RETHINKING CORPORATE GOVERNANCE AND CONTROLS

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KEYNOTE REMARKS MADE AT THE EDWARD LANE-RETICKER SPEAKER SERIES SPONSORED BY THE MORIN CENTER FOR BANKING AND FINANCIAL LAW

November 2, 2006

Thank you, Dean [Maureen] O'Rourke. It is a pleasure to be here at Boston University School of Law. As those of you who are lawyers know, it is appropriate to discuss the subjects of corporate governance, ethics, and controls at a law school because it is often lawyers who provide the moral compass for corporations and other institutions in our society.

Today, I would like to try to address a few basic issues, including: (1) why companies like Citi care about corporate governance, ethics, and controls; (2) the people and practice areas

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that ensure good governance; and (3) how to develop an effective governance scheme. While these three issues may seem straightforward, implementing them is not as easy as one might think. We have all seen the ramifications of recent lapses in judgment by corporate officers.

As an advisor, as I was for many years, and now as a corporate executive, I face dilemmas every day. It is a mistake for anyone to believe that problems cannot arise, particularly in a large enterprise. For example, Citi has more than 325,000 employees and almost 200 million clients around the world, ranging from governments and large corporations to families and individuals. In such a large company, it is possible that an employee might do something that, in hindsight, seems unwise and that consequently imperils the organization.

So why does this matter? The simple answer is that the organization can suffer significant economic loss if it makes mistakes in governance and controls. Additionally, the lack of a sufficient governance system may expose the organization to substantial liability, particularly in our legal system. Furthermore, missteps can damage the organization's relationships with regulators and thus limit its ability to do business in a particular area or region.

But the above reasons only provide a partial answer. In addition to those motivations, I believe that companies strive for best-in-class governance and controls, as well as the right set of values and the right view about corporate responsibility, because that is the way they want to project themselves in the marketplace. For example, when a company has as many clients and as many complex relationships – with suppliers, government officials, and communities – as Citi does, it wants to be respected for the values it represents in the way it does business.

At Citi, we have embedded our core values – what we call our Shared Responsibilities to our clients, to each other, and to our franchise – in our business. We are not only focused on *what* business we do – profits, revenue and market share – but also *how* we do business according to these Shared Responsibilities. Thus, at Citi, we pay attention to corporate governance to limit risk and exposure, and also to enhance the way we are perceived by our different constituencies in over 100 countries around the world. For example, we want our employees to identify Citi as both a good employer and a respectable institution because we believe that it will enhance their view of their own jobs and thus their effectiveness.

Our desire to be viewed in this manner by our customers is what drives us to both invest so heavily in corporate governance and controls, and pay so much attention to corporate social responsibility and the values we want to represent. For example, at Citi, we take great pride in the leadership role we played in the development of the Equator Principles, which are designed to ensure that large project finance deals such as dams, power plants, pipelines and the like, do not significantly harm the environment or local communities.[2] When the Equator Principles were created three years ago, we were one of only ten banks – and the only American company – to help both create and sign the Principles, which have become an international standard for project finance transactions in the private sector.[3]

Citi is also working to develop a Statement on Human Rights. While creating this statement is a complex and daunting task, given the scope of Citi's operations, we have learned a lot through our company's bench-marking and consultation with human rights non-governmental organizations. Citi, like other companies that have such statements, is working to promote high standards for individual rights and open markets in the countries where we do business. For us, the solution focuses on engagement, and we believe that our example can help elevate the principles and practices in the markets where we do business.[4]

Additionally, Citi is very proud of its leadership position in microfinance - whereby we securitize microfinance lending for businesses – and of the efforts of the Citigroup Foundation to act as an incubator of intermediary organizations.[5] Microfinance in India,

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[2] Claudia H. Deutch, *More Lenders Join in Pledge to Support the Environment*, N.Y. TIMES, July 6, 2006, at C11.
[3] *Id.*
[4] In January 2007, Citi released its Statement on Human Rights, which describes how Citi addresses human rights in four areas: our employees; our suppliers; our clients; and the countries where we do business. The statement can be viewed at http://www.citigroup.com/citigroup/citizen/humanrights/index.htm.
[5] *Citi Partners With FDC and BWTP to Strengthen Microfinance*, THE ASIAN BANKER JOURNAL, March 15, 2007.

Bangladesh, Pakistan, Indonesia, Mexico and much of South America drives entrepreneurship in impoverished villages.[6] These entrepreneurs are almost always women who become small business owners and may eventually develop larger businesses. Oftentimes, they become sources for building schools, improving housing stock, and creating social and political networks in their own communities. We support microfinance and these activities because we feel that they are good business practices and because they send a message to our different constituencies about the values we deem important to being a corporate citizen.

In addition to our corporate social responsibility activities, we must also be heavily focused on corporate governance. As you know, there has been significant debate about and a number of important changes in corporate governance in the last few years. Boards of directors have been asking themselves many of the following questions: (1) do you have the right makeup for your Board?; (2) do you meet standards that the stock exchanges or regulators set for independence?; (3) do you have the right conflict management policies?; (4) have you designated either a Chairman separate from the CEO or a Lead Director?; (5) do you spend enough time on the Audit Committee or the Compensation Committee?; and (6) do you have incentives built into compensation systems to align executives' interests with that of shareholders? However, I feel that at times these discussions have focused too much on what I would call "checklist governance."

The above questions, and the reforms that have addressed them, have been important to improvements in corporate governance over the last several years. Much of the change – brought on by scandals, investigations, reform movements, and legislation like the Sarbanes-Oxley Act – has been for the good. Even so, there is some criticism of Sarbanes-Oxley,[7] regarding the harsh impact that may

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[6] *Id.*

[7] Charles Schumer & Michael Bloomberg, *To Save New York, Learn From London*, WALL ST. J., Nov. 1, 2006, at A18 ("With the benefit of hindsight, the Sarbanes-Oxley Act of 2002, which imposed a new regulatory framework on all public companies doing business in the U.S., also needs to be re-examined. Since its passage, auditing expenses for companies doing business in the U.S. have grown far beyond anything Congress had anticipated. Of course, we must not in any way diminish our ability to detect corporate fraud and protect investors. But there appears to be a worrisome trend of corporate leaders focusing inordinate time on

result from the imposition of Sarbanes-Oxley requirements, particularly those that involve financial controls that are perceived as burdensome to small- and medium-sized companies.[8] However, the Securities and Exchange Commission (SEC) will likely attempt to reduce some of those burdensome effects. In addition, some people find Sarbanes-Oxley to be detrimental to competition because its rules, and the costs associated with compliance, apply only to U.S. companies or companies traded on U.S. exchanges.[9] Furthermore, Sarbanes-Oxley requirements are not necessarily in harmony with governance principles applicable to international companies with whom U.S. listed companies compete.[10]

However, we should be cautious about cutting back on these Sarbanes-Oxley requirements. While some of these requirements may be onerous, especially for smaller companies, many of Sarbanes-Oxley's requirements have had positive effects and have helped restore investor confidence.[11] For example, Sarbanes-Oxley has instituted better regulation of financial statements by outside auditors and has enhanced accountability by having senior executives certify the financial statements.[12]

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compliance minutiae rather than innovative strategies for growth, for fear of facing personal financial penalties from overzealous regulators.").

[8] *See* Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Exchange Act Release No. 47,986 [2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,923 (June 5, 2003) ("As directed by Section 404 of the Sarbanes-Oxley Act of 2002, we are adopting rules requiring companies subject to the reporting requirements of the Securities Exchange Act of 1934, other than registered investment companies, to include a report of management on the company's internal control over financial reporting.").

[9] *See* Schumer & Bloomberg, *supra* note 6, at A18 ("Industry experts estimate that the gross financial regulatory costs to U.S. companies are 15 times higher than in Britain."); *see also* The Implications of U.S. Corporate Governance Requirements for America's Competitiveness, THE FINANCIAL SERVICES FORUM at 5, July 10, 2006.

[10] *See id* at A18 ("Beyond cost savings, the British enjoy another advantage: While our regulatory bodies are often competing to be the toughest cop on the street, the British regulatory body seems to be more collaborative and solutions-oriented. . . .[F]oreign markets may be tempted to lower regulatory requirements to achieve a temporary competitive advantage. Though deregulation may help some countries gain more business in the short term, over the long term it could hurt the stability and reliability of the global marketplace.").

[11] THE FINANCIAL SERVICES FORUM, *supra* note 8, at 6.

[12] *Id.* at 4.

I would also argue that recent governance reforms in the U.S. have influenced attitudes toward governance in other parts of the world. I serve as a director for ArcelorMittal, which was recently created by the merger of Arcelor and Mittal Steel. Mittal Steel was founded several years ago by Lakshmi Mittal, an Indian entrepreneur who began building and acquiring steel plants in emerging markets and then acquired the International Steel Group in the U.S. Arcelor, one of the great European steel companies, was itself the combination of several steel companies from France, Luxembourg, and Spain. Despite the companies' different cultures and histories, they both exhibit a strong commitment to best-in-class governance. When ArcelorMittal Chairman, Joseph Kinsch, and President and CEO, Lakshmi Mittal, spoke to its Board of Directors, the message was the same - the new company should have the best governance standards – the best practices in governance and corporate responsibility of any company in the world. I do not believe that many companies would have delivered that type of message five or ten years ago.

Governance reform is raising the standard for companies in the U.S. and abroad. While there is little disagreement that the spirit of this reform has been extremely beneficial, I believe some of this reform has fallen into this category of "checklist governance" that emphasizes meeting prescribed requirements and checking off the boxes. Without more, this narrow view of corporate governance may fall short of the mark.

After an organization has met or established basic requirements, and has ensured sufficient independence of its board of directors, that organization still may not have a fully effective governance process. Implementing the highest quality governance standards involves determining: (1) what it takes to have an effective board; (2) what is expected from directors; and (3) how the organization will ensure that these components will work well together.

A company's directors often come from different fields, organizations and industries to form a collective, collegial group. The directors may run other companies, be presidents of universities or foundations, or be former government or military officials. The number of board members can range from fewer than seven to more than seventeen, and it is imperative that a significant number of them be independent under the standards set by regulators or exchanges. How does a company ensure that a board functions appropriately given the directors' diverse perspectives and experience? The most effective way is to educate and prepare the Board via Board and committee meetings, site visits, tutorials, and the distribution of key materials, for when it is called upon to make the most important decisions. Such important decisions include the selection or replacement of the chief executive officer, the management of crises, and decisions regarding other personnel, regulatory, and key strategic issues.

Being an effective board director requires unusual qualities. I believe one of the hardest attributes for directors to perfect is understanding when to speak and when to be quiet. Some directors hurt their credibility by talking too much or making assertions in areas of the business that they may not fully understand. Others diminish their potential involvement by saying nothing, even when they could make a valuable contribution. It is important for directors to find the right balance and to express their views at the right moment and in the right context.

For the board to function well, it must be prepared, have the right mix of members and have the capacity to reach a collective decision with the right data and inputs. In my view, this is much more important to quality governance than having all the boxes checked.

I will never forget the advice that Gertrude E. Michelson, a longtime director at General Electric and other major corporations, gave me when we met roughly thirty years ago. She said that the most important thing for a director to do is to make site visits and get to know the people who run the plant or facility and understand what they really think, instead of merely talking with the senior executives. Additionally, Citi Chairman and CEO Chuck Prince gave me similar advice when I joined the firm. Even though I do not directly oversee any of Citigroup's business operations he encouraged me to visit with our people who run our branches, offices, and operations around the world.

In fact, I visited a new Citibank branch here in Boston this morning. We have recently opened bank branches in this city for the first time, even though some of our other businesses, including Smith

Barney and CitiCards, have been here for years. Our Boston branch is a new office that is implementing a new approach, by offering banking and investment advice within the same branch by placing Smith Barney and retail Citibank offices under the same roof, and the level of enthusiasm from the staff has been terrific. Meeting with our employees "on the ground," who interact with our clients, has been an important part of my educational process as a Citi officer. That educational process should be continuous to produce good directors and good boards.

Overall, corporate governance will continue to be a critical focus for companies, and there will be continued debate and reform as different issues arise. Let me briefly discuss some of the current hot topics.

To begin, there is the issue of shareholder proxy ballot access for the election of directors. The Securities and Exchange Commission (SEC) is considering opening up the proxy, and there is a big push in that direction from shareholder activists, unions, and institutional investors.

Also, there is significant discussion surrounding executive compensation and the disclosure rules regarding compensation. The new tables, which will be available in 2007 proxy statements, are intended to provide more transparency about senior executive compensation, benefits, and perquisites. This is a good thing, although the SEC is still fine-tuning it to make sure the reforms achieve the desired goal of increased transparency.

Finally, as I visit with regulators around the world, I suggest that there ought to be more effort put into regulatory convergence around the world to produce greater cooperation among financial service regulators and greater consistency of regulations. Many financial service companies work in a global economy and deal with different and sometimes conflicting regulatory standards and directives. The inconsistencies in the regulatory and competitive environment should be the subject of greater consideration and eventual modification.

I began today's speech by describing the importance of corporate governance, ethics and controls because corporations play very complex and varied roles in our society. They are answerable to many different constituencies including, but not limited to: employees, shareholders, regulators, governments, suppliers, and communities. Therefore, I believe that the most successful corporations will pay attention to not only playing by the rules, but also to representing a set of values and practices that will earn them respect in the different markets in which they do business.

As corporate leadership wrestles with these issues, institutions like Boston University's Morin Center for Banking and Financial Law, and comparable centers at other institutions of higher education, have a very important role to play in shaping the discussion. The interaction among the legal, business, and educational communities is crucial if we intend to keep improving the values and practices in this area around the world. Thank you very much.