The Fiduciary and Investment Risk Management Association

28th National Risk Management Training Conference

Corporate Governance and Business Ethics

April 30, 2014

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Our Corporate Governance System Is Getting Better

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Corporate governance requirements continue to be of increasing importance in these unsettled times of blurred legislative directives, global business boundaries and increased regulatory oversight.

Business ethics apply to all aspects of business conduct and is relevant to the conduct of individuals and entire organizations.

Examination of the roles of boards, corporate management and employees in in various governance structures and the ethical principles and moral and ethical problems that arise in a business environment.

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A little more than a decade ago, the term "corporate governance" was largely academic jargon.

Today, the term is familiar to everyone. Unfortunately, its familiarity in our society comes due to two major calamitous period in our recent history: corporate scandals (WorldCom and Enron) and the failure of financial firms and the ensuing global economic crisis.

Why is corporate governance important?

Because it instills confidence and trust in our companies, in our markets, and in our economies.

Corporate governance is the formal system of accountability, oversight and control.

Accountability: How closely workplace decisions are aligned with an organizations stated strategic direction and its compliance with ethical and legal considerations.

Oversight: A system of checks and balances that limit employee and manager opportunities to deviate from policies and strategies aimed at preventing unethical or illegal activities.

Control: The process of auditing and improving organizational decisions and actions.

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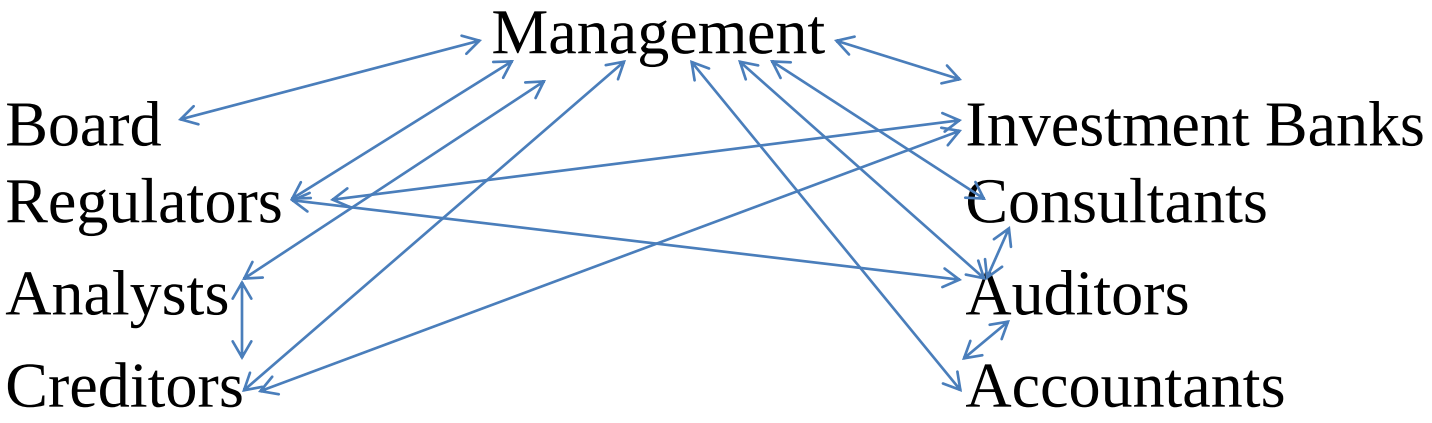
1. Corporations and Corporate Governance
2. Executive Incentives
3. Accountants and Auditors
4. The Board of Directors
5. Investment Banks and Security Analysts
6. Creditors and Credit Rating Agencies
7. Shareholders and Shareholder Activism
8. Corporate Takeovers: A Governance Mechanism
9. The Securities and Exchange Commission and the Sarbanes-Oxley Act
10. Moral Hazards, Systemic Risk and Bailouts
11. Corporate Citizenship

A Good Corporate Governance System is Integrated and Complicated. There are Interlinking Relationships Among Business Participants:



Executive Incentives

The Board of Directors, auditors and other components of the governance system should serve to monitor management.

Executive incentives should be aligned with shareholder incentives.

Accountants and Auditors

- Accountants and auditors are an important part of any corporate monitoring system.
- Accountants keep track of the quantitative financial information of the corporation.
- Accounting gathers, compiles, reports and archives business activities.
- Because mistakes and other problems may occur with accounting, there are auditors who review financial information.
- External auditors are accountants from outside the corporation. Who review the firm's financial statements and its procedures for producing them and attest to the fairness of the statements and that they materially represent the condition of the firm.
- Internal auditors oversee the firm's financial and operating procedures, check the accuracy of the financial record-keeping, and implement improvements with internal controls.

The Board of Directors

The board acts as the shareholders agent in charge of running the company. While not involved in running the day-to-day operations of the corporation, it handles major decisions and delegates responsibility for everything else to corporate officers.

- Hires, evaluates and fires top management
- Votes on major operating proposals
- Votes on major financial decisions
- Offers expert advice to management
- Ensures the firm's activities and financial condition are accurately reported to its shareholders.
- Directors have a ***Fiduciary Duty*** to conduct activities to enhance the firm's profitability and share value.

Investment Banks and Securities Analysts

- Help companies issue new debt and equity securities.

- Securities analysts primary job is to evaluate securities and make buy and/or sell recommendations to their clients based on their evaluations.

- We would expect investment bankers to "sell" good securities (securities that they think will not go down in value) and for analysts to recommend "good" securities (they should not be representing stock that they think will go down in value).

- They both represent an important and integral part of the governance system.

Creditors and Credit Rating Agencies

- Creditors are lenders and care about corporate governance because a well run company is more likely to have the cash to pay off its loans.
- The credit agency's purpose is monitoring debt issuers to protect public investors. While the credit rating helps investors understand the riskiness of a bond issue, the system has a built in conflict because the company pays the bill for its own rating. There is a potential for "shopping" for ratings can lead to an issuer receiving too high a rating.
- Since the agencies interactions and the fees they earn are with the firms they rate, these circumstances can create misaligned incentives. In addition, The U.S. government has made credit ratings a closed and low-competition industry that has unusual immunity under the First Amendment from being sued for poor ratings. This immunity prevents investors from seeking damages when the agencies make mistakes.

Shareholders and Shareholder Activism

- What can shareholders do to improve corporate governance or change the actions of management?
- At the annual meeting, shareholders can vote to replace ineffective directors and shareholders can make proposals to change the way the firm is governed.
- Shareholders can bring lawsuits against directors and/for officers to recover damages or force them to comply with the law.
- Institutional shareholders activism usually has more success in influencing corporate governance than individual shareholder activism.
- One reason is that it is costly to monitor. Only large shareholders find it worth while to be a shareholder activist.

Corporate Takeovers: A Governance Mechanism

- Historically, acquisitions could have been characterized as hostile takeovers, as acquiring firms were looking to take over target firms whose management and boards did not want their firm to be bought. Many of these acquirers believed they could take over a poorly performing firm and convert them into profitable firms. In the was, M&A can be viewed as "disciplinary takeovers."
- However, the recent mergers we have seen seem to be more focused on simply increasing market power. What happened to the disciplinary takeover? In response to the hostile takeover activity of the 1980's, many firms and states adopted antitakeover devices, thereby weakening a potentially powerful corporate governance device.

The Securities and Exchange Commission and the Sarbanes-Oxley Act

- The SEC seems to be a powerful and effective monitor, but has encountered problems in the performance of its duties.
- It may be overworked, underfunded and understaffed.
- It possesses only civil powers to punish wrongdoers, not criminal powers – shareholders suffer from both the wrongdoing itself and the SEC punishment.
- The failure to detect the $50 Billion Madoff Ponzi scheme or the looming financial collapse of 2008 suggest the effectiveness of SEC monitoring is still problematic
- It is hard to say at this point if the Sarbanes-Oxley Act has been beneficial.
- Cost of complying has been criticized widely by legal scholars, business executives and even large shareholders

New Aspects of Corporate Governance

- **Moral Hazards:** A situation when a decision maker who is insulated from the bad outcomes of the decision may behave differently than one who must endure all consequences of a decision.

- **Systemic Risk:** The possibility of one company's bankruptcy causing a chain reaction through an economy.

- **Bailouts:** Policy of the federal government deciding which companies survive and which fail. Due to unequal political power, bailouts can be structured to benefit large inefficient companies at the expense of their low-cost competitors.

Corporate Citizenship

- The view that corporations have a greater responsibility in society than just maximizing shareholder wealth and have unique opportunities to improve society.

- Stakeholders have legitimate interests in the firms activities.

- Corporate governance is then defined as the mechanism to ensure corporations take responsibility for directing their activities in a manner fair to all stakeholders.

The Reasons for Studying Business Ethics

- Business ethics is not merely as extension of an individual's own personal ethics
- Moral rules can be applied to a variety of situations in life.
- When a person's preferences or value's influence performance does an individual's ethics play a major role in the evaluation of business decision.

The Benefits of Business Ethics

The field of business ethics continues to change rapidly as more firms recognize the benefits of improving ethical conduct and the link between business ethics and financial performance.

- Ethical Culture Contributes to Employee Commitment
- Ethical Culture Contributes to Investor Loyalty
- Ethical Culture Contributes to Customer Satisfaction
- Ethical Culture Contributes to Profits

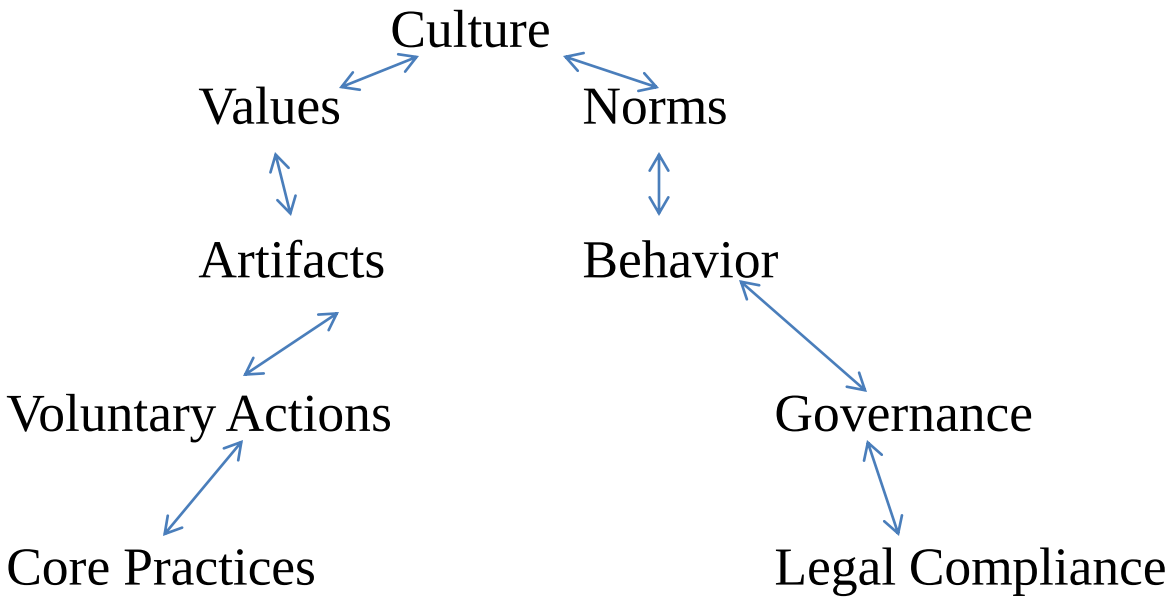
Ethical Dilemmas

- Stakeholders Define Ethical Issues In Business
- Social Responsibility and Ethics
- Ethical Issues and the Institutionalization of Business Ethics
- Ethical issues typically arise because of conflicts among individuals' personal moral philosophies and values, the values and culture of the organizations in which they work and the values of the society in which they live.

Recognizing an Ethical Issue

Honesty	Harassment
Fairness	Environmental
Integrity	Fraud
Conflicts of Interest	Misconduct
Corporate Intelligence	Intellectual Property
Privacy	

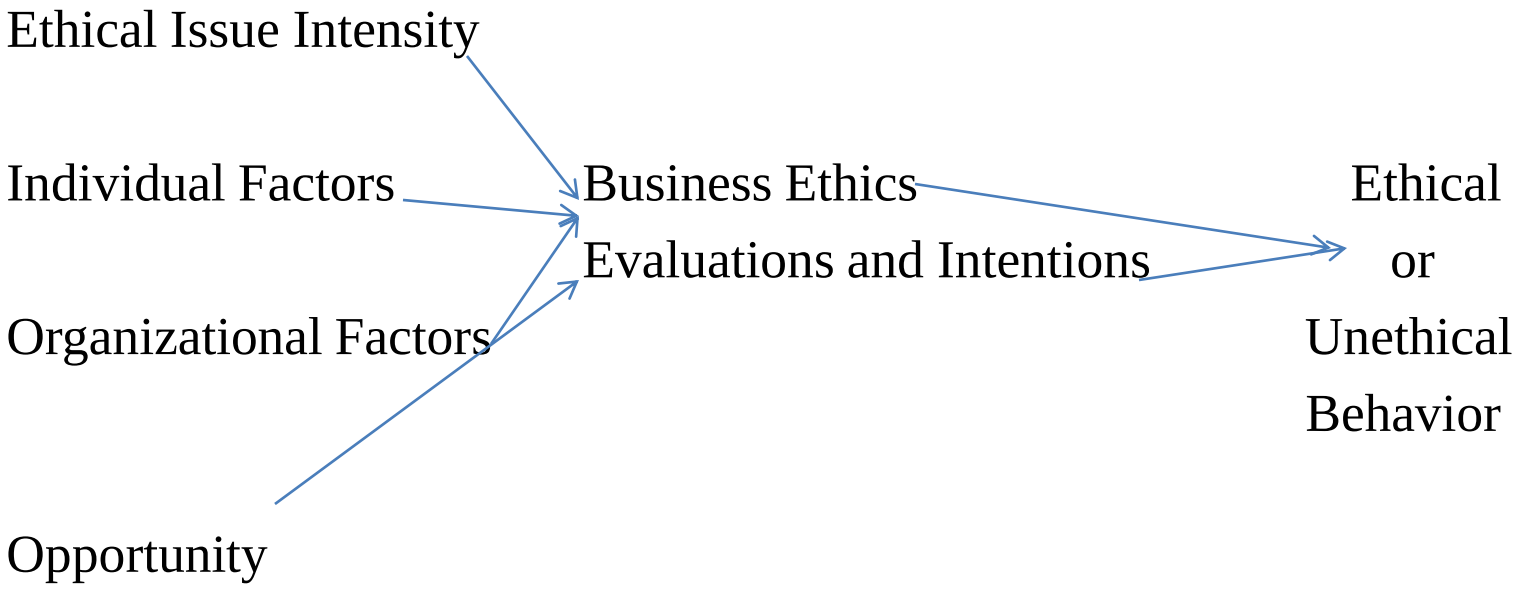
Elements of an Ethical Culture



Institutionalization of Business Ethics

- Laws
- Gatekeepers
- Risk Assessments
- Sarbanes-Oxley Act
- Whistle-Blower Protection and Bounty Program
- Corporate Voluntary Responsibilities

Ethical Decision Making and Ethical Leadership



Seven Habits of Strong Ethical Leaders

1. Ethical leaders have strong person character
2. Ethical leaders have a passion to do right
3. Ethical Leaders are proactive
4. Ethical leaders consider stakeholder interests
5. Ethical leaders are role models for the organization's values
6. Ethical leaders are transparent and actively involved in organizational decision making
7. Ethical leaders are competent managers who take a holistic view of the firm's ethical culture

Ethics Programs

- Values versus Compliance Programs
- Codes of Conduct
- Ethics Officers
- Ethics Training and Communication
- Systems to Monitor and Enforce Ethical Standards
- Ethics Hotline
- Ethics Audit
- Global country cultural values are subjective and based on the social environment: “We Differ From Them”

Sources

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