

It's not just what you do, it's the way that you do it

Exercising oversight in the sanctity of the boardroom and proving that you have done it are two different things. In order to restore trust, boards have to prove it.

BY LEON PANETTA

THE BOARD OF DIRECTORS was created to be a vehicle for leadership in public companies. In the current debate about corporate governance, that fact has gone relatively unnoticed. There should be no question that leadership is our role as directors. There is only the question of how that leadership should be exercised and — in the current era of corporate mistrust — demonstrated.

Here is another often ignored fact: Despite the spectacle of corporate disappointments during 2002, most boards have worked effectively over time, quietly helping companies negotiate all sorts of challenges without roiling the markets. Still, outside the boardroom, questions persist about the role of the board of directors in public companies.

Some would say more refinements to the structure of boards

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will resolve the questions that remain. Among board members and experts, we can debate the merits of European-style nonexecutive chairmanship, the definition of financial expertise for audit committee members, and other possible refinements that can enhance the structure of governance and help limit the liability of board members.

But broader questions still set the tone for public concern: What do board members do? Are they doing it well? How do we know they are doing their job if we cannot see them do it?

Credibility under pressure

Although new rules like those put in place by the New York Stock Exchange offer a needed improvement by codifying best practices, the credibility of the public company board as an institution remains under pressure. At this point, it seems that the tension between public expectations and board performance is less a matter of the structure and function of boards and more a matter of public demand for visible demonstrations of leadership by boards and their members.

In short, as a result of corporate crises, investors, employees, regulators, and critics of public companies are not just looking for good stewardship by board members, operating within new guidelines. They are looking for evidence of the ongoing process of leadership *as it unfolds*.

Anyone who has served in government or closely observed politics will be familiar with the challenge this presents. My own perspective on the emerging visibility of boards and their

actions is based on my perspective as a veteran both of the public policy arena and of several boardrooms.

Governing by crisis

I am a believer that we govern our democracy either through leadership or through crisis. If leadership is there, and it's wise and understanding and is willing to take risks, I think you can avoid crises. But if that is not present, then crises take place.

Today, we have a number of examples of governing by crisis, whether it's energy or the budget, or health care and prescription drugs, or even foreign affairs.

I think corporate governance is an example of an area that has been driven by crisis, and if there's any question in your mind, just look at the continuing headlines of the papers, whether it's *The Wall Street Journal*, *New York Times* or the *Washington Post*.

Just to give an example, I looked at the *Washington Post* business section one day in September, and saw these headlines: "Tyco CEO Arranged for Giving of Loans"; "Welch Cuts Back Perks"; "Options Accounting Changes Backed"; "Citigroup Pledges Lending Changes." Four of the five stories on the front page of the business section involved corporate problems of one kind or another. Perhaps by now we've grown so used to the litany of negatives that we forget how unusual this convergence really is. Each of these corporate events would have been difficult enough to accept on its own. But the series of scandals that has come together — beginning with Enron, going to WorldCom, Global Crossing, Tyco, Arthur Andersen, Martha Stewart, et cetera — may have changed the environment for corporations for a generation.

Stepping forward

There have been effective responses as a result of this crisis. The NYSE felt it was important to address these problems with new listing standards, probably some of the toughest listing standards we've proposed in the 210-year history of the market. I was a co-chair of the committee that developed those standards, and while it was difficult, I think it was important for the NYSE to step forward with those kinds of requirements.

Congress obviously stepped forward with the passage of Sarbanes-Oxley, and the SEC is engaged in a number of investigations, enforcement efforts, and regulatory changes to ensure that these problems are confronted.

I think all of us recognize that you cannot legislate honesty, but at the same time, you can't ignore dishonesty when it takes place. For that reason, we demand a system of checks and balances to try to protect against fraud. In doing that, however, there has to be a balance in protecting our free-enterprise

system, which is important to this country, to jobs, to creativity, to wealth, to innovation. At the same time, we try to ensure that we protect investors, the public, employees, so that they can trust and rely on that free-enterprise system not to act against their interests.

Trust — in companies and in the investment markets — is important not only to our democracy, but also to our economy. Right now, trust has to be restored.

Important steps have been taken by the markets, by the Congress, and by the SEC. But the test of the success or failure of

these efforts, in the end, will rest with whether CEOs and boards of directors recognize that operating with integrity, with accountability, and with transparency is not only in the best interests of their business, but also in the best interests of their investors and of the general public. That will be the test that will determine what's next for corporate America.

Doing what is expected

The challenge, now and in the future, is the challenge of restoring trust. That trust will come from boards doing what is expected under the new rules and visibly demonstrating that they are taking the actions that shareholders and the public expect. In other words, boards will

need to meet challenge of leadership, against a new, higher standard, in the spotlight of public attention.

While we haven't quite gotten to the point of real-time public scrutiny of board decisions, the desire for more information about board deliberations is building. What issues did the audit committee raise? What were the answers? What questions should have been asked? Who else was considered by the nominating committee for that open seat? Why were they rejected — or did the candidate reject the company?

I sit not only on the NYSE board but also on audit committees of the boards that I'm involved with. Prior to all of this happening, generally, audit committees reviewed the documents, largely approved them, and moved them on to the full board. In the period that we're now in, the audit committees are in fact asking a lot more questions about the documents that are being presented to them — a lot more incisive questions, a lot more questions about what accounting measures are used. Of course, we're now requiring that the audit committee be made up of independent directors, with one having a financial background. I can assure you that committees understand that they have got to exercise greater oversight than they have in the past.

But exercising oversight in the sanctity of the boardroom and proving that you have done it are two different things. In order to restore trust, boards have to prove it. Those of us who routinely tackle tough questions in the boardroom need to

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think about what the process might look like if viewed by those who have the opportunity to vote with a sell order. They are asking: How can the shareholder know that the board is doing its job? How can the shareholder know soon enough to make a judgment about the impact of the board's stewardship on the value of the company as an investment?

Consequences of transparency

Those who — directly or indirectly — seem to be calling for the board process itself to be more transparent need to consider the unintended consequences of a more public display of board-level interaction. In the best case, showing the interaction between board members and management would demonstrate not only the active role of oversight but also the strength and depth of management, the rationale for strategic actions, and the rock-solid reliability of financial results. But, in a less clear situation, an attempt by a board, or individual board members, to publicly showcase their supervisory role could affect the ability of a CEO to lead, or a CFO to manage capital market relationships, or customers to make a buying decision, or employees to line up behind a current business strategy.

Boards, and management teams, will need to move carefully. We are in uncharted territory, beyond the carefully choreographed public interactions that now characterize communication by and about most companies' boards.

From a political perspective, the dilemma of boardroom transparency reminds me of the comment attributed to Bismarck about the making of sausages and laws — that both were better unseen by the public. There are valid concerns that public exposure to the board process might lessen confidence in management or expose information to competitors.

But, despite those concerns, it is hard to say that more knowledge of the debate and scrutiny by board members would universally be a bad thing for management or for investors. And it may be too late to object. In America at least, history favors openness of institutions, and each generation of technology has accelerated the spread of information once it is released.

Although no one I know of has suggested the live broadcast of board meetings on a kind of corporate C-Span, the trend toward board accountability naturally leads to public exposure. And it is clear that, in some quarters at least, independent board members are expected to act like representatives of an opposition party in government. That is not what most companies want or need, since independence and opposition are not synonymous. Across thousands of public com-



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panies it seems quite clear that expert guidance is different from cross-examination. Certainly, much more has been accomplished for shareholders by well-constructed boards working cooperatively than by contentious boards.

Necessary orchestration

While the comparison of the board process to the political process has natural limits, the environment of concern and the

new requirements of stricter standards may produce better boards, and — like it or not — a more public role for board members.

Those who are concerned about the potential public scrutiny of boardroom debate can take some comfort in the fact that much of what is debated in a political arena is negotiated privately ahead of time. The political process and its observers learned long ago that if progress is going to be made, some displays of oversight by elected representatives must be well-orchestrated summaries of the true dialogue behind the scenes.

But, even viewed with cynicism, the agenda, the viewpoints, and the decisions in most parts of the political process provide information that the citizens can use to evaluate their leaders. By contrast, the history of open access to information and a public view of the boardroom debate is very brief and concerned almost exclusively with dire situations, consisting mainly of comments leaked to the media or deposition transcripts.

Until 2002, the obligatory functions of board members — especially outside board members — were accomplished out

of public view and were hardly ever a topic of discussion, except in the most extreme circumstances: hostile takeover, imminent bankruptcy, the incapacity of a CEO. Good questions were asked in thousands of board meetings, and good guidance given. But that happened in private, and in most companies, every effort was made to show public unanimity if any action of the board was visible at all.

Where's the evidence?

Many of us who serve on boards feel that directors of most public companies have been pretty effective in carrying out their roles — most of the time and mostly in private. Yes, more can be done, and will be done under the new rules. But one source of frustration and conflict for board members is their feeling they have done well to raise and resolve difficult corporate issues quietly, while in the current environment investors, customers, employees, and policy makers are now looking back for the evidence, feeling that they could have better managed their own risk if the board's process had been more public.

'Tremendous dangers for companies'

We who sit on boards know that many public company boards have already taken on a more active role, and I think you're going to see much more accountability with regard to operations within corporations. In the investment community, standards of operation and performance are being examined and the structure of organizations may be changed, making them more accountable, as well. But there is one other part of the equation, if we are going to "prove it" to the investing public and their representatives. We must hold the media to a high standard, too.

My larger concern with the media is not so much whether they use integrity and honesty in dealing with news, it's whether or not they focus on hard news with regard to this country and its economy, markets, and companies.

In terms of the overall picture of the critical issues that are confronting this country, there isn't enough attention to those issues that need to be debated and that the public needs to be educated on. Some would say that's because the audience isn't interested, but which comes first, news or interest? Except for the highlights of the scandal of the day, what context does the audience get when they watch television as shareholders, employees, customers, or citizens?

Despite my concerns, the media are going to continue to play a large role in determining what attitude people outside the boardroom

have about the success of public companies, and therefore about the capital markets and our economy. The media cannot be ignored by boards, any more than shareholders who get their information from the media can be ignored. And with the call for more transparency and more information from and about the board-level issues that face every company, the media's role may be even larger.

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Given the public's interest and the media's role, what can be done to make the public dissemination of information most productive? One of the things the New York Stock Exchange committee discussed when we were looking at disclosure issues was whether there is a way to present financial information in a more simplified fashion, both to the members of the board of directors and to the audit committee, and ultimately to the public.

There is no question that you can present more complex information to achieve disclosure. But the real key is, can you simplify it so that shareholders can follow along with the board's review and draw the same conclusion?

For example, can you provide simplified information so that a shareholder can know whether or not a company is taking accounting risks? Can we show the answers to the larger questions that the board is asking, and in the accounting, identify some broad standards that everybody can relate to? I hope and believe that the new accounting oversight board will be able to develop some of that simplicity, which will help make disclosure meaningful and accessible to those who can benefit from it.

As it stands now, the intersection of complicated information and public concern, and the desire of the media to demonstrate that they are addressing that concern, leads to tremendous dangers for companies. Almost any report that comes out from any company can become the subject of attention, and can be under-reported or over-reported in the media, and misunderstood. In the heated environment of public concern, that combination of factors can have a dramatic impact on investors. It can impact stock price, and it can impact on the integrity of that corporation. Before you know it, in a two-day period, you can have a tremendous diminution of the value of a company. Unfortunately, this isn't just a 2002 phenomenon — the combination of factors that face us in 2003 will provide just as volatile a backdrop for corporate news on any given day.

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Some board members and advisers seem to believe that enhanced rules and a period of reflection will take us back to quieter times, but it is more likely that broad public scrutiny of boards will continue. That isn't just because some of the most egregious corporate failures are still in the news. The public questions about the role of boards and their members may be inspired by the intersection of two fundamental American beliefs: the free flow of information and the delegation of the public's will to elected representatives.

This is not a legal question, of course, because the differences between political power and corporate enterprise are many and well-defined. This is a question of public attitudes and expectations and, to some degree, the long history of public oversight of the capital markets. In fact, those who say that the passage of Sarbanes-Oxley helped to satisfy the public concern about the adequacy of corporate governance will probably be disappointed. Ultimately, legislation did not cool the investing public's desire to see boards demonstrate their leadership role more aggressively. Instead, the legislative, regulatory, and litigation processes have confirmed for individual investors, retirement plan participants, voters, and those who represent them that *there is something to be concerned about*.

What we must ask

So, board members — especially independent board members — need to look at all these factors as they take on their publicly mandated more-visible role.

Not only must we say among ourselves, "Are we asking the right questions, and did we get the right answers?" We also must ask ourselves how to demonstrate that the review process has worked, and we have to ask what the media are going to do with the evidence to show that we have led the process well (*see sidebar*). We have to ask ourselves what the shareholders are going to hear and see, and we must anticipate how they — and customers, employees, regulators, and competitors — will react.

This is new territory for boards. It isn't clear how far we will have to go — not to do our jobs well, but to make it apparent that we have done so. Will the board have to communicate separately from the CEO? That's one of the consequences now, with a majority of the board being independent directors, and the requirement that those independent directors have the opportunity to meet separately from management. Does the board have to have its own communications function, its own advisers? Many will.

Boards as a whole will face new challenges in 2003, major questions that will affect whole industries and shareholders in large numbers. There is the question of domestic security, the volatility of the financial markets, and the demands of an increasingly aging population on retirement benefits and



Leon Panetta with H. Carl McCall (left), then-comptroller of the State of New York, and Gerald Levin (right), retired CEO of AOL Time Warner: The three co-chaired the NYSE's Corporate Accountability and Listing Standards Committee.

healthcare costs. The latter question alone could occupy many board meetings, especially if poor investment returns keep retirement security and worker benefits at the top of investors', employees' and public policymakers' lists of worries. In those concerns, the intersection of corporate decision making and public policy making will again intersect.

I cannot foresee a decline in concern about the effectiveness of public company boards. If that concern does continue, and if it can be satisfied only by the public knowing more about what board members think and do, then how can outside directors of public companies move forward in 2003?

End of a long tradition

Can we, and should we, better demonstrate our leadership? Can we end the long tradition of the boardroom as a sealed chamber from which we issue only unanimous endorsements of management's actions and results? Can we move toward more transparency about the boardroom process, without undermining the ability of management teams to produce the results that shareholders want?

We can, if we as individual board members continue to do what we have done well in the past, but do more of it, and if we communicate our actions in a timely and effective way. ■