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# REMARKS BY

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**U. S. SECURITIES AND EXCHANGE COMMISSION**

**CONFERENCE ON THE RISE AND EFFECTIVENESS OF NEW CORPORATE GOVERNANCE STANDARDS**

**FEDERAL RESERVE BANK OF NEW YORK**

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Thank you. As many of you know well, the mere mention of the phrase "corporate governance" might once have induced heavy eyelids and wide yawns. As my remarks today immediately follow lunch, it might still have that effect for some of you in the back row. Fortunately, corporate governance is no longer an academic discussion. It is not an arcane topic for high-minded legal debate. Nor is it a dusty, little-used flowchart in a vacant boardroom.

Like never before, the broad idea of corporate governance has attracted an extraordinary degree of public attention and new level of industry awareness. One might point to the financial crisis in emerging markets not so long ago, implicating a lack of corporate as well as governmental oversight. Or, more recently, the allegations of high-profile financial reporting failures in our own markets. While these certainly have played a role, the renewed attention given enhanced corporate oversight, in my view, springs from an even deeper well.

New imperatives now demand a revitalized and modern perspective on the fundamental responsibilities of companies to their investors. In a marketplace driven by technology, information, and a more empowered investor base, strong corporate governance is more than just a sensible business practice – it's an indispensable by-product of market discipline.

As you well know, capital markets, in the long run, place a premium on well-run companies. But in the shorter term, markets aren't always as rationale – and that's where a large part of the challenge lies for management, auditors and boards of directors. The question arises: How do you reconcile short-term market expectations with sustainability over the longer term?

Having served on a number of audit committees, boards, and now at the Commission, I'm convinced there are few bright-line tests or methodologies that ensure effective corporate governance. In many respects, the discussion of effective corporate governance is more a cultural one than a programmatic one: Does a company expect its board to ask the tough questions and reject easy answers? Does it expect the board to challenge management? Does it expect its audit committee to consider the quality of the work and the independence of the auditor?

Public companies operate uniquely through the separation of ownership and control. This system works brilliantly, provided those in control operate for the sole benefit of the true owners of public companies – the shareholders. Modern corporate governance practices promote accountability – not just for financial performance, but for ideas, practices and decisions. And how do you ingrain this accountability? Through an independent board. Through an engaged audit committee. Through a culture that demands a steadfast commitment to the interest of shareholders. In today's more interconnected and global marketplace, it's this approach to governance that makes tomorrow's more efficient, resilient and robust markets possible.

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*A More Global Marketplace*

We seem destined for a marketplace unfettered by boundaries. Through greater innovation, enhanced communications, and new computer networks, the notion of distance as a barrier has been all but archived. In record pace and staggering volumes, capital investments are crossing borders, transcending oceans, and traversing continents – almost instantaneously. An explosion of information sources, real-time news feeds, and on-line resources has reinvented how we gather and disseminate information.

High quality information is the lifeblood of markets. But unless investors trust this information, investor confidence dies. Liquidity disappears. Capital dries up. Fair and orderly markets cease to exist. As the volume of information increases exponentially, the quality of information for investors and the markets they comprise must be our signal concern. As more countries move to an equity culture, high quality financial information – safeguarded by a rigorous process of corporate oversight – becomes the currency that will drive a more interconnected and global marketplace.

But incentives that bring us a more global market also demand that every market promote the very highest standards at home – not just to compete, but to survive. Like never before, the effects of a company's behavior resonate not only nationally, but more likely, globally. If a country does not have a reputation for strong corporate governance practices, capital will flow elsewhere. If investors are not confident with the level of disclosure, capital will flow elsewhere. If a country opts for lax accounting and reporting standards, capital will flow elsewhere. All enterprises in that country – regardless of how steadfast a particular company's practices may be – suffer the consequences.

Markets must now honor what they perhaps, too often, have failed to recognize: markets exist by the grace of investors. And it is today's more empowered investors who will determine which companies and which markets will stand the test of time and endure the weight of greater competition. *Quality* will hone the competitive edge for all markets. Those who consider lowering their standards to attract more business, or who do not fully embrace transparency, should think long and hard before they start a race to the bottom. In an era when investors are increasingly able to shift their capital in and out of markets cheaply and easily, it serves us well to remember that *no* market has a divine right to investors' capital.

*Markets At Home*

Here in our own country, we have seen capital move from stocks, to gold, to oil and gas, to real estate, and these days, back to stocks. But ultimately, what draws investors in, or drives them away, is market quality and transparency. Investors want timely, dependable, and accessible information. They want responsiveness and efficiency. And through the Internet and other new technologies, investors now have greater access to the data they need to evaluate whether their demands are being met.

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Thanks to today's swift flow of publicly-disseminated information, corporate decision-making has become more accountable to public shareholders. Over the last two decades, our companies have become more open. Boards are now armed with the information they need to make key decisions and oversee the performance of corporate managers. Shareholders can more fully monitor the performance of corporate directors and officers. In short, modern corporate governance practices have become a part of everyday business.

Yet there is one area, in particular, where corporate decision-making may not be so readily transparent to the investing public: executive compensation packages. In a nutshell, it seems that companies on our two largest markets are granting options to executives in a way that side-steps the process of shareholder approval. The management of the New York Stock Exchange has committed that they will push hard to reinstate the time-honored, common sense rule that requires shareholder approval for plans that grant options or award stock to officers and directors, if Nasdaq does likewise. Last week, Nasdaq sought input from its issuers regarding the advisability of this approach.

I do not believe that there is necessarily a "one size that fits all" when it comes to determining when grants of options to *non*-officers and directors should be required to be put to a shareholder vote. Flexibility in employee compensation has been an important fuel for innovation in our economy in recent years. Without the ability to award options, we would, no doubt, have seen less dynamism from many cash-strapped, high-tech companies.

But none of us can deny the plain conflict that officer and director compensation presents, and the critical, curative effect that shareholder approval brings. Simply put, it is shareholder money that officers and directors are using to pay themselves. Shareholders should not be diluted in the dark. It is absolutely essential that the voice of investors be heard loud and clear by Nasdaq as it considers this issue. At stake is the rightful balance between shareholder and management interests, and, in the end, public confidence. I urge you not to miss the opportunity to comment on this matter of fundamental fairness and good corporate governance.

More and more markets are prompting companies to improve their governance structures and communications with their shareholders. But at the same time, these markets have also pushed many other companies to adopt dangerous and ultimately self-defeating practices. These last few years, I've talked about an unhealthy trend where the motivation to satisfy Wall Street analysts' earnings expectations too often overrides common sense business practices and long-term decision making. And with it has come a gradual but perceptible erosion in the quality of financial reporting.

We've all seen what happens when a company misses an analyst's earnings target by just a few pennies. The stock plummets 20, 30, sometimes 40 percent. I can't tell you how many times an investor has approached me – incredulous and exasperated – because a company's market capitalization dropped by millions of dollars simply because it was a penny or two shy of its earnings estimates. The hypersensitivity of stock prices to a company's ability to meet analysts' estimates is a market sensationalism that threatens investor confidence.

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You can't have a meaningful conversation about the role of analysts without at least mentioning the "tail wagging the dog" phenomenon of consensus Street estimates. While these estimates have always been around, the importance of beating these numbers has ascended to an almost mystical importance.

Getting caught-up in the game means "talking down expectations" or "giving guidance" or "pre-announced earnings." With the challenges of business today, I wonder whether a system that requires senior corporate executives to spend so much time stepping to the tune of this quarterly dance really makes sense. An abiding focus on long-term fundamentals – in corporate oversight, in management decisions, and in sound financial reporting which does not bend to analysts' quarterly earnings models, must win out the day.

Strong and effective corporate governance is both a dynamic system and a code of standards, measured by the *quality of relationships:* the relationship between companies and directors; between directors and auditors; between auditors and financial management; and ultimately, between information and investors. But if strong corporate governance is to permeate our marketplace, its practice must extend beyond prescribed responsibilities and obligations.

It is absolutely essential that a corporate governance ethic emerges and envelops all market participants: issuers, auditors, rating agencies, directors, underwriters, and exchanges. Its foundation must be an unwavering commitment to integrity. Its cornerstone – an undying commitment to serving the investor. Ultimately, this ethic should be safeguarded by those entrusted with the public's interest. And this begins with an active and independent board of directors.

*Board of Directors*

Boards must understand a company's operations – top to bottom. They must demonstrate a keen interest in hunting down problems, and a genuine determination in finding solutions. They must see the both the snapshot picture and the panoramic view. They must strive to reconcile long term objectives with short term goals. Above all else, directors must ask tough questions – the kind that make management think harder and auditors dig deeper.

The truth is, no regulatory body can marshal the kind of resources to oversee fully the management of every company – nor would it necessarily be in the best interest of our markets. Even the most expansive regulatory regime imaginable still would not be as effective as an active, inquisitive, and engaged board of directors. Directors are uniquely situated to monitor new developments and troubleshoot problems as they arise. What's more, directors set the tone and enable management to focus away from the ephemera of today's stock price and onto what really counts in building and operating a vibrant, profitable business. Yet today, their job has taken on new challenges and new demands that call for an even greater commitment to their public duties.

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America's companies are more complex than ever before; partnerships, strategies and business plans are not only more complicated but also more fluid in order to meet the demands of innovation and technology. Directors must review and approve more intertwined mergers, acquisitions, and business combinations. They must answer to institutional investors who are vocal and vigilant in defending their interests. They must monitor management and gauge compensation levels in an ever-changing environment. There is simply no place for a board that simply checks off a list of perfunctory responsibilities – their duties require rigorous attention and a steadfast sense of purpose.

*Audit Committees*

There's another critical component to effective corporate oversight. During my almost eight years at the Commission, I've come to believe that one of the most reliable guardians of the public interest is a competent, committed, independent and tough-minded audit committee. In an environment where the quality of financial information is more critical than ever before, the audit committee stands to protect and preserve the integrity of America's financial reporting process.

Given their importance, there is no reason why every public company in America shouldn't have an audit committee made up of the right people, doing the right things, and asking the right questions; an audit committee that meets several times a year; where every member has an understanding of the basic principles of financial reporting; where there are no personal ties to the company; where, ultimately, the investor interest is being served.

Towards this end, the Blue Ribbon Committee on Improving the Effectiveness of Audit Committees set forth principles and "best practices" standards. It called for audit committees to oversee both internal and external audits, to ensure independent communications with auditors, to engage in robust, candid, and probing discussions about the quality of the company's financial reporting, and to adopt measures that ensure the outside auditor's objectivity. More recently, the Panel on Audit Effectiveness, commonly referred to as the O'Malley Panel, recommended that audit committees obtain annual reports from management assessing the company's internal controls, and pre-approve non-audit services provided by the independent auditor.

Almost a year ago today, the Commission – building on the work of the Blue Ribbon Committee – adopted rules that strengthen the audit committee's independence, and give its members the tools and the wherewithal to fulfill their duty to the investing public. In addition, the rules improve communications, through greater disclosure, among the board, outside auditors and management.

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By asking audit committees to consider the quality – not just the acceptability – of a company's financial statements, we recognize the systemic importance of justifying decisions that directly affect a company's financial reporting process. What's more, when auditors and the board engage in frank and meaningful discussions about the significant, but sometimes gray areas of accounting, both the company's and its shareholders' interests are served. In this way, the board, including the audit committee, management, and outside auditors form a "three-legged stool" of responsible disclosure and active oversight, laying the foundation for financial integrity and greater accountability.

On this last point, there are few words more reassuring to investors than *accountability*. That word sends a clear, unambiguous message that reputation, stability and long-term growth will not be sacrificed for short-term expectations. While some have suggested that active involvement may expose audit committee members to increased liability, I've never heard of a board or audit committee that got into trouble because it was too engaged, too diligent, or too effective. Promoting corporate accountability is at the very heart of what boards and audit committees do – fulfill a legal duty and a moral mandate to represent shareholders. As an investor, I would find it quite disheartening if anything prevented my board from having meaningful and substantive discussions with management and auditors on critical financial reporting issues.

Now, I certainly don't take unnecessary exposure concerns lightly, and in the Commission's rules, I believe we've addressed them squarely. But for the sake of America's markets, we simply cannot discourage more information, more public disclosure, and more active and diligent oversight by America's audit committees.

There is another area in which audit committees must increasingly focus their attention, and that is the issue of the outside auditors' independence. As you are well aware, the dramatic transformation of the accounting industry has been marked by a rise in the types of non-audit services firms provide their audit clients. As a result, auditors who provide consulting services for their audit clients are at risk for fees sometimes far greater than those generated by the audit. The incentive to compromise an audit has never been greater.

Three weeks ago, the Commission issued new rules that I believe will go far toward assuring the continued integrity of this country's company financial information. The rules identify certain non-audit services that, if provided to an audit client, would impair an auditor's independence. In addition, the rules require disclosure of fees by firms who offer information technology and other consulting services to their audit clients.

And under the rules, audit committees will now disclose whether they considered the types of non-audit services performed and the fees involved. Too often, I've heard stories of audit committees simply negotiating down the audit fee rather than discussing the firm's broader relationship with the company. In some respects, that only diminishes the apparent value of the audit. Independence is the cornerstone of rigorous, objective, and high-quality financial reporting. As long as investor confidence hangs in the balance, the sanctity of the numbers must never be in question.

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In the next few weeks, I will be sending a letter to audit committees asking them to engage their auditors on the question of independence and quality of their financial reporting. Disclosure now makes such scrutiny possible. I encourage audit committees to take every step possible to ensure that the integrity of the financial statements, and by extension, the interest of shareholders, remains second to none.

*Conclusion*

Nearly three decades ago, a broad-based dialogue began on corporate governance between the Commission, academia, the legal community and companies. And through the years, it's been a discussion that has moved forward with the evolution of our markets. But today, like no other time in the history of markets, we face new opportunities and new challenges that bring a greater relevance and urgency to this market fundamental. A more globally integrated and interconnected marketplace is upon us. The need for vigilant oversight has become nothing less than a new global directive.

Yet the dynamic nature of today's capital markets creates issues that increasingly move beyond the bright line of right and wrong. More often, financial market participants grapple with questions where there are no easy answers. It is in this realm that judgment and integrity are indispensable for effective corporate governance.

In some respects, a renewed commitment to the highest corporate governance practices may require a cultural shift in the way all market participants think about their duties. Simply put, it is not enough to have rules and guidelines securely in place and then ignore their practical application, or even greater, the public spirit that brings them to life. It's a call that all of us in this country must embrace as our own collective mandate. It's a call that will continue to make America's companies and its markets an enduring beacon of what vigilance and integrity can cultivate. And, it's a call that will help ensure that America's capital markets remain the deepest, most liquid, and most respected in the world.

Thank you.