



DM Extra!

Alert Edition

May 23, 2002
Alert Edition

Timely Commentary on Critical Events
and Regulatory Developments

Current Governance Reforms: Passed vs. Pending vs. Proposed

Directors need to stay informed about rules and regulations affecting their work. With so many reform proposals out there, though, it is hard to keep up. Even before the bankruptcy of Enron, corporate governance activists were working on various manifestoes, many of which had already met with legislative and/or regulatory results. The Enron bankruptcy merely added focus and urgency to these existing proposals—while generating additional ones.

This issue of DMX groups important governance reforms into three categories: *passed* (reforms that have attained final regulatory status as of May 2002), *pending* (reforms

that have begun the legislative process to achieve this status), and *proposed* (reforms that are still in the advocacy stage).

For a comprehensive look at the reforms, see the [Research Edition of this DMX](#).

Reforms That Have Passed

Some governance reforms have already *passed* and have become rules and regulations of the self-regulatory organizations (SROs) and federal agencies. Let us examine what has happened since March 1999, and then bring ourselves up to date.

Director
Summary >>>

The “Fuzzy Logic” of Governance Reform: A Commentary

This *DMX* discusses governance reforms that are passed, pending, and proposed. A natural question in the minds of directors may be this: Of the proposed reforms, which are the *most likely* to pass, and become laws and/or regulations?

I would like to say that as CEO and President of **NACD**, and as a longtime association executive, I can accurately predict the success or failure of various reform initiatives. However, that would be an exaggeration.

Governance change, to use a term from the fields of mathematics and engineering, is a “fuzzy” science. Rather than dealing in *probability* (with percentages of likelihood for passage or failure), it tends more to deal with *possibility*.

The real question to ask about any given reform, then, may well be this: Given all the data we have about the way the private and public sectors both operate, where does this particular reform lie in the spectrum between the possible and the impossible?

In my view and experience, as long as a reform is *close to possible*, then it is in the realm of consideration. That is why *DMX* is continuing to report most pending proposals to our members. Our discussions with the self-regulatory organizations, including most recently **Nasdaq** (see box on p. 4), have been most encouraging.

Truly, in the realm of governance, almost “anything is possible”—including positive and lasting reforms.

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In the past three years, the two main SROs—the [Nasdaq](#) and the [New York Stock Exchange](#)—as well as the [Securities and Exchange Commission](#), have issued many new rules, some of which originated in **Congress**. Most of these rules apply to brokers, but some apply to corporations and their boards. Here is a bullet list of some important ones that have come to NACD’s attention. (Again, for details, see the “Research Edition” of this *DMX* at [nacdonline.org](#).)

- On *March 16, 1999*, the **NYSE** advised member organizations to send their financial reports to beneficial owners (not just to intermediaries).
- On *October 22, 1999*, effective *January 24, 2000*, the **SEC** adopted comprehensive revisions to the rules and regulations applicable to takeovers.
- On *December 14, 1999*, following the SEC’s consideration of the *Report of the Blue Ribbon Committee on Audit Committee Effectiveness*, the **NYSE** adopted new rules on audit committee composition. The **American Stock Exchange** and **Nasdaq** adopted similar regulations on that day. (For details on the rules, see *DMX* February 2000, by Paula Lowitt of Weil, Gotshal & Manges.)
- On *December 22, 1999*, effective *January 31, 2000*, the **SEC** adopted new rules and amendments to its current rules to require that *companies’ independent auditors review* the companies’ financial information before the companies file their quarterly reports, and require that companies make certain *disclosures about their audit committees* (see item immediately above).
- On *August 15, 2000*, the **SEC** adopted new rules to address several issues relating to insider trading. One of them involved the selective disclosure of nonpublic information. *October 23, 2000*, was the effective date of *Regulation FD, barring selective disclosure*. Companies still had to issue *press releases* about material developments, the **NYSE** later affirmed.
- On *July 1, 2001*, Regulation S-P, requiring safeguarding of customer information, based on the Gramm-Leach-Bliley Act of 1999 (re financial modernization), became mandatory for institutions offering financial services, including department stores.
- On *December 17, 2001*, the **SEC** issued two “cautionary advice releases” on the adequacy of financial information disclosure—one that cautioned against *pro forma financial information*, the other requiring companies to ensure that their accounting policies are “*appropriately reasoned*” and disclosed.
- On *October 23, 2001*, the **SEC** released a *Report of Investigation* that included a Commission statement on the *relationship of cooperation to agency enforcement* describing how the agency will evaluate *corporate cooperation* following discovery or allegations of violation of securities laws.
- On *December 21, 2001*, the **SEC** adopted amendments based on the Securities Exchange Act of 1934 enhancing disclosure of the number of certain features of equity compensation plans. The new rule is effective for fiscal years ending on or after *March 15, 2002*, or for proxy statements for meetings held on or after *June 15, 2002*.
- On *November 21, 2001*, effective *February 5, 2001*, the **SEC** adopted rule amendments regarding auditor independence.
- On *January 22, 2002*, the **SEC** issued a statement reminding public companies of existing rules mandating disclosure of “*material uncertainties*.” This mandate, said the SEC, should apply to such matters as “off-balance-sheet arrangements,” “contracts,” and transactions with “related parties” (all Enron trouble spots).
- On *May 10, 2002*, the **SEC** approved proposed rule changes at the **NYSE** and **Nasdaq** relating to research *analysts’ conflicts of interest*. The new rules address conflicts of interest for analysts who recommend companies’ securities while being employed by firms that have investment banking or other business relationships with the companies. The rules would limit communications between research and other parts of firms and would mandate greater disclosure of conflicts.

Reforms That Are Pending

The March 11, 2002, issue of *DMX* reported on legislation pending in **Congress** as of that date. Since that time, a few reform bills have passed the House.

On *April 11*, the **House** passed [H.R. 3762, the Pension Security Act of 2002](#). The bill would require companies that sponsor 401(k) plans to provide participants with new rights to diversify their stock holdings (rather than holding them in particular stocks such as the company’s own stock). The bill would also exempt companies from liability for advice provided by the plan administrator, as long as disclosure requirements are met.

On *April 24*, the House passed [H.R. 3763, the Corporate and Auditing Accountability and Transparency Act of 2002](#). The bill, also known as the “Oxley bill” after its sponsor **Rep. Michael**

Oxley (R-Ohio), chairman of the House Financial Services Committee, has five major components. It would establish an independent accounting oversight body; bar auditors from offering certain types of consulting to their clients; mandate the disclosure of special purpose entities and other off-balance sheet transactions*; require faster and clearer disclosure of material financial information, including company stock sales by insiders; and mandate application of lockout periods (for buying and selling stock) for senior executives as well as employees, ending double standards in this regard.

In addition to the reforms that are pending in **Congress**, some are pending with the **SEC**. Three in particular merit mention. They are rules proposed for comment.

- On *April 12, 2002*, the **SEC** proposed new rules relating to the acceleration of financial report filing dates. The proposed rules would accelerate the filing of quarterly reports by 15 days (reducing it from 45 to 30 days after the close of the quarter) and would speed the filing of annual reports by 30 days (cutting it from 90 to 60 days). The proposed rules also include a directive relating to disclosures about website access to reports. The comment period for these rules has almost expired (it is *May 23, 2002*).
- Also on *April 12, 2002*, the **SEC** proposed a rule for Form 8-K disclosure of certain management transactions. The rule would require some public companies to file current reports describing directors' and officers' transactions in their companies' securities, as well as any company loans involving directors and officers. Comments are due by *June 24, 2002*.
- On *May 10, 2002*, the **SEC** released proposed changes on disclosure in the Management's Disclosure and Analysis (MD&A) statement concerning the application of critical accounting policies. The proposals cover two areas: accounting estimates a company makes in applying its accounting policies, and adoption of an accounting policy that has a material impact on its financial presentation.

—With respect to estimates, a company would have to identify any accounting estimates that required the company to make assumptions about matters that were highly uncertain at the time of estimation, and that would have a material impact on the presentation of the company's financial or operating condition.

—With respect to the adoption of accounting policies with a material impact, a company

that has initially adopted such a policy would have to disclose information that includes: why it adopted it, what impact the adoption will have, what gave rise to the initial adoption, the impact of the adoption, the accounting principle and method involved, and the choices it had among accounting principles. Companies would place all of the new disclosure in the MD&A, updating estimates quarterly.

Comments on this proposal should be received on or before *July 19, 2002*.

Reforms Proposed for Consideration by the SROs, SEC, and/or Congress

So many organizations and individuals have proposed reforms, that it would be impossible even to list them all in the space of this *DMX*. We refer readers to past issues of *DMX* and of the NACD print newsletter, *Director's Monthly*, for descriptions of these reforms. For example, in order of appearance, the April 2002 issue of *Director's Monthly* features reform concepts and/or proposals from the NACD board of directors, as well as from **Ira M. Millstein**, NACD director and a partner with **Weil, Gotshal & Manges**, and **John H. Biggs**, Chairman and CEO, **TIAA-CREF**. The issue also summarized proposals from **President George Bush**, which one can view on whitehouse.gov, and from **Comptroller General David M. Walker** of the **General Accounting Office** (who recently agreed to chair a newly formed **Center for Continuous Auditing at Texas A&M University**). The following list includes only items not already reported in *DMX* or *DM*.

In the area of *general governance reforms*, the NYSE has appointed a special committee to its board of directors—the **Corporate Accountability and Listing Standards Committee**, announced *February 13, 2002*. The committee, co-chaired by **H. Carl McCall**, **Gerald H. Levin**, and **Leon E. Panetta**, has heard from various groups, including the NACD, which proposed 10 governance standards for mandatory disclosure by listed companies. A report is expected as early as *June 2002*.

Nasdaq undertook a similar review and has already issued some recommendations. On *April 11, 2002*, the executive committee of the board of Nasdaq approved "initial" recommendations proposed by the **Nasdaq Listing and Hearing Review Council** that will significantly tighten corporate governance practices at firms listed on the exchange.

* For an excellent discussion of special purpose entities, visit the Financial Executives' Institute at fei.org.

The **NYSE** and **Nasdaq** are not the only private-sector groups involved in governance reform. The CEOs of the nation's largest companies have been at work on reform ideas as well.

On *May 14*, the **Business Roundtable** issued its [2002 Principles of Corporate Governance](#). The list includes eight main points, ranging from stockholder approval of stock options and restricted stock plans in which directors or executive officers participate, to stronger procedures for audit committee oversight of auditors.

In *March 2002*, the [Financial Executives Institute \(fei.org\)](#) issued recommendations for

NACD members have asked about the progress we have made with our reform recommendations in 2002.

Hon. John J. LaFalce (D-NY), ranking minority member of the Financial Services Committee of the House, spoke at our Annual Governance Conference on *April 29th*. A senior staffer and I will be meeting with Rep. LaFalce on *June 5* to see how the NACD and **Congress** might work together for governance reform.

On *April 4*, I testified before the **New York Stock Exchange** concerning NACD's 10 reform proposals.

On *May 13*, I had a 45-minute discussion with **Edward S. Knight**, executive vice president of **Nasdaq**, as well as his senior legal staff. He liked our idea of putting together small groups of NACD member directors who would be available to meet with Nasdaq officials throughout the country.

Nasdaq will meet in *July* to finalize its report and recommendations. Prior to the meeting, Mr. Knight will provide a draft of the report for our comments.

NACD members are encouraged to contact me with views of interest to the **SROs**, to the **SEC**, and to **Congress**.

Roger W. Raber, NACD President and CEO

“Improving Financial Management, Financial Reporting, and Corporate Governance.” The group offered recommendations in four areas: strengthening financial management and commitment to ethical conduct; rebuilding confidence in financial reporting, the accounting industry, and the effectiveness of the auditing process; modernizing financial reporting, and reforming the accounting standards-setting process; and improving corporate governance and the effectiveness of audit committees.

The [Institute of Internal Auditors](#) has issued recommendations in three main areas. The IIA wants the SROs to jointly issue a uniform set of corporate governance principles for publicly held companies. Moreover, the IIA says that the boards of public companies should be required to disclose in their annual reports the extent to which they are in compliance with those principles. (The NACD issued a similar recommendation on *March 1, 2002*, accompanied with 10 suggested principles for adoption.)

The [Financial Accounting Foundation](#), which oversees the **Financial Accounting Standards Board** (FASB), has recommended ways to streamline the FASB rulemaking process. Shareholder activists have not been asleep on the job, either. **Nell Minow**, Editor, [The Corporate Library \(thecorporatelibrary.com\)](#), has proposed five major changes to the **Corporate Accountability and Listing Standards Committee** of the NYSE. Among other reforms, Minow wants an SRO requirement that listed companies include their corporate governance policies and conflict of interest policies in their proxy statements. Her proposed reforms include specific recommendations for these policies.

Looking Ahead

Clearly, corporate governance concerns have generated many important ideas before and after the watershed of Enron. Corporate boards need to study these ideas, apply them voluntarily if they make sense, and, perhaps most important, remain aware of their changing regulatory status. ■

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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.