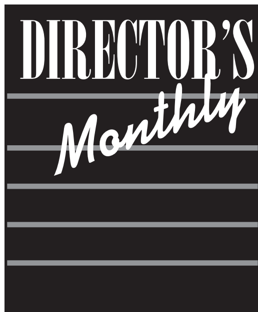

DM Extra!

Research Edition

May 23, 2002
Research 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.

Director Summary

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).

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.

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. 6), have been most encouraging.

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

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A publication of the
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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 list of some important ones that have come to NACD's attention.

- On *March 16, 1999,* based on **SEC** Rules 451 and 465 of the Securities Act of 1933, the **NYSE** advised member organizations to send their annual reports, interim reports, and other material to beneficial owners (not just the financial intermediaries that represent the owners).
- On *October 22, 1999*, effective *January 24, 2000,* the **SEC** adopted comprehensive revisions to the rules and regulations applicable to takeover transactions (including *tender offers, mergers, acquisitions,* and similar extraordinary transactions). The revised rules permit increased communications with security holders, balance treatment of stock and cash tender offers, simplify and centralize disclosure requirements, and eliminate regulatory inconsistencies in mergers and tender offers.
- 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. Following the 1999 rule change, the NYSE amended its *Listed Company Manual* (Section 303.02C) to require "written affirmation" of the *independence, financial literacy, and financial management experience* of each listed company's audit committee members. The written affirmation must be submitted no later than one month after the annual shareholder's meeting, and must be resubmitted every time the audit committee changes. The NYSE rules also require that companies certify completion of the *mandatory annual review of the audit committee charter.* The **American Stock Exchange** (AMEX) and **Nasdaq** adopted similar regulations on *December 14* as well. (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 on nonpublic information. *October 23, 2000,* was the effective date of *Regulation FD, barring selective disclosure.* This rule said that if a company disclosed nonpublic material information in a conference with analysts, it had to simultaneously disclose this by appropriate means to the public. The rule listed many acceptable forms of prompt disclosure. After that, companies listed on the **NYSE** asked if they still had to issue *press releases* about material developments, as required under the "timely alert" policy, and the NYSE said yes, in a release dated *March 22, 2001.*
- *July 1, 2001*, Regulation S-P, based on Section 504 of the Gramm-Leach-Bliley Act of 1999 (re financial modernization), became mandatory for institutions offering financial services, including department stores. It was adopted by the **SEC** on *June 22, 2000*, and became voluntarily effective later that year. This regulation requires that companies *safeguard customer information.* This regulation applies to any company that has credit activities, including major retailers.
- On *December 17, 2001*, the **SEC** issued two "cautionary advice releases" on the *adequacy of financial information disclosure*.

  —In one of the releases, the **SEC** cautioned companies against using *"pro forma" financial information* in their earnings releases. Pro forma financial information is information that does not conform to generally accepted accounting principles, but is used for illustrative purposes.

  —In the other release, the **SEC** told public companies that the selection of their *accounting policies should be "appropriately reasoned" and disclosed.* The SEC said that public companies should provide plain English discussions of their accounting policies in the Management's Discussion and Analysis (MD&A) part of the proxy statement.
- On *October 23, 2001,* the **SEC** released a *Report of Investigation* that included a Commission statement on the r*elationship of cooperation to agency enforcement* describing how the agency will evaluate *corporate cooperation* following discovery or allegations of violation of securities laws. The statement, based on Section 21 (a) of the Securities and Exchange Act of 1934, said that a company

would be deemed "cooperative" based on the extent to which it showed evidence of: self-policing prior to the discovery of the misconduct, self-reporting of misconduct upon discovery, remediation (including dismissing or appropriately disciplining wrongdoers), and cooperation with law enforcement authorities. The SEC said it would reward companies that cooperated by bringing reduced charges, seeking lighter sanctions, using mitigating language in announcing and resolving their cases, and/or refraining altogether from enforcement action, except in extreme cases.*

- On *November 21*, effective *February 5, 2001*, the **SEC** adopted rule amendments regarding *auditor independence.* Until *August 5, 2002*, an auditor may provide an audit client with certain nonauditing services (namely appraisal or valuation services or fairness opinions, or internal audit services), if the services do not break any rules from the SEC, the **Independence Board**, or the accounting profession. After that date, such services will be deemed to impair independence.
- On *December 21, 2001*, the **SEC** adopted amendments based on the Securities Exchange Act of 1934 enhancing *disclosure* of the number of outstanding options, warrants, and rights granted by companies to participants in *equity compensation plans,* as well as the number of securities remaining available for future issuance under the 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*. *Compensation committee members should note this development.*
- 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 a speech at the **NACD** Annual Governance Conference, **Hon. John J. LaFalce**, sponsor of a more comprehensive reform bill, charged that the bill did not go far enough. Rep. LaFalce, who is ranking minority member of Rep. Oxley's committee, faulted the bill in particular for not provided more resources to the **SEC**, which would need more resources to enforce reforms. The full text of Rep. LaFalce's speech, as well as a description of the Oxley bill, will appear in the July 2002 issue of *Director's Monthly*.

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

* This statement is similar to others issued by the federal government. The Federal Sentencing Guidelines of November 1991 offer leniency to companies with compliance programs. Also, the Antitrust Division of the Department of Justice has a Corporate Leniency Policy through which the DOJ may grant amnesty for corporations that cooperate early on in an investigation.

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

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 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 summarizes 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. A cross-section of the comprehensive proposals includes: ensuring the independence of directors on audit committees and strengthening the authority of audit committees; expanding shareholder approval of stock option plans; recommendations that all companies adopt codes of conduct; harmonizing Nasdaq's regulations with Regulation Fair Disclosure; and continuing education for board members. Nasdaq officials also called for a ban on stock market executives holding board seats at companies listed on their exchange. If adopted by all U.S. markets, such a rule would oblige NYSE chairman **Richard Grasso** to resign his current directorships at **Home Depot, Inc.** (HD) and **Computer Associates International** (CA).

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*, we received a copy of the *2002 Principles of Corporate Governance* of the Business Roundtable (BRT). The BRT wants companies to adopt a number of best practices

in corporate governance. It urges member companies and others to:

- require stockholder approval of stock options and restricted stock plans in which directors or executive officers participate
- create and publish corporate governance principles so that everyone from employees to potential investors understand the rules under which the company is operating
- provide employees with a way to alert management and the board to potential misconduct without fear of retribution
- require that only independent directors may sit on the board committees that oversee the three functions central to effective governance—audit, corporate governance, and compensation
- ensure that a substantial majority of the board of directors comprises independent directors both in fact and appearance
- ensure prompt disclosure of significant developments
- establish a management compensation structure that directly links the interests of management to the long-term interests of stockholders, which includes a mix of long- and short-term incentives, and
- require the audit committee to recommend the selection and tenure of the outside auditor and consider what policies should be adopted by the company with respect to changing the outside auditor, rotating the audit engagement team personnel, or limiting the hiring of such personnel.

These new guidelines build on the work the **BRT** has done on corporate governance issues for 25 years. Some may consider them conservative, noting the points they do not cover (such as director education). On the other hand, this consensus view—significant and no doubt hard-won—is clearly a valuable addition to the dialogue. A copy of the BRT's 2002 *Principles of Corporate Governance* can be obtained by visiting the BRT website at **www.brt.org**.

And there is more!

- In *March 2002*, the **Financial Executives Institute (fei.org)** issued recommendations for "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. For additional information contact **Bob Shepler** at **bshepler@feidc.org**.

The **Institute of Internal Auditors** has also issued recommendations, as follows:

- **NYSE**, **AMEX**, and **Nasdaq** should jointly issue a uniform set of corporate governance principles for publicly held companies. Moreover, the board of directors 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 boards of directors of all publicly held companies should be required to publicly disclose an assessment of the effectiveness of internal controls within their organizations. Such disclosures should address internal controls broadly, rather than being limited to accounting controls over the recording and reporting of financial information.
- All publicly held companies should establish and maintain an independent, adequately resourced, and competently staffed internal auditing function to provide management and the audit committee with ongoing assessments of the organization's risk management processes and the accompanying system of internal control. If an internal auditing function is not present, the board of directors should be required to disclose in the company's annual report why the function is not in place.

Meanwhile, the **Financial Accounting Foundation**, which oversees the **Financial Accounting Standards Board** (FASB), has recommended these three items:

- reduction in the size of the FASB from seven to five members
- a simple majority-voting requirement of 3-2 for the five-member board (the current board has a 5-2 supermajority requirement), and
- a recommendation to the FASB that it expose proposed standards for shorter comment periods.

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**.

1. Listed companies should be required to include their corporate governance policies and conflict of interest policies in their proxy statements. If they waive those policies at any time, that should be disclosed, along with the reasons for the waiver. The policies should include provisions governing the sale of company stock (including cashless exercise of options), the schedule of executive session board and committee meetings (meetings without any executives or other representatives of management present), and the procedures for finding new directors.

   —The policies should also disclose whether committees have authority to hire or replace service providers like accounting or headhunter firms, whether they have access to their own counsel or consultants when they deem it necessary, and what kind of direct staff support they have within the company.

   —If the listed company has a pension plan, the corporate governance policies should include the role of the board with regard to the plan, including responsibility for the way that proxy votes and exercise of other shareholder rights are undertaken for the exclusive benefit of plan participants, the employees, and retirees.

2. When a shareholder proposal gets a majority vote and is still rejected by the directors, in the next proxy the shareholders should have the option to nominate one director candidate. The procedure would be similar to that of a shareholder proposal—the candidate would be included in the company's proxy materials with a brief statement from the proponent and any rebuttal from management. At other times, shareholders who

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*. I will be meeting with Rep. LaFalce on *June 5*, accompanied by NACD senior research analyst **Alexandra Lajoux**, 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. We met in their Washington, D.C., offices on 1735 K Street.

Mr. Knight led the discussion. He complimented NACD on our recommendations and leadership in raising the visibility of good governance with Nasdaq-listed companies. He and his colleagues were mainly focused on a more rigorous definition of independence, accountability of internal and external auditors to the audit committee and board, importance of a non-executive chair or lead director, and requiring education for new and continuing directors. While we did discuss the other recommendations as well, most of our discussion revolved around opportunities to educate CEOs and boards.

I invited him and any of his colleagues to attend our programs, by noting that one of Nasdaq's senior officers attended the eight-hour NACD audit committee program at the Willard on *May 1*, led by **Gerry Czarnecki**, NACD faculty member and chair of the **State Farm** audit committee. 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**, or to contact these institutions directly (with a copy to me).

Roger W. Raber, NACD President and CEO

hold at least five percent of the stock should have the same right to nominate a single director for inclusion in the company's proxy materials.

3. Any online proxy voting system should be required to include all proxies circulated by all parties. Both sides in a proxy contest should have access to the cheaper and more accurate system for counting votes available through **ADP**. All votes should be counted the same way, especially if there is any form of shareholder initiative, from a proposal to a contest.
4. Companies that exceed minimum standards should benefit, perhaps through some program of certification or a rating system.
5. Improvement of the system for distributing proxy materials is long overdue. Over the years, this system has grown into a cumbersome, complicated, and technologically outdated process. The current fee structure, which is set by the **NYSE** and approved by the **SEC**, along with **ADP**'s contracts (some longer than 10 years) with nearly all major brokerage houses ensures the continuation of the current cumbersome system—essentially a self-regulated monopoly. This is especially treacherous in matters like determination of what is and is not "contested." Should it require use of ADP to be considered "contested" if ADP is the entity making the determination? Technology advances should significantly transform this important process.

Minow endorses the recommendations of the **Council of Institutional Investors (cii.org)**, particularly those regarding clarifying the definition of independent director, repealing the broker vote provisions, and requiring shareholder approval of all stock option plans.

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.

A final note: If you have gone to the trouble of reading this special "research edition," you are undoubtedly someone who is (or is becoming) knowledgeable about governance. Therefore, we encourage you to express your views. Speak out! **NACD** is proud to be a source of information for members, but we want this information to become action—in the boardroom, and in the nation. Take the time to comment directly to **Congress**, the **SEC**, and the **SROs**—and be sure to send me a copy of your communication. You will serve a worthy cause: good governance. ■

Acknowledgments: For the first part of this *DMX*, concerning reforms that have passed, NACD would like to acknowledge the contributions of the following law firms, whose client letters alerted us to these developments or clarified their meaning: **Fried, Frank, Harris, Shriver, and Jacobson**; **Gibson, Dunn & Crutcher**; **Mayer, Brown, & Platt**; **Jones Day Reavis & Pogue**; and **Weil Gotshal & Manges**. Our reporting is also based on **SEC** documents provided through **Bowne Financial Publishing**, via the "Bowne Red Box Service."

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.

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