

**Corporate Governance in the Global Economy:
Roles and Responsibilities of Corporate Directors**

Good morning. I am **Dr. Roger Raber**, president of the **National Association of Corporate Directors**, the only **membership organization** for members of corporate boards in the United States. Most of our 8,500 members are from the U.S., but a few hundred are from other countries, including some located right in Tokyo! All of you would be welcome to join our association.

On behalf of NACD members and directors everywhere, **I want to acknowledge the sponsors** of this event:

- Institute for International Studies and Training,
- Multilateral Investment Development Corporation,
- Ministry of Economy, Trade and Industry
- Organisation for Economic Co-operation and Development
- Tokyo Centre
- Japan Corporate Auditors Association,
- Japan Investor Relations Association

And respectful greetings to our distinguished guest from Japan Management Association.

Collectively, you represent the interests of all the major constituents of corporate life: employees of all ranks (workers to senior managers), investors, lenders, and the general public. Even though you are not all directors, you all do care about employees, you care about investors, you care about bankers, and you care about the citizens of this productive **city of Tokyo** and **noble country, Japan**.

And because you care about all these constituents, you care about corporate governance. That is why you have asked me to speak on **Corporate Governance in a Global Economy**.

First, let me echo what I have already heard from our distinguished conference organizers. We truly do live in a global economy. This is the second time in my presidency **that I have come here to Tokyo** to talk about governance; and one of your key organizers **Raita Sakai, has traveled to Washington** many times to visit me and my association.

Some of you may know the old Japanese folk tale about the two travelers—one from Osaka and one from Kyoto—who decide to return to their homes before they ever make it to their destinations. We are not like them! **Raita-San and I both know that there is a global economy** where laws are becoming increasingly similar. We could call this the *convergence of corporate governance* That is why we are here exchanging ideas. So let us begin.

My talk today will cover five points.

1. First, corporate governance—what is it? And what does it have to do with auditing?
2. The corporate director as a “fiduciary.”
3. Duties of corporate directors under state and federal law in the United States.
4. Global governance.
5. A lesson for Japan.

1. DEFINITION OF CORPORATE GOVERNANCE

What is corporate governance? It has been defined in many ways, but one of my favorite definitions is one that NACD first published 20 years ago when we started our work:

“Corporate governance ensures that long-term strategic objectives and plans are established and that proper management structure is in place to achieve those objectives, while at the same time making sure that the structure functions to maintain the corporation’s integrity, reputation, and responsibility to its various constituencies.”

Now this definition raises a question: Who is responsible for corporate governance? And

the answer is, the **board of directors**. That is why the subtopic of my speech is “**Roles and Responsibilities of Corporate Directors.**”

Now of course auditors do play an important role in governance as well. Independent external auditors can certify that a company’s financial reporting conforms to generally accepted accounting principles -- both nationally and, if appropriate, internationally. And internal auditors can work with management, directed by the audit committee of the board of directors, to ensure strong internal controls. Today, external and internal auditors are both doing more to minimize corporate risk. This is because the general public wants more financial safety in corporations, and also because regulators are passing new rules – for example Standard 2 of our Public Company Accounting Oversight Board.

But even though external and internal auditors are very important, in this speech I will focus on the **role of directors**.

Tomorrow we will have a panel on the “professionalism” of directors. This is a very important topic. To be a good director is following a profession. Like any professional persons, corporate directors have knowledge and skills that they must bring to their job, which they must perform with ethical integrity.

But my speech today is not about the professionalism of directors. I won’t speak about directors as they do their job around the boardroom table. That is microeconomics. As I said, we will take a close look at that tomorrow. Today I want to talk about the big

picture: the director's **role and responsibilities not only in a particular company but also as part of a broader society and a global economy.**

2. ROLE OF THE CORPORATE DIRECTOR AS A "FIDUCIARY"

What is a corporate director? Under U.S. law, a director is a fiduciary.

The word fiduciary comes from the Latin word *fides*, or faith. ((You may have heard the expression of one of the branches of the U.S. armed services: "Semper Fi" - always faithful. "Fi" is from the same word.)) **A fiduciary is someone that others put their faith in; they trust directors to watch out for their interests.**

(Another word for "fiduciary" is "trustee." In the U.S., However, the word trustee is used only in charities—not for profit-making corporations.) The concept is the same—a fiduciary is essentially the same as a trustee.

So who exactly has "faith" in the fiduciary and "trust" in the trustee? It is all those **constituencies you represent: employees, investors, lenders, and the general public.**

They are counting on directors to make the right choices for them.

Common Law

In U.S. law, the idea of the fiduciary goes back to the so-called **common law**. This is the law of the people and it does not have to be legislated into law. In the “common law,” ordinary ideas of decency, generated by ordinary people, can become requirements in court, and a legal decision by a judge can have a profound impact on society.

Some state legislatures have turned the common law into a state law, which may vary by state. The American Bar Association, the leading association for attorneys, has tried to harmonize those laws. It produces an ongoing document called the “Model Business Corporation Act” (which is really a guidebook, not a law). Many states follow what this document says about the duty of care and the duty of loyalty.

Under all these sources of guidance--common law, state law, and the Model business Corporation Act—directors have a **duty of good faith**, which includes a **duty of care and a duty of loyalty**.

Duty of Good Faith: A Hot Topic

The duty of good faith is very ancient. However, today it is a hot topic! It got rediscovered in the recent case of Disney in 2005. This case emphasized the importance of **good faith** for fiduciaries. The Disney decision (in the Chancery Court of Delaware)

said directors should act with honesty of purpose and in the best interests of the corporation. Courts may find lack of good faith if directors are intentionally derelict in their duties or consciously disregard their responsibilities. The Court found that even though directors paid a lot of money to a departing CEO, Disney directors had done so in good faith.

Another duty of directors under our common law is the **duty of care**. This duty requires that directors be informed and exercise appropriate diligence and good faith as they make business decisions and oversee the company. The corporate law of most states says that the business and affairs of a corporation “shall be managed by or under the direction of a board of directors.”ⁱ

Finally, under the common law and state law, the **duty of loyalty** (similar to and some say part of the duty of good faith) requires a director to act in the best interests of the corporation. When conducting the business of the corporation, directors must not act in their own interests or in the interests of associates (a friend, family member, or contacts at another organization). Directors may not use confidential information or other aspects of their position to benefit themselves or their associates.

I would also like to mention our business judgment rule. It is not really a rule, but a legal principle. When a court wants to see whether directors breached their fiduciary duties, the business judgment frequently applies. A court presumes that when making a business decision, the directors acted in good faith and in the honest belief that their

decision was in the corporation's best interest, taking into account appropriate information.

3. DUTIES OF CORPORATE DIRECTORS UNDER STATE AND FEDERAL LAW IN THE UNITED STATES.

So aside from being a fiduciary entrusted with the faith, care, and loyalty, **what do directors actually do?** Director activities vary by company. However, a good list of director duties can be found in state corporation statutes. Delaware corporation law, for example, says the "business and affairs" of Delaware corporations "shall be managed by or under the direction of a board of directors," and lists certain corporate decisions that can be made only by the board. This is consistent with laws of other states. It is also consistent with the Model Business Corporation Act of the American Bar Association, which many states use to guide their statutes. Board activities customarily include some or all of the following:

- approving a corporate philosophy and mission
- selecting, monitoring, evaluating, compensating, and – if necessary – replacing the CEO and other senior executives, and ensuring management succession

- reviewing and approving management’s strategic and business plans, including developing a depth of knowledge of the business being served, understanding and questioning the assumptions upon which such plans are based, and reaching an independent judgment as to the probability that the plans can be realized (referred to as “constructive engagement” in strategy)
- reviewing and approving the corporation’s financial objectives, plans, and actions, including significant capital allocations and expenditures
- reviewing and approving transactions not in the ordinary course of business
- monitoring corporate performance against the strategic and business plans, including overseeing the operating results on a regular basis to evaluate whether the business is being properly managed
- ensuring that the corporation has in place systems to encourage and enable ethical behavior and compliance with laws and regulations, auditing and accounting principles, and the corporation’s own governing documents
- assessing the board’s own effectiveness in fulfilling these and other board responsibilities, and
- performing other such functions as are prescribed by law, or assigned to the board in the corporation’s governing documents assessing its own effectiveness in

- fulfilling these and other board responsibilities (subject to minimum statutory requirements such as quorum requirements for meetings under state corporation law), and
- performing such other functions as are prescribed by law, or assigned to the board in the corporation's governing documents

(The list above is adapted from *The Report of the NACD Blue Ribbon Commission on Director Professionalism* (Washington, D.C.: National Association of Corporate Directors, 2005),

State corporation statutes often list actions to be performed by **full boards alone**.

- Only boards (not committees or managers) can adopt a plan *of merger or consolidation*, or recommend an *action for shareholder approval*. Shareholders must approve (and only the full board can propose) *the sale, lease, or exchange of all of the company's assets*, and/or a *decision to dissolve a corporation*. The board may not delegate these duties to a committee or to management.

Some board responsibilities can be delegated to committees, officers, and/or advisors.

When the board delegates these responsibilities to these parties, it is permitted rely on information, reports, and recommendations from them, but it still has to oversee their work.

Here are board duties that **may be done through committees**, subject to the preceding caveats.

- Amendments to Charter; Adoption and Amendment of By-laws. The board must approve charter amendments and, except for certain incidental amendments, submit them to the stockholders for approval. Most corporate charters give the board the power to amend the company's by-laws.
- Declaration of Dividends. Any dividends must be declared by the board.
- Derivative litigation. If a shareholder wants the board to sue management on behalf of the corporation, the board must approve this so-called "derivative" litigation.
- Compensation of Directors. Director compensation must be fixed by the board.
- Compensation of Officers. In general, boards must approve all transactions in which officers are interested, including the compensation of officers.ⁱⁱ Del. Gen. Corp. L. § 144.
- Dissolution. The board may adopt a resolution to dissolve the corporation, but must submit it to the stockholders for approval.
- Election of Officers. The board must determine the positions and functions of officers, as well as select officers.

- Issuance of Stock Options and Rights. The board must approve the issuance of stock options and rights.
- Mergers and Consolidations. The board must approve any proposal for a merger or consolidation and, except for certain incidental transactions, recommend the transaction to the stockholders for approval.
- Indemnification of officers, directors, employees, and agents. Under certain circumstances, this must be determined by the board.
- Reduction of Legal Capital. Only the board can reduce the corporation's legal capital.
- Retirement of Stock. Only the board can retire shares of stock that are issued but are not outstanding.
- Sale, Lease, or Exchange of Assets. The board must approve the sale, lease or exchange of all or substantially all of the corporation's property and assets and submit the transaction to the stockholders for approval.

Stock Issuance. The board must approve the issuance of stock.

In addition, under federal securities laws, directors are responsible for:

- Registration statement liability (The Securities Act of 1933)
- SEC reporting and proxy statement liability (The Securities Exchange Act of 1934)

The **Sarbanes-Oxley Act of 2002** clarified and expanded some of these duties, and triggered stricter stock exchange listing standards, such as having independent compensation and governance committees, and strengthening the requirements for independence of the audit committee.

The Sarbanes-Oxley Act has eleven Titles. Each title has multiple sections. (80 total.)

Here is a list of Titles with the most important sections for directors.

Title I establishes a **Public Company Accounting Oversight Board (PCAOB)** to oversee auditors. One task of the PCAOB has been to set standards for the auditors' review of internal controls.

Title II sets stricter guidelines for **Auditor Independence**.

Title III addresses **Corporate Responsibility**.

Sections in this title:

- * sets stricter definition of independence for **Public Company Audit Committees**.

- *require **Corporate [CEO/CFO] Certification of Financial Reports**.

- *requires **Forfeiture of Certain Bonuses and Profits** (if paid under financial statements that are later restated due to misconduct)

- *bars **Insider Trades During Pension Fund Blackout Periods**.

(If employees cannot trade, directors and officers cannot trade.)

Title IV addresses **Enhanced Financial Disclosure**.

Sections in this title require:

- **Management Assessment of Internal Controls**
- This is the famous “Section 404). (Of all the sections of Sarbanes-Oxley, Section 404 has been the most controversial. Many smaller companies complained about the cost of complying with this section. In May 2006, following joint roundtables, the PCAOB and the Securities and Exchange Commission issued guidance that will ease this problem.)

disclosure of an **Audit Committee Financial Expert**.

Title V addresses **Analyst Conflicts of Interest**.

Titles VI and VII are legalistic; they cover government authority and reports.

The final titles address fraud, namely: **Corporate and Criminal Fraud and Accountability, White Collar Crime Penalty Enhancements, and Corporate Fraud Accountability** (with an intervening section on corporate tax returns). This includes “Protection for Employees of Publicly Traded Companies Who Provide Evidence of Fraud (“Whistleblowers”).”

Most of these reforms have been very significant for directors - for obvious reasons.

4. GLOBAL GOVERNANCE

Just a few final words about the main theme of this conference, Global Governance.

Twenty years ago, there really was not such thing as global governance. Every country or region had its own code (many of them developed in the early 1990s), and they still do today. But in June 1999, the **Organization for Economic Cooperation and Development**, one of the sponsors of this conference, got all 29 of the countries that belong to agree to a single code as a baseline.

The OECD Principles, most recently updated in 2004, has become a baseline standard around the world. But this was only possible because delegates from both our countries traveled to Europe for the deliberations.

5. A LESSON FOR JAPAN?

What are the lessons for Japan? In my mind, the most important lesson is to continue to respect the true meaning of the word “fiduciary.” As I stated in the opening of this speech, **a fiduciary is someone that others put their faith in; they trust directors to watch out for their interests.** That means **employees, investors, lenders, and the general public.** All these groups are counting on directors to make the right choices for them.

Official Version of July 5, 2006

You in Japan have always had a very strong fiduciary culture. You must keep that culture strong while adopting new practices. So, returning to the example of Mr. Sakai and me, when it comes to learning more about how to be a good director one must travel far—and not look back. I look to you here in Tokyo for new and helpful ideas.

Thank you.
