



DM Extra!

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Timely Commentary on Critical Events and Regulatory Developments

Governance Hot Zones: What's Ahead in 2003

What regulatory changes will boardrooms face in 2003? We are grateful to be “alive and well” enough to ask this question, after surviving a banner year for regulations impacting boards—notably with the passage of the **Sarbanes-Oxley Act of 2002**¹ as well as proposed new listing rules for the **New York Stock Exchange, Nasdaq, and American Stock Exchange**.² These developments will

continue to yield new rules in 2003 as the **Securities and Exchange Commission (SEC)** implements their myriad imperatives.

In 2003, we anticipate greater shareholder influence in boardroom deliberations, as well as greater director and officer vulnerability to lawsuits from shareholders (and from regulators suing on behalf of shareholders). In this *DMX*, we survey these “hot zones.”

Director Summary >>

Independent Board Oversight Can Solve Problems Before They Begin

This year, directors face more pressures from shareholders and regulators, as this *DMX* reports. **NACD** is taking actions on both fronts. Ever since our founding in 1977 as the nation’s only membership organization for corporate directors, **NACD** has advocated a strong independent oversight role for boards. In the past several years, we have tried to offer practical guidance, through both publications and educational seminars and consultations, on how to achieve this goal.

We threw down one gauntlet in 1996, with our **Blue Ribbon Commission on Director Professionalism**, chaired by **NACD** director **Ira M. Millstein**, a partner of **Weil Gotshal and Manges LLP**. This Commission stated that “the board should ensure that someone is charged with: organizing the board’s evaluation of the CEO and providing continuous ongoing feedback, chairing executive sessions of the board, setting the agenda with the CEO, and leading the board in anticipating and responding to crises.”

In 2002, our **Blue Ribbon Commission on Risk Oversight**, co-chaired by Millstein and **Norman Augustine**, past chairman of **Lockheed Martin**, stated that “If the same person holds both the chairman and CEO positions, then the board should assign responsibility for ensuring effective board governance to the chairman of a key committee, such as an independent governance committee, or another independent director.” A summary of the Commission’s findings appears in the January 2003 issue of *Director’s Monthly*. The same issue includes guidance on the chairman’s role.

In 2003, we see encouraging signs that we have been in vanguard of change, since others have expressed agreement with our principles. For example, the **Conference Board of New York** released a panel report yesterday (January 9, 2003) advocating the use of either an independent chairman or a lead director.

We believe that boards that heed this advice will improve their *relations with shareholders* and reduce their *exposure to litigation*—two of many “hot zones” coming up in 2003.

Roger W. Raber, *NACD President and CEO*

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1 The Sarbanes-Oxley Act is the Public Accounting Reform and Investor Protection Act sponsored by **Paul Sarbanes** (D-MD) and **Michael Oxley** (R-OH), and signed into law July 2002.

2 DMX has already reported extensively on NYSE and Nasdaq initiatives. For American Stock Exchange initiatives, which closely parallel Nasdaq initiatives, visit www.Amex.com. The Amex initiatives were approved by the Amex board November 25, 2002, and await SEC approval.

3 Letter from Peg O'Hara to Roger Raber, December 4, 2002.

4 Private Securities Litigation Reform Act of 1995, signed into law December 1995.

5 For example, participants may discuss the increasing burden of disclosure by funds, e.g., the rules the SEC proposed December 18, 2002, on "[Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies](#)" (Release Nos. 33-8164; 34-47023; and IC-25870.) Comments must be received on or before February 14, 2003. (Comments may be submitted electronically to rule-comments@sec.gov).

6 Previous issues of DMX have outlined the content and timing of this law. See August 2, 2002, and October 25, 2002, respectively.

Hot Zone 1: Board-Shareholder Relations

This is an area crying out for improvement, and NACD has begun a dialogue with the [Council of Institutional Investors](#) to foster it. So what's the problem?

- Shareholders could complain—as stated in a recent letter from the Council to the NACD³—that “shareholders have no input into selecting director nominees (see Box 1), no meaningful choice in their election, and, generally, no hope of ever hearing from or exchanging views with them.” Furthermore, again in the Council’s own words, “Companies do not encourage shareholders (indeed some will not allow them) to meet with the independent directors to discuss issues of concern. Some do not even require directors to attend the annual meeting or let them respond to shareholders’ questions.”
- On the other hand, we directors could complain that some shareholders are looking for short-term gains at the expense of the long-term value of the company. With the help of a well-organized plaintiff’s bar, shareholders sometimes try to sue directors for failing to warn them of declines in stock price, even when those declines are unpredictable and unavoidable. This remains true despite past reforms in private securities litigation.⁴ Also, when shareholders wage proxy fights to assume control of a company, they have used methods termed “crude” by at least one CEO—**Maurice Saatchi**. The founder of **Saatchi and Saatchi** once likened his firm’s shareholders to hit men: “Take your chairman into a corner and shoot him quickly—we don’t want the fuss of a public trial.”

Clearly, there are grievances on both sides of the board-shareholder table, and that is why NACD has joined with the Council to address them.

NACD Plans re Board-Shareholder Relations

In 2003, NACD will form a joint task force with the **Council of Institutional Investors**, Washington, D.C., to explore the challenges of communication with a variety of institutional investors, including public (federal and state employee) pension funds, private (corporate) pension funds, labor pension funds, mutual funds, and endowment funds.

Reminder: Institutional investors want corpora-

tions to improve their governance, but the governing bodies of these investors can benefit from better governance, too.

In this vein, NACD also plans to hold a Roundtable with the newly formed **Mutual Fund Directors Forum**, Washington, D.C., to discuss regulatory trends⁵ and to exchange governance best practices between the public company and mutual fund realms. For example, the Roundtable will discuss the pros and cons of having one board vs. many boards for a mutual fund family. There may be lessons from complex corporations that use subsidiary boards to supplement the work of their parent company board. Conversely, mutual fund boards will have best practices to communicate to the corporate arena. The Roundtable will include NACD members who are directors of both corporations and of mutual funds. About 5 percent of NACD members serve as directors on both types of entities.

Since compensation oversight is a leading concern of directors in their role as fiduciaries of shareholder value, NACD has chosen the compensation committee as the topic of the 2003 **NACD Blue Ribbon Commission** report. The report will guide boards in implementing new rules from the SEC stemming from passage of Sarbanes-Oxley and in response to the proposed new listing rules from the New York Stock Exchange, Nasdaq, and Amex.

New rules such as "[Accounting for Stock-Based Compensation](#)" ([Financial Accounting Board Statement 148, issued December 2, 2002](#)) will also be featured. This statement amends FASB Statement No. 123 of the same title to provide “alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation.” It also amends Statement 123 to require prominent disclosures in both annual and interim financial statements about the “method of accounting for stock-based employee compensation and the effect of the method used on reported results.”

Another development that can make or break directors in forming good relations with shareholders involves the all-important audit committee—the supreme watchdog of shareholder value. NACD is updating the year 2000 report of the **NACD Blue Ribbon Commission on the Audit Committee** to reflect new developments. For example, just two days ago (January 8), the SEC released a proposed rule on "[Standards Relating To Listed Company Audit Committees](#)" (Release Nos. 33-8173, 34-47137, and IC-25885). This rule imple-

ments the audit committee requirements established by the Sarbanes-Oxley Act of 2002 relating to the independence of audit committee members, the audit committee's responsibility to select and oversee the issuer's independent accountant, procedures for handling complaints regarding the issuer's accounting practices, the authority of the audit committee to engage advisors, and funding for the independent auditor and any outside advisors engaged by the audit committee. The new rule must become effective by April 26, 2003.

Hot Zone 2: Litigation Against Directors and Officers

The coming year could be litigious. In 2003, some shareholders may sue board members alleging violation of provisions of Sarbanes-Oxley.⁶ The law itself contains some protection from such lawsuits. Specifically, Section 105 protects information prepared for or received in connection with an investigation from the **Public Accounting Oversight Board** (proposed by the law and now in formation). This information will be "confidential and privileged as an evidentiary matter" and therefore will not be subject to civil discovery or other legal process.

David Nadler, chairman of **Mercer Delta**, an NACD associate member, would like to see similar protections for information coming from board evaluations, which may become mandatory in 2003 for firms listed on the **New York Stock Exchange**. On November 20, 2002, Nadler wrote **Jonathan Katz**, secretary of the **SEC**, to ask the Commission to protect the confidentiality of information from a board evaluation. NACD president and CEO **Roger Raber** wrote Katz as well expressing agreement.

Despite this provision in Section 105, however, Sarbanes-Oxley, like any new regulation affecting boardrooms, will heighten directors' potential exposure to lawsuits. For example, since the last edition of *DMX*, the SEC has published (at www.sec.gov/rules/proposed.shtml) several new rules under Sarbanes-Oxley:

- *Attorney-client privilege.* Sarbanes-Oxley says that lawyers must blow the whistle on clients who violate the law. This rule explains the conditions under which this must occur. See [Release No. 34-46868](#) (November 27, 2002; final rule due January 26)

- *Audit committee approval of non-audit services, audit partner rotation, auditor compensation, and other matters pertaining to the audit committee.* The Sarbanes-Oxley Act sets forth new powers for the audit committee, and asserts the importance of auditor independence. One new rule expands on the law by saying that an audit cannot be considered independent if a partner-level member of the audit team provides or procures nonaudit consulting services. See [Release No. 34-46934](#) (December 2, 2002; final rule due January 26, 2003); also see [Release Nos. 33-8173, 34-47137, and IC-25885](#), cited earlier on p. 2.

- *Disclosure of off-balance-sheet transactions.* Under Sarbanes-Oxley, companies must disclose transactions that are not required under generally accepted accounting principles (GAAP) to be on the balance sheet. This new rule explains this provision, and adds a requirement for disclosure in chart form. See [Release No. 34-46767](#) (November 4, 2002; final rule due January 26, 2003).

- *Insider trade filings.* Sarbanes-Oxley gave accelerated dates for filings by insiders who buy or sell company stock. This new rule sets the limit as 24 hours. See [Release No. 34-47069](#) (December 27, 2002; final rule due February 10, 2003).

- *Pro-forma financial information.* The Sarbanes-Oxley Act said that if companies report information that is not in conformity with GAAP, they must avoid material misstatements. This new rule goes further by saying that the company must provide an

Box 1:

The Committee of Concerned Shareholders (www.concerned-shareholders.com), a grass-roots organization composed of activist shareholders of **Luby's, Inc.**, a **New York Stock Exchange** company, have joined with website publisher **James McRitchie** (www.corpgov.net), to petition the SEC to modify provisions of SEC Rule 14a-8(i), a long-established rule that determines which shareholder proposals may be included in proxy statements. As McRitchie wrote to SEC Secretary **Jonathan Katz** in a letter dated August 1, 2002, the proposed modifications would, in effect, permit investors to use shareholder proposals for the purpose of electing directors. Although this proposal is a "long shot" it could have an impact on shareholder expectations at the very least, and is certainly worthy of director attention. As of January 10, 2003, this initiative is still gathering momentum—at least at the grass roots level.

7 Case number “No. Civ. A. 18553, dated October 25, 2002; Westlaw 2002 w/ 3148233 (Del.Ch.).

8 DMX Editors acknowledge helpful materials from several law firms: [Akin Gump](http://www.akingump.com) www.akingump.com; [Hogan & Hartson](http://www.hhllaw.com) www.hhllaw.com; [Fried, Frank, Harris, Shriver & Jacobson](http://www.friedfrank.com) www.friedfrank.com; [Gibson, Dunn & Crutcher](http://www.gibsondunn.com) www.gibsondunn.com; [Patton Boggs](http://www.pattonboggs.com) www.pattonboggs.com; [Jones Day Reavis & Pogue](http://www.jonesday.com) www.jonesday.com; [Weil, Gotshal & Manges](http://www.weil.com) www.weil.com.

explanation of the information that does conform to GAAP—in essence eliminating the option of pro-forma language). See [Release No. 34-46768](#) (November 5, 2002; final rule due January 26, 2003).

NACD Plans re Litigation Against Directors and Officers

In response to these developments, NACD will be issuing a Board Leadership Series publication on *Lessons Learned from Litigation: A Guide for Directors and Officers*. This research report will outline trends in lawsuits against directors, reporting on court decisions and noting trends in insurance payments following settlements and awards.

The report will also cover the implications of new sources of liability risk stemming from Sarbanes-Oxley—especially attorney-client privilege, mentioned above and highlighted in a front-page *Wall Street Journal* yesterday (on January 9, as our editors were preparing this DMX on the very same topic). If a lawyer (whether internal or outside counsel) sees wrongdoing, he or she must warn the company about it and, if the company fails to respond, must report the wrongdoing and make a “noisy withdrawal” by stating that he or she is resigning for “professional considerations.” Considering the extent and complexity of securities rules, this development should motivate directors to ensure that they remain educated about securities laws on a continual basis.

There are some obvious danger zones here. The violation need not involve large sums of money or gross negligence. It must merely be a “material violation” of a securities rule—and there are hundreds to monitor. Also, if the

company discloses findings to the SEC, the information may not be protected by attorney-client privilege; shareholder litigants might have access to the information. Corporations should have the right to preserve attorney-client privilege in such circumstances, but will the courts and regulators agree?

Larry S. Gondelman, a partner with **Akin Gump Strauss Hauer & Feld** in Washington, D.C., sent DMX editors a note alerting them to *Noel Saito v. Mckesson HBOC, Inc.*, a recent, unpublished opinion of the Court of Chancery of Delaware.⁷ Gondelman writes:

The Court of Chancery of Delaware has recently ruled that selective waiver of the privilege to benefit law enforcement agencies assists the agencies in resolving their investigations expeditiously and efficiently. As the court noted, “[w]hen corporations become less adversarial with law enforcement agencies, this cooperation is in the investing public’s best interest.” Assuming that this provision of the proposed rule survives, it could significantly advance a company’s interest in cooperating with the Commission *without hampering its ability to defend itself against litigation against third shareholders.*” (Emphasis added.)

Looking Ahead

It is not easy to predict governance in any given 12-month period. After all, in any single year, Congress proposes thousands of laws, while federal agencies and national stock exchanges propose hundreds of rules. In 2003, as in 2002, boards will receive more than their share of this bounty—and burden.⁸

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National Association of Corporate Directors (NACD), an independent not-for-profit organization founded in 1977, is the country’s only membership organization devoted exclusively to improving corporate board performance. The NACD conducts educational programs and standard-setting research, and provides information and guidance on a variety of board governance issues and practices. Membership comprises board members from U.S. and overseas companies ranging from large publicly held corporations to small over-the-counter, private, and closely held firms. NACD lists all interested members on The Director’s Registry, which is used by member companies and others that seek qualified directors. With chapters in many major cities providing educational programs and networking opportunities, NACD operates at both a national and local level. To educate the corporate community and to provide networking links among NACD chapter members, the NACD holds an annual Corporate Governance Conference, where it presents a Director of the Year Award.