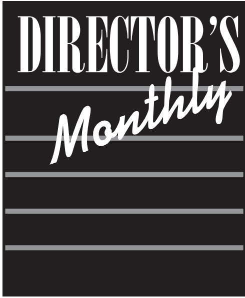

DM Extra!

April 10, 2002

Timely Commentary on Critical Events and Regulatory Developments

Shareholders Call for Reforms in Wake of Enron

What do shareholders want?

This question may be overly broad, but contemplating it can be useful. After all, directors serve as fiduciaries on behalf of shareholders (as well as other constituencies as circumstances warrant).

To be sure, not all shareholders are alike. Generalized answers about what "shareholders" want may not suit each specific case. Nonetheless, every director should have more than a passing interest in understanding the collective goals, if any, shared by the broad mass of shareholders.

So what *do* shareholders want? This is an auspicious time to ask this question. In the long wake of the **Enron** bankruptcy filing, several shareholders and shareholder-affiliated groups have made statements to the press, or advocated formal governance reforms. This *DMX* describes these organizations and summarizes their proposals (with brief commentary). In conclusion, we review a current statement from **Harvey Pitt**, the chairman of the **Securities and Exchange Commission (SEC)**, that ultimate champion and enforcer of shareholder rights.

Heeding Shareholders' Ideas for Reform: A Commentary

Ever since the founding of NACD, we corporate directors have worked side by side with shareholders to bring about positive changes in corporations. This issue of *DMX* focuses on "post-Enron" governance reforms proposed by a variety of shareholder groups, including notably the **Teachers Insurance and Annuity Association–College Retirement Equity Fund (TIAA-CREF)**, whose senior consultant for corporate governance is our chairman, **B. Kenneth West**.

Of course, shareholders are not the only ones advocating governance reforms. Several financial organizations, including the **Institute for Internal Auditors** and the **Financial Executives Institute** have issued statements, which we will describe in the next issue of *DMX*. The most recent issue of *Director's Monthly* (our print newsletter) featured the reforms that NACD and others have proposed. On April 4, I had the honor of presenting our board's **10-point reform plan** to the **New York Stock Exchange**.

Following all these reform proposals can be challenging. Fortunately, the proposals are similar. Throughout all of these statements—from the NACD, from shareholders, from financial groups, and others—several themes resound: the importance of *director qualifications* and *independence*, *auditor independence*, and *improved disclosures*.

Boards should consider meeting the highest standards in these areas voluntarily, if they do not meet them already. They will then be better prepared to meet any new legislative requirements that may be imposed along these lines.

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California Public Employees Retirement System (CalPERS) represents 1.2 million working and retired Americans, and oversees $150 billion in retirement funds on their behalf. The CalPERS website states that the system is "urging **Congress**, the **Securities and Exchange Commission (SEC)**, and others to adopt a package of financial market reforms and intends to keep the heat on to ensure meaningful market change. CalPERS will urge the improvement of audit committees, clear laws and regulations to make audits independent, and help to create accounting standards that will prevent future Enrons."

"CalPERS will urge the improvement of audit committees, clear laws and regulations to make audits independent, and help to create accounting standards that will prevent future Enrons."

Specifically, CalPERS advocates a set of *Financial Market Reform Principles*, as follows:

- The SEC and/or national stock exchanges should require minimum training standards for audit committee members, increase the number of audit committee members that are "financially literate," provide the market with clear guidelines for "financial literacy," and provide audit committees with the power to hire and fire the auditor.
- Congress and/or the SEC should pass laws to ensure that companies' audits are truly independent, including a bright-line ban on external auditors simultaneously providing consulting or internal audit services to a company, a requirement that firms periodically rotate auditors, and the establishment of an independent accounting and audit industry oversight board that includes investors and has subpoena and disciplinary power.
- The **Financial Accounting Standards Board (FASB)** or other appropriate authority should put an end to unintelligible or manipulative information.
- The markets must expose potential conflicts of interest that exist with bankers, equity analysts, rating agencies, lending institutions, outside auditors, and other consultants.
- Congress, the SEC, and the stock exchanges should work together to strengthen and clarify the importance and meaning of "independent directors" so that every corporate board in America will be truly independent and accountable.

The CalPERS board has already passed the above principles. On March 18, 2002, the CalPERS staff recommended to the CalPERS investment committee that the board vote to revise CalPERS' *Financial Market Reform Principles* to include the following 10 additional points:

- Directors can show "financial literacy" for purposes of audit committee membership by passing the Series 7 examination.
- Audit committees should meet at least once per quarter, review the company's internal audit functions at least annually, and have at least one meeting per year with the external auditor that does not include any company employees.
- Audit committees should have access to their own resources (*e.g.* dedicated staff), subject only to overall budgetary control by an independent board.
- Audit committees should have full access to company books and records.
- CalPERS' bright-line test should specify that the only non-audit services that do not jeopardize an external auditors' independence are the preparation of tax forms and registration statements.
- The "cooling off" period (during which companies should not be able to hire employees from their external audit team) should be at least one year.
- The Private Securities Litigation Reform Act of 1995 should be amended to restore joint and several liability for external audit firms, but only for those auditors who fail the "independence" bright-line test, or who fail to comply with the financial and fraud reporting provisions within existing securities laws.
- FASB should require that stock options used to attract, retain, or compensate employees be reported as an expense on income statements.
- All directors should fully disclose financial ties to the company and its board, including personal, family, business, political, and philanthropic connections.
- The SEC should revise its executive compensation disclosure rules to improve readability, include all sources and forms of compensation (including perquisites), and require current disclosure of stock option exercises by the company's executives.

Comment: Many of these proposed practices are consistent with the recommendations of past NACD reports, and with the actions of NACD members. The larger question is, to what extent should these practices be required by law, as recommended here?

Council of Institutional Investors (CII) is a membership organization for 250 major institutional investors responsible for $2 trillion in pension assets. Headed by **Sarah Teslik**, the firm conducts research and develops policy positions on issues affecting corporate and union pension funds. The bankruptcy of Enron caused CII members to lose hundreds of millions on their Enron investments. Therefore, two months ago (February 4), CII called for reforms to the U.S. auditing and corporate governance systems "designed to ensure that another Enron won't happen."

In letters to congressional committees investigating the Enron case and to Chairman **Harvey Pitt**, the Council suggested seven reforms (many of which it had previously championed). They are:

- *Prohibit auditors from providing any non-audit services to their audit clients.* CII also suggests that the SEC consider requiring companies to rotate their outside auditors every few years, imposing "cooling-off" periods before audit firm employees can work for audit clients, and barring outside accountants from providing any internal audit services to audit clients.
- *Strengthen the oversight of auditors.* CII believes that the creation of a new, independent auditing entity should be considered and publicly debated.
- *Require enhanced disclosure of director links to companies.* The CII has been calling for heightened disclosure for over four years.
- *Toughen the stock exchanges' listing standards on board independence and board composition.* The Council supports the stock exchange requirement that all audit committee members be independent, but it wants the exchanges to adopt a definition of independent director that matches its own or comparable definitions endorsed by major investors such as TIAA-CREF or CalPERS. It also advocates requiring independence of a substantial majority of the board (at least two-thirds).
- *Do not soften the SEC's stance on enforcement.* The Council believes tough enforcement efforts—and criminal prosecutions whenever possible—are the most effective deterrents to criminal activity.
- *Restore integrity to the proxy voting system by eliminating the stock exchanges' "broker may vote" rule,* which allows brokers to vote on so-called "routine" proposals, including important matters such as the election of directors and the ratification of auditors. Permitting broker votes amounts to "ballot stuffing for management," the Council says.
- *Meaningfully update disclosure requirements for financial and other critical information.* CII urged the SEC to consider investors' views on what types of disclosures are material to them as it moves forward with reforming disclosure requirements.

Comment: Boards can preempt federal regulation in most of these areas by establishing qualified, independent boards that ensure disclosures that are meaningful to shareholders.

Question: Should Congress give the SEC the authority to set stock exchange listing standards? That is the view of some governance experts.

* * *

Institutional Shareholder Services (ISS), is a proxy advisory service owned by **Proxy Monitor**, and based in Rockville, Maryland. Founded in 1985 by **Robert A.G. Monks**, and currently headed by **James E. "Jamie" Heard**, the service has grown to become one of the most influential voices on governance matters, tracking proxy resolutions on 5,000 public companies for 500 institutional investors and some corporations. (As recently as 1998, NACD Vice President of Research, **Peter R. Gleason**, headed up the organization's financial research operations.)

The influence of ISS is well known. For example, consider the March 19 vote by **Hewlett-Packard** shareholders on the proposed merger between Hewlett-Packard and **Compaq**. As we go to press, Hewlett-Packard is claiming that a majority of shareholders have approved the merger. A final tally is expected any day now. The yes votes may have been inspired by the endorsement issued two weeks earlier by ISS. HP President **Carly Fiorina** called the report a "crucial milestone" in the company's efforts to obtain shareholder approval for the transaction.

ISS does not take formal positions on national policy issues. However, it has developed a model code of corporate governance. (See the March 2002 issue of NACD's print newsletter, *Director's Monthly*, p. 16.) Also, ISS publishes a *Proxy Voting Manual* that includes guidance for proxy voting on a variety of issues. Furthermore, ISS's director of corporate governance research, **Pat McGurn**, often makes statements to the press about the reforms generally supported by ISS. Recent statements indicate a strong support for proxy resolutions that would bar auditors from performing consulting services at audit client companies.

Comment: Directors should keep a close watch on these influential advisors.

The Corporate Library, like ISS, is a research and policy group that serves institutional investors. Founded in 1999 by ISS founder Monks and his first president, **Nell Minow**, the group conducts research on issues of interest to shareholders. Ms. Minow and Mr. Monks have not published any position papers on post-Enron board reforms. However, they have developed a product that promises to help prevent the kinds of governance problems that allegedly led to Enron's bankruptcy.

Board Analyst™ provides "screening tools" and "access to comparative data across firms and individual directors," combined with a "rating system." According to a description posted on the company's website, "This product will be of particular interest to: investment managers for its ability to provide an early warning system regarding dysfunctional or mediocre boards; insurance brokers and underwriters in establishing relative risk assessments for D&O and other corporate insurance; executive and board search firms for data and analysis of individual prospects and board best practices; and corporate consultants, investor relations executives, and legal advisors for insight into industry benchmarks and best practices research."

Comment: In theory at least, Board Analyst™ can be used in two ways. Shareholders and other board watchers can use it as a way of exposing and punishing poor governance, or directors can use it as a way of improving their boards. The latter seems preferable. NACD will be studying the usefulness of this product for directors as soon as the product is available.

* * *

TIAA-CREF is the nation's largest pension system for educational and research institutions, and indeed, the largest institutional investor in the U.S., overseeing $250 billion in assets. Its current activities (announced April 2, 2002) include a "major push" to secure the right of shareholders to approve stock option plans, as well as efforts to encourage auditor independence. To date this year, CREF, the public equity investment arm of TIAA-CREF, has submitted 19 shareholder resolutions to U.S. companies for 2002, including 13 advocating shareholder approval of all material equity compensation plans.

The TIAA-CREF website includes **full testimony from CEO John Biggs and Senior Vice Peter Clapman**.

Mr. Biggs advocated three main reforms in his testimony to the United States Senate Committee on Banking, Housing, and Urban Affairs on February 27, which was reprinted in the April 2002 issue of NACD's *Director's Monthly.* The three "needed changes" were curbing overuse and abuse of stock options, fostering auditor independence, and creating a strong regulatory model for auditor oversight. For the full details on these proposals, see *DM* April, or **visit tiaa-cref.org**.

Mr. Clapman testified on March 20 before the House Financial Services Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises. He focused on these reforms:

- *Reducing conflicts of professionals.* Too often accountants and lawyers ostensibly representing the company in fact wind up representing only its senior management. Such conflicts were at the heart of the problems at Enron. The professional organizations themselves must do a better job through education and discipline to minimize these abuses.
- *Regulating the accounting profession.* Companies should ensure the integrity of the auditing process by not giving the audit firm consultant work and by periodically rotating the audit firm. He also urged that an independent board oversee the accounting profession with its own funding source, and with the legal authority to enforce rules and impose sanctions for wrongdoing.
- *Curbing abuses on executive compensation—stock options*. The reforms needed are (1) require that the cost of stock options be reflected in financial statements, and (2) require shareholder approval for dilutive stock option plans, thus introducing greater accountability in this most important area of executive compensation.
- *Clarifying the role of stock exchanges.* The exchanges should impose stronger standards of director independence, requiring shareholder approval for all material equity plans, promoting education of directors, and implementing more stringent policies to ferret out conflicts of interest. If the exchanges fail to act, the SEC, using its regulatory powers and persuasive influence, should press for needed reforms.
- *Education of directors.* "The education of directors is a major concern. Not all individuals are qualified to be directors in today's complex market place simply because they are asked to serve. Directors on audit committees only recently had to meet a standard of financial literacy—literally to have the ability to understand a financial statement. Directors on compensation committees often do not take a pro-active role on behalf of their company because they lack an understanding of compensation issues and do not obtain independent consultants when needed. The abuse and overuse of stock options results from inadequate performance of many compensation committees and the board as a whole."

Comment: The TIAA-CREF reforms deserve close attention from board compensation committees.

So what does the SEC itself have to say about these proposed reforms? In a recent, SEC chairman **Harvey Pitt** explained (see box).

Chairman Pitt's closing statement included this sage comment: "Our system can be improved and modernized. True reform requires rigorous analysis, respect for competing views, compromise, and statesmanship, by all concerned." Corporate directors who discuss reform ideas, and offer their own, will be well on their way to fulfilling that goal. ■

SPEECH BY HARVEY L. PITT, NORTHWESTERN UNIVERSITY, APRIL 4, 2002

"We have asked the **New York Stock Exchange** and **Nasdaq** to work with the corporate and shareholder communities to review their corporate governance and listing standards, including important issues of officer and director qualifications and codes of conduct of public companies. In addition to posing specific topics for them to consider, our hope is that they will think expansively, in concert with the corporate and shareholder communities, and determine whether companies that list in their respective market places meet the highest ethical and practice standards. We also separately asked Financial Executives International to review its code of ethics in light of recent developments. The responses to date have been incredibly gratifying, with the best yet to come.

...Our primary concern is to ensure that management's interests are aligned with shareholders' interests.... The key, in my view, is to ensure that, if a company chooses to grant options to corporate managers to create incentives to build value in the company, the options actually work as intended, rather than create an unearned windfall for those managers. There are, in my view, several components to this.

- First, I believe that *stock option plans (and other equity compensation plans) for officers and directors should be approved by shareholders.* Making equity incentive compensation available to management is in the interest of shareholders, but because it is (or is supposed to be), companies should be required to make full disclosure and submit such plans to a shareholder vote as a fundamental first step.
- Second, *the decision to grant options to senior management, and the terms of those grants, should be entrusted to a committee of independent directors.* The decision to grant options should, in most cases, be entrusted to a formal compensation committee, which would have the same authority over compensation matters that audit committees today have over financial matters and reporting. The core function, and key benefit, of the independent directors is to help prevent management practices that may deliberately, or inadvertently, misalign shareholder and management interests.
- Third, it seems to me that options are potentially troublesome if they are structured to reward, or are capable of rewarding, short-term performance. Corporate boards would do well to consider whether officers *should be required to demonstrate sustained, long-term growth and success before they can actually exercise any of their options.* This would help abolish perverse incentives to manage earnings, distort accounting, or emphasize short-term stock performance. The award of options would seem to be most compatible with shareholder interests if they are tied in the main to the long-term performance of companies.
- Fourth, as **President Bush** has suggested in re-establishing the true accountability of corporate leaders, *CEOs should be prepared to certify to their shareholders that everything investors should know about the company has been disclosed, completely, fairly, and in understandable format.* And, as a corollary, they should be prepared to certify that anything that hasn't been disclosed to shareholders wouldn't be important to them in assessing the value of their shareholdings and developing their investment strategy. This means that companies should have a defined process for causing information to flow from various corporate outposts to a central disclosure locale to which the CEO has access.
- Fifth, audit committees, which have been much improved in recent years, can be made even better. *Audit committee members should question and test the disclosure and financial reporting processes.* This means they need to understand the company's critical accounting principles and how they are applied, as well as urge continuous improvement to systems of internal control. It also means they must *be free to hire their own independent counsel and accounting experts* in instances where they reasonably think there is a need to enhance the quality of corporate disclosures. While *shareholder approval of outside auditors* is now a well-established part of corporate governance, I believe we should also explore whether the audit committee should be vested with the initial decision about which firm is recommended to the shareholders. I also believe that *audit committees should have the authority to fire outside auditors* (or prevent management from firing them). We have asked the NYSE and Nasdaq to consider *whether audit committees should be vested with the sole authority for assessing the quality and independence of their companies' outside auditors,* including the extent to which their audit firms can perform other functions."

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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.