



DM Extra!

March 11, 2002

Timely Commentary on Critical Events
and Regulatory Developments

Reform Season: More than Sound and Fury

During times of intense reform, the three branches of our government—executive, legislative, and judicial—can find themselves working on the same matters. Now is such a time. The executive branch and the leg-

islative branch are currently proposing interrelated reforms in the wake of the December 2001 **Enron** bankruptcy. This special issue of *DMX* describes these reforms, plus a recent proposal from the **Bush Administration**.

“Post-Enron” Reforms: A Commentary

The December bankruptcy of **Enron Corporation**, by its sheer size and complexity, has inspired a wave of proposed legislative reforms from the **Bush Administration** (announced March 7, 2002) and from **Congress**. This *DMX* rightly focuses on those reforms, which will, if passed, have a major impact on boardrooms. Interestingly, our own members, in a January 2002 survey, expressed interest in seeing better rules or guidelines for disclosure of related-party transactions, auditor independence, and retention of audit records by external auditors—all issues highlighted in the newly proposed regulations.

The most important reforms, however, must come from within the boardroom. What are directors doing to improve their governance procedures in the aftermath of the Enron situation? To find out, the NACD joined with the **Institute of Internal Auditors** to poll our respective memberships to find out what boards and internal auditors are already doing as a result of the Enron situation. Almost all directors (98 percent) reported that they had monitored the Enron situation very closely or somewhat closely, and a majority had either already addressed Enron-type issues, or were planning to do so at their next board or audit committee meeting. [Full survey results](#) are posted on our website.

These findings show that directors—or at least those who belong to the NACD—can respond quickly to crises. The question, though, is how well directors anticipate them. Only 37 percent of directors said that their organizations had a formal risk management process.

Overall, we give our members high marks for their responsiveness to the Enron situation. Our only advice to board members would be to keep their eyes open and the heat on. For example, directors should ask frank questions about how their organizations are managing risk. We commend to your future attention the newly commissioned study on risk management by the [Committee of Sponsoring Organizations of the Treadway Commission \(COSO\)](#), scheduled for release in 2003.

Directors must attempt to understand and oversee risk to fully discharge their duty of care. If they do not oversee risk, there will more “Enrons,” and more new regulations, to come. ■

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Reforms Proposed by President Bush

On March 7, 2002, President **George Bush** proposed a series of sweeping corporate reforms.

Some of the Bush Administration reforms put the heat on auditors. A new more independent board (not affiliated with the **Association of Independent Certified Public Accountants**, or AICPA) would oversee accounting firms, and new rules would curb conflicts of interest for auditing firms, who in the past have been allowed to provide financial consulting services to their audit clients.

Other reforms put the heat right in the proverbial governance “kitchen”: the boardroom. One proposed reform would require CEOs to attest each quarter to the accuracy of their companies’ financial disclosures. Executives found to be remiss would have to give up their bonuses and other compensation, and in some cases could be barred by the **Securities and Exchange Commission** from serving as

officers or directors for other publicly held corporations.

The barring of officers and directors from service is currently up to the federal district courts, where nearly 50 such requests for D&O bans have been languishing.

The Bush reforms would also speed up insider trading disclosures; corporate officers and directors would have two business days (not months or a year) to disclose when they buy or sell company stock. The reforms would also require companies to disclose more information between reporting periods.

These reforms did not come out of the blue, and they are not going to happen overnight. The groundwork for the reforms is being laid in **Congress**, and that is where many of them must occur if they are ever going to become the law of the land. Here, therefore, is a special *DMX* report on the current work of the 107th Congress. (Future *DMX* issues will highlight other proposed reforms, including SEC initiatives and investor group proposals.)

Reforms Proposed by Congress

The spring legislative session of the current Congress could well go down in history as “Enron season.” While members were out on their year-end break in late 2001, Enron Corporation filed for bankruptcy—immediately entering the record books as the biggest corporate financial failure ever.

In response to Enron’s bankruptcy, Congressional leaders have been holding hearings to determine the causes of the failure, and introducing bills to seek solutions. (See Box 1.) To date, 10 different Congressional committees have held hearings, including the **House Committee on Energy and Commerce**, where [NACD President Roger Raber testified](#) on February 6, and the **Senate Committee on Banking, Housing, and Urban Affairs** where [NACD Director Ira M. Millstein testified](#) on February 27.

Some may discount this as “sound and fury, signifying nothing” (to quote the two Williams, Shakespeare and Faulkner). In fact, however, the actions of Congress could well result in some permanent changes to our corporate way of life, so they merit close attention. (See Box 2 on p. 3.) This summary of legislative action from January through these current “ides of March,” provides a “heads up” for directors wanting to anticipate legislation that may have a direct effect on boardroom practices.

Box 1.

BILL CHECKLIST (Organized by Number*)

This list of major reform bills by numeric code shows how furious the pace of Congressional action has been over the last several weeks. (Bill numbers are assigned sequentially, so if numbers are close, that means the bills were introduced at around the same time.) Keep this list handy. It may be a handy deciphering tool in case any bill gets “hot.”

Bills Introduced in the House

- H.R. 3617 Accountability for Accountants Act of 2002
- H.R. 3634 Enron Employee Pension Recovery Act of 2002
- H.R. 3644 Securities Fraud Prevention Act of 2002
- H.R. 3657 Employee Pension Freedom Act of 2002
- H.R. 3669 Employee Retirement Savings Bill of Rights
- H.R. 3693 [Short Title Pending] A Bill to Prevent Accountants from Providing Non-Audit Services to Audit Clients
- H.R. 3725 Investment Disclosure Act of 2002
- H.R. 3736 Financial Accuracy in Reporting Act of 2002
- H.R. 3745 Corporate Charitable Disclosure Act of 2002
- H.R. 3763 Corporate Auditing, Responsibility, and Transparency Act of 2002
- H.R. 3769 Insider Trading Full Disclosure Act of 2002
- H.R. 3795 Investor, Shareholder, and Employee Protection Act of 2002
- H.R. 3818 Comprehensive Investor Protection Act of 2002

Bills Introduced in the Senate

- S. 1895 Independent Investment Advisors Act of 2002
- S. 1896 Auditor Independence Act of 2002
- S. 1919 Retirement Security Protection Act of 2002
- S. 1933 Investor Protection Act of 2002

*The full code for each bill has the letters IH or IS following each number.

■ **Auditing.** One topic that appears in many post-Enron bills is the quality of audits of financial statements. This is of direct relevance to all directors, because directors are charged with the financial oversight of corporations. One forceful bill is the [Investor, Shareholder, and Employee Protection Act of 2002 \(H.R. 3795\)](#). This proposed legislation would establish a federal bureau of audits within the Securities and Exchange Commission to conduct audits of all public companies.

Another newly proposed bill, which still has not been assigned a “short title,” is legislation “to prevent accountants from providing non-audit services to audit clients” ([H.R. 3693](#)). Also seeking to reform accountants is the [Accountability for Accountants Act of 2002 \(H.R. 3617\)](#), and, in the Senate, the [Auditor Independence Act of 2002 \(S. 1896\)](#) deals with this same issue.

Congress is not alone in its concerns about audit quality. **Barry C. Melancon**, President of the AICPA, has said that his group will not oppose legislation banning the outsourcing of internal audit functions (such as designing computer systems or conducting reviews of operations) to a company’s external auditing firm. Four of the Big Five firms have already announced that they will no longer provide both services under one roof.

Meanwhile, mirroring reforms proposed by the Bush Administration, the SEC has proposed a new public oversight group for external auditing, not affiliated with the AICPA. This is also the focus of a corporate governance panel formed by the **General Accounting Office (GAO)**. Comptroller General **David M. Walker** has appointed NACD President **Roger W. Raber** as a member of this panel.

■ **Charitable giving disclosures.** The inspiration for this topic came from allegations that at least one “independent” Enron director had a conflict of interest because the director served on the board of a charity that received major donations from Enron. The [Corporate Charitable Disclosure Act of 2002 \(H.R. 3745\)](#) would require disclosure of such ties. This bill is relevant to any director who serves on the board of a company that receives charitable donations from the company the director serves.

■ **Financial reporting.** Disclosure rules would be expanded in the [Financial Accuracy in Reporting Act of 2002 \(H.R. 3736\)](#), and in the [Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002](#)

([H.R. 3763](#)). The latter bill emphasizes the role of the audit committee, and is worth watching. Financial reporting improvements will undoubtedly receive support from the executive branch. Treasury Secretary **Paul O’Neill**, whose governance panel helped President Bush formulate his early March position, has suggested shifting more burden of oversight to corporate officers and away from auditors. “The duty ought to be on the performers, not the observers,” Sec. O’Neill told *Business Week* in an interview published on February 12, 2002.

■ **Insider trading.** This is a topic directly relevant to directors, because whether they are “independent” or not for the purposes of serving as lead directors or serving on an audit or other independent committee, all directors are considered insiders under federal securities laws. Therefore, when they buy or sell the stock of the company they serve, that is considered insider trading. Not all insider trading is illegal, but it is

Box 2.

Access to Reform Bills

Of the approximately 4,000 bills already proposed in the 107th Congress, only four bills to date specifically mention Enron in their titles or text. Dozens of other bills, however, originated in post-Enron governance concerns—as speeches on the floor of Congress attest. These “post-Enron” bills target a variety of concerns, ranging from audits to securities law. (See Box 1.)

The general business press has identified some of the post-Enron topics now being tackled in Congress, but do not typically provide the exact name or number of the bills. Directors and others need these details in order to track a bill’s status and progress. Knowing the exact name and number of a bill enables directors or others to view the full text of the bill, to learn who is sponsoring and cosponsoring the bill, and to see where it stands in committee review.

Post-Enron governance bills are now being considered by a variety of committees, including in the **House** the Committees on Energy and Commerce; Financial Services; and Judiciary; and in the **Senate** the Committees on Banking; Commerce, Science, and Transportation; Housing and Urban Affairs; Finance; and Judiciary. Most of the committees deal with civil law, but the Judiciary Committee deals with criminal law. Each committee maintains its own website, so it is not always easy to learn the status of a particular bill, without knowing the name and number of the bill.

To see details on any bill, visit www.house.gov, or www.senate.gov. These sites give an overview of the membership, committee structure, and legislative activities of the House and Senate respectively. They also enable researchers to find out more about any particular bill by typing in the name or number of the bill. Another useful cite is <http://thomas.loc.gov/home/c107query.html>, which enables detailed search of bills by words—including key words buried within the text of the bill.

illegal for an insider (or a “tippee” of an insider) to buy or sell a company’s stock while knowing things about the company not known to the general public. The [Insider Trading Full Disclosure Act of 2002 \(H.R. 3769\)](#) would increase investor awareness of insider trading.

■ **Pension fund management and oversight.** Clearly pension fund oversight is a matter that concerns directors. Pension fund law, as expressed in the Employee Retirement Security Act of 1974 (ERISA), still the current law of the land, considers corporate directors to be the ultimately fiduciaries of pension funds. Several bills would improve the financial reporting and management of funds. These bills include the [Enron Employee Pension Recovery Act of 2002 \(H.R. 3634, for Enron employees\)](#); the [Employee Pension Freedom Act of 2002 \(H.R.](#)

[3657\)](#); the [Employee Retirement Savings Bill of Rights \(H.R. 3669\)](#), the [Investment Disclosure Act of 2002 \(H.R. 3725\)](#); and, in the Senate, the [Investor Protection Act of 2002 \(S. 1933\)](#).

■ **Securities law reforms.** Several bills would undo the reforms ushered in by the landmark Private Securities Litigation Reform Act of 1995, which helped control abusive lawsuits against corporate officers and directors. In this current Enron season, some legislators are trying to re-empower the plaintiff’s bar (lawyers who sue boards).

One such bill is the [Securities Fraud Prevention Act of 2002 \(H.R. 3644\)](#), to “eliminate securities fraud exemption from civil remedies for racketeering violators.” In plain English, if a director or officer is found guilty of fraud, this could be considered a criminal offense under the Racketeering Influenced and Corrupt Organizations Act (RICO, the anti-Mafia law) and directors and officers would pay triple penalties and serve jail time. One of the major accomplishments of the Private Securities Litigation Reform Act was to take securities fraud out of RICO statutes; this bill want to put it back in.

■ **Comprehensive reforms.** Of all the bills, the most sweeping is the [Comprehensive Investor Protection Act of 2002 \(H.R. 3818\)](#). This bill, described further in the box on this page, covers 16 topics in 17 sections—ranging from audit standards to securities law changes. (See Box 3.)

Clearly, many reforms are afoot. Whether they come from the White House, Congress, or, most likely, a combination of the two, they will arrive. The best way directors can prepare for them—and even perhaps pre-empt them—is to look beyond the “sound and fury” to seek positive, lasting change. Directors can and should support valid reforms, while opposing burdensome or unfair ones. Though it all, they should do their first job: exercising their duties of careful, independent oversight as fiduciaries. ■

Box 3.

The Comprehensive Investor Protection Act of 2002 (H.R. 3818): A Snapshot

H.R. 3818, the aforementioned Comprehensive Investor Protection Act sponsored by **John J. LaFalce**, former chairman of the **House Small Business Committee**, and now a high-ranking member of the **House Committee on Finance**. It parallels many of the reforms now being sought by the Bush Administration.

- Sec. 1. Short title; table of contents.
- Sec. 2. Auditor independence.
- Sec. 3. Improper influence on conduct of audits.
- Sec. 4. Public Accounting Regulatory Board.
- Sec. 5. Study on the improvement of corporate governance.
- Sec. 6. Insider trades during pension fund blackout periods prohibited.
- Sec. 7. Improvements in financial reporting.
- Sec. 8. Creation of current disclosure reporting system.
- Sec. 9. Enhanced oversight of periodic disclosures by issuers.
- Sec. 10. Reauthorization of appropriations of the Securities and Exchange Commission.
- Sec. 11. Electronic disclosure of affiliate transactions.
- Sec. 12. Restoration of joint and several liability.
- Sec. 13. Credit rating agencies.
- Sec. 14. Restoration of aiding and abetting liability.
- Sec. 15. Destruction of records.
- Sec. 16. Analyst conflicts of interest.
- Sec. 17. Definition of securities laws.

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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.