DEVELOPING GUIDELINES FOR INDEPENDENT AND COMPETENT DIRECTORS USING WHAT WE HAVE LEARNED FROM RESEARCH AND COMPANY EXAMPLES

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Abstract

These guidelines are developed for independent and competent Board Directors:

- Directors must have no material relationships with the company over the past year.
- Directors should have business savvy, a shareholder orientation, and a genuine interest in the company.
- Pay for performance, not presence, and use a mix of short and long-term performance measures for Directors' compensation.
- Evaluate Directors' performance over a three year period, using both stock price and accounting performance. Use claw-back provisions for Board members' compensation if the firm does poorly, compared to its peers over this period.
- There should be a mix of skills for Board members, such as industry knowledge, experience, and expertise in financial accounting, risk management, and cyber security.
- There should be term and age limits for Board members.
- There should be women on Boards.

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There are many issues regarding the independence of Board of Director members. Three key related issues have been found to occur in many of the large frauds of the 21st Century: all-powerful Chief Executive Officer (CEO), weak system of internal control, and focus on short-term performance goals (Basilico and Grove, 2008). The New York Stock Exchange (NYSE) established a Commission on Corporate Governance as an independent advisory commission to examine U.S. corporate governance and the overall proxy process (2010). This advisory commission took a comprehensive look at strengthening U.S. best practices for corporate governance and the proxy process and it also cited these three issues in developing key corporate governance principles.

These three issues are all related to Board of Directors' independence. If the CEO is also the Chairperson of the Board (COB), then how can he/she evaluate his/her own performance since there is no lead director as an independent COB? Furthermore, this situation may allow the CEO to pack the Board with his/her own insiders or friends and to obtain possible majority control of the Board, due to an inadequate number of independent directors. As a result, there may be an inadequate number of independent directors to challenge a weak system of internal controls which allows the company to "make the numbers" and enhance short-term compensation. Without an adequate number and/or mindset of independent directors, such compensation policies may go unchallenged.

Accordingly, major global stock exchanges have listing requirements concerning this issue of independent Board of Directors' members (Aljifri et. al., 2014). For example, in the United States, both the New York Stock Exchange and the NASDAQ (2003) have now required that the majority of board members be independent which is defined as no material relationships over the past year with the company itself. The Sarbanes-Oxley Act (SOX, 2002) has prohibited corporate loans to directors and corporate officers. This Act also gave the Securities and Exchange Commission (SEC) the power to ban, temporarily or permanently, officers or directors who have committed securities fraud.

In the United Kingdom, the London Stock Exchange has a rule that the board include a balance of executive and non-executive (independent) directors such that no individual or group of individuals can dominate the decision-making. Another rule requires a clear division of responsibilities at the head of the company between running the board and the executive responsibility for the running of the company's business and stated that no one individual should have unfettered powers of decision. In Asia, the Singapore Stock Exchange has a rule that there must be an independent board comprised of at least one-third independent directors.

Another rule requires a clear division of responsibilities at the top of the company (the board) and executive responsibility for a balance of power, such that no one individual represents a considerable concentration of power.

These three independence issues for Board members are elaborated in the next three sections. They are followed by sections discussing executive and board compensation, the effectiveness of executives and directors, and the behavior of boards during the 2007-2010 financial crisis. Finally, we present guidelines to develop independent and competent directors.

1 All-Powerful CEO

An all-powerful CEO can exist when the CEO is also the Chairperson of the Board of Directors (COB), and insiders (senior company managers) on the Board have majority control. Cullinan and Sutton (2002) found that the CEO and other senior managers were involved in 90% of the 276 companies cited by the SEC for earnings management or fraud in its Accounting and Auditing Enforcement Releases (AAERs) from 1987-1999. Beasley et al. (1999) found similar results in their study of AAERs from 1987-1997. Basilico et al. (2005) also found significant statistical differences for insider majority control of over 100 fraud companies in AAERs from 1986-2001 versus matched non-fraud companies.

For example, the original CEO, usually the company founder, was also the Chairman of the Board at Enron, WorldCom, and Global Crossing. The Qwest Chairman of the Board, who was the largest single Qwest shareholder, hand-picked the CEO. In Europe, Parmalat (nicknamed "Europe's Enron") began as a family-owned meat company that grew into a global food giant. The CEO, who was the company founder, the Chief Financial Officer (CFO), and the company lawyer continued to run the corporation together as insiders controlled the Board of Directors even after it went public.

Satyam (nicknamed "Asia's Enron") was an Indian technology outsourcing company. Satyam had listed on the NYSE to raise capital at a lower cost partially because the NYSE has higher standards of corporate governance than many other stock exchanges. Satyam was not a case of pure CEO duality since Ramalinga Raju, the COB, was not the CEO. However, his brother, Rama Raju, was the CEO. Therefore, there was a lack of independence between the CEO and the COB, and, thus, the presence of an All-Powerful CEO.

Concerning corporate governance for an effective board structure, Buffett (2005) observed: "true independence - meaning the willingness to challenge a forceful CEO when something is wrong or foolish - is an enormously valuable trait in a director. It is also rare." He looked for people whose interests are in line with shareholders in a very big way. All eleven of his directors each own more than $4 million of Berkshire stock. They are paid nominal director fees. No directors and officers liability insurance is carried, not wanting them to be insulated from any corporate disaster that might occur.

All the major stock exchange listing requirements for corporate governance have emphasized an independent Board of Directors to help counter-balance an all-powerful CEO in order to help protect investors. For example, the NYSE requires that its listed companies have a majority of independent directors and has defined independence as directors having no material relationships with the company over the past year. One such material relationship was a Director on the Board of Anheuser Busch (AB). He appeared to be independent as the CEO of a Brazilian company, but AB owned almost 50% of that company!

To help promote more independent Boards, SOX prohibits corporate loans to company officers and directors and also gives the SEC the power to ban, temporarily or permanently, individuals from serving as officers or directors of public companies if the individuals have committed securities fraud, like Enron's Jeff Skilling and WorldCom's Bernie Ebbers. Only 22% of U.S. S&P 500 companies have separated the two jobs of CEO and COB (Bussey, 2012). However, JPMorgan Chase shareholders rejected such a separation in May, 2014 and the Board's Compensation committee awarded the CEO with a 70% pay raise since he had helped limit the company's fines paid to U.S. federal authorities in 2013 to $20 billion (Silver-Greenberg and Craig, 2014).

2 Weak System of Management Control

This issue can exist when the system of internal control (checks and balances, separation of duties, internal audit etc.) is so weak that senior management can override it anytime it wants. A weak system of internal controls was almost always present in major fraudulent financial reporting cases, both in current and past frauds (Grove and Basilico, 2011). Senior management encourages such a weak control system so that it can be easily overridden to make the desired financial targets, preferably by subordinates without the specific knowledge of top management. For example, although Parmalat had reported profits each year, a report prepared by an independent auditor for prosecutors in Milan said that Parmalat only had one profitable year between 1990 and 2002. Also, Parmalat's CEO admitted to shifting over EUR 500 million cash from the company to other businesses. However, the independent Parmalat report put that number closer to EUR 1 billion cash and blamed the CEO. A Milan Magistrate close to the Parmalat case observed: "We need individuals and a culture that exercise controls" (Barber, 2004).

Similarly, Satyam's two co-founders, the Raju brothers, admitted to shifting over $1 billion of cash to family-related, "sister" companies and overstating Satyam's financial statements to cover up this theft. Concerning Satyam's weak system of management control, investors were explicitly warned in Satyam's SEC Form 20-F: "We do not have an individual serving on our Audit Committee as an 'Audit Committee Financial Expert' as defined in applicable rules of the SEC. This is because our Board of Directors has determined that no individual audit committee member possesses all the attributes required by the definition 'Audit Committee Financial Expert" (Basilico, et.al, 2012). Thus, Audit Committee expertise was inadequate to analyze Satyam's internal controls and financial reporting.

Another example concerning the competence of Board of Directors was the Swiss company Adecco, the world's largest temporary employee agency. It had a Board of Directors and a three-person Audit Committee composed of only Europeans. Meanwhile, 20% of total revenues were in the U.S. where the fraud occurred from overstated revenues, billing errors, lack of internal controls, and poor information technology security. Adecco and its Board failed to exert proper control over its foreign subsidiaries, primarily due to lack of competence in controlling its U.S. operations.

This control problem has appeared to be timeless as the 2007 KPMG survey of 138 top corporate executives found that inadequate internal control was the primary contributor in the previous year to a fraud incident against their company. The survey found that a major contributor to fraud was management's override of internal controls. The lead partner for KPMG's Forensic practice concluded: "Applying lessons learned from their efforts to implement controls over fraud risk could help boards, senior executives and others who have responsibility to manage the risk of fraud with early detection and prevention" (KPMG, 2008).

Concerning corporate governance for management controls, Buffett (2004) observed that many intelligent and decent directors failed miserably due to a "boardroom atmosphere." He elaborated: "It's almost impossible, for example, in a boardroom populated by well-mannered people, to raise the question of whether the CEO should be replaced. It's equally awkward to question a proposed acquisition that has been endorsed by the CEO, particularly when his advisors are present and support his decision." To avoid these "social" difficulties, Buffett has enthusiastically endorsed the NYSE requirement that outside directors regularly meet without the CEO. Also, the NYSE requires that every publicly listed company have an Audit Committee of at least three members composed entirely of independent directors who must be financially literate. Furthermore, it requires that every listed company have an internal audit function.

All the major stock exchange listing requirements now emphasize a strong system of internal controls to help protect investors. Various exchanges, like the NYSE, have specifically cited the need for independent Audit Committees and internal audit functions. Since a strong internal control environment is critical to preventing fraud, SOX requires that both the CEO and the CFO discuss their firm's internal controls. Firms must also report on the policies and procedures in place to prevent fraud in their annual reports. CEOs and CFOs are required to state that establishing and maintaining the internal control structure is their responsibility and to provide an annual assessment of the effectiveness of those policies and procedures. Also, the U.S. Public Companies Accounting Oversight Board (PCAOB), created by SOX, requires that the external auditor give an opinion on the effectiveness of a firm's internal controls in addition to the required opinion on the fairness of the firm's financial statements.

3 Focus on Short-Term Performance Goals

Too much focus on short-term performance goals can occur when the overriding performance goal is to "make the numbers," for each quarter and each year. Emphasis is given to both revenue, or 'top-line' growth, and earnings, or 'bottom-line' growth, since Wall Street financial analysts focus on both numbers as their key performance metrics. For example, Qwest's CEO was criticized by his own board for having a short-term focus on making the numbers, particularly double-digit revenue growth. Qwest did quarter-end swaps of its fiber optic networks with other companies, such as Global Crossing and Enron, to make its quarterly double-digit revenue targets. None of these swaps were disclosed to investors. Qwest also recorded thirteen months of advertising revenues from its telephone directories, instead of the normal twelve months, to make its annual revenue growth target one year. To make its own revenue goals, the Dutch company Ahold recorded supplier rebates as revenues. Two German firms rejected proposed mergers with Enron and Qwest, similarly citing aggressive revenue and earnings management accounting practices and huge off-balance sheet debt of these companies.

IBM is currently being investigated in 2014 by the SEC for its aggressive revenue recognition in its cloud computing business. Enron used the gross, not net, revenue method up until its demise in 2000. Groupon attempted to use this same gross revenue method in its 2012 IPO prospectus, but it was rejected by the SEC which had essentially banned that method since 2002. WorldCom hid $4 billion of expenses in long-term assets before its demise in 2002.

SOX has required CEOs and CFOs to certify, in a written report, that they have reviewed all quarterly and annual reports filed with the SEC. They must state that, to the best of their knowledge, the reports present

fairly the financial condition and operations of the firm and do not omit material information. Individuals can be fined up to $5 million and be sentenced to up to 20 years in prison for violating this requirement. This regulation has helped prevent earnings manipulation by companies to meet, or beat, the quarterly and annual earnings targets of financial analysts.

SOX also enabled the SEC to adopt Regulation G for the required disclosure and reconciliation of pro-forma financial measures to generally accepted accounting principles (GAAP). U.S. companies, especially technology companies, had been using pro-forma (non-GAAP) accounting to make short term revenue and earnings targets in their quarterly and annual press releases and conference calls. They are now required to reconcile any such pro-forma numbers to GAAP financial statement numbers in an 8-K report to the SEC. For example, in 2013, Facebook eliminated $295 million of executive stock option compensation in its first public reporting quarter after its IPO in order to turn an operating loss into an operating profit. However, Facebook had to file an 8-K report with the SEC, reconciling its own numbers to GAAP, which had prohibited such practices since 2006.

Buffett (2007) has argued that a red flag should exist if a company always does meet its quarterly and annual goals, like Enron did for twenty quarters in a row, since such performance ignores the reality of competitive environments and business cycles. Buffett further commented in his CEO Letter (2010):"Charlie (his longtime number-two executive) and I believe that those entrusted with handling the funds of others should establish performance goals at the onset of their stewardship. Lacking such standards, managements are tempted to shoot the arrow of performance and then paint the bull's-eye around wherever it lands. If we really thought net income important, we could regularly feed realized gains into it simply because we have a huge amount of unrealized gains upon which to draw. Rest assured, though, that Charlie and I have never sold a security because of the effect a sale would have on the net income we were soon to report. We both have a deep disgust for "game playing" with numbers, a practice that was rampant throughout corporate America in the 1990s and still persists, though it occurs less frequently and less blatantly than it used to."

4 Executive and Board Compensation

To guard against an undue focus on short-term financial performance for compensation packages, a total compensation package could be divided into fixed and variable components for both executive and Board members' compensation. For example, the variable component could be made up of several performance measures (Hilb, 2008):

- long-term financial performance over three years,
- comparative value indices (e.g. 50% Economic Value Added, 20% customer loyalty, 20% employee satisfaction, and 10% public image), and
- functional performance assessments (20% board committee performance, 30% individual board member performance, and 50% corporate performance).

Concerning guidelines for executive compensation, Buffett (2006) stated: "In judging whether Corporate America is serious about reforming itself, CEO pay remains the acid test. To date, the results aren't encouraging." He noted that when CEOs meet with boards' compensation committees, too often one side (the CEO) has cared much more than the other side about the pay package. The difference often had seemed unimportant to the board's compensation committee, particularly when stock option grants had no effect on earnings prior to 2006 under U.S. accounting rules. He observed that such negotiations often had a 'play-money' quality and said that directors should not serve on compensation committees unless they are capable of negotiating on behalf of the shareholders. Buffett noted that "CEOs have often amassed riches while their shareholders have experienced financial disasters. Directors should stop such piracy. It would be a travesty if the bloated pay of recent years became a baseline for future compensation."

The 2008 financial crisis with the bloated severance packages for fired and continuing CEOs reinforced this observation. However, the median CEO pay package has increased more than 50% since the great recession, and the median CEO compensation in 2013 was $10.5 million. The female CEOs' median pay package was higher than the male CEOs' pay package for all 12 females versus 325 males (Associated Press, 2014). Concerning adding new investment managers at Berkshire Hathaway to assist Charlie and him, Buffett (2010) said: "We will probably have 80% of each manager's performance compensation be dependent on his or her own portfolio and 20% on that of the other manager(s). We want a compensation system that pays off big for individual success but that also fosters cooperation, not competition."

All the major stock exchanges have independent compensation committee requirements to help protect investors concerning these types of compensation problems. For example, the NYSE requires that all listed companies have a compensation committee comprised solely of independent directors. This committee must have a written charter which includes objectives for CEO compensation and performance evaluation. Annual performance evaluations of the board and its committees are required. Also, the SEC requires an annual compensation committee report with specific disclosures from the board in proxy statements to shareholders.

Why haven't these independent compensation committees been evaluating CEOs' performance in

terms of stock price performance and accounting performance? A new study (Cooper, Gulen and Rau, 2013) reported that the more CEOs get paid, the worse their companies do over the next three years in terms of both stock price and accounting performances. The conventional wisdom among executive pay consultants, board of directors' compensation committees, and investors is that CEOs make the best decisions when they have more stock and stock options in their compensation packages. This new study by professors at the University of Utah, Purdue University, and the University of Cambridge studied 1,500 U.S. companies with the biggest market capitalizations. They analyzed pay and company performance from 1994-2013 and compared these companies' revenues and net income with industry competitors. They found that the more CEOs got paid, the worse their companies did, and this negative effect was the strongest in the 150 firms with the highest-paid CEOs. The companies run by CEOs in the top 10% of CEO compensation had the worst overall performance, returning 10% less to their shareholders than their industry peers, but the companies of CEOs in the top 5% were even worse, returning 15% less than their peers.

These results have significant implications for independent and competent board members. The authors summarize these astonishing results as indications of CEO overconfidence and explain that CEOs with huge compensation amounts tend to think less critically about their decisions. These CEOs tend to think that they can do no wrong or they would not be entrusted with their position and their pay. One of the authors commented: "They ignore dis-confirming information and just think that they are right. That tends to result in over-investing—investing too much and investing in bad projects that don't yield positive returns for investors" (Adams, 2014). For example, the study found that among the 150 top-paid CEOs, 19% did mergers which resulted in negative performance of 1.4% over the following three years which was almost three times lower than mergers done by firms with low-paying CEOs.

Furthermore, this study found that the longer CEOs were in charge, the worse was the firm's poor performance. The authors explained that since these CEOs were able to appoint more allies to their boards, these allies were likely to go along with these CEOs' bad decisions. The authors summarized their findings: "For the high-pay CEOs, with high overconfidence and high tenure, the effects are just crazy. They return 22% worse in shareholder value over three years as compared to their peers" (Morgan, 2014). The authors and other finance experts recommend claw-back provisions in CEO compensation packages for board compensation committees to implement; if the firm does poorly compared to its peers, the CEO would lose a share of his/her compensation. Thus, the focus would be on "Pay for Performance, not Presence", as advocated by Kostyuk (2014), for top executives and board members. Both the Sarbanes-Oxley Act and the Dodd-Frank Act have such claw-back provisions when financial statements are restated. Some boards have advocated say-on-pay provisions that would allow shareholders to vote on executive compensation while various investors and others have pushed companies to disclose more information on pay ratios. For example, the CEO-to-worker compensation ratio in the U.S. was 20-to-1 in 1965 but is 296-to-1 in 2013.

Buffett (2007) also commented on independence and competence issues concerning Board members' performance and compensation: "board members must be truly independent because many directors, who are now deemed independent by various authorities and observers, are far from that, relying heavily as they do, on directors' fees, often ranging between $150,000 to $250,000 annually, to maintain their standard of living." Buffett wanted his directors' behavior to be driven by the effect of their decisions on their net worth, not by their compensation. He called this approach 'owner-capitalism' and said that he knows of no better way to create true independence for board directors as well as facilitating competent performance. In contrast, Lehman Brothers' Board of Directors averaged $350,000 in compensation in 2007, the last year of its existence before its bankruptcy, as opposed to U.S. Board members' average compensation of $239,000. Also, Enron's Directors' average compensation was in the top ten of all U.S. Boards in 2000, its last year of existence before its bankruptcy.

5 Effective Executives and Directors

Concerning guidelines for an effective Board, Buffett (2006) commented: "When the CEO cares deeply and the directors don't, a necessary and powerful countervailing force in corporate governance is missing. Getting rid of mediocre CEOs and eliminating overreaching by the able ones requires action by owners - big owners. Twenty, or even fewer, of the largest institutions, acting together, could effectively reform corporate governance at a given company, simply by withholding their votes for directors who were tolerating odious behavior." However, this is probably not likely to happen. Fidelity Mutual Funds have never voted against Board directors, possibly due to a conflict of interest in running the pension plans of many companies. Also, a lesson that should be learned from the Satyam fraud is that a strategy to reduce fraudulent financial reporting is to have strong corporate governance with an effective, independent, and competent Board of Directors (Basilico et. al., 2012). However, the Satyam Board's successful 2014 defense in a class action lawsuit was that they knew nothing about this massive Satyam fraud!

To help supervise senior management and director effectiveness, a competent, independent

nominating committee of the Board of Directors could select senior managers and directors who are interested in the long-term success of the company and its shareholders. Buffett (2005) commented: "In addition to being independent, directors should have business savvy, a shareholder orientation, and a genuine interest in the company. In my 40 years of board experience, the great majority of these directors lacked at least one of these three qualities. As a result, their contribution to shareholder well-being was minimal at best and too often negative. They simply did not know enough about business and/or care enough about shareholders to question foolish acquisitions or egregious compensation." Buffett (2011) further stated: "The primary job of a Board of Directors is to see that the right people are running the business and to be sure that the next generation of leaders is identified and ready to take over tomorrow. I have been on 19 corporate boards, and Berkshire's directors are at the top of the list in the time and diligence they have devoted to succession planning. What's more, their efforts have paid off." Berkshire Hathaway recently had the fifth highest market capitalization of any American company at $314 billion, and Warren Buffett was the third richest person in the world at $65 billion (The Economist, 2014).

Concerning poor company performance, Buffett (2009) said: "CEOs and directors of the failed companies, however, have largely gone unscathed. Their fortunes may have been diminished by the disasters they oversaw, but they still live in grand style. It is the behavior of these CEOs and directors that needs to be changed. If their institutions and the country are harmed by their recklessness, they should pay a heavy price – one not reimbursable by the companies they've damaged nor by insurance. CEOs and, in many cases, directors have long benefitted from oversized financial carrots; some meaningful sticks now need to be part of their employment picture as well."

Concerning effective Board members, Buffett (2009) commented: "When stock is the currency being contemplated in an acquisition and when directors are hearing from an advisor, it appears to me that there is only one way to get a rational and balanced discussion. Directors should hire a second advisor to make the case against the proposed acquisition, with its fee contingent on the deal not going through. Absent this drastic remedy, our recommendation in respect to the use of advisors remains: Don't ask the barber whether you need a haircut." This same advice pertains to the use of consultants for executive pay packages—would any of them ever say executives are currently being overpaid at the risk of never being hired again by that company?!

In an attempt to protect investors, there are several requirements that focus on a Board's nominating committee. The NYSE has a requirement that each listed company have a nominating/corporate governance committee comprised solely of independent directors. This committee must have a written charter which includes the criteria and responsibilities used to identify individuals qualified to become board members. Also, a version of the UAE requirement for directors could be used which states that a director shall stay in office until he is succeeded, becomes deceased, resigns, or is dismissed via a Board of Directors' decision. A statutory requirement, similar to the SOX requirement on insider trading, could be used to increase investor protection. Senior management turnover would have to be disclosed on a company's website within two days and simultaneously reported to the SEC.

6 Board Problems in the Financial Crisis

The Financial Crisis Inquiry Commission (Commission) was a ten-member commission appointed by the U.S. government with the goal of investigating the causes of the financial crisis of 2007-2010. Citing dramatic breakdowns in corporate governance including taking on too much risk, the Commission portrayed Board of Directors' and management incompetence with the following examples. Citigroup executives conceded that they paid little attention to mortgage-related risks. Executives at American International Group were blind to its $79 billion exposure to credit-default swaps. Merrill Lynch managers were surprised when seemingly secure mortgage investments suddenly suffered huge losses. The banks hid their excessive leverage with derivatives, off-balance-sheet entities, and other accounting tricks. Their speculations were aided by a giant "shadow banking system" in which banks relied heavily on short-term debt. The Commission concluded: "when the housing and mortgage markets cratered, the lack of transparency, the extraordinary debt loads, the short-term loans, and the risky assets all came home to roost" (Chan, 2011). For example, Lehman Brothers hid $50 billion of short-term loans off its books before its demise in 2007 (Dutta et.al., 2010).

For corporate governance guidelines to help foster independent and competent Board members, the New York Stock Exchange (NYSE) Commission on Corporate Governance issued the following key corporate governance principles (2010):

The Board of Directors' fundamental objective should be to build long-term sustainable growth in shareholder value. Thus, policies that promote excessive risk-taking for short-term stock price increases, and compensation policies that do not encourage long-term value creation, are inconsistent with good corporate practices.

Management has the primary responsibility for creating a culture of performance with integrity. Management's role in corporate governance includes establishing risk management processes and proper

internal controls, insisting on high ethical standards, ensuring open internal communications about potential problems, and providing accurate information both to the Board and to shareholders.

Good corporate governance should be integrated as a core element of a company's business strategy and not be simply viewed as a compliance obligation with a "check the box" mentality for mandates and best practices.

Transparency in disclosures is an essential element of corporate governance.

Independence and objectivity are necessary attributes of a Board of Directors. However, subject to the NYSE's requirement for a majority of independent directors, there should be a sufficient number of non-independent directors so that there is an appropriate range and mix of expertise, diversity and knowledge on the Board.

Shareholders have the right, a responsibility and a long-term economic interest to vote their shares in a thoughtful manner. Institutional investors should disclose their corporate governance guidelines and general voting policies (and any potential conflicts of interests, such as managing a company's retirement plans).

Various empirical studies have investigated impacts of corporate governance upon banks' risk taking (stock market based measures) and financial performance (return on assets, non-performing assets, etc.). The following corporate governance variables have been found to have a significant, negative impact on risk taking and financial performance (Allemand et. al. 2013, Grove et. al., 2011, Victoravich et. al., 2011):

- CEO duality (the CEO is also the Chairman of the Board of Directors)
- Board of Directors and CEO entrenchment (25% of U.S. S&P 500 companies have staggered re-elections of the Board versus all Board members re-elected every year, Bussey, 2012, and CEOs being in the job for more than a decade)
- Older Directors (over 70 years of age; only 4% of U.S. S&P 500 companies have term limits, Bussey, 2012)
- Short-term compensation mix (cash bonuses and stock options versus long-term stock awards and restricted stock)
- Non-independent and affiliated Directors (larger percentages of such directors versus independent directors)
- Ineffective risk management committees (few or no meetings)
- Also, high leverage (debt to equity) levels were associated with high levels of banks' risk taking and poor financial performance in these studies. When implementing the $700 billion bailout of major U.S. banks, the U.S. Treasury did not replace any existing bank Board members but added new Directors to represent taxpayer interests. Many of these original Directors oversaw the big banks and brokerage firms when they were taking huge risks during the real estate boom. A corporate government specialist concluded: "these boards had no idea about the risks these firms were taking on and relied on management to tell them" (Barr, 2008). A senior corporate governance analyst said: "this financial crisis is a direct result of the compensation practices at these Wall Street firms" (Lohr, 2008).

The tipping point for the financial crisis was generally acknowledged to be the bankruptcy of Lehman Brothers in the Fall of 2008. Corporate governance for risk management and company oversight was very weak at both Lehman Brothers and Bear Stearns, which was bailed out from going into bankruptcy in the Spring of 2008. Independence and competence issues for both Boards were raised by the following red flags cited in the empirical research on corporate governance in banks (Grove and Patelli, 2013):

Independence Issues:

- CEO Duality: At Bear Stearns, the CEO, James Cayne, had also been the Chairman of the Board (COB) for the last seven years. At Lehman Brothers, the CEO, Richard Fuld, had also been the COB for the last seventeen years.
- Board Entrenchment: At both banks, there were no staggered board elections as all members were re-elected annually. However, both CEOs had been in their jobs for more than a decade: 26 years for the Bear Stearns CEO and 17 years for the Lehman Brothers CEO. Also, there was a majority of older and long-serving Directors as noted below.
- Short-term Compensation Mix: Both companies had large portions of their compensation packages for their top executives in short-term cash (bonus) and stock options.
- Non-independent and affiliated directors: Long-serving Directors may lose or reduce their independent perspective. For Bear Stearns and Lehman Brothers, respectively, the number of Directors serving since the 1980's were 38% and 9% and since the 1990's were 31% and 55% for totals from the 1980's and 1990's of 69% and 64%.

Competence Issues:

- Older Directors: For Bear Stearns and Lehman Brothers, respectively, the majority of the Directors were over age 60: 85% and 91%, over age 70: 23% and 55%, and over age 80: 15% and 18%. Also, 54% of the Bear Stearns Directors were retired or just "private investors" or in academia. 91% of the Lehman Brothers Directors were retired or "private investors."
- Ineffective Risk Management Committee: Bear Stearns' risk committee only started in January

2007, just 14 months before JP Morgan Chase bailed out the company by taking it over in March 2008. Three of the four members were 64 years old and the other was 60 years old. Lehman Brothers' risk committee had only two meetings in 2006 and 2007 before the company went bankrupt in 2008. The chairman of the risk management committee was 80 and a retired Salomon Brothers investment banker. The other members were 73 years old (retired chairman of IBM), 77 years old ("private investor" and retired Broadway producer), 60 years old (retired rear admiral of the Navy), and 50 years old (former CEO of a Spanish language TV station).

- Opaque Disclosures: There was an inability for investors to get sound financial information necessary for making sound investment decisions. This meant resisting any calls to repeal the current mark-to-market standards and also meant expanding the requirement to disclose the securities positions and loan commitments of all financial institutions. There was no fair value reporting at either bank which would have provided the information investors needed to make informed decisions, and bring much needed transparency to the market.

7 Summary of Board Performance in the Financial Crisis

Both Bear Stearns and Lehman Brothers had weak risk management and weak corporate governance practices, indicating both independence and competence problems with their Boards. They seemed to be in similar, very weak financial positions. Bear Stearns' bailout may have been helped by Wall Street connections, like Henry Paulsen, the U.S. Treasury Secretary and former CEO of Goldman Sachs. However, possibly the federal government later thought that Lehman Brothers was "too big to save" since it was twice the size of Bear Stearns. Then, after the Lehman Brothers bankruptcy ignited the world financial crisis, the federal government reversed its thinking and bailed out the largest 19 U.S. banks since they were now "too big to fail." This bailout occurred despite the fact that all these banks had received unqualified audit opinions on their financial statements and internal controls in their last annual reports before the bailout. No "going concern" qualified audit opinions were issued for possible bankruptcies in these banks and audit opinions appear not to be a tool for assessing the risk management of such banks. Thus, it appeared that there was inconsistent and unjustified treatment by the U.S. federal government in helping bail out Bear Stearns but letting Lehman Brothers go into bankruptcy.

Another Board competence problem was the lack of disclosure transparency by these banks in not using fair value reporting for their assets as both Arthur Levitt and Lynn Turner, former SEC chairman and former SEC chief accountant, respectively, observed (Levitt and Turner, 2008):

"There is a direct line from the implosion of Enron to the fall of Lehman Brothers—and that's an inability for investors to get sound financial information necessary for making sound investment decisions. The only way we can bring sanity back to the credit and stock markets is by restoring public trust. And to do that, we must improve the quality, accuracy, and relevance of our financial reporting. This means resisting any calls to repeal the current mark-to-market standards. And it also means expanding the requirement to disclose the securities positions and loan commitments of all financial institutions. Fair value reporting, when properly complied with and enforced, will simplify the information investors need to make informed decisions, and bring much needed transparency to the market. By reporting assets at what they are worth, not what someone wishes they were worth, investors and regulators can tell how management is performing. This knowledge in turn is fundamental to determining whether or not an institution has sufficient capital and liquidity to justify receiving loans and capital. We should be pointing fingers at those at Lehman Brothers, AIG, Fannie Mae, Freddie Mac, and other institutions who made poor investment and strategic decisions and took on dangerous risks."

At a Town Hall meeting, entitled Does Wall Street Really Run the World?, Lynn Turner (2011) made the following comments. "There was greater attention to risk management when Wall Street firms were partnerships with individual partner liability twenty years ago versus today as corporations (similar to the evolution of the Big 4 Accounting firms). Wall Street firms changed from raising money for corporations and being investment brokerage firms to a new emphasis on trading for their own sake and their own shareholders. An eleven trillion market cap destruction occurred from the economic crisis of 2008. These firms were not really creating value but were selling toxic investments such that a Rolling Stone reporter nicknamed Goldman Sachs the Vampire Squid. Paul Volcker has commented that the last real innovation of Wall Street banks was the ATM thirty years ago, actually by a Nebraska bank."

The chairman of the International Accounting Standards Board had commented that the fraudulent financial reporting problems of this century were really failures in corporate governance (Tweedie, 2007). There may have been audit problems, not noted by the Board Audit Committees of both Lehman Brothers and Bear Stearns, since both companies received unqualified or "clean" opinions on their 2007 financial statements and internal controls even though both companies had solvency and "going concern" issues.

Since risk management at the major U.S. (bailout) banks appeared to be very poor and contributed significantly to the U.S. financial crisis, in

March 2010 the SEC started requiring all publicly traded companies in the U.S. to provide disclosures that describe the Board's role in risk oversight. Such disclosures are required in the annual proxy statements. In July 2010, the Federal Financial Reform (Dodd-Frank) Act was signed into law. It mandates risk committees for Boards of financial institutions and other entities that the Federal Reserve System oversees.

The following interview with Satyajit Das, an international respected expert on finance with over 30 years of working experience in the industry, provided comments on risk management, corporate governance, Board independence and competence in the banking industry (Das, 2011):

"As banks expanded, you exhausted the pool of people who you could lend to and then moved onto the others - until you came to people who couldn't ever really pay you back. So the trick was to hide or get rid of the risk of non-payment---it became a case of NMP (not my problem) or risk transfer. So you made loans that you shouldn't and then transferred them to people who probably didn't quite grasp the risk fully or were incentivized to look the other way. It was a culture of fraud and self-delusion. It's amazing how much money you can make just shuffling paper backwards and forwards. Paul Volcker, the former chairman of the Federal Reserve Bank, argued: I wish someone would give me one shred of neutral evidence that financial innovation has led to economic growth - one shred of evidence.

Management and directors of financial institutions cannot really understand what is going on - it's simply not practical. They cannot be across all the products. Non-executives are even further removed. Upon joining the Salomon Brothers Board, Henry Kaufman found that most non-executive directors had little experience or understanding of banking. They relied on Board reports that were neither comprehensive nor detailed enough about the diversity and complexity of our operations. They were reliant on the veracity and competency of senior managers, who in turn were beholden to the veracity of middle managers, who are themselves motivated to take risks through a variety of profits compensation formulas". Such poor risk management at banks has recently occurred again as UBS lost over $2 billion through the manipulations of a UBS rogue trader, just like the Barings Bank episode several years ago which bankrupted that bank. Un-hedged trades by this rogue trader had been going on since the 2008 financial crisis, despite the clean opinions given by a Big 4 auditor on the internal controls of UBS (Craig et al., 2011).

"Henry Kaufman later joined the Board of Lehman Brothers. At that time, nine out of ten members of the Lehman Board were retired, four were 75 years or more in age, and only two had banking experience, but it was from a different era. The octogenarian Kaufman sat on the Lehman Risk Committee with the former chairman of IBM, a Broadway show producer, a former CEO of a Spanish-language TV station, and a former Navy admiral, The Committee had only two meetings in 2006 and 2007. The last two Risk Committee members were the only minority and female members, respectively, on Lehman Brothers' Board, perhaps to try to mitigate the criticism that companies are not well served by Boards that are too often "male, pale, and stale" (Cohen, 2014).

A similar competence issue was raised about AIG's Board which included several heavyweight diplomats and admirals even though Richard Breeden, former head of the SEC told a reporter: 'AIG, as far as I know, didn't own any aircraft carriers and didn't have a seat in the United Nations.' It's silly to think that everybody in finance is evil or engaged in fraud. Most people involved are very smart, diligent, hard-working and passionate about what they do. It's groupthink. They have ways of thinking about the world. They think it's the right way so they keep trying it again and again. At least until there is a horrendous disruption and then they go: "Oh dear? There's a problem." Take Alan Greenspan. He thought deregulated markets were the solution. He thought that any problem could be fixed by flooding the system with money. He was wrong, but even today he doesn't really see that his world view is erroneous. They are very good at rationalization and don't tolerate dissent. As for responsibility, they are doing what is accepted practice - they think they are doing the best for their stakeholders. As long as you follow convention, you are unlikely to be successfully prosecuted or made liable. Ultimately that's the only purpose of corporate governance - to ensure that by following a set of accepted practices, you make yourself and your organization litigation proof" (Das, 2011).

Few bank officers and Directors from the financial crisis have been found liable under either state or federal law. The Lehman Brothers CEO and top executives did owe $90 million in fines, but they were covered by insurance. Also, many directors from Bear Stearns (six), Lehman Brothers (six), and Enron (seven) continue to serve on other Boards. The "old boy" network is emphasized here as is the decline in importance of reputation on Wall Street. Prior bad conduct simply is not viewed as a problem (Davidoff, 2011). In fact, the lack of independence and competence of such Board members may be an advantage if a company is engaging in inappropriate behavior!

In response to an email about this issue of why Bear Stearns was saved and Lehman Brothers let go into bankruptcy, Lynn Turner (2012) replied: "Both were highly risky with very, very arrogant CEOs and chairmen. Neither had a great board, but Bear Stearns may have had better connections on their board and in this instance, Lehman Brothers being second was fatal. Both depended way too much on very short term

financing, including overnight commercial paper or repurchase agreements (repo's) - a very ill advised and highly risky strategy for any company let alone one with very little capital." Similarly, when asked in an October 2008 interview about Rabobank's role in the Bear Stearns crisis when it refused to renew $2.5 billion in short-term loans coming due in two weeks, Bert Heemskerk, Rabobank's chairman, said: "It is not true that Rabobank helped to bring down Bear Stearns. No, Bear Stearns had set up their balance sheet totally the wrong way." Asked if he understood that when one bank stops refinancing, others will follow, Mr. Heemskerk responded: "And rightly so" (Yale, 2011).

Concerning such risk management during the financial crisis, Buffett wrote in his CEO letter to shareholders (2008): "I have pledged – to you, the rating agencies and myself – to always run Berkshire Hathaway with more than ample cash. We never want to count on the kindness of strangers in order to meet tomorrow's obligations. When forced to choose, I will not trade even a night's sleep for the chance of extra profits. Sleeping around, to continue our metaphor, can actually be useful for large derivatives dealers because it assures them government aid if trouble hits. In other words, only companies having problems that can infect the entire neighborhood – I won't mention names – are certain to become a concern of the state (an outcome, I'm sad to say, that is proper). From this irritating reality comes The First Law of Corporate Survival for ambitious CEOs who pile on leverage and run large and unfathomable derivatives books: Modest incompetence simply won't do; it's mindboggling screw-ups that are required."

Buffett commented on risk control in his 2009 CEO letter: "Charlie and I believe a CEO must not delegate risk control. It's simply too important. If Berkshire Hathaway ever gets in trouble, it will be my fault. It will not be because of misjudgments made by a Risk Committee or a Chief Risk Officer. In my view, a board of directors of a huge financial institution is derelict if it does not insist that its CEO bear full responsibility for risk control. If he's incapable of handling that job, he should look for other employment. And if he fails at it – with the government thereupon required to step in with funds or guarantees – the financial consequences for him and his board should be severe."

8 Conclusions: Guidelines for Independent and Competent Directors

Based upon the research and company examples cited in this paper, the following guidelines are recommended for assessing and ensuring the independence and competence of Board of Director members:

- Independence: "Directors must have no material relationships with the company over the past year" (NYSE, 2003).
- Independence and Competence: "In addition to being independent, directors should have business savvy, a shareholder orientation, and a genuine interest in the company" (Buffett, 2005).
- Independence and Competence: "Use stock, not pay, for Directors' compensation" (Buffett (2007) and use a mix of short and long-term performance measures for Directors' compensation (Hilb, 2008).
- Independence and Competence: "Pay for Performance, not Presence" (Kostyuk, 2014). Evaluate performance over a three year period, using both stock price and accounting performance. Use claw-back provisions for both executive and Board members' compensation if the firm does poorly, compared to its peers over this three year period (Adams, 2014).
- Independence and Competence: There should be a mix of skills with Board members, such as industry knowledge and experience and expertise in financial accounting (required by U.S. SOX Act), risk management (required by U.S. Dodd-Frank Act) and cyber security (Thomson, 2014).
- Independence and Competence: There should be term and age limits for Board members (Bussey, 2012).
- Independence and Competence: There should be women on Boards. For example, Credit Suisse research found that over a six-year period, companies with at least some women on Boards did better, in terms of share price, than those with none. Morgan Stanley has started a fund that invests in companies with women on Boards (Alden, 2013). In summary, there should be no "male, pale, and stale" Boards (Cohen, 2014). "If Lehman Brothers had been Lehman Sisters, it would still be in business" (Hilb, 2009).
- Competence: There should be efficient and effective monitoring of risk without dependence on any corporate bailout financing. "The CEO of any large financial organization must be the Chief Risk Officer and must not delegate risk control to a Risk Committee or a Chief Risk Officer. Risk control is simply too important" (Buffett, 2008).
- Competence: There should be no reimbursements by companies or insurance policies to executives or Boards for legal damages or fines when their incompetence harmed their institutions or the country. "In many cases, directors have long benefitted from oversized financial carrots; some meaningful sticks now need to be part of their employment picture as well" (Buffett, 2009).
- Competence: As required by the NYSE and NASDAQ, make sure there is a viable financial accounting expert, primarily an independent CPA or CFO, not another CEO, on the Board's Audit Committee to check for fraudulent financial reporting or earnings management by a company. "We both have a deep disgust for game playing with numbers, a practice rampant throughout

corporate America in the 1990s and still persisting, although now less frequently and blatantly" (Buffett, 2011).

- Competence: There should be strict procedures for communicating with Wall Street to avoid insider trading and Regulation FD (Fair Disclosure) violations (SEC, 2000). For example, Facebook informed only some favored financial analysts about its declining revenues just before its initial public offering (IPO) which resulted in a shareholder class action lawsuit immediately after the IPO (Ruel, 2012).

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