SEC to Review Performance of Boards in Financial Crisis

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The deepening of the financial crisis is creating renewed Congressional and regulatory interest in risk management practices of companies. The recent shifts in executive compensation and corporate governance standards announced by Treasury Secretary Timothy Geithner for the Troubled Asset Relief Program (TARP)[1] and the new compensation and governance provisions in the American Recovery and Reinvestment Act of 2009 (Recovery Act)[2] reflect a mood in Washington that signals a far more rigorous review of corporate accountability and oversight.

While the TARP rules and Recovery Act provisions are limited to companies receiving TARP assistance from the government, there is clearly a growing appetite for heightened scrutiny of compensation and governance practices across the board. Indeed, the perception that corporate compensation structures may have substantially contributed to excessive risk-taking is becoming received wisdom. Recently, the focus has broadened to include the performance of boards of directors as well as of management itself.

The more stringent review will likely be both forward and backward looking. According to recent press reports, SEC Chairman Mary Schapiro intends, early in her tenure, to examine the performance of boards of financial institutions to determine whether they conducted effective oversight in the period leading up to the current financial crisis.[3] The recent appointment of Robert Khuzami, a former federal prosecutor, as director of the SEC's Division of Enforcement, and the zero-tolerance rhetoric surrounding his appointment, suggest an increased emphasis on enforcement and underscore the probability of an exacting review of past risk management practices. We expect that, in addition to looking at how boards performed, the work of audit and compensation committees may be put under the microscope. The review would generally cover a board's post-Sarbanes-Oxley governance and controls, including independence from management, risk assessment oversight and policies for senior management accountability, reporting and monitoring systems, codes of conduct and compliance policies, and even the board's general review and understanding of the company's business.

It is not clear what process the announced SEC review of board oversight will take. That is, will there be a broad survey of governance at financial services firms? Will there be some forum involving public hearings at which selected board members and committee chairs will be asked to appear, akin to a Congressional hearing? Or will this review follow the more traditional enforcement process, with subpoenas and examinations of witnesses under oath? It seems the review of corporate board performance suggested in press reports would be unlikely to yield recommendations for enforcement actions, but the risk associated with any such process should not be dismissed. It is difficult to imagine that the SEC will proceed without resort to its investigatory and enforcement powers. There may well be inquiries launched by the Division of Enforcement directed specifically at how various boards functioned, what they knew, how they performed risk assessment, and what skepticism accompanied their oversight of the overall business models and strategy employed by management. It is also likely that similar questions will be asked about compensation practices and formulas.

In the current climate, none of this would be surprising. And this process may be the beginning of a broader effort at regulatory reform of boards. A key part of the Administration's executive compensation plan is consideration of long-term reform to ensure that compensation structures at financial institutions are consistent with sound risk management and long-term value and growth. Chairman Schapiro recently hired shareholder and investor advocate Kayla Gillan as a senior adviser. Ms.Gillan will lead numerous projects, including "the creation of an Investor Advisory Council, reconsidering access to the proxy, and evaluating shareholder advisory votes on executive compensation."[4] In a recent speech, SEC Commissioner Elisse Walter reaffirmed this new direction, emphasizing that the SEC intends to look closely at actions that will enhance shareholder participation and promote greater board accountability, including enhanced shareholder access, consideration of the elimination of uninstructed broker votes from director elections, and advisory "say-on-pay" votes for shareholders.[5] Chairman Schapiro reportedly also intends to seek greater disclosure of directors' backgrounds and skills, especially with regard to risk management. We likely will also see increased scrutiny of "luxury expenditures," in light of public reports about expensive corporate events and other lavish expenditures.

Much of the discussion about the role of boards in the current crisis reflects a view that the directors bear some responsibility for the failures contributing to the crisis. There is also concern that boards may have too much latitude in making compensation and other governance decisions that may have a direct impact on risk. The emphasis on reforming boards, partially through enhanced shareholder access, suggests a concern that boards will not adopt best practices in the absence of greater shareholder or public pressure. While the assessment of board performance leading up to the financial crisis may focus on financial institutions, it is likely that governance reforms will be substantially broader in their application.

What to do about all this? The broader questions on the table concerning corporate governance and risk assessment, executive compensation and related issues are likely to remain center stage. In the current climate, the rhetorical question of "how did this happen?" is only eclipsed in the frequency with which it is asked by the question of "who should be held accountable?" The issues surrounding the financial crisis are quite complex and, in the end, may well yield answers that are not entirely satisfactory from anyone's perspective, much less that of the SEC. With respect to corporate governance, whatever the imperfections in our system of board oversight—or the perceived failures of any specific company or board—our capital markets have experienced the equivalent of a financial tsunami, the likes of which were foreseen by neither the regulators or policy makers in Washington, nor by many of those in the executive suites or the board rooms. There is, however, little solace to be taken now from either the breadth of the crisis or the fact that the failures in foresight extend to those in government as well. The appetite for accountability will likely grow and the questions to be posed to executives and board members will only expand.

That said, boards of all public companies should consider a proactive review and reevaluation of their risk management and compensation policies and procedures, with a view to ensuring that their oversight has been and will continue to be effective. The decision by a board to devote resources and energy to this type of endeavor, particularly in the midst of the day-to-day market crisis in which many companies currently find themselves, is indeed a difficult one. Such a review could impose additional stress on resources that are needed to address the current business needs of the enterprise. In light of the anticipated broad-based external examination of board performance, however, an internal review would nonetheless be a valuable exercise.

[1] "Treasury Announces New Restrictions On Executive Compensation," Treasury Press Release, Feb. 4, 2009.

[2] The executive compensation and governance provisions are contained in Section 7001 of the Recovery Act.

[3] *See* "SEC to Examine Boards' Role in Financial Crisis," *Washington Post*, Feb. 20, 2009.

[4] "Kayla J. Gillan Named Senior Advisor at SEC," SEC Press Release, Feb. 17, 2009.

[5] "Restoring Investor Trust through Corporate Governance," Remarks Before the Practicing Law Institute by Commissioner Elisse B. Walter, Feb. 18, 2009.

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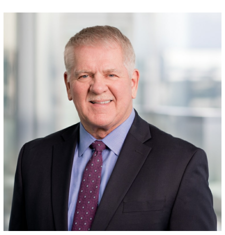

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