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September 15, 2009

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington DC 20549-1090

Via email: rule-comments@sec.gov

Re: File No. S7-13-09; Release Numbers: 33-9052, 34-60280; IC-28817

Dear Secretary Murphy:

On behalf of the Ethisphere Institute, a leading research and measurement institution in the field of examining correlations between business ethics and corporate performance, we hereby submit comments on the Securities and Exchange Commission's proposed rule, entitled "Proxy Disclosure and Solicitation Enhancement," File No. S7-13-09.

Before providing our commentary, we would like to make three fundamental observations derived from the Ethisphere Institute's research.

1. **Companies that emphasize compliance and ethics outperform the market—both in terms of upside performance as well as in avoidance of catastrophic investor loss.**

The Ethisphere Institute routinely examines the compliance, ethics and risk programs of thousands of corporations, the majority of which are publicly traded. The Institute scores these companies' programs and regularly publishes its findings.[1]

In researching and scoring these programs, Ethisphere Institute has discovered certain correlations between a company's performance and its approach to ethics and compliance. The research indicates that companies with greater transparency and stronger programs in compliance, ethics and related risk management outperform their industry peers, when measured over a minimum 5-year period.[2] These results and similar correlations have been recognized broadly in the private business community, such as by the chairman of Deloitte.[3]

[1] In Fall 2009, all companies' scores will be made publicly available through the Institute's Ethicenter at www.ethisphere.org.
[2] "2008 World's Most Ethical Companies," Ethisphere Magazine 6 (Q2 2008): 17-24.
[3] Sharon Allen, The New ROE: Return on Ethics. www.forbes.com (Aug 10, 2009)

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Of equal importance, however, was that increased focus on ethics brings protection against downside risk. The financial crisis, which enveloped the global economy in 2008 and 2009, provided a perfect laboratory to positively prove the correlations in the Ethisphere Institute's research.

Every year the Ethisphere Institute designates a select number of companies that have the strongest ethics and compliance commitment as being the "World's Most Ethical Companies" (WME). The banking industry has been one such industry measured. When examining the history of WME Companies designations for the banking industry, not a single WME bank failed nor even required governmental support in the financial crisis.[4] However, a number of the more poorly scoring banks did. This is proof positive that a strong ethics and compliance program reduces catastrophic risk for investors.

2. **The Board is typically unaware of most malfeasance that occurs within an organization.**

Our research indicates that commonly the board of directors is isolated from the actual workings of a corporation's compliance and ethics function. Although an increasing number of boards require corporations to disclose all inquiries and reports placed by employees to any anonymous reporting channels (as instituted under mandate by Section 301 of the Sarbanes-Oxley Act of 2002), there is a high likelihood that most risky or illegal behavior remains unreported. This is corroborated by recent independent research which indicates that 42% of employees who witness illegal behavior or misconduct in the workplace do not report it.[5]

Compounding the problem is that the person who may most likely learn about illegal or improper behavior occurring, the Chief Ethics or Chief Compliance Officer, commonly does not have an open and direct channel to the CEO or board to discuss concerns. In some organizations the person responsible for the compliance and ethics function reports to the General Counsel or Chief Legal Officer.

The Ethisphere Institute has found that actively engaging the CEO and board in the ethics and compliance function greatly reduces potential investor-harming fraudulent behavior.

Increasingly, the government regulatory and judicial communities are beginning to realize this as well.

For instance, every single corporate deferred prosecution agreement entered into by the U.S. government in 2008 included a revamp of the

[4] "2009 World's Most Ethical Companies." Ethisphere Magazine 9 (Q1 2009): 19-27.
[5] *The 2007 National Business Ethics Survey*, The Ethics Resource Center.

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offending corporation's compliance and ethics program. Many of these overhauls included specific involvement of the senior leadership team and board.

One such agreement, between the Department of Health and Human Services and Pfizer, requires that the company establish a Chief Compliance Officer who reports directly to the CEO, updates the audit committee directly at least quarterly, and has unfettered access to the board on any issue at any time.[6] As part of its responsibilities, the audit committee of the board is expected to oversee and regularly evaluate the effectiveness of the company's compliance program.[7] Furthermore, the audit committee is expected to adopt a resolution for each reporting period under the Corporate Integrity Agreement that attests to proper inquiry and oversight.[8]

### 3. The next generation of management needs an emphasis on ethics

As legendary management guru Peter F. Drucker once told us in a private counseling session, *"People often ask me how I can predict what happens in business in the future. I tell them that I can't. It's simply all about demographics."*

The demographics are not necessarily in our favor when it comes to ethics in business. The majority of high school students admitted cheating on a test in the past year.[9] Furthermore, as studies demonstrated, 75% of MBA candidates admitted that they cheated in order to get into business school, and convicts in 11 minimum security prisons scored *better* than MBA students on an ethical dilemma exam.[10] In a few short years, today's newly minted MBAs will be tomorrow's corporate CEOs.

[6] *"The Chief Compliance Officer shall be a member of senior management of Pfizer, shall report directly to the Chief Executive Officer of Pfizer, shall make periodic (at least quarterly) reports regarding compliance matters directly to the Audit Committee of the Board of Directors of Pfizer (Audit Committee) and shall be authorized to report on such matters to the Audit Committee at any time. The Chief Compliance Officer shall not be, or be subordinate to, the General Counsel or Chief Financial Officer."*, Corporate Integrity Agreement between the Office of Inspector General of the Department of Health and Human Services and Pfizer Inc., dated August 31, 2009.

[7] *"The Audit Committee shall meet at least quarterly to review and oversee Pfizer's Compliance Program, including but not limited to evaluating its effectiveness…,"* Ibid.

[8] *"For each Reporting Period of the CIA, the Audit Committee shall adopt a resolution, signed by each individual member of the Audit Committee, summarizing its review and oversight of Pfizer's compliance program and compliance with Federal health care program requirements, FDA requirements, and the obligations of this CIA. At minimum , the resolution shall include the following language: 'The Audit Committee has made a reasonable inquiry into the operations of Pfizer's Compliance Program, including but not limited to evaluating its effectiveness and receiving updates of its Chief Compliance Officer and other compliance personnel."* Ibid.

[9] "2008 Report Card on the Ethics of American Youth." Josephson Institute of Ethics. http://charactercounts.org/pdf/reportcard/2008/data-tables_gender-demographic-breakdowns.pdf

[10] Cited in Stephen Covey, *The Speed of Trust* (New York: Simon and Schuster 2008), p 12.

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Rather than new rules and regulations, businesses and the investing public will be well-served to have educational institutions emphasize general business ethics overall.

## SPECIFIC COMMENTARY RECOMMENDATIONS

We at the Ethisphere Institute applaud the SEC's effort to expand and clarify corporate governance and compensation disclosures. When companies provide further and understandable transparency about these transactions, investors will be able to make better decisions. Our commentary specifically focuses on the role of the board in risk management, compensation disclosure on business units that are significantly more profitable than others within a corporation, and director background disclosure.

### Commentary 1: Expanding Disclosure on Board's Involvement in Risk Management

The SEC writes…

> We also are proposing to require additional disclosure in proxy and information statements about the board's role in the company's risk management process. Companies face a variety of risks, including credit risk, liquidity risk, and operational risk… Given the role that risk and the adequacy of risk oversight have played in the recent market crisis, we believe it is important for investors to understand the board's, or board committee's role in this area. For example, how does the board implement and manage its risk management function, through the board as a whole or through a committee, such as the audit committee?

We recommend that the SEC expand this definition beyond the risk management process to include what sort of oversight role the board plays for the compliance and ethics program and function. Certainly the risks presented by compliance failures are equally important to other risks.

For example, take AIG. As the Institute noted in December 2008, the problems within the financial structured products unit of AIG were not unknown. In fact, the chief compliance officer of the unit, Joseph W. St. Denis, raised these concerns but was kicked out of at least one meeting directly related to the company's valuation of its Super Senior Credit Default Swaps for fear that he would "pollute" the process by bringing transparency.[11] [12]

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[11] Alexander F. Brigham and Stefan Linssen ,"What Went Wrong Ethically in the Financial Collapse?" Ethisphere Magazine, 8 (Q4 2008): 19-23.
[12] Joseph W. St. Denis, Testimony to members of U.S. Congress. Oct 4, 2008. http://oversight.house.gov/documents/20081007102452.pdf

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In contrast, The Ethisphere Institute has determined that leading organizations have the compliance and ethics function report to the CEO, with a dotted line of authority to the board of directors. Recognizing that compliance and ethics issues are distinct and oftentimes very different from financial audit issues, some boards even have a board-level committee separate from the audit committee and dedicated to the compliance and ethics function. These sort of best practices are risk-reducing. Therefore, we recommend that companies that adopt such practices should be encouraged to disclose such to investors.

**Commentary 2: Increasing Criteria Specificity Around Business Units That Are "Significantly More Profitable"**

The SEC writes…

> We believe that disclosure of a company's overall compensation policies in certain circumstances can help investors identify whether the company has established a system of incentives that can lead to excessive or inappropriate risk taking by employees….

And highlights one of the existent factors which could require additional compensation disclosure as:

> At business units that are significantly more profitable than others within the company

We applaud the SEC for recognizing this area of risk. As the Ethisphere Institute pointed out in December of 2008, the company should probably scrutinize the most profitable and highest margin division or highest performing individual, rather than turning a willful blind eye to potential risk areas. This was the case with AIG, as Joseph Cassano's AIG Financial Products Unit was rewarded with a relatively hands-off approach from senior company leadership. By February of 2008, Cassano's department had racked up $11 billion in losses.[13]

To encourage more companies to adopt this disclosure, we recommend that the SEC provide additional and more specific guidance in how to determine what is considered "significantly more profitable," such as:

- Division size and profits relative to the overall enterprise profits and scale
- Growth of a business unit over a series of years that occurs at a grossly disproportionate rate versus other business units

[13] Alexander F. Brigham and Stefan Linssen, "What Went Wrong Ethically in the Financial Collapse?" Ethisphere Magazine 8 (Q4 2008): 19-23.

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**Commentary 3: Including Positive Integrity Indicators**

The SEC writes…

> Item 401 requires disclosure of specified legal proceedings over the past five years involving directors, executive officers, and persons nominated to become directors that are material to an evaluation of the ability or integrity of any director, director nominee or executive officer. In 1994, we proposed rules that would have increased the reporting period for legal proceedings from five to ten years. Because the legal proceedings listed in Item 401 reflect upon an individual's competence and character to serve as a public company official, we believe it is appropriate to extend the required reporting period from five to ten years in order to give investors more extensive information regarding an individual's competence and character.

The stated intent of the SEC in this disclosure is to aid in the evaluation of the ability or **integrity** of a director. While certainly legal proceedings against the director are one proxy, this is only one proxy and serves as a negative control. Positive factors are equally important indicators that should be disclosed.

Therefore, the Ethisphere Institute recommends that, in addition to proceedings disclosure, the SEC encourage the disclosure of positive factors, such as leadership positions related to ethics or compliance activities or titled job experience in ethics and compliance.

**Commentary 4: Expanding Director Disclosures Beyond Risk Assessment Skills to Include Compliance and Ethics**

The SEC writes…

> We are proposing that, for each director or nominee, disclosure be included that discusses the specific experience, qualifications or skills that qualify that person to serve as a director and committee member. The types of information that may be disclosed include, for example, information about a director's or nominee's risk assessment skills and any specific past experience that would be useful to the company.

While enhanced risk management certainly would improve corporate governance, the Ethisphere Institute holds that having a board member who is qualified to understand what constitutes a strong corporate compliance and ethics program **and who has an ability to evaluate its effectiveness** would be an overall enhancement of good corporate

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governance. Expanding proposed disclosures to this end would be a step in the right direction.

In our opinion, the SEC may want to go so far as to visit whether an "ethics and compliance" expert should be required for each board of directors. Just as the Section 407 of the Sarbanes-Oxley Act of 2002 stipulated that each board have an "Audit Committee Financial Expert" (as later defined by the SEC), efforts to bring a greater emphasis and awareness of business ethics and compliance into the board room would benefit and bring greater security to the investing public.

**Conclusion**

Ethisphere Institute recommends that taking these steps to enhance disclosure around ethics, compliance and integrity will be of service to the investing public and reflect an increasing trend and interest in the business community.

It is important to note that the Ethisphere Institute does not believe in adding unnecessary regulatory burden to corporations—nor would our commentary and recommendations do so. Put simply, emphasizing ethics in business is a fundamental good practice and benefits companies and the investing public alike.

Sincerely,

/s/ Alexander F. Brigham
*Executive Director*
The Ethisphere Institute

/s/ Stefan Linssen
*Editor-in-Chief*
The Ethisphere Institute

/s/ Stephen Martin
*Managing Director*
The Ethisphere Institute

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