

Regulatory and governance reform

On June 30 and July 1, 2009, members of the European and North American Audit Committee Leadership Networks met to discuss several topics,¹ including the current enforcement and corporate governance agenda of the US Securities and Exchange Commission (SEC). Regulatory issues have been a central theme of every Audit Committee Leadership Summit, and the fourth was no exception.² The economic and financial crisis has elevated regulatory and governance reform to the top of political agendas globally. However, fears abound that the result will be more, but not necessarily better, regulation.

Meeting participants were joined by John White, a partner at the law firm Cravath, Swaine & Moore LLP and former director of the Division of Corporation Finance (Corp Fin) at the SEC.³ In his previous role, Mr. White met with the Audit Committee Leadership Network in North America in September 2007 to discuss regulatory balance⁴ and hosted six members from the European and North American networks at SEC headquarters in September 2008 to establish a dialogue with Corp Fin.⁵ For further information on the networks, see “About this document” on page 12. For a full list of participants and of subject matter experts interviewed ahead of the summit, see the appendices on pages 13-15.

Executive summary

The depth of the financial and economic crisis has led to a groundswell of opinion in political and activist investor circles that enforcement should be strengthened and that major changes in corporate governance should be implemented. Summit participants discussed key elements of the regulatory response to the crisis:

- **Expectations of an enhanced enforcement environment** (*Page 2*)

Audit chairs heard that Mary Schapiro, the new SEC chairman, places enforcement at the top of her agenda. She has moved quickly to empower enforcement officials under a new leadership. Companies can expect more and faster investigations, and more and higher fines. European regulators are also toughening their stance on enforcement. Audit committees should ensure that companies are taking steps to reduce the likelihood of getting entangled in enforcement actions.

¹ Other summit discussions included “Current issues in financial reporting: a discussion with Bob Herz,” and “Risk in emerging markets.” *ViewPoints* for these discussions can be found at http://www.tapestrynetworks.com/networks/net_audit_summit4.html.

² For relevant *ViewPoints*, see http://www.tapestrynetworks.com/networks/net_audit_summit.html, http://www.tapestrynetworks.com/networks/net_audit_summit2.html, and http://www.tapestrynetworks.com/networks/net_audit_summit3.html.

³ *ViewPoints* reflects the use of a modified version of the Chatham House Rule whereby names of members, guests, and company affiliations are a matter of public record, but comments made by members before and during meetings are not attributed to individuals or corporations. However, Mr. White, who was speaking in a personal capacity and whose views do not necessarily represent those of his organizations, has given permission for his comments to be attributed. Comments made by participants at the summit are shown in italics.

⁴ Audit Committee Leadership Network, “Regulatory balance: a dialogue with John White,” *ViewPoints*, October 19, 2007. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Oct07_View17.pdf.

⁵ Audit Committee Leadership Network, “Working with the Division of Corporation Finance,” *ViewPoints*, December 8, 2008. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Dec08_View23.pdf.

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- **Regulator-driven corporate governance reform** (*Page 5*)

Companies should expect more prescriptive corporate governance rules. In the United States, board members will face new disclosure requirements on director qualifications, risk oversight, compensation, and board leadership. Greater shareholder rights also appear inevitable. In Europe, there may be a move to institute principles in law or listing rules, rather than depending mainly on “comply-or-explain” approaches. At a minimum, audit committees will be drawn into reviewing, and in some cases approving, new disclosures.

- **Limited progress on regulatory coordination** (*Page 11*)

The focus on enforcement and new corporate governance rules has pushed regulatory coordination down the agenda, notwithstanding a clear signal from national leaders that coordination is essential in the wake of the financial and economic crisis.

Expectations of an enhanced enforcement environment

Audit chairs recognize that tougher enforcement is inevitable, given the regulatory lapses that the economic and financial crisis revealed. Regulators have warned that they will enforce existing rules more vigorously, leading one regulatory expert interviewed prior to the summit to comment, “The change in the tone on enforcement is very real.”

Enforcement is top of Ms. Schapiro’s agenda

Mr. White commented at the meeting, “*Enforcement has been a major focus [this year].*” As Ms. Schapiro stated, “We have started to revitalize our enforcement program ... we will revamp the Enforcement Division so that we bring the cases that count, we bring them as quickly as fairness allows, and we achieve results that impress upon wrongdoers the folly of breaking the federal securities laws.”⁶

Ms. Schapiro has moved quickly to invigorate enforcement. In February, she initiated two changes (both returns to historical practice) that indicate public companies can expect to see more investigations and more penalties from the SEC. First, she eliminated the need for enforcement staff to have full Commission approval before negotiating a settlement with a corporate defendant. Second, she streamlined the process by which the enforcement staff obtain a formal order of investigation: now a single commissioner, rather than the Commission as a whole, may approve the order. The number of formal orders issued by the SEC in the first six months of 2009 was more than double the same period in 2008 (224 orders compared to 93).⁷

⁶ Mary Schapiro, “Building a Stable and Efficient Financial System.” Address to the Investment Company Institute, Washington, DC, May 8, 2009. Available at <http://www.sec.gov/news/speech/2009/spch050809mls.htm>.

⁷ Mary Schapiro, “Testimony Concerning SEC Oversight: Current State and Agenda.” Testimony before the US House of Representatives Financial Services Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises, July 14, 2009. Available at <http://www.sec.gov/news/testimony/2009/ts071409mls.htm>.

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Robert Khuzami, the new director of the Division of Enforcement, has set out a broad agenda of proposed changes and requests for additional powers to upgrade the SEC's enforcement capabilities.⁸ One legal expert interviewed before the summit predicted that these developments, taken in tandem with moves to recruit more investigators, indicate that "companies can expect to see more and faster investigations, with penalties imposed more frequently and in higher amounts." Mr. White noted at the summit that Mr. Khuzami "needs to show that he's tough and getting results ... [and] high profile companies make good examples."

SEC disclosure reviews play a role in enforcement

Enforcement, of course, goes well beyond the Division of Enforcement. Ms. Schapiro has stated clearly that to protect investors, the SEC must continue to foster "information that is accurate, meaningful, and timely through thousands of disclosure reviews each year."⁹

Under Mr. White's tenure, the SEC sought to improve its review process for public disclosures.¹⁰ When network members met with Mr. White previously, they expressed concerns about the filing review process, with one participant at the September 2008 meeting noting, "The 'Q&A' [comment letter] process is different and welcome, but it takes longer than it did. There are multiple rounds of questions ... It is taking longer each time there's a review."¹¹ Between 2005 and 2008, the number of SEC comment letters received per company increased from an average of 2.06 letters per company to 2.51, an increase of 22%.¹² One member noted before the summit that the implications are significant: "The amount of time, effort, and cost that is associated with the back and forth of these comment letters can get very expensive."

However, Mr. White did not expect any significant changes in the frequency or nature of the review process, as a result of the crisis, in the short to medium term. "There is no pressure to act differently," he noted at the summit. That said, he did believe that "the crisis will impact the [focus of the] reviews. Corp Fin will look carefully at liquidity, MD&A [management discussion and analysis], executive compensation, and risk management disclosures."

Other regulators are focused on more stringent enforcement

Other regulators have signaled an intent to take a tougher approach to enforcement. For example, Jean-Pierre Jouyet, chairman of the French Autorité des marchés financiers (AMF), said in April, "Our top

⁸ Robert Khuzami, "Testimony Concerning Strengthening the SEC's Vital Enforcement Responsibilities." Testimony before the US Senate Banking, Housing, and Urban Affairs Subcommittee on Securities, Insurance, and Investment, May 7, 2009. Available at <http://www.sec.gov/news/testimony/2009/ts050709rsk.htm>.

⁹ Mary Schapiro, address to the Society of American Business Editors and Writers, Denver, April 27, 2009. Available at <http://www.sec.gov/news/speech/2009/spch042709mls.htm>.

¹⁰ The SEC's Division of Corporate Finance reviews documents that publicly held companies are required to file with the Commission to ensure that companies are meeting disclosure requirements and as part of an effort to improve the quality of disclosure. The Division also provides interpretive guidance on securities laws, monitors the activities of the accounting profession, including the Financial Accounting Standards Board (FASB), and the use of International Financial Reporting Standards by US registrants. For more information, see <http://www.sec.gov/about/whatwedo.shtml#corpfin>.

¹¹ Audit Committee Leadership Network, "Working with the Division of Corporation Finance," 5.

¹² Data from Audit Analytics, "SEC Comment Letter Analysis: Total Letters Per Company," an unpublished data analysis conducted for Tapestry Networks in June 2009.

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priority must be to ensure uniform enforcement of rules already on the books.”¹³ Subsequently, Mr. Jouyet said that there is “no confidence without monitoring, and no monitoring without effective sanctions.”¹⁴ Similarly, Hector Sants, the CEO of the UK’s Financial Services Authority (FSA), has stated, “In the future we will seek to make judgements on the judgements of senior management and take actions if in our view those actions will lead to risks to our statutory objectives. This is a fundamental change. It is moving from regulation based only on observable facts to regulation based on judgements about the future.”¹⁵

Audit committees should take certain steps

Audit committee chairs recognize that they need to adjust to the current enforcement environment. One audit chair remarked in preparing for the summit, “[The] audit committee is going to need to be more vigilant. Audit committees are going to need to review allegations that are raised ... and [they have] the ability to investigate directly.” Other steps audit committees can take include:

- **Proactive relationship building with regulatory officials.** Having a better relationship with regulatory staff even when there are no issues could pay dividends. Steve Cutler, the former director of the Division of Enforcement, noted at the 2007 summit, “I advise senior management to meet with regulators whenever they can. It is critical to establish a relationship, a human face, in the absence of a problem. You don’t want the regulators to see you as a faceless institution.”¹⁶
- **A strong focus on compliance.** As one regulatory expert interviewed before the summit noted, “In the current climate of cost cutting, now is not the time to be cutting back on compliance staff. On the contrary, audit committees should be ensuring they have credible compliance and control processes in place, lest they have to explain why they cut them in the future.” At the summit, Mr. White urged audit chairs to focus particular attention on ensuring scrupulous compliance with the Foreign Corrupt Practices Act (FCPA).¹⁷
- **Effective use of outside counsel.** Proactive audit committees have had a list of counsel vetted by their legal teams to ensure they have access to independent counsel when they need it. Some even have such counsel on retainer so they can be called into action at a moment’s notice.
- **Active involvement in overseeing any investigations.** One legal expert interviewed before the summit believes companies under investigation can earn credibility with the SEC by demonstrating that the audit committee is playing an active role in the matter – for example, by being involved in investigating the facts and by expressing strong opinions on cooperation with the government and public

¹³ Autorité des marchés financiers, “Towards a new supervisory framework,” *Financial Regulation Newsletter*, no. 13 (2009), 2. Available at http://www.amf-france.org/documents/general/8812_1.pdf.

¹⁴ Private translation of Jean-Pierre Jouyet, “Propos liminaires devant la Commission des Finances.” Hearing before the Finance Committee of the French National Assembly, Paris, February 4, 2009.

¹⁵ Financial Services Authority, “FSA consults on changes to the rules for approved persons,” press release, December 19, 2008. Available at <http://www.fsa.gov.uk/pages/Library/Communication/PR/2008/153.shtml>.

¹⁶ Audit Committee Leadership Summit, “Working with the SEC,” *ViewPoints*, January 23, 2008, 7. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_Summit_View3_Jan08.pdf.

¹⁷ Audit Committee Leadership Summit, “Risk in emerging markets,” *ViewPoints*, August 4, 2009. Available at http://www.Tapestry_EY_Summit_View11_Jul09.pdf.

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disclosure of the matter. The legal expert stated, “With the SEC’s focus on accelerated enforcement investigations, companies should be prepared to respond faster than ever.”

On a positive note, recent data show that the SEC is more diligently closing resolved investigations, rather than leaving them open, a habit that frustrated many audit committees in the past. “The SEC has significantly improved in terms of closing cases that are no longer being actively pursued,” said a legal expert. Mr. White noted at the summit that he expects the SEC to maintain a strong focus on closing investigations faster than in the past.

Regulator-driven corporate governance reform

The momentum behind corporate governance reform has been growing steadily for the past year or more. Leading institutional investors in Europe and the United States interviewed prior to the summit expect reform to be significant. “The authorities are moving swiftly towards regulation ... We can expect wave after wave of regulation,” predicted one leading European institutional investor. Another investor stated, “In the US, we are just about to implement the biggest-ever experiment in corporate governance.”

The SEC is focusing on disclosure and accountability

Ms. Schapiro has led the way, in many respects, with an agenda based on stronger shareholder rights and enhanced disclosures. Mr. White remarked at the summit, “*Now that [Ms. Schapiro] has set the enforcement agenda in motion, under the leadership of Robert Khuzami, she is focused on corporate governance reform, with a strong focus on accountability.*” He continued, “*The focus is on disclosure, the traditional SEC tool.*”

The commissioners met on July 1 and passed several key elements of Ms. Schapiro’s agenda.¹⁸ First, they approved an application from the New York Stock Exchange to change its rules so that brokers who do not receive voting instructions from their clients cannot vote those shares in uncontested elections of directors. Typically, such votes – which can make up to 20% of the count – favor management; removing them enhances investors’ votes, particularly when a company has adopted majority voting. Ms. Schapiro commented on this change in her opening remarks at the Commission meeting: “[This] addresses a variety of issues regarding the accountability and responsiveness of public companies and their boards of directors to the interests of shareholders. The most fundamental way in which shareholders can ensure that directors remain accountable to them is through the director election process.”¹⁹ As Mr. White noted at the summit, the removal of broker non-votes could have a significant effect on future director elections. Several audit chairs concurred with his viewpoint.

Second, the commissioners approved a set of new governance disclosures. In general, meeting participants agreed with one participant who concluded that these disclosures “*are not onerous.*” Another suggested that the disclosure “*may influence behavior a little.*”

¹⁸ US Securities and Exchange Commission, “SEC Proposes Measures to Improve Corporate Governance and Enhance Investor Confidence,” press release, July 1, 2009. Available at <http://www.sec.gov/news/press/2009/2009-147.htm>.

¹⁹ Mary Schapiro, speech at an SEC open meeting, Washington, DC, July 1, 2009. Available at <http://www.sec.gov/news/speech/2009/spch070109mls.htm>.

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Additional SEC governance disclosure proposals²⁰

- **Director credentials.**²¹ Companies would have to disclose “the particular experience, qualifications, attributes or skills that qualify that person to serve as a director [and committee member].” The rule would also require disclosure of any public company directorships held during the past five years and legal proceedings over the past 10 years (currently it is five years) that “are material to an evaluation of the ability or integrity of any director.”
- **Leadership structure.**²² Companies would have to disclose “the company’s leadership structure and why the company believes it is the best structure ... [and] whether and why they have chosen to combine or separate the [CEO] and board chair positions ... [and] whether and why the company has a lead independent director, as well as the specific role the lead independent director plays in the leadership of the company.”
- **Risk oversight.**²³ Companies would have to disclose “the board’s role in the company’s risk management process.” The disclosures “might address questions such as whether the persons who oversee risk management report directly to the board as a whole, to a committee, such as the audit committee, or to one of the other standing committees of the board; and whether and how the board, or board committee, monitors risk.”
- **Employee compensation.**²⁴ The proposal would broaden the compensation discussion and analysis to include information about “how the company’s overall compensation policies for employees create incentives that can affect the company’s risk and management of that risk.” The disclosures would cover overall design philosophy, the risk assessment in setting pay, how the structures align risks and payouts (e.g., by requiring clawbacks or imposing holding periods), policies on compensation adjustments due to changes in the company’s risk profile, and the manner in which the company monitors how pay affects risk. The proposal describes situations that could trigger disclosure (e.g., a business unit carries a significant portion of the company’s risk profile, or has a compensation structure that is significantly different from others units’ compensation structures, or is significantly more profitable than other units).
- **Compensation consultants.**²⁵ When the company’s compensation consultant provides additional services, the company would have to disclose details on those services, fees (overall and for advice on executive compensation), whether management was involved in selecting the consultant for the additional services, and whether the board or its compensation committee approved all fees.

²⁰ The points listed are summarized from US Securities and Exchange Commission, “Proxy Disclosure and Solicitation Enhancements,” proposed rule, July 10, 2009. Available at <http://www.sec.gov/rules/proposed/2009/33-9052.pdf>.

²¹ Ibid., 25, 27–28.

²² Ibid., 34.

²³ Ibid., 35.

²⁴ Ibid., 8, 9, 11.

²⁵ Ibid., 40–41.

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Ms. Schapiro has also signaled her intent to implement proxy access, the right of shareholders to nominate directors to the board via the company proxy. As noted above, proxy access would complement the change to broker non-votes. As Ms. Schapiro put it, “Proxy access is about making boards more accountable for the risks undertaken by the companies they manage,”²⁶ and “for their compensation decisions.”²⁷ Mr. White noted at the summit that, while proxy access has long been a contentious issue within the Commission, Ms. Schapiro sees it as a central tenet of her governance reform agenda: “[She] is committed to permitting proxy access in some form.”

US politicians are considering broader governance reforms

Mr. White noted that several bills have emerged in Congress aimed at putting more stringent corporate governance rules in place. Most notably, both the “Shareholder Bill of Rights, 2009” proposed by Senators Charles Schumer (D-NY) and Maria Cantwell (D-WA) and a similar bill from Congressman Gary Peters (D-MI)²⁸ call for a mandatory annual advisory shareholder vote on executive compensation (say on pay), statutory majority voting (whereby directors not receiving at least 50% of the shareholder vote must step down from the board), and the separation of the board chairman and CEO roles.²⁹ The Schumer-Cantwell bill would also mandate annual director elections and require public companies to establish a separate risk committee.

It is still too early to tell which elements of the bills will be enacted. However, Mr. White noted that say on pay is part of a number of legislative efforts and is also being pushed by the Obama administration, which has already made it a part of the Troubled Asset Relief Program. “*It sounds like this one is coming,*” he concluded.

Other compensation proposals aimed at capping or greatly constraining pay would be more difficult to implement (other than for those companies that received government subsidies). However, Mr. White noted that the administration is focusing attention on the independence of the compensation-setting process. Summit participants were not concerned about the focus on independence. “*Our compensation committees are already filled with independent directors,*” noted one.

European regulators may follow suit

Policymakers in Europe are also seeking or considering governance changes. Speaking at the April European Audit Committee Leadership Network meeting, Mr. Jouyet asserted, “Our priority is first to see about the extension of our remit over governance. The legislature has to do that ... The governance of boards – such as the frequency of meetings, composition, risk controls – all the rules should be strengthened to protect the

²⁶ Mary Schapiro, address to the Council of Institutional Investors, Washington, DC, April 6, 2009. Available at <http://www.sec.gov/news/speech/2009/spch040609mls.htm>.

²⁷ US Securities and Exchange Commission, “Chairman Schapiro Statement on Executive Compensation,” press release, June 10, 2009. Available at <http://www.sec.gov/news/press/2009/2009-133.htm>.

²⁸ Gary Peters, “Congressman Peters Introduces Bill to Empower Shareholders,” press release, June 12, 2009. Available at <http://peters.house.gov/?sectionid=22§iontree=21,22&itemid=148>.

²⁹ “U.S. Sen. Schumer unveils shareholder bill of rights,” *Reuters*, May 19, 2009. Available at <http://www.reuters.com/article/ousiv/idUSTRE5414PF20090519>.

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companies.”³⁰ In the United Kingdom, the FSA has proposed to “clarify the role of non-executive directors to make clear that the FSA will, in the future, look at non-executives more closely where it believes they should have intervened more actively with a firm’s management.”³¹ In addition, the UK’s Financial Reporting Council is reviewing the London Stock Exchange’s Combined Code on Corporate Governance to determine if any parts “need further reinforcement,”³² and Sir David Walker recently published a consultative report on the corporate governance in the UK banking industry.³³

The European Commission has also been active. It has commissioned a review of the “comply-or-explain” governance codes in Europe, with a remit to “evaluate the effectiveness of enforcement mechanisms in the Member States and provide recommendations ... [that] will lay the groundwork for informed decision making by the European Commission.”³⁴ One European governance expert interviewed before the summit predicted “a wave of revisions of codes across Europe ... perhaps with greater emphasis on the manner in which risk governance can be strengthened ... and on director expertise.” Another European corporate governance expert explained, “We are seeing general principles being required by law ... The enthusiasm for codes ... has fallen significantly.”

International regulators have also focused on pay practices. The Financial Stability Forum (FSF) stated in its report on compensation, “Compensation practices at large financial institutions are one factor among many that contributed to the financial crisis that began in 2007.”³⁵ The G-20 endorsed the FSF’s principles on pay and committed to implementing them. Since then, the FSA and European Commission have both issued recommendations on financial institution compensation,³⁶ and the Commission also issued recommendations on executive compensation within non-financial corporations.³⁷ National legislatures have been pressing for broad changes to pay practices as well, such as the new requirements being considered in Germany.³⁸

³⁰ European Audit Committee Leadership Network, “The future of financial regulation: a discussion with the chairman of the AMF,” *ViewPoints*, May 8, 2009, 3. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_Euro_ACLN_May09_View18.pdf.

³¹ Financial Services Authority, “FSA consults on changes to the rules for approved persons,” press release, December 19, 2008. Available at <http://www.fsa.gov.uk/pages/Library/Communication/PR/2008/153.shtml>.

³² Financial Reporting Council, “2009 Review of the Combined Code,” March 18, 2009. Available at <http://www.frc.org.uk/corporate/reviewCombined.cfm>.

³³ David Walker, *A review of corporate governance in UK banks and other financial industry entities* (London, HM Treasury, 2009). Available at http://www.hm-treasury.gov.uk/d/walker_review_consultation_160709.pdf.

³⁴ RiskMetrics Group, “RiskMetrics Group conducts survey for European Commission,” press release, February 4, 2009. Available at <http://www.riskmetrics.com/press/ECsurvey>.

³⁵ Financial Stability Forum, *Principles for Sound Compensation Practices* (Basel: Financial Stability Forum, 2009), 1. Available at http://www.financialstabilityboard.org/publications/r_0904b.pdf.

³⁶ The G-20 gave its endorsement in G-20, “The Global Plan for Recovery and Reform,” communiqué, April 2, 2009, 3. Available at <http://www.g20.org/Documents/final-communique.pdf>. The FSA’s recommendations can be found in Financial Services Authority, *Reforming remuneration practices in financial services* (London: Financial Services Authority, 2009), available at http://www.fsa.gov.uk/pubs/cp/cp09_10.pdf. The European Commission’s recommendations are detailed in Commission of the European Communities, “Financial services sector pay: Commission sets out principles on remuneration of risk-taking staff in financial institutions,” press release, April 29, 2009, available at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/674&format=HTML&aged=0&language=EN&guiLanguage=en>.

³⁷ Commission of the European Communities, *Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies* (Brussels: Commission of European Communities, 2009). Available at http://ec.europa.eu/internal_market/company/docs/directors-remun/directorspay_290409_en.pdf.

³⁸ Bertrand Benoit, “Germany gets tough on executive pay,” *Financial Times*, May 29, 2009. Available at <http://www.ft.com/cms/s/0/2b08297a-4c57-11de-a6c5-00144feabdc0.html>.

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Boards and audit committees consider the implications

Individual company boards and business groups recognize that they should be contemplating preemptive changes. As one audit chair put it before the meeting, “The best answer is for business, professionals, and board leaders to take the initiative on some sensible issues, elaborate on best practices to broadcast recommendations, to check implementation – for example, on internal controls, risk management, audit processes. In Europe or North America, we don’t want a new Sarbanes–Oxley Act.” Another agreed, stating, “The feeling is, companies can influence this by doing things voluntarily instead of waiting until they have to be done.” At the summit meeting, several participants called on network members to play an active role in shaping the new regulations, as individuals or with their companies.

On a more practical level, perhaps the most significant concern among audit chairs, and directors more generally, is the extent to which corporate governance reform will leak over into non-financial sectors. As one member put it before the summit, “The behavior in banks is not generally reflected in corporate America ... Putting these regulations on the rest of us ... is unfortunate.” This sentiment accords with concerns expressed by some members of the EACLN in its April meeting.³⁹

Audit chairs have mixed views on the governance reform agenda. One European audit chair said before the meeting, “[We] are facing [prescriptive governance standards], but [I don’t expect] a sea change.” An American audit chair expressed a similar opinion: “There are many other policy reforms on the agenda that will have more significant effects on the economy [than governance reform].” However, other audit chairs have grave concerns.

Regardless of their positions, directors agree that the crisis has forced them to rethink their governance approach. One audit chair said before the summit, “The key question ... for the audit committee – indeed, the board as a whole – is what should we change? Is it just a given that we have to experience these kinds of blowups? Or are there things we should be doing in all sectors to have a better understanding of what’s happening with the business model?”

Many of the proposed governance changes would have implications for the governance and nominating committee, or the board as a whole. However, audit committees will be affected, particularly given the new disclosures on risk and compensation. Summit participants did not seem concerned about the proposed disclosures; one even said *“I like those disclosures.”*

More active audit committee involvement in compensation issues seems inevitable, as discussed by the North American ACLN and Tapestry Networks’ Compensation Committee Leadership Network in February.⁴⁰ One audit chair predicted before the summit, “[Compensation] will get closer to the audit committee, because the committee is going to assume some liability for it ... The SEC is asking for extreme detail on formulas ... [so it] won’t be long before they ask the audit committee to attest to the accuracy of the

³⁹ European Audit Committee Leadership Network, “The future of financial regulation: a discussion with the chairman of the AMF,” 5.

⁴⁰ Audit Committee Leadership Network, “Joint considerations for audit and compensation committees,” *ViewPoints*, March 5, 2009. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Mar09_View26.pdf.

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calculations.” Audit committees may also seek a clearer view into the discussions between their external auditor and key regulators, which are becoming more routine, particularly in Europe.

Limited progress on regulatory coordination

Audit chairs and guests at the 2008 summit agreed that the financial crisis has highlighted the need for more effective coordination among regulators, and events since the summit have only reinforced that impression, as governments continue to intervene in major financial institutions in many markets and the transformation from financial crisis to global recession continues.

Indeed, G-20 leaders placed regulatory coordination at the center of their agenda at their April 2009 meeting in London. They stated in the summit communiqué that they “agree to establish the much greater consistency and systematic cooperation between countries, and the framework of internationally agreed high standards, that a global financial system requires.”⁴¹ Since then, the European Commission has proposed a number of changes in the regulatory structures to support more effective coordination and, where possible, to introduce more harmonized rules. Moreover, President Obama’s recently proposed financial regulatory reform includes support for G-20 international coordination initiatives, such as for capital requirements, convergence of regulators, and cross-border resolution mechanisms for problems relating to global financial firms.⁴² There has also been sustained impetus in the EU and in the United States to create systemic risk regulators – institutions that would be tasked with gathering information from other regulators and from individual institutions to evaluate macro-level risks that go beyond any one regional regulator’s remit.

However, beyond that, participants and guests at the 2009 summit were more skeptical about the possibility of making significant strides in cross-border coordination or agreeing on international standards, notwithstanding the public rhetoric from national leaders. As Mr. White noted at the summit, given the current demand on Commission time, other than in the area of cross-border enforcement, international coordination “*is not front and center within the current SEC.*” Summit participants, especially from Europe, were concerned by the lack of attention to cross-border coordination, particularly given the potential for disjointed, and potentially costly and conflicting, regulation.

Conclusion

The financial and economic crisis has brought regulatory and corporate governance to the forefront. Politicians, regulators, investors, and the public at large are demanding change. Audit chairs recognize change is inevitable and will spread well beyond the financial institutions at the center of the crisis. Non-financial institutions will also have to comply with new requirements. The general tide of reform is towards greater disclosure, stronger shareholder rights, and more prescriptive rules. More stringent enforcement of existing requirements is also promised by regulators, in both North America and Europe.

Audit chairs have mixed opinions on the reforms. Some view the proposed changes as unnecessary, overly prescriptive, and, in some cases, punitive toward non-financial institutions that were not, in their view, the

⁴¹ G-20, “The Global Plan for Recovery and Reform.”

⁴² Ibid.

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cause of the crisis. Others are more sanguine, seeing many of the changes as neutral or marginally beneficial, particularly those that necessitate more disclosures on risk, compensation, and governance practices. Regardless of their perspectives, however, audit chairs, as a group, recognize that there are proactive steps the board and audit committee can take to establish their own governance approach, rather than yielding all control of the agenda to regulators.

About this document

The European Audit Committee Leadership Network (EACLN) and Audit Committee Leadership Network (ACLN) are groups of audit committee chairs drawn from leading European and North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The networks are convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit committee environment.

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of ViewPoints lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives ViewPoints may share it with those in their own network. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

The views expressed in this document represent those of the European or North American Audit Committee Leadership Networks. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young, or Tapestry Networks. Please consult your counselors for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization.

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ViewPoints

FOR THE AUDIT COMMITTEE
LEADERSHIP SUMMIT



Appendix 1: Participants at the Audit Committee Leadership Summit

European and North American Audit Committee Leadership Network members participating in the summit, who sit on the boards of over 50 large-, mid-, and small-cap public companies between them, included:

- Denny Beresford, Audit Committee Chair, Kimberly-Clark
- Aldo Cardoso, Audit Committee Chair, GDF SUEZ
- John Dillon, Audit Committee Chair, Caterpillar
- Gene Fife, former Audit Committee Chair, Caterpillar
- Dick Harrington, Audit Committee Chair, Xerox
- Phil Hodgkinson, Audit Committee Chair, BT
- Judy Richards Hope, Audit Committee Chair, Union Pacific
- Labe Jackson, Audit Committee Chair, JPMorgan Chase
- DeAnne Julius, Audit Committee Chair, Roche Holding
- Marie Knowles, Audit Committee Chair, McKesson
- Daniel Lebègue, Audit Committee Chair, SCOR
- George Muñoz, Audit Committee Chair, Altria and Marriott International
- Oscar Munoz, Audit Committee Chair, Continental Airlines
- Anders Nyrén, Audit Committee Chair, Sandvik and SCA
- Pam Patsley, Audit Committee Chair, Texas Instruments
- Ian Prosser, Audit Committee Chair, BP
- Pierre Rodocanachi, Audit Committee Member, Vivendi
- Guylaine Saucier, Audit Committee Chair, Areva and Danone
- Tom de Swaan, Audit Committee Chair, Ahold and GlaxoSmithKline
- Bernd Voss, Audit Committee Chair, ABB
- Sandy Warner, Audit Committee Chair, General Electric Company
- Chris Williams, Audit Committee Chair, Wal-Mart
- Mario Zibetti, Audit Committee Chair, Fiat Group

Ernst & Young partners participating in the meeting included:

- Tom Hough, Americas Vice Chair of Assurance Services
- Steve Howe, Americas Managing Partner
- Tom McGrath, Managing Partner, EMEA Financial Services
- Christian Mouillon, Global Vice Chair of Assurance Services

ViewPoints

FOR THE AUDIT COMMITTEE
LEADERSHIP SUMMIT



Appendix 2: Questions for audit committees

- ? What concerns you most about the intensified focus on regulatory and governance reform? What proactive steps can audit committees take in this regard?
- ? Has the audit committee stepped up its review of compliance processes, especially with regard to the FCPA? Has it discussed compliance and enforcement risks with its external auditor?
- ? Has the audit committee – or board as a whole – discussed whether the apparent move away from principles-based regulation will affect the way in which your company and its external auditors interact with regulators? Are there proactive steps audit committee members, or other board members, should take in this regard?
- ? Have you discussed which proposals for reform will have the most effect on your board’s governance practices? Which proposals will present the most significant challenges? In what areas is your board or audit committee being proactive in improving its governance approach?
- ? What steps will the audit committee take to get ahead of the new SEC requirements for disclosures on risk, compensation, and other governance matters? Has the audit committee considered looking at draft disclosures under the current proposals? Is the committee changing the manner in which it engages other board committees on these topics?
- ? How will governance reforms change the dynamic between boards and shareholders? Will there be an increase in communication with shareholders, and if so, what role will the audit committee chair play in that?



Appendix 3: List of subject matter experts consulted

Tapestry Networks discussed regulatory and governance reform with a number of subject matter experts in preparing for the summit, including:

- Roger Barker, Head of Corporate Governance, Institute of Directors (UK)
- Marco Becht, Professor, Finance and Economics, Université Libre de Bruxelles; Executive Director, European Corporate Governance Institute
- Les Brosen, National Director, Government Relations, Ernst & Young
- Richard Ferlauto, Director of Corporate Governance and Pension Investment, American Federation of State, County and Municipal Employees (AFSCME)
- Patricia Jackson, Financial Services (FSO) Regulatory, Ernst & Young
- Peter Montagnon, Director of Investment Affairs, Association of British Insurers; former Chairman, International Corporate Governance Network
- Chris Pierce, CEO, Global Governance Services
- Russ Ryan, Partner, King & Spalding
- Damon Silvers, Associate General Counsel, AFL-CIO; Member, Congressional Oversight Panel
- Anne Simpson, Portfolio Manager for Corporate Governance, CalPERS; former Executive Director, International Corporate Governance Network
- Daniel Summerfield, Co-head, Responsible Investment, Universities Superannuation Scheme
- Donald Vangel, Financial Services (FSO) Regulatory, Ernst & Young