financial management, representing 15,000 CFOs, treasurers and controllers from companies worldwide, primarily in North America.

We at FEI have been very concerned about the rash of corporate governance and financial reporting failures that have recently been uncovered, failures that have shaken the faith of the investing public in corporate America. We agree with the opinion of this American Bar Association task force that most executive officers, directors and professional advisers act honestly and in good faith; but unfortunately, honest or not, we all suffer to some degree from the fallout that these high profile failures have caused. We also agree with the task force, that these failures are historic in their scale and scope, that they point to certain systemic weaknesses in corporate governance and our

checks-and-balances control system, and that these weaknesses cannot be overlooked.

We applaud this task force of the ABA for its efforts to identify these weaknesses and make recommendations to address them. Our organization has made a similar effort. In January of this year, FEI formed a task force made up of twelve prominent members who assembled a set of observations and recommendations that were published in March of this year. Those recommendations suggested steps to be taken to:

- Strengthen financial management and the commitment to ethical conduct,
- Rebuild confidence in financial reporting, the accounting industry and the effectiveness of the audit process,
- Modernize financial reporting, and reform the accounting standards-setting process, and
- Improve corporate governance and the effectiveness of audit committees.

It is not surprising to find that some of the FEI recommendations are very similar to the ones made by this ABA task force. We hope that by participating in a dialog with the ABA and other professional organizations like the Business Round Table, the Conference Board, and others, that we can contribute to strengthening our framework of laws, regulations and ethical principles, reinforce the commitment to ethical conduct of corporate officers, lawyers, financial executives and others and rebuild investor confidence in corporate America.

## Recommendations Relating to Internal Corporate Governance

### ***Recommended Standards for Public Companies***

We agree with the majority of the recommendations made by this ABA task force regarding improvements in corporate governance. The NYSE and NASDAQ have made similar recommendations in their proposed new corporate governance standards for listed companies issued in July and August of this year. FEI has also made some similar proposals as they relate to the structure of audit committees of public company boards of directors.

We believe:

- Establishing a requirement that public company Boards of Directors include a substantial majority of independent directors will help assure their effective independent oversight of senior corporate management.
- Requiring all public company boards to have a Governance Committee, an Audit Committee, and a Compensation Committee made up of independent board members would also be an important step in this regard.
- We agree with the proposed assignment of responsibility to these board committees, namely making the Corporate Governance Committee responsible for identifying potential new board members, assigning the Audit Committee responsibility for engaging, overseeing and approving the work of the outside auditors, and giving the Compensation Committee authority over issues involving senior executive officer compensation. We also agree with the recommendation that the Corporate Governance Committee and Audit Committee meet regularly and in private with the corporate officers responsible for implementing internal controls, codes of ethics and compliance policies. We believe that, at least in the case of audit committees, this is already a best practice that many companies follow and often something specified in their Audit Committee charters.

- We fully support the ABA task force recommendation for adoption of a code of ethics and conduct. FEI has recommended to congress, the SEC and the stock exchanges this year that they consider requiring companies to actively promote ethical behavior by adopting a corporate code of ethics, by giving employees training to ensure their understanding of the code, and by providing them with a means of confidentially reporting violations. We have also spoken with the NYSE and NASDAQ and are encouraged by their proposed new listing requirements that would require company codes of ethics. However we have further advocated that corporations require all their financial executives to adhere to a specialized code of ethical conduct. We believe it is important that corporations obtain a formal commitment from their financial executives to avoid conflict of interest relationships, provide information that is accurate, complete, and objective, and not misrepresent material facts or allow their independent judgment to be subordinated. We discussed this particular recommendation with legislators and were pleased to support the provision in the Sarbanes/Oxley Bill that addresses this area.
- Concerning the ABA task force recommendation that a committee of independent directors approve any transactions between the corporation and its directors and executive officers and all material related party transactions, we believe this recommendation has merit. It is certainly a corporate governance best practice that many companies already follow. However we are not sure implementation of this recommendation will deal with the type of abuses that occurred in the case of Enron, Adelphia, Tyco and others. The audit committee of Enron, a committee made up entirely of independent board members, specifically approved the infamous related party transactions that occurred between Enron's financial executives and it's Special Purpose Entities. What's more, the audit committee

waived the company code of ethics to do it. To some extent, the boards of these companies also approved some of the loan arrangements that are now considered by many to be excessive. We think it possible that the line between what is acceptable and what is excessive regarding executive loans may have moved in reaction to the events of the past year, and that these recommendations are a reflection of that. In any event, we already have new legislation on the books, specifically Section 402 of Sarbanes/Oxley, dealing with executive loans, legislation that has become a challenge for many companies to implement. By issuing an extensive prohibition on personal loans to directors and executive officers, this legislation appears to have called into question what we believe to be perfectly justifiable loans; loans for relocation, loans from 401K plans, and loans for the cashless exercise of corporate stock options to name a few. We hope that further clarification of this provision of the legislation will be forthcoming. However, in the end, we don't believe anyone has yet come up with a substitute for the good judgment and careful scrutiny of the Corporate Board of Directors.

### ***Recommended Governance Enhancements for Boards of Directors of Public Companies***

We would prefer that the task force's recommendation that companies consider use of a "lead" independent director be left as a discretionary item for boards to consider. We believe in many cases, independent board members have no problem effectively expressing themselves directly in board meetings. While it may make sense for the independent directors to appoint a spokesperson in certain cases, mandating a permanent arrangement of this kind is likely to become awkward,

effectively setting up a “dual” chairmanship that would contribute to factionalism and unnecessary friction within the Board.

We like the idea of term limits or policies calling for rotation of the chairmen of the Governance, Audit, and Compensation committees. We think requiring rotation of all the members of each of those committees, however, would be a problem, particularly in the case of Audit Committees. Both the NYSE and NASDAQ now require one Audit Committee member to qualify as a “financial expert”, and FEI has recommended that the exchanges raise the qualifications of these financial experts to a higher standard. It would therefore be a problem if at some point this financial expert were required to rotate off the committee. We therefore recommend that boards be allowed flexibility to structure their rotation rules so as to avoid this type of problem.

Finally, the third ABA task force recommendation, to institute and maintain an education program for all directors, is something we strongly support.

## Recommendations Relating to Lawyer Responsibility and Conduct

### ***Proposals to Amend the Model Rules of Professional Responsibility***

We read with concern the revisions to the rules of professional conduct proposed by the task force in this report. While we don’t profess to have a thorough familiarity with all the issues associated with the rules of conduct and responsibility of the legal profession, and don’t profess to have particular expertise in this area, we do have some observations we would like to make.

With regards to the proposed amendment of Rule 1.13, we believe it is important for corporate management to feel open and secure when discussing problems and issues with a corporation's general counsel. The expectation that any disclosures that occur during these discussions will be kept confidential is a significant aid in establishing this openness and security. Often times the financial officer seeks the assistance of the general counsel to serve as a "sounding board", particularly when trying to draw the line between actions that may be overly aggressive. Those distinctions are often difficult to draw. It would be a bad thing to "chill" this dialog with the prospect that whatever is discussed with a corporate lawyer or general counsel might be passed up the line to top management or the Board.

By the same token, it may be equally important to allow a lawyer to bring information involving misconduct or suspected conduct that has resulted in injury to the financial interests or property of another to the attention of higher corporate authorities. This is especially true in cases where timely notification would allow prompt action to be taken to curb the misconduct and minimize the damage it might otherwise cause. I can only offer encouragement to the task force and those that deliberate over changes in these rules, to frame any changes in a way that will serve to accomplish both objectives.

***Proposals for Establishing Lines of Communication by General Counsel and Outside Counsel.***

First, as we have already stated, we agree with the recommendation that the Corporate Governance Committee and Audit Committee meet regularly and in private with the corporate officers responsible for implementing internal controls, codes of ethics and compliance policies. We believe that this would result in the General Counsel

participating in those private meetings with independent board members. We therefore support the proposal.

Second, regarding the recommendation that all outside counsel formally set up a direct line of communication with Corporate General Counsel at the start of every engagement, for reporting potential violations of law and fiduciary duty; we think this arrangement is excessive and unwarranted. We believe the recently enacted Sarbanes/Oxley legislation deals adequately with this matter. Sec. 307 of that legislation requires attorneys to report evidence of a material violation of securities law or breach of fiduciary duty to the chief legal counsel of the corporation, and if the counsel fails to respond appropriately, to report the condition to the board of directors. Considering the number of outside attorneys retained to perform specialized work within even medium sized corporations, we believe is unnecessarily bureaucratic to require the establishment of formal procedures for periodic communications from all outside counsel. It would add a layer of cost to all the legal work that could otherwise be avoided.

That completes my prepared statement. I would like to thank the Task Force for giving me the opportunity to testify. I will be happy to answer any questions that you might have.