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Interview with Bernard Rethore, Emeritus Chairman, Flowserve Corporation, USA

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Governance, Sarbanes-Oxley, corporate wrong doing, the US chairman/CEO role duality against that of the British and Continental European role separation and a new theme for non US audiences, corporate democracy. These are just some of the issues discussed by Bernard Rethore.

Bernard Rethore, Chairman of the Board *Emeritus*, Chairman/CEO, board member of numerous US companies and farseeing thinker speaks about some of the controversial issues facing profit and not-for-profit organisations in the USA. An expert on governance with a strong interest in the emerging subject of "corporate democracy", Bernard Rethore refers his comments to US and non US audiences alike.

What do you consider the future to be for the chairman CEO/role duality practice of the US?

I think that the dual chairman/CEO in the United States will continue to be dominant, despite the increase in the number of companies that reflect role separation. This latter increase arises because of "governance committees" that are responding to pressure for presumed improvement in organizational approach. Further, a practice that will probably not change is role separation at the time, typically, of internal succession. Until the new person 'beds in', they will often serve only as CEO, but once 'in', they will be offered the CEO/chairman combination. But, all that said, the dominant culture is, and likely will be, to have the CEO also be chairman.

What are the advantages of role duality?

Representation! For the most senior management person in the organisation, having that double role, lends additional gravitas. Sitting down at the table as only President and Chief Executive diminishes status and stature in the US environment. Consider a military analogy, how many four star officers negotiate as equals with those that have three stars? There's a clear difference.

The two principal obligations of a Board are to insure that an effective CEO is in place and that he/she has a sensible strategic plan, a long term vision and a program for creating value for shareholders. Giving the CEO dual authority can facilitate this.

Some assert that a separate Chairman is needed to craft the board agenda. But that is not a major task. There's an ebb and flow of things that companies must do over

time, and that boards must do. Having a separate chairman who presides over such duties is not really a requirement, nor is it significant as an activity.

And, in the US, we have made major strides forward here by taking an alternative approach to improving the quality of governance. The US strongly leans toward the identification of a lead independent director (LID) -- a role that comes in several forms. There is a regulatory requirement that a public company have an individual who is an independent director to chair the executive sessions of the board. This individual need not be a first among equals but more a spokesperson for the independent directors. That individual tends to serve de facto as the non- executive chairman in terms of keeping an eye on the board agenda and also being a governance mentor for the CEO. The lead independent director can also serve as an advisor and counsellor for the dual chairman and CEO.

Is the lead independent director (LID) sufficiently respected to be given the necessary support when intervention is necessary?

The lead independent director tends to be selected by his/her peers, according to the stature of the person, and perhaps their longevity on the board of the company. To be the lead director, you need to be recognised by your peers. When that individual meets with the chairman/CEO, he/she already has a great deal of respect in the eyes of the chairman/CEO. We have an environment in the US where the CEO turns over about every five years. An independent director who has been on that board for a time and is respected by his/her peers, and has probably hired the chairman/CEO, is quite different from the case where a long standing CEO/chairman has seen the board turn over. The lead independent director should be someone who is not going to be

antagonistic to the CEO, but someone who can be quite strong in what they do, while still doing it, collegially.

Is it unrealistic to expect collegiality with a strong chairman/CEO?

No! Such dynamics I see in the board room. There is some natural conflict around being part of a team but needing to stake out your own ground. But, this is about qualities of directors: the ability to be independent; to have a sense of judgement; to have the courage of one's convictions; to be a little bit sceptical; to raise hard questions; and, to challenge one's peers when necessary. The subject could be strategy or a proposed operational programme. I think directors of a like mind and type have no problem with that.

Does the dual chair/CEO role reduce the moral character of its incumbent?

Perhaps I'm just utopian but I have been very impressed with the CEOs and chairman/CEOs I've served with in public companies. I've served on eight public company boards and, in the main, found CEOs/chairman CEOs of substance and integrity, who are committed to creating value for their shareholders. There may be a degree of self selection here because it would be unwise in the United States to become a director of a company and not have undertaken rigorous due diligence about the character of the company and the principles of the people, both management and on the floor, who comprise it. The stakes are too high.

Many people talk about due diligence. Very few people go into detail. What are you looking for? How long does due diligence take?

This depends on each case. Let me divide the world into two parts. One part is just to understand the company situation, which comes from my McKinsey days! Understanding a company and its industry was a sort of Management 101 training for McKinsey Associates. Get a sense of the profit economics of the enterprise. What drives it? What makes it go? Where does this particular institution fit into the competitive universe in the Michael Porter sense?

That's the first piece of due diligence and usually that's pretty readily determinable. The other side of due diligence is around insight on reputation and character. That is done through individuals that you know or that you can get to. Conversations of that sort are open to litigation and question in the USA. So, people may be circumspect about what they say. You've got to enter the network and find out about Joe Jones or Sally Smith and what have they done before, what is their signature, how well are they regarded by other people, either in companies or on boards or industry associations? To some degree, it is what a search firm does with candidates going out for reference! The advantage of the network is that people know one another. I think that still has value today. Not simply "You scratch my back and I'll scratch yours", but rather the ability to have an off-the-record conversation of substance.

Is your experience that a board more selects than vets candidates or both?

Both. Increasingly, the real locus of selection for directors is the Nominating and Governance Committee. That committee's existence and importance have grown dramatically over the last few years, with the emphasis on director independence. Typically, the lead director is the chair of the Nominating and Governance Committee. The days when the CEO tells the board, I want to bring these three guys

on the board, three people who are members of my club, whom I know, that is history!

What is the balance between the board directors trawling their network for a new director and that of hiring search consultants?

I believe it's more going to search. And, it's become an important line of business for the large search firms. Fees have escalated but search consultants have contacts at the highest levels. And, from their perspective, this has become an interesting and sought after activity.

Is the search process, then, really the privilege of the larger corporation?

Certainly it's easier for the large company because of the fees that are involved. You have to look at that more closely, if you're a small company. On the other hand, what is large and what is small? More companies are feeling the heat to find qualified directors in a tightened market. And, the fact of the matter is that, if you introduce a search firm into the process, there is a certain confidence that comes forward as a result in terms of the independence, thoroughness and perhaps integrity of what is done.

You made a strong point about culture underlying US role duality versus UK role separation. Is that how you see these two systems, as aspects of national culture, or is there a governance and business advantage of one against the other?

Well, I certainly think that culture dominates. When I say culture, I mean the history of practice in the country. My assertion is that if you diminish the importance of the

CEO in the USA, if he/she is not also chairman, then the person simply isn't heard as well. If you're in the UK, the strong CEO role has served well for companies and so people listen. Really, we're talking what makes sense for the particular enterprise in the environment in which it operates.

Why then has the "not-for-profit sector" gone for role separation bearing in mind US cultural norms of role duality?

The "not for profit sector" has less moved to role separation than simply followed the practice for some time. Let me take the example of academia. There is typically a Chairman of the Board of Trustees and there is a President who is CEO of the college or university. That works incredibly well in my view and I would do nothing to change those positions. It is largely a matter of history. But, also the practice has worked. The same occurs for major foundations. The profit and not-for-profit worlds simply have different traditions in the US.

How do you see the impact and validity of the Sarbanes-Oxley legislation?

At the outset, I was sceptical, even antagonistic about Sarbanes-Oxley. But, I remember a meeting at the University of Delaware Director's College, at which one presenter made the point that something like 15% of all large companies in the United States had to acknowledge "material weaknesses" -- as defined in the legislation -- in their control systems. That's outrageous and the statement really rocked me. It is disturbing that there were so many large public companies who found such deficiencies in control. So beyond and despite role separation or role duality, we still face substantial control problems. And, often it is very basic stuff. It's a quality mandate. You should have a series of steps to follow to effect a control and you must

follow them. And, by the way, write it all down so that people can read it because you can't rely on people remembering.

Putting proper controls in place is essential, and confirming this is necessary, even though it adds materially to the cost of the audit. However, there is another perhaps more significant 'cost' of Sarbanes-Oxley. And, it can go all the way up to board room. It is termed the 'check the box' mentality, in which individuals are so focused on conforming to the rules that their focus goes almost exclusively to those rules! Not on strategy, competitive situation or value creation but on compliance.

Then, what is the future for Sarbanes-Oxley?

I think Sarbanes-Oxley will endure. However, I would expect that the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) are going to be more creative and thoughtful in their interpretation of some of the requirements of Sarbanes-Oxley. The level of detail needs reducing, which can reduce cost. Hopefully, too, the frequency of compliance audits under Section 404 of the Act, will be reduced. And, there are some efforts to reduce the requirements for smaller companies. But, still, Sarbanes-Oxley will remain.

Many of our public policies do not drive off good, hard economics but come out of the political arena. This goes to one of my concerns and it's a growing concern here in the US: the things done in the name of "corporate democracy", which could lead instead to governance anarchy.

Please explain corporate democracy?

Like so many business terms, “corporate democracy” is terribly imprecise in definition. What one sees and hears in the media under the banner of corporate democracy is a range of things that have as their end purpose some modification in the way enterprises, public enterprises, are governed here in the US, presumably with more input and involvement from their shareholders. This has favourable connotations around it because of the word ‘democracy’. But, unfortunately, under that umbrella and, to some degree I would say, under the guise of something good and elevating of governance, come a number of things which at the end of the day could combine to have a quite different impact, and in fact be antithetical to the success of enterprise and the openness and transparency of management action.

Had corporate democracy simply gone more towards the arena of independence of directors who are working for shareholders rather than acting as colleagues of senior management, that would be a beneficial direction. Unfortunately, attached to corporate democracy are initiatives that I think individually may have great merit (and apparent logic) but which combined can be counter productive and have quite unintended consequences, indeed the proverbial ‘perfect storm’.

Boards have largely been moved to annual election of all directors, rather than the staggered three-year terms typical in the past. Elections are moving to a ‘majority’ versus ‘plurality’ form. The voting of broker held shares is under review, as is making it easier for shareholders to nominate alternative directors. Some seek also to reimburse those who champion outside proxy proposals for the cost of so doing. Self-interested, and likely quite short term, shareholders such as hedge funds can

increasingly threaten and combine votes to push managements to act in ways the funds judge appropriate.

At the end of the day, direction and control of an enterprise could be moved in the worst case from an experienced board, committed as it must be under the law, to serving the interests of *all* shareholders, to some new board influenced strongly to serve relative special interests.

Why has this movement arisen?

Why has it arisen? Many people with quite different agendas are involved, with motives that range from selfish to pure. And much has been driven by the failures and patent self interest of the senior managements of some corporations, not just in the US but also in Europe. With their boards, they have sometimes breached their trust through actions that were illegal, unethical, or simply sleazy. This ranges from major events like the Enron debacle to now the myriad number of cases of options backdatings that are surfacing. Who is asking the question, "What are we doing here?,or "Is this right?" You have to challenge yourself and you have to challenge the practices that are out there and the ground rules of 'cultural law' that let them occur. So there's one piece of it.

Then we have another piece in the USA and that is the sometimes outrageous compensation of Chief Executive Officers (CEOs), often paid out when shareholders themselves have had no gains in value. As you know, in the US we've tended to have more generous compensation packages than has been the case elsewhere. So out of that comes a real distaste, which has been heavily touted in the media, either as news

or through people who have their own agenda, but none of which is flattering or complimentary to the captains of industry.

As they should, people want to rein in and punish villains; aspects of corporate democracy may seem like ways to do so.

So what to do?

I think we need to be damned careful. Let's come back to a couple of basics here. Where laws have been broken, and much of the stock option backdating seems to be that, we can find law that says, '*this is a misappropriation of the assets of companies and their shareholders*'. Then, we have to be absolutely vigilant in prosecuting people that did the wrong thing. And doing it as publicly as possible, because 'public hangings' do have a therapeutic effect, particularly on the public who properly expect accountability from people who hold great responsibility. And, I think we have to be religious about that. Unfortunately, the legal process can take very long to get something finally done. People want bad deeds punished today.

The other area where we need to be vigilant is about opening access to the proxy to shareholder groups. A hedge fund that might have 5 or 6% of the stock of a company, but can get some colleague funds to join it, something easily done, may get elected two or three members of a board of perhaps ten members. Now we've got a 5% per cent shareholder with the muscle to account for literally 20 or 30% of the board's composition. That's appalling!

If you think of the climate in the States, where litigation is so much a part of our culture, the thought of ongoing 'shareholder' fights with some very tough people who are well armed in lawyers, is depressing! I think it's going to be a further depressant on the pool of the people whom we'd like to have serving on boards, those being ones that serve beyond personal interest and with a sense of doing the right things for the benefit of the entire shareholder group.

What happened on those boards that allowed backdating of remuneration (i.e. options) to take place?

My sense is many directors just didn't pay adequate attention, which of course is a capital crime. But, for perspective, let's just model something together for a minute. You and I are on a compensation committee. In comes a normal proposal for the award of options and it's brought in by a management, whom you have come to respect and with a believed history of ethical management. With them come representatives from one of the premier consulting firms who assist management and their boards on matters around human resources and compensation. They say, "*you know, we would like to go forward with this year's award to management (or to an individual manager).*" Yet, they don't point out the fact that there is a loophole in how and when one can date the award. Unless we are particularly vigilant and go a couple of levels deep in questioning, we might not ask the right questions that would surface what is really being proposed for approval. Now, if an award has already been made and someone comes in and says, "*we'd like to change the rules*", that should be infinitely easier to see but, again, one may never know what might get passed by on a piece of paper unless carefully read.

Is it the discomfort to challenge or directors being overwhelmed with too much data that has allowed bad practice to continue?

Collegiality is an important value on a board. Having good working relationships with management is important. But, do I not raise a question because I don't want to disturb my colleagues? Do I not raise the question because I don't want to challenge management? Probably both dimensions to some degree dull debate. Data overload, by comparison, may more be the case in the new world of heightened board concern and attention!

Do you feel that Sarbanes-Oxley has made people more defensive or is Sarbanes-Oxley pushing people to hold themselves to greater accountability?

I think Sarbanes-Oxley has done a little of both. Sitting on, over the last years, 4 audit committees at different times, I have become a reluctant convert to Sarbanes-Oxley, as I mentioned earlier. Where at the outset my supposition was that anything that passed the United States Senate, 98 to 0, had to be a bad thing, I watched so many enterprises in the US having surfaced, not just inefficiencies, but material weaknesses in their audit reports that I ended up being supportive of the benefits from Sarbanes-Oxley.

My only caveat would be that it is unfortunate that under Section 404 we must now continue to have to pay the due bill for that every year going forward. That's why I hope there will be some changes in future. But that aside, boards and audit committees have been able to use Sarbanes-Oxley as the 'ugly gorilla in the corner' that really facilitates getting people to do things they should have been doing better

before. So, I've become a reluctant believer in the benefits of Sarbanes-Oxley. I think it's ended up empowering directors.

Will Sarbanes-Oxley assist the remuneration concerns you have raised?

Most matters of remuneration are not Sarbanes related. But, we will see -- are already seeing -- impact from the new SEC requirements for compensation disclosure in public companies' proxies, which will be visible with the proxies issued to shareholders starting in 2007. The changes are extensive. They are driven by the recognition that CEO pay has simply gotten out of hand.

Some of this goes all the way back to some of the disclosures that came out of Jack Welch's divorce. His former wife illuminated some of the incredible perks that went with his pension. This was a very acrimonious divorce, as he allegedly began a relationship with one of the editors of Harvard Business Review who worked with him on articles and ultimately his last book. Then, he abruptly moved to divorce his wife, who in her own right had been a very successful lawyer, and was having none of it. To make sure that the record was clear (and perhaps gain the leverage of public opinion in her settlement), she identified things like the availability of private corporate aircraft, the availability of apartments, the allowances for flowers and chefs, etc. that were part of part of his pension package -- none of which had been specifically disclosed to the public. It was eye opening.

And, prurient interest aside, when one individual in an organization may earn 300 or 400 times the pay of the average individual in that organization, something is patently wrong and in need of correction.

What about hedge funds and their growing effect on the market?

Though I have concerns about the actions of some hedge funds, I guess I am libertarian enough in these matters to be concerned about the thought of regulating them, which is now becoming an issue here in the US. Quickly come the questions around: what should the regulation of the hedge fund involve? Part of me instinctively says, stay away from any more governmental intervention. But, if we are going to have organizations that are indeed unregulated and can bend rules and have an adverse influence on other organizations that, by comparison, are pretty keenly regulated, then perhaps something needs to be done.

With all that we have discussed, where is corporate democracy going?

I think at the end of the day we are going to see more regulation that facilitates it. Parties with relative, narrow interests are quite likely going to have greater access to the governance of public companies in the US. And, matters of economic value creation may well be increasingly burdened with elements of political agendas, as well.

For instance, various labour unions that have wanted to get access to the governance process and proxy and clearly they are not doing it simply as shareholders interested in the value of their shares. Their policy is to promote greater influence in the board room affecting policy unionisation and issues of interest to unions. There are other groups also with their own agendas, often more political than economic. We even have orders of nuns in the US that have small shareholdings, which they use to argue for (self-)perceived 'good causes' rather than improved economics.

And, there are many others who are part of this broad movement for supposed greater "democracy". And the media is certainly not pro business in the US. Most important, what we all face is that the average worker, perhaps living on a household income of perhaps $40-50,000 a year, including a wife who also works, trying to educate children, trying to meet the normal bills, who hears about these people getting these zillion $ compensation awards. It makes perfect sense to such an individual to think there is something wrong here -- and there is! So, they want to know why and what can be done to remedy the situation. All of this is part of "corporate democracy".

May I say thank you so much.

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