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THE GOVERNANCE OF AMERICAN MULTINATIONALS

Remarks by

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This evening I want to open a discussion that begins where Sarbanes Oxley leaves off. My starting point is that SOX is an important part of the American corporate governance landscape and will continue to be, notwithstanding legitimate debates about its benefits and costs. But this evening, I'd like to set aside SOX as well as some other hot-button issues such as CEO compensation and shareholder democracy. In doing that I don't want to minimize the importance of what is preoccupying Corporate America today. Rather, I want to look ahead, say, 5-10 years to the emerging governance agenda for American companies doing business in the global economy. They include those that are deeply involved in foreign countries by virtue of investment, those who will soon be, and even those who will be on the receiving end of mergers from foreign firms. There are many such companies, of course, and everyday there will be more of them.

My central point is straightforward: The Boards of Directors of American multinationals are going to face a formidable array of challenges for which many are not prepared. Put another way, among US companies in the global arena there will be a huge gap between what companies *need* by way of board oversight and what they will *have the capacity to do*. I'd like to outline what some of the issues and suggest some changes in how boards might function.

SOME PREMISES ABOUT BOARDS

Before I go too far, here are a few of my strong biases.

I believe in active, engaged boards that don't create strategy but participate in its development, approve it and monitor it; boards that advise senior management on a wide range of critical issues ranging from acquisitions to financial structure; boards that evaluate the performance of senior management, approve pay levels, participate in discussions regarding the attraction and retention of talent; boards who take responsibility for succession planning; and so forth.

I believe that the mission of boards is to insure the sustainability and profitability of a company. Of course, boards are must be representatives of shareholders and must above all be dedicated to protecting their interests. But in today's world, this is no simple matter given the broad range of shareholders themselves – from retirees to hedge funds – and their divergent interests. However, I conclude that the board's job is to help the company create long-term value, and that this means it must take into account the welfare of other constituencies – employees, customers, suppliers, and communities – whose activities greatly influence value creation, not just for the next few quarters but for the next few decades. Because the average CEO is likely to be in office only several years at best, it's not he or she but the directors who can

realistically be expected to be the long-term stewards of the enterprise.

I also think its worth underlining that as complex as overseeing a corporation is today, it's a cop out to say that board members are doing their duty if they ask the right questions. The reason is that you have to know a lot about a subject to do that, and especially to know when there is a crucial follow up question to pose, and you have to be more than just intellectually curious to be able to evaluate the answers that are forthcoming from management. Likewise, while directors have to depend on legal and counting professionals, in the post-Enron era it has been shown in spades that these groups cannot be relied on for judgment and wisdom to the extent once thought, nor that relying on their advice alone is an excuse for making bad decisions.

I also sense that we are at an inflection point in the way that corporations will be relating to society. It will no longer suffice for companies to hold the myth that their job is to make money for their shareholders and that everything else by way of building a societal infrastructure is the job of government. In 2002, I wrote a book about this called "The Politics of Fortune: A New Agenda for Business Leaders" and its sole purpose was to make that point and illustrate it many ways. What I said then, and what I think will be increasingly true in the next decade, is that the relationship between business and its broad constituencies, including governments, will be changing in a way that forces companies to take a much broader view of their role in addressing the public's concerns – health and health care, retirement anxieties, clean air, energy efficiency, poverty reduction, human rights, for example. The essence of what I wrote in my book was expressed well by Sam Palmisano, chairman and CEO of IBM. "All business today faces a new reality," he said. "Businesses now operate in an environment in which long-term societal concerns – in areas from diversity to equal opportunity, the environment and workforce

policies – have been raised to the same level of public expectation as accounting practices and financial performance.”

Nothing I say should detract from the responsibilities of a CEO and his or her management team. Boards do not manage companies; they oversee them. Boards cannot know anything close to what the CEO and management do. Boards cannot execute strategy. But I maintain that Boards can't do their job without certain in-depth knowledge of the business and the environment in which it operates.

I mention all this because if you do not subscribe to the basics of what I just outlined, you will disagree with everything I am about to say. If you think that the job of a board is primarily to comply just with the literal interpretation of the law, you will consider what follows as absurd. If you hold the view that the board can assure itself that management has all the right processes and people in place without having the knowledge of an industry or a geographical region to delve deeper into what management is doing, then we are living on different planets. This is not to assert that I'm necessarily right, for many talented people with significant corporate leadership experience have a much more modest view of what directors should do or what companies should be. I respect their views. But my description of the challenges American boards will face, and the changes that they will have to undergo, derive from a robust perspective of their functions and responsibilities.

By the way, in focusing on US companies, I do not mean to say that their competitors from other countries have better or more internationally capable boards. I am focusing on American firms just because we have predominantly an American audience tonight. I am just enough of a chauvinist to believe we should have the best boards anyway, but also believe that even if we do, that doesn't make them good enough.

GLOBAL SETTING

With that as background, I will turn to the global setting that American companies and their boards will be operating in this next decade. Here are some of the key features:

- More and more US companies will be involved in other countries, not just by exporting and importing, but by setting up operations abroad, including substantial outsourcing of production and services. This is a reflection of rapidly growing American links with the world economy, epitomized by the doubling of the volume of total US trade in the past ten years to \$3.3 trillion in 2005. Already a large number of the Fortune 500 earns over 30% of their revenues from abroad. In 2004, moreover, the direct investment of American companies abroad reached \$229.3 billion annually, about 300% increase from 1994. The trend towards increasing globalization of US companies is bound to continue, too.
- The penetration by US companies of foreign markets will become deeper. This is because of fierce global competition to satisfy the local needs and demanding expectations of citizens everywhere. Look for the much more of the development of products and services to be geared just for customers in foreign locations; for more of the marketing to make products and services appear local in origin; for senior management to come from abroad; for recruiting of talent to come more from local sources; for R&D itself to be conducted overseas; and for companies to go to extraordinary lengths to be good local citizens. Given the possibility for anti-Americanism, look, too, for less overt identification with Uncle Sam. Look, too, for companies' shareholder base to become more globally diversified, too.

- The competitive environment will be characterized by hyper-competition.” Every component of the chain of operations will be under stress from someone doing just that one specialized job.
- Beyond that, a new class of competitor will be arising – the emerging multinational company from a developing country, like South Korea’s Samsung, Mexico’s Cemex, India’s Infosys, Russia’s Gazprom, or China’s Huawei. A firm in which I am a partner, Garten Rothkopf, has done proprietary research of these companies and has identified over 500 with sales over \$1 billion. Some are publicly listed, some are state-controlled, some are privately operated by families. But in the aggregate, this group is likely to change the global corporate map of world class companies – and soon.
- In fact, the single biggest global challenge that American companies will face will be in emerging nations such as China, India, South Africa, and Brazil. These markets have moved from the periphery to the center of the global economy. In 2004, the output of emerging markets contributed about 50% of the world’s GDP (at purchasing parity calculations.) Over the last 5 years, they have contributed over a third of total domestic demand in the world economy. Over the last decade, their share of world trade has increased from about 27% to 33%. In the same period, foreign direct investment in them has increased by 92%. All these trends are set to intensify because emerging markets are growing 2-3 times as fast as developed countries.
- And these markets are not just expanding and opening up, but their policies have improved enormously over the past several years, their needs for infrastructure are estimated to be some \$3 trillion over the next decade, and the potential to

sell consumer goods are illustrated by the fact that consumer lending in emerging markets has more than tripled in the last four years to \$477 billion, and by 2009 it is expected to double to nearly \$1 trillion.

It's not surprising then that GE has said that 60% of its revenue growth will come from emerging markets; nor that Wal*Mart has established 259 stores in Brazil since 1995; nor that PepsiCo has exceeded Coke in capitalization with a strategy that has focused on emerging markets; nor that Intel has not only been ensconcing itself in China and India, but also Costa Rica and most recently Vietnam; nor that Procter &Gamble is at the forefront of developing special products for poor populations such as low costs packets of powder to purify water; nor that FedEx has taken on deliveries throughout China, including intra-Chinese mail; nor that Home Depot, which has heretofore confined its overseas operations to NAFTA has made a major foray in China with a large acquisition of a chain of stores; nor that 3M has identified emerging markets as their priority growth area.

Jeff Immelt has been saying that one day GE might have 50,000 employees in China, compared to the current 12,000. I thought that was an amazing statistic. Then I saw that IBM already has many more than 30,000 in India.

But these emerging markets are relatively unfamiliar territory when it comes to political systems and social and cultural preferences. Their politics and their economies will be more volatile than those of, say, Germany, Japan or England. It's not just the economies that are in transition but so are their entire societies. US companies will be wrestling with different laws and regulatory pressures. They are going to be grappling with a wide range of tricky issues. Think of Yahoo!, Google and Microsoft in China; think of oil

companies having to hire their own often repressive militia to protect their operations in countries like Nigeria; think of Pfizer doing clinical trials in India (and the prospect of something going wrong.) Truth is, American firms may well be caught in the crosshairs of great social unrest in many emerging markets where income disparities have been growing alongside massive accumulation of riches by a few, and where these tensions are aggravated by the ability of modern communications to make everyone aware of the differences.

- While US companies will have the opportunity to expand into new markets, they will face a number of serious global risks. In my view, there is in process a resurgent nationalism spreading around the world, including in our own country, that spells protectionist trouble for global trade and investment. At a minimum, the climate for mergers and acquisitions may become much more politically sensitive around the world. There are enormous – even unprecedented -- economic imbalances that could lead to serious financial turbulence. And of course there are geopolitical risks – including terrorism, health pandemics, turmoil among major ethnic groups, and environmental catastrophe.

SPECIFIC CHALLENGES TO BOARDS

This is a very cursory picture of what US firms will be dealing with. I can't give you a complete picture of globalization in a few minutes. But I did want to set the stage for some of the issues that will fall on the plates of directors. I am not alleging that any of these issues is totally new, only that they will become more intense and envelop many more companies.

Let's begin with issues of strategy and organization. Boards will need special competence to provide active oversight of global strategies. This could include the following issues:

- Overseeing strategies that reach the billions of new customers in the emerging global middle class, who, despite their relatively well-off status in their countries, are not the same as America's middle class. There is also the challenge to reach those further down the income ladder, a group that is comprised of billions of people who live on just a few dollars per day. This "bottom of the income pyramid" focus is likely to be among the most important strategic innovations for MNCs, but every aspect of it is light years away from the experience of most US directors.
- Making a judgment about a company's complex global supply chains and sourcing strategy. This entails consideration of structure but also physical security, and it is a very rapidly changing "science."
- Evaluating the benefits and liabilities of outsourcing high end R&D. Many American companies are transferring their crown jewels of knowledge. Perhaps they have no choice. But how this is done, where it is done, and with what protections and political sensitivities in the US would be a challenge to any leader. Perhaps it is too much to expect directors to take account of national policy implications of outsourcing R&D, but sooner rather than later this may become a big issue for companies and the US government.
- Assessing how a company should enter or expand into another market, whether alone, by alliance with another company, etc. Hook ups with established European and Japanese companies are one thing, and a lot of knowledge and experience exists on this score. But combinations with emerging multinationals from developing nations could present a much bigger challenge because they are often less transparent, often tied to their governments, and often

schooled in business practices that are much different than most US executives have had experience with.

Second, there is the challenge of overseeing human resources. Boards are now charged with keeping an eye on top talent, not just the CEO but senior executives, also. But in the future the span of these people will be much greater.

- The board is likely to have to evaluate the people who run a company's subsidiary in India or China, because that unit could well be more important to a company's future than many other parts of a company close to home. It will be harder to assess the performance of a Chinese national running the Greater China region, and to review his compensation, than to do the same with, say, the executive V.P. in charge of the worldwide engine division in Chicago. Yet this same leader might be in line to run the entire company – or, in any event, should be in line for that.
- In addition, the issue of cultural diversity will loom ever larger in US MNCs. For boards that themselves are generally very homogeneous and struggling to add women and people of color to their own ranks, working with senior management to make national, cultural, religious and gender diversity a critical priority throughout the worldwide operations is not just difficult, not just a politically correct thing to do, but essential to the competitiveness of the multinational enterprise. A recent Wall Street Journal article pointed out the great lengths that PepsiCo and IBM have gone to diversify their management and the impressive gains that new insights to marketing and product development make to the bottom line results in the US and increasingly abroad. too.

Third is accounting and finance. Two issues are illustrative of the challenges that boards will face in terms of the knowledge they will need to have.

- In the next few years, in addition to US GAAP accounting, boards will need to be familiar with new International Accounting Standards. Now we all know that our own system is obscenely complex. But the SEC has now agreed that there will be some convergence with international standards. Not complete convergence but some. Perhaps one day there will be one global system, but in the next decade or two there will be a highly complex transition and boards are going to have to deal with a number of new rules.
- There are other new complications, too, regarding the financing of large foreign subsidiaries of US companies. It used to be that most financing was provided by the parent company. But as local markets gain in sophistication, there will be many other options. These could be big deals with big risks that require audit committees understand, say, the financial regulatory system in South Africa or South Korea.

Fifth, there will be a bevy of political, social and reputation issues – call it corporate citizenship -- but it's much more than that. The increasing penetration of foreign countries by US MNCs, coupled with the higher expectations on the part of societies everywhere about what a company should do means that companies and their directors are going to be dealing with a host of issues for which they have little experience. I mentioned some examples before. But what's changing is this: minimal, defensive responses to societal pressures on the part of companies won't suffice. Coca Cola found that out in Europe; Nike found that out in Asia.

Fact is, companies will have to acquire a more sophisticated understanding of deep seated trends and get ahead of the curve. They will be doing this in a world where government capacity to manage complex economic and social problems, such as health or education, is likely to be strained to the breaking point, and where corporations will be looked at to help. They will be doing this in a world where democracy and freer speech are exploding, where the twenty-four hour media—including the growing blogosphere -- is looking for any news to blow up, and where thousands of single-issue non-governmental organizations are watching them. The non-financial activities of MNCs will be measured, too, by a multiplicity of new global codes for governance. There are also a growing number of organizations such as the Global Reporting Initiative that are developing metrics to measure how a company is reducing its greenhouse emissions, how it is dealing with labor standards, or what its record is with protecting human rights. Bottom line: the world is forcing unprecedented responsibility on MNCs for more than generating profits and unprecedented transparency on the way they do it.

Fifth, enterprise risk management. Everything that I have discussed so far leads to more pressure on a company's having the most robust possible total enterprise risk management system. I realize that many corporations are well on their way, but I doubt whether they are doing enough and whether many boards have the capacity to assimilate the knowledge they need. Since the end of the Cold War, in my view, the world has become a more complex and more dangerous place for companies to operate. There have been many good years up to now, admittedly, but some of the factors – enthusiasm for more open trade and investment, for example, or low cost capital – may not characterize the next decade or two. The requirement is not just to categorize and rank the risks, but to understand how they may be connected; it is to have in place policies that not only mitigate risks but are designed to recover from unanticipated disasters. The board of tomorrow, in

my view, will not presume to take this task on without some of the following:

- involvement of outside experts who can link a company's business strategy with the political, economic and social factors making the world a more risky place
- a means of stress testing its own assessment of risks with sophisticated out-of-the-box scenario planning

WHAT CAN BE DONE?

How many Boards have the capacity to address the challenges that I just described ? Of course, some do. GE, for example, has a number of directors with extensive international experience – such as Sandy Warner or Ralph Larsen. Citigroup has people such as Bob Rubin and Ken Derr. Intel, IBM, PepsiCo – there are certainly some exquisitely qualified people doing an excellent job. But the reality is that when you consider the numbers of US companies that are becoming global in one way or another, there are relatively few business leaders with the requisite experience, and many who do have it – namely, sitting ceos of MNCs – are reducing their board activity outside their own firms such that the pool may be getting smaller.

I know how hard it is to change Board culture and mentality. I understand, too, that it is not realistic to ask existing board members, whose time commitments have mushroomed these past few years, to send much more time on governance than they already do. It's also the case that finding executives from abroad to serve on American boards is extremely difficult, given the time and travel requirements. So my "proposals" are couched with these kinds of constraints in mind.

So what could be done to improve governing capacity for global American firms? Here are some thoughts we might discuss.

Each has its pros and cons, but my aim is to provide not a silver bullet but a framework for discussion:

The first idea is the simplest: just make more of an effort to hire retired CEOs or other senior executives, perhaps even retired senior diplomats with substantial international experience, to enhance a board's existing talents and experience. This could be augmented by holding more Board meetings and briefings on location abroad, receiving more extensive briefings from the field, instituting a system in which board members are each obligated to travel to certain foreign locations regularly and observe for themselves what's going on. A few companies do all this, but the requirements will become more intense in the future.

A more far reaching alternative would be to rethink how boards function. Instead of the entire board meeting six times a year, they would get together in their entirety say half that much and some of the freed up time would be used for more intensive committee work. To this end, more committees would be created to deal with some of the issues I have discussed. These added committees need not be permanent; in fact, it might be better to call them "task forces," because they could be established for finite periods of time to examine specific issues. For example, in some companies one could envision a task force on "Strategy Towards China," or "Global Supply Chain and Outsourcing Strategies." The task forces themselves might include outside experts that are not on the board. If all is satisfactory in the task force's view, it could make a written informational report to the board. If there are concerns and issues for decision, then the work of the task force could become a board agenda item.

There is also the alternative of either establishing or strengthening existing regional advisory boards, without of course giving them fiduciary responsibility. To the extent these boards already exist, many are quite ceremonial. They are filled with

people with impressive titles and/or high level government experience in their respective countries, and they meet once or twice a year and talk over big global issues with tangential relationships to the core business. Individual members are used to help with business introductions or perhaps to help with regulatory authorities in tricky situations. But there is an alternative to these limited functions, and that is to make these boards smaller, more professional, more active, and focused on the company's core concerns.

How many of these advisory boards would be necessary depends on the nature of a company's business. But for some companies, you could imagine an "Asian advisory board," for example, that meets three times a year and that itself has task forces that looks at issues like "regulatory risks in the region," "scenarios for China's economy," or "human resource strategy including identification of the region's top talent at an early age." To make these committees function, monitor their work, and bring their insights to the directors themselves would require some organizational innovation on the board. If a company has a non-executive chairman, he could do it. Otherwise, a member of the board could become vice chairman with international responsibilities.

CONCLUSION

I am not saying I have the answers, only that there is a growing problem worth thinking about. To me, the trick with any problem is to size it correctly, and to the extent boards are going to be responsible for real oversight of American MNCs, there are real questions surrounding their capacity to do so. This is not about intentional negligence, nor about ignorance of the problem. It's about the real world of governance where the demands on directors are escalating, and where the complexities of globalization add

many more burdens that risk outstripping the ability of our corporate governance system to respond adequately.

At the heart of everything I said is this: In the post-Enron era, we have necessarily been preoccupied with the establishment of laws and processes that make sure that boards do their job. But nothing has changed with regard to the fact that directors need expertise, experience, and information to do that job. The expansion of US firms in the global economy will stretch the need for all three, presenting American corporate governance with some awesome challenges.

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