

DealB%k

Another View: MF Global's Corporate Governance Lesson

December 16, 2011

By MICHAEL W. PEREGRINE

Michael W. Peregrine, a partner at the law firm of McDermott Will & Emery, advises corporations, officers and directors on issues related to corporate governance, fiduciary duties and internal investigations.

The demise of MF Global offers a very practical governance lesson. No, it is not how best to find that missing \$1 billion or so. Rather, it is that the corporate chief risk officer or compliance officer is the equivalent of a "protected class" for governance purposes, and the sooner leadership gets that, the better.

The three high-profile Congressional hearings on MF Global this week and last focused on the search for the missing \$1 billion of customer funds, and how company executives could have lost track of so much money. But the more lasting governance lesson may ultimately prove to be whether proper deference was paid to the warnings of the chief risk officer.

News reports about MF Global paint a picture of a dedicated chief risk officer, Michael Roseman, who grew increasingly concerned with the investment strategy of the firm's then-chief executive, Jon S. Corzine, shared that concern on numerous occasions with Mr. Corzine and with the board, clashed with Mr. Corzine and eventually left the company before the "crash" — his qualifications criticized and his warnings apparently gone unheeded. Then, his successor, Michael Stockman, comes on board with a substantially reduced portfolio.

Ouch. These allegations paint an ugly picture; one that is not unique to MF Global or to the financial services sector. Even if the money is found, this characterization, of corporate leadership dismissive of a risk officer's warnings, is likely to stick. It may ultimately occupy an important chapter in the final story of the MF Global implosion. And that is a chapter that all board members and senior executives should read. For one of the lasting legacies of the Sarbanes-Oxley era is not to mess with the risk officer or compliance officer. The position is a linchpin in organizational efforts to comply with applicable law. Board and/or management efforts to marginalize its influence are typically made at organizational and personal peril. Thus, these unfolding allegations offer cautionary guidance on how leadership may effectively work with the compliance officer, and avoid the serious, negative presumptions (and headlines) created by MF Global-type allegations.

This is not to suggest that corporate boards and executive leadership must reflexively defer to the advice of the compliance officer as they exercise their oversight and business judgment. Leadership of course has the right to challenge, disagree or even reject that advice. Indeed, the Delaware courts continue to be enormously respectful of the board's determination of business and compliance risk, and establish an extremely high bar to prove a breach of its related oversight duties. Rather, this is to suggest that leadership must assure that its oversight and

decision-making processes are respectful of the role that the compliance officer is expected to play. That's a big difference. And just what kind of "respect" are we talking about?

Pretty simple stuff, in the scheme of things. From a structural perspective, separate the positions of general counsel and compliance officer or risk officer, and fill them with different people. Make sure the job descriptions clarify the different roles of those officers. Establish qualifications and a compensation arrangement for the compliance officer position that reflect the regulatory environment faced by the company. Assure a conflict-free reporting relationship of the compliance officer to the chief executive or chief operating officer. Allow the compliance officer to report straight to the board when circumstances demand it. Examine closely any recommendation to terminate, or reduce the duties of, the compliance officer.

From an operational perspective, give the chief risk officer or compliance officer his or her due. Make sure that person has regular, substantive access to executive leadership. Assure a culture in which the compliance officer's advice is welcomed and is given appropriate weight, even if not always accepted in full or in part. Avoid petty criticisms; don't make pejorative statements (e.g., "you're too risk averse"; or "you're abrasive"); manage performance evaluations to focus on specific deficiencies, and to reduce the perception of punitive action or retribution. And when the company is involved in "bet the farm" deal-making, make sure the compliance officer is very much in the loop, and listen more closely.

Regulators are extremely supportive of the role and function of the chief risk or compliance officer, as well they should. They will react with great suspicion when presented with allegations suggesting that management, or the board, seeks to reduce the role or influence of the compliance officer in corporate affairs. Let's be clear: headlines like "A Romance With Risk That Brought On a Panic" and particularly "MF Global's Risk Officer Said to Lack Authority" are not a good thing, and the board should recognize them as such.

Is this placing the chief risk officer or compliance officer in a special, elevated position within the organization? You bet, and that is exactly what public policy and the law have in mind. As an "ombudsman" of sort, with a broad and unique portfolio to monitor the organization's legal and ethical response to compliance issues as they arise. In this regard, regulators typically view the compliance officer as having obligations uniquely distinct from those of the general counsel (although many general counsel may not agree). Regardless of whether leadership intellectually accepts the role (i.e., the dreaded "compliance board"), they must deal with it as part of their broader duty to support a culture of compliance with the organization. You can thank Enron, WorldCom, and Sarbanes-Oxley, for that.

Ultimately, this is not about what really happened at MF Global between Mr. Corzine and the firm's former chief risk officer. We will leave that to Congress, the regulators and, probably in the end, to the judicial process. Not every corporation loses track of \$1 billion of customer funds; but just about every corporation has a compliance or risk officer function. So, the practical lesson from this mess is the risk associated with mishandling the compliance officer relationship. Or, more directly, the need for corporate leadership to be sensitive to the "care and feeding" of the compliance officer. For, as the news reports make so very clear, the cost of failing to do so is very high.

Mr. Peregrine's views do not necessarily reflect the views of McDermott Will & Emery or its clients.