

## **Corporate Governance: Setting the Context**

*General Counsel and the governance agenda - a time of opportunity*

*by William Friedrich, General Counsel and Deputy CEO, BG Group plc*

**Economist Conferences' General Counsels' Summit, 10<sup>th</sup> November 2004**

### **Introduction/where are we now?**

Ladies and gentlemen, good morning. I'm Bill Friedrich and I would like to begin by thanking the organisers of this conference for inviting me to give this address. I regard it as a great privilege both for myself and for our company, BG Group.

In fact, I don't usually accept invitations to speak - mainly because I'm more than busy enough but also because I'm a relatively private person and I prefer to avoid the limelight. A typical New Yorker, you might say!

However, this was an opportunity I felt I couldn't resist. Why? Well, I know I've spent most of my working life aspiring to do things right and to do the right thing - as I'm sure you will have done. So when everyone from governments to the media to the general public appears to be questioning whether business and the professions are even **capable** of integrity, then something's awry. And I think we need to address that discrepancy.

I suppose we've arrived at where we are today as a result of a series of spectacular corporate episodes.

Allow me to give just a few examples:

- Enron - where we read that the chairman claims he didn't know what was "going on".
- Tyco - where, apparently, the accountants said it was okay.
- Marconi - where a company once worth £35bn moved to the brink of bankruptcy in the space of a few years.
- WorldCom - where former CEO Bernie Ebbers started every board meeting with a prayer, yet in one year the company held just four board meetings, but 17 remuneration committee meetings. I guess we have a clue about what Bernie was praying for!
- Hollinger - where fees and other payments made to Lord Black and other senior executives represented more than 95% of the company's net income.
- Parmalat - where the Italian dairy giant filed for bankruptcy protection with nearly \$18bn of debt and Milan prosecutor, Francesco Greco, began investigating what he and his team believed might be "vast market deception".

And yet, despite all of that, ex-SEC chairman Arthur Levitt, tells us to forget Enron, WorldCom or mutual funds. The crisis enveloping the insurance industry is - quote - "the scandal of the decade, without question" and "dwarfs anything we have seen thus far".

He was, of course, referring to the accusations made just last month by New York Attorney General, Eliot Spitzer, that the world's biggest broker of insurance, Marsh & McLennan has been conducting what was described as "an elaborate charade of sham bidding". When Spitzer announced the lawsuit on October 14, Marsh's stock fell by 24% and by a total of 48% over the next four days, wiping \$11.4 billion off the company's market value.

Now, we can debate which scandal has done the most damage but one thing is clear: the last few years have created a corporate climate that has tended to confirm the suspicions and preconceptions of too large a percentage of the public for my - and I suspect your - comfort. And the preconceptions of those people are that the likes of us are 'fat cats' driven by greed and power. By fear? Yes, occasionally. But by ethics? Never.

But, if we look more closely at the mood out there, it becomes clear that there are nuances to people's view of the corporate world. In fact, there's good news and bad news for people like us. And let me give you the bad news first: a MORI poll earlier this year showed that only 30% of British adults interviewed felt they could trust business leaders to tell the truth. That compares with 92% trust in doctors and 55% trust in the ordinary man or woman in the street.

And it's in response to that negative picture that we have seen an external response from governments, regulators and other authorities - even NGOs. And

we can sum up that response in this way: we can't trust you to do it yourselves, so we'll impose a raft of standards of behaviour via legislation, regulation and public lobbying. And, in many respects, I'd say: who can blame them?

The good news from the MORI poll is that business leaders' rating is higher than politicians, who scored 22%, and higher than journalists at 20%. More tellingly, it is a little higher than business leaders scored five years ago. Fortunately, lawyers didn't figure in the poll!

But, seriously, I very much hope that this modest increase was due to some members of the public registering the proactive way in which many businesses have responded to the prevailing corporate climate. Many firms have long acknowledged the scale of the problem. And the more progressive are already well down the track of framing - and adopting - fresh, ethical corporate philosophies *without* any particular need for prompting or nudging from the authorities.

So, if that's the backdrop, let me tell you what I hope to do today:

- First, I want to talk about the scale and range of the scrutiny facing business in the months and years to come and the likely implications of that;
- Then I'd like to talk about the overall attitude regulators and others are likely to adopt;

- Next, I want to make some suggestions about how business in general might respond;
- Then I'll consider how general counsel in particular might navigate a way through the challenges; before reaching some broad conclusions.

First, the scale of external activism and scrutiny aimed at improving corporate behaviour appears to be rising inexorably. And I say this as an observation rather than a complaint.

And let's look at those different levels of scrutiny. There is for example:

- Political action in the form of legislation, such as the Sarbanes-Oxley Act in the US - not to mention the added pressure from politicians, who hint at further dire consequences in the event of business not cleaning up its act.
- Regulators too are realising that now is a good time for them to flex their muscles. The SEC is a more active body these days and, in the UK, the FSA has demonstrated that it will use its power to enforce the rules.
- External advisors have a new role too - UK money-laundering and terrorism legislation now requires outside lawyers, accountants and tax advisors to 'shop' their clients to the authorities if they uncover wrongdoing.
- Journalists and NGOs are stronger players now as well. And, although you might regard them as self-appointed scrutineers, it's fair to say that both realise that now is a great time to try to make a splash. Journalists are probably at least as likely to become award-winners for corporate scoops

these days than any other kind of exclusive. NGOs have their tails up too, conscious that their analyses of corporate behaviour are listened to more closely by governments now than at any other time.

But as well as these appointed - or self-appointed - scrutineers of corporate governance, firms face being hit where it really hurts - in the share price - by the investor community and by monitoring bodies such as credit rating agencies.

Investors now routinely assess a company's corporate governance practices as part of the investment decision-making process. In countries where poor governance practices are suspected, a company's share-price will often trade well below its 'real' value.

You may have read about a new development from the credit ratings agency Standard & Poor's. And there appears to be some confusion about what this will involve. Well, rest assured - S&P won't be carrying out governance dawn-raids and they won't be evaluating your legal teams.

What their Governance Services department *will* be doing is issuing corporate governance bulletins on rated issuers where they believe that there may be a 'specific governance issue' or where they believe that investors would benefit from their comment on the corporate governance practices of certain companies. They have started this initiative because they concluded that many

of the corporate failures of the past few years have shown similar management culture and corporate governance characteristics before the full extent of their problems became known.

These governance bulletins may be driven either by specific events or by the presence of certain characteristics that might prompt S&P to review a rated company's governance issues in more detail including:

- The aggressiveness of the business model and growth strategy, including acquisition strategy;
- The aggressiveness, complexity and transparency of corporate legal, financial and tax structures (and objectives behind these structures), including the use of derivative and off-balance-sheet financing structures in financial management;
- The aggressiveness, complexity or frequency of changes in accounting and financial reporting practices;
- The aggressiveness and short-term focus of equity price strategy;
- Unusual management turnover and absence of adequate succession planning; and
- The frequency of litigation and/or government or regulatory actions, judgments, or settlements against the company, compared to its peers.

And, according to recent reports, around 200 major companies can expect this kind of scrutiny in the next two years.

What all of this means is that governance issues are now seen to range more widely - and they include how companies deal with a broader church of stakeholders. It also means that there is a need now to do far more than guard against fraud. In essence, policy-makers are seeking to introduce scrutiny and systems that will encourage sound decision-making. And *they* believe that that should help companies be successful.

Perhaps inevitably this widening of the governance range has meant more senior management time devoted to the issues. In an *Economist Intelligence Unit* survey last year of 310 senior executives around the world, more than half of the respondents reported that top management was spending over 10% of its time on governance. And corporate leaders expect the demands of governance to rise further. Almost two-thirds of respondents expect their top managers to devote more than 10% of their time to governance this year.

And that's hardly surprising when we look down the track at what is actually facing us.

### **Where are we bound?**

Well, I'd suggest there are two parallel developments here: first, a raft of specific regulatory proposals; but, second - and perhaps as critical to us all - a behavioural development in regulators' approach to implementation.

In terms of specific measures, we have, for example:

- The EU's Financial Services Action Plan - which amounts to a drive towards a single European financial market.
- The EU's Action Plan on Company Law and Corporate Governance - which has resulted in the establishment of a European Corporate Governance Forum and could mean harmonised corporate governance statements for all listed companies.
- The introduction of International Financial Reporting Standards at the start of 2005 for listed companies in the EU and many other countries worldwide.
- A UK Government White Paper on modernising company law and a draft Companies Bill.
- The Operating and Financial Review Regulations, which will require directors to provide a total-context picture of the business.
- The Companies (Audit, Investigations and Community Enterprises) Act, which received Royal Assent on 28 October.
- Revised Governance Rules for the New York Stock Exchange; and
- The Financial Reporting Council's review of the Combined Code.

In terms of attitude, it's not surprising that we are now seeing a more vigorous approach to implementation from the regulators, as they seek to respond to the prevailing mood.

For example, section 408 of the Sarbanes-Oxley Act requires SEC staff to review filings of all registrants on a “regular and systematic” basis and at least once every three years. If you haven’t been reviewed yet, be prepared - it will probably happen by July of next year. And the SEC won’t necessarily choose a time that is particularly convenient to the smooth running of your business.

In the UK, the Financial Reporting Review Panel has staffed up sixfold. Whereas previously the Panel only looked at complaints, from now on it will review proactively companies’ audited financial statements and, under the new Companies (Audit, Investigations and Community Enterprises) Act, will review interim as well as annual accounts.

But, before we start feeling persecuted, let me say this: if, in the short term, companies inevitably face more regulation and a more vigorous approach to implementation, in the longer term, this need not be a continuing trend. And whether we can reach a more tranquil regulatory environment, I believe, lies in our own hands.

I referred earlier to how MORI had found a public crisis of confidence of sorts in business. Our task *has* to be to restore public trust in business. That will take time - and it will also take commitment.

In my view, that means that not only is non-compliance or grudging compliance not an option; it also means that doing simply what is required will, in many cases, be insufficient too.

Some people in business want to question the whole assumption that tighter governance will inevitably lead to improved corporate performance. Well, I think that's the wrong place to start from.

It may be the case that no-one has proved an empirical link between a strong ethos of corporate responsibility and a rising share-price - though I do want to question that a little later in this speech. But if we don't show a willingness to comply and an inclination to think imaginatively about how we might rebuild trust in the corporate world, then I think we're on a collision course not just with governments, regulators and the investor community - but with the general public as a whole.

And we needn't be too gloomy about our ability to do this. As I said before, public confidence in business may not be high but it is on the rise - however modestly - according to MORI. I think it's also fair to say that the proactive response of a significant number of firms to both the governance and corporate social responsibility agenda in recent years has enabled us to hold the line against some still more intrusive regulation.

For example, at both a UK Government and European Union level, attempts by elected members to impose mandatory Corporate Social Responsibility reporting have been resisted. The UK government has clearly stated that it falls to directors to identify, manage and report on significant CSR risks. This should allow companies the scope to be innovative rather than follow mandatory schemes that encourage 'box-ticking'. However, the call from some quarters for mandatory, standard CSR reporting will continue.

And let me turn to a sector outside my own for an example of how firms can turn things round. In the late '90s, several of the chief executives of the leading mining companies recognised that the industry was looked on with suspicion - to say the least - for their activities in developing countries. They took decisive action to improve performance and consequently the reputation of the sector.

The first step was a lengthy, multi-million dollar global programme of stakeholder engagement to understand the views of those affected by the industry - including local communities, environmental and development NGOs, and host governments. Out of this, the industry developed a system of self regulation - an association of leading mining companies that would sign up to minimum performance standards.

Not all companies found they could accept these standards and some left the association. Small companies, some of which were the principal cause of the

sector's poor reputation, are not included. But the reputation of the industry as one capable of putting its own house in order and setting standards of best practice for the mining business has now been established

So, in that 'can-do' spirit, let's look at what our response to these challenges might be - both as companies and as corporate counsel.

And I think a good place to start from is by asking this simple question:

### **What really matters?**

Philip Augar, author of *The Death of Gentlemanly Capitalism*, commented as follows on the corporate collapses: "To me there is nothing at all surprising about what happened. Because just think about it: if you take a bunch of alphas, mainly males, but not exclusively, and you do the following things to them - deregulate them, ease off the professional controls, basically leave them to get on with things - then there is nothing irrational about the exuberance that followed. It is human behaviour."

That is perhaps an extreme viewpoint. Another way of putting it would be to say that we need the rules, the corporate mission statements and the compliance programmes to set an ethical tone and create a corporate atmosphere that discourages wrongdoing. But I would go further: the essential message here is

that rules are necessary, but not sufficient. They have to be accompanied by personal values that shape the culture of an enterprise.

Enron had some of the best governance manuals and structures in the industry and its ethics committee voted three times to waive its own code of conduct. Similarly, on paper WorldCom exceeded the accepted norms of best practice in corporate governance.

Yes, we should look to independent audit and to predominantly independent boards to ensure our assurance frameworks are sound. But rules can never be a substitute for personal values. There has therefore got to be a balance, an essential combination of rules and the right people with the right values, complementing each other. Ultimately the quality of governance is dependent on the quality of the people.

I have posed the question “what really matters?” Well, here are some of the attributes I would look for today before joining a board:

- An independent board. This starts with an independent chairman - but it isn't sufficient just to have independent directors. The board needs to *function* independently. Independent directors are in danger of 'conforming' if they are put into a group that discourages dissent. But the board should not be merely an arena for challenge. It has to be somewhere where board members form their own views. They also have to have absolute direct

access to information. They have to consider how they can access information on the issues that matter.

- Also essential is the board being confident that they have the best people in senior management. For me the essential qualities are character, capability and judgement. People of character who want to do things right and do the right thing, who are capable - up to the job and who possess outstanding judgement.
- There needs to be an exemplary relationship between board and management. If management has a relationship with the board that is trusting and open, they will talk to the board about problems early and frankly.
- There also needs to be a solid succession plan for management. Good succession management is an issue for companies and its absence an indicator of the quality and values of a company. Most dictators don't groom successors! Senior management must possess the emotional intelligence - by which I mean the self confidence - to be able to devolve power and develop people underneath.
- Finally, there must be a strong culture and the right values. For me this means really believing in the right values and persuading the rest of the

organisation that you really do believe. No nod or winks, no double-talk or ambivalent body language. Employees who believe that senior management will not control inappropriate conduct, if it hurts business, will not endanger their own positions by reporting concerns.

### **So, what are the implications for the role of corporate counsel?**

If you can foster the kind of ethos I have just described within your company, in my view, you're close to achieving what we might call 'a state of grace' - a position in which you can be confident that the likelihood of ethical shocks to the system has been minimised and employees can get on with the job of creating value for their company.

But, unless you're very fortunate, creating this kind of ethos within your company will depend in large part upon you and the efforts you put into shaping the company you work for.

And, again, there's good news and bad news here. And, again, let's start with the bad news. Let's be clear: there *is* no magic formula. There *is* no blueprint or template that we can apply or lay over our companies that will guarantee success in the governance arena.

If there were, I wouldn't be here talking to you about the subject today and it wouldn't be a topic that has risen steadily up the corporate agenda.

But the good news is this: because of the nature of the governance challenge at this time, because of the position we hold within our companies, there has rarely before been a better opportunity for us, as general counsel, to assert ourselves constructively. There has rarely been a situation better suited to our shaping the spirit and ethos of the companies in which we work.

And, when I say that, I'm not suggesting all of us today set off on some kind of ego-trip. Or revel in the way we can mould our companies. Yes, it's challenging and it's exciting - but the governance role we assume also amounts to a pretty hefty responsibility. And it's a responsibility that is relentless.

But, if there's no strict formula for success, there are a few key guidelines you can follow that I believe can make the difference between your being effective in fixing and sustaining the right ethical parameters for your company or not:

- First, make sure you are a leader and an activist, setting the tone for your firm;
- Second, strike the right balance, weighing up the specific nature of your company and creating a suitable governance framework for it; and
- Third, make sure you have the right tools to do the job.

And let's briefly look at each of these in turn.

First - leadership.

I cannot overstate the importance of this. You can only set the right tone by the way you behave - and this means being an activist within your firm.

It means devoting real time and effort to considering the key ethical and governance questions. But, once you've conducted the analysis, as well as offering clarity of direction to your colleagues, you need to go out and sell the message vigorously. And you have to do that in a way that encourages debate and fires the imagination of those you work with.

You have to promote the corporate ethos you're advocating not just among senior management but across the employee population. You have to design programmes and educate internally at all levels. You have to embed your vision within your company - not by *fiat*, but by stimulating thinking, by encouraging debate and - personally - by being an example to your colleagues.

Your company's employees should think of you when they're considering high standards of integrity. And I don't want to exaggerate but a good sign would be that, when you walk into - or even walk by - people's offices, their instinctive reaction is to ask themselves whether they're doing enough to sustain or

enhance the company's reputation. Because that's one of the things that they associate with *you*.

And there can be no transfer of responsibility, when it comes to any major decision affecting corporate reputation. President Truman used to have a sign on his desk at the White House which read: "The buck stops here".

In the case of general counsel, 'the buck stops here' means that while we may well - indeed we should - devolve some key decisions to members of our team, we can never cast off responsibility for those decisions. We can never allow their consequences to hit us blindsided.

Now, all of this can mean some tough decisions. The paramount obligation of general counsel is to protect the interests of the company and its ultimate owners rather than merely its officers. You have to see that your client gets the right legal advice at the right time. You also have to take all the measures that you reasonably can to ensure that your client complies with applicable law.

But are you part of a team that is committed to doing things right and doing the right thing? Are you a business partner or an in-house cop? Are you the corporate conscience or a member of the management team? Can you be all of these things?

I think you have to be - but, on each of these, with a first class team beside you, you won't be alone. In a properly functioning company, senior management needs to share these roles and these responsibilities. If that doesn't sound like your company, then you need to work to put in place a process that will turn things round. And, when you succeed, it will mean that you're never alone.

But to deliver all of these leadership requirements, you need those attributes I mentioned a little earlier: character, capability and outstanding judgement. And, in my view - in this case - two out of three *won't* do.

Second requirement - striking a balance.

And what do I mean by that? Well, I stressed a moment ago that there was no magic formula, no template we could apply to produce the correct governance framework regardless of the size or nature of the company in question. 'One size fits all' doesn't work when it comes to governance.

A key role for general counsel lies in identifying what is special about the make-up of your firm and designing a governance structure that, taking proper account of the essentials, is bespoke - that is uniquely suited to it. And it's back to that question again of 'what really matters?'

I think you have to begin with idea that governance has to mean more than the processes required for legal and regulatory compliance. At its heart, it must also be about creating the structures that will produce sound decision-making. This means striking the right balance in the authority we grant and the responsibilities we impose on individual members of staff. It means being clear - where they are devolved - about the extent of decision-making powers. And it means an effective appraisal process for achieving informed and timely decisions.

Third requirement - having the tools you need to do the job.

And, to put it as precisely as I can, you cannot accept a position in which your responsibility exceeds your authority.

In a Baker & McKenzie survey of 35 FTSE 500 companies, senior executives recognised the importance of in-house counsel's participation in decision-making but only 54% involved general counsel before making a final decision, 11% said general counsel helped generate strategy and only 26% took part in initial board discussions.

Now, though that was only a small survey, those figures seem to me to be totally inadequate. But I think we can address them by insisting on three specific requirements:

- Access and information;

Clarity of authority and responsibility, which should be spelled out in a clear job-description; and

- Clear reporting lines both up and down.

On the first of those requirements, when I joined British Gas before BG Group emerged as a separate company, I agreed two principles before I accepted the job. That I could attend all board meetings and no one could say “no” to me if I asked for information.

Should you be part of the board or advisor to the board? I know that this question is on the conference agenda for more detailed consideration later today - but let me give you my personal view. You don't have to be a member of the board to be effective but it is extremely helpful to attend all board meetings. You can't be much of an advisor if you're not in the room. Automatic attendance at board meetings takes the issue of board access off the table. It also enables the general counsel to develop positive relationships at board level that will facilitate communication.

In terms of information, there should be no corner or recess of your firm that is hidden from your sight or tucked away out of reach.

And don't overlook simple things like the scope of your job-description. Do you have one? If so, does it currently *really* reflect your responsibilities and your

authority? One thing you might want to consider - and I make no apologies if it sounds a little radical - is to redraft your job-description. That will help to create new clarity around how you operate and your level of influence. It might also make your senior colleagues stop and think again about the significance of your role in this new climate of corporate scrutiny.

I spoke earlier about succession-management. I suppose most people think that that is something that Human Resources departments deal with. Well, of course they do have a major role to play but, at a senior level, the existence of a credible succession plan is a basic element of good governance and it's for - among others - the general counsel to see that it's in place and effective.

Finally - do you have an unambiguous reporting structure - both up and down?

I suspect we have become somewhat enamoured of so-called 'dotted line' responsibility. It's sometimes an easy way of resolving an accountability problem. But what does a dotted line mean? Which elements of a job-description - assuming there is one - flow through a solid line and which through a dotted line? I would suggest we can do better than this. The more clarity of responsibility and accountability our organisations can demonstrate, the clearer the structures and the smaller the scope for confusion.

So let me close my remarks with some final conclusions.

Yes, there are challenging currents swirling around us at present. But my message to business is this: seize the initiative, demonstrate that we are capable of going beyond compliance, show innovative thinking and *then* we stand a chance not only of retaining some degree of self-regulation but, more importantly, of turning the tide of public opinion from cynicism to respect – even if it is grudging!

My message to general counsel is this: these are testing times but there has never been a better time for general counsel to be leaders. Although rules are necessary, they are insufficient. Personal values must shape an enterprise. *That* is the bottom line. And we, as general counsel have to embody those personal values, if we are to help our companies identify the right way forward.

There are those who still to this day question the value of the governance and corporate responsibility agenda. Let me give you my view: I do not believe there can be any serious doubt about an absolute connection between companies that govern themselves well and those that prosper economically. Why might that be? As I said earlier, the heart of governance should be the creation of structures that produce sound decision-making. And that in itself is a good enough reason for us to reassess our systems and our structures, to take on that leadership role with enthusiasm and to move forward.

Ladies and gentlemen, I hope you have found some of these thoughts interesting. Thank you for listening.