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Chairman of the U.S. Securities and Exchange Commission

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Donaldson: Good evening, and thanks, Dick for your kind introduction. And Dick, I must say you actually look pretty good for having spent the past couple weeks dodging the arrows coming your way. Speaking from experience, I know you've got a tough job. To be sure, there was no shortage of arrows tossed my way during my tenure at the New York Stock Exchange. Take heart, though, I somehow made it out alive, but expect that before my days are done at the SEC, I'll have plenty of arrows slung my way too.

Seriously, though, Dick deserves our appreciation for the dedication he has shown the NYSE and American investors over the past 30 years. Thank you very much, Chairman Grasso.

And thanks also to the Economic Club of New York for inviting me to speak. I consider it a great privilege to represent the SEC here tonight, particularly at such a critical time for our nation's economy and financial markets. Before I go any further, I feel obliged to make the standard disclaimer that the views I express today are my own and not necessarily those of the Commission, or its staff.

I have had the good fortune of hearing many of the nation's and the world's leaders speak at this podium over the past 40 or so years on issues affecting our markets, our economy, and our lives.

Before this period, I imagine that the most challenging issues presented to the Club since its inception in 1907, other than the obvious hardships that accompanied World Wars I and II, concerned the aftermath of the boom of the 1920s, with revelations of malfeasance that accompanied it, and the depression that followed.

That was an extraordinary time in American history, and it left a permanent impression on the landscape of the American financial system - most notably in the passage of the Securities Acts of 1933 and 1934 and the founding of the Securities and Exchange Commission itself.

In many ways, the runaway bull market of the 1990s and the scandals that have come to light both on Wall Street and throughout corporate America since the bubble burst, resemble the market boom of the 1920's and the period after the crash of 1929. In both cases, as the band played faster and faster, standards continued to deteriorate, and in both periods, those deteriorations came to light in a dramatic fashion that prompted a major reexamination of purpose and practice.

There is at least one significant difference: while the country has not witnessed the intense human suffering that accompanied the depression of the 1930's, the downturn in the stock market that began 2 - 3 years ago has directly and indirectly affected far more people today than the crash of 1929. As you know, in the past seventy years, the markets have become a widely accessible alternative for college savings and retirement planning where they once were the investment tool of a fortunate few. All in all, a substantial percentage of the total population - millions of Americans and their families have suffered significant losses in the past few years.

At the outset of my remarks tonight, I feel it is most important to note that currently, there are approximately 15,000 publicly held companies in the United States. Despite the recent attention to malfeasance in corporate America and conflicts of interest on Wall Street, I believe that the majority of companies are run by honest, dedicated people who consistently strive to make good decisions on behalf of their shareholders, employees and other stakeholders and in Wall Street's case, strive to offer investment services in a sincere and transparent way. But, despite long track records of integrity built over the course of many years, as the bubble fever accelerated, standards began to erode, even among the very best and even, I might add, among the traditional gatekeepers charged with ensuring legal and accounting integrity.

As the market boom intensified throughout the 1990's, the appetite for real-time reports of market activity and breathless stock analysis throughout the day grew beyond Wall Street and its professional

observers. Savvy media entrepreneurs saw a golden opportunity and developed new information sources to augment the traditional business pages of newspapers around the country, delivering viewers the latest corporate news via the Internet and multiple 24-hour cable networks.

When the news of scandals broke, these outlets reported them not only as business stories, but also as human interest stories with all the shameful components more typical of the tabloids: glamorous lifestyles, big bank accounts, intrigue, power and victimization. This only fueled the fire of broad-based American outrage with the business community.

Out of that outrage, a general disillusionment with Wall Street and corporate America developed and has continued to grow. In my view, such cynicism is a major threat to the long-term health and growth of our economy. Without the confidence and participation of mainstream America, our markets cannot resume their rightful and necessary place as the engine of American prosperity.

If anything positive can be said about the revelations of malfeasance and the scandals that followed, it is that they forced into the open some fundamental flaws in the way that companies have been doing business. They have prompted widespread calls for reform and for action to seek justice on behalf of those who have been harmed. I hardly need to mention or catalogue to this audience the significant actions that have been taken by state and federal regulators, Congress, the Bush administration or the increased scrutiny that has accompanied them. I'm sure many of you feel that you know them all too well.

While there has been no shortage of commentary on the state of corporate governance in America, it is time to move the discussion beyond the almost-cookie cutter approach that has developed centering largely on the structure of the board of directors. Beliefs about the independence of corporate directors and the structure of compensation, audit and governance committees have become near-conventional wisdom.

I would submit that these obvious reforms are well underway. Some will soon be formalized in long overdue enhanced SRO listing standards as the aroused investor, legislative and regulatory communities have demanded. It is now time to embark upon a more fundamental examination of the core issues involved in a wholly reinvigorated concept of corporate governance.

In many ways corporate governance is like an onion, and no I don't mean that corporate governance is likely to bring us to tears. But it does have many layers, like an onion. As we peel the layers of the onion away, at the core, past the layers of board structure, process, and committee composition, lie some fundamental responsibilities for the Board of Directors. If we expect to see true change in both attitude and practice throughout corporate America, boards of directors must establish a corporate culture; evaluate the meaning of true corporate performance and redefine how it is evaluated and rewarded.

Let me suggest a few fundamental areas for intense Board deliberation and action as the governance debate moves forward.

In my mind, the most important thing that a Board of Directors should do is determine the elements that must be embedded in the company's moral DNA, as one might call it. In humans, DNA encompasses the very building blocks of life and determines or influences almost every aspect of our physical development. So too should the moral DNA of a company.

It should be the foundation on which the Board builds a corporate culture based on a philosophy of high ethical standards and accountability. This culture should penetrate every level of the organization and influence all of the board's decisions including the selection of a CEO and the senior management team who will ultimately ensure that the company's operations reflect its philosophy.

As we move past Sarbanes-Oxley and the requirements, rules and regulations that have come in its wake, it's essential that corporate

boards look beyond the letter of the law and be ever mindful of the spirit of the reforms. By determining what makes up the moral DNA of the company and establishing a culture that puts ethics and accountability first, a company and its Board are less likely to fall into the common trap of mere compliance - where simply identifying a new line of legally acceptable behavior and how to maneuver the loopholes that accompany it passes for a commitment to reform.

Second, the Board must devote continuing effort to the evaluation and understanding of their own group dynamic and the way that affects their decision-making process. At the top of the list of issues to be examined in this context is the balance needed to affect a positive and creative tone to the inevitable tension that exists between the role of supporting the CEO, while at the same time, fulfilling a fiduciary responsibility of oversight on behalf of shareholders and other stakeholders.

Just as we expect that corporate boards should have a constant eye towards evaluating the performance of the company as a whole, its management, and particularly the CEO, there is another place that they should remember to look on a regular basis - in the mirror. Like all groups of people, each corporate board has its own dynamic, influenced by human nature. It's inevitable that their decisions will be influenced not only by their commitment to fulfilling their duties, but also by the group dynamic that comes into play in the boardroom.

A third area for intense deliberation stems from the new demands on corporate directors evolving in the post-Enron era. A greater commitment of both time and attention is expected of all directors, and their actions are being scrutinized more closely than ever before. Therefore, each director must make an honest assessment of the number of boards and committees he or she and, for that matter, Board candidates, can serve on while meeting the heightened expectations of shareholders.

This raises an important point, though. Every board and all interested observers of corporate America need to recognize that there is a balance

to strike in this respect. As a director myself of many companies over the years, I know first hand that directors are feeling pressure to devote more time to their board commitments, delve deeper into the operations of the organization and be generally more skeptical of the information they are being provided. Despite this pressure, we must be careful not to compromise the very nature of the job before the board - to provide strategic guidance and effective oversight. If corporate boards devolve into operating committees, a crucial component of corporate governance is neglected and shareholders, employees, and management are not served well.

The last of my top four areas for board concentration demands that every board evaluate the true definition of corporate performance, the criteria by which they measure it and how it should be rewarded. Lest we doubt that a reexamination of performance is needed at the Board of Directors level, one only has to examine the disconnect between compensation and performance that the current proxy season has revealed.

We are all too familiar with the disturbing syndrome of forcing earnings into an artificial model of apparent uninterrupted quarter-to-quarter growth. This practice is too often dictated by Street research analysts and not by sound corporate strategy, and influenced by the many temptations available to corporate management to "make the numbers work" It is a pattern that pays no regard to the cost of postponed investment or bending of accounting standards.

No organism - human, plant or even corporate animal - grows consistently in such an uninterrupted pattern. Add to this the rewarding of options tied to short term performance and without mandated holding periods that extend beyond the inevitable write off corrections that often follow - and you have a potent formula that screams for a reevaluation of what Boards should mean by true performance.

Not only is a new definition of performance needed - but also an examination of the methods used by outside consultants to assist compensation committees in determining the scale of performance

rewards. Like the children of Lake Wobegon, where all are above average, too many companies want to be in the top quarter in all areas - most particularly compensation - which leads to the constant ratcheting up year by year of executive compensation.

As part of monitoring and evaluating true corporate performance, boards must pay particular attention to the growth and expansion of the companies they serve. Many times during periods of great growth, a boom mentality takes over, and companies often succumb to the temptation to rapidly expand and grow without the necessary regard for long-term strategic considerations. This trend is often most easily seen in an expansion of human resources.

Inevitably, though, when the boom comes to an end and it's time to tighten the belt a bit, the first victims of ill-conceived expansion are the new employees who were brought on during the boom times. While a company's management and even the board may fall prey to the temptation to take advantage of the good times when they can and deal with the consequences later, this cycle is detrimental to a company's long term health and undermines the loyalty and morale of their workforce - the company's most valuable asset. The ability to resist such temptation and keep an eye on long-term performance goals is one of the fundamentals that must be embedded into the corporate DNA that I discussed earlier.

Although we do not have time this evening to delve into what should be the criteria for performance beyond earnings per share and stock price - suffice it to say that the measures of product and service quality, investment in research, employee and consumer satisfaction, and controlled, sustainable rates of expansion and investment, among others are likely to define a more accurate picture of true management performance.

In looking beyond the frequent elements of the corporate governance debate to some of the issues at its core, it's easy to see that the discussion is far from over. And despite some encouraging evidence that new

regulations, legislation and many enforcement actions are beginning to effect corporate governance changes, I'm afraid an examination of the issues raised during this year's proxy season and even a simple perusal of the business pages demonstrate that the message still may not be sinking in.

I'm afraid that at a minimum the ***appearance*** suggests that the seriousness of the malfeasance and the gravity of its consequences are not warranting the kind of changes in behavior they deserve. This is not the right message for Americans to hear from Wall Street and corporate America these days. It illustrates a lack of concern for the undeniable erosion of standards that has taken place and a lack of respect for the individuals who became the victims of that erosion.

As I close, I'll admit that I have spent the past few minute offering lots of free advice. That's one of the things you get to do as Chairman of the SEC. I think they call it the "bully pulpit." But I recognize that my own responsibilities in this area are just as great. Therefore, I will close with a few words of advice for myself, my agency, my colleagues at other regulatory agencies, both state and federal, and for lawmakers.

The power of the American economy is tremendous, and the American spirit of entrepreneurship is an inspiration to the entire world. In our enthusiasm to correct and redress the problems of the past, we must take care that the solutions we propose are calculated and well thought out. We must make sure that we do not throw the baby out with the bathwater, so to speak. To ultimately stifle and inhibit the innovation and entrepreneurial zeal on which the American economy is built, would be just as tragic as the losses that investors suffered in the past several years, and ultimately, investors would be on the losing end again.

Thank you very much, and I will be happy to take questions.