



IR Strategy Series

Governance Moves to Center Stage

Restoring investor confidence will require companies to embrace both the letter and spirit of reforms

In the current environment of mistrust and erosion of shareholder value, corporate governance has moved to the forefront of investors' minds. Beyond the spate of new laws and regulations being enacted, governance speaks to fundamental issues of trust:

- What degree of confidence does a stockholder have that the corporation is being run for his or her benefit?
- What assurance do investors have that information provided by companies is accurate and fair?

Every CEO should be thinking about how to positively differentiate their company on this score. What was once primarily a legal responsibility now has immense and wide-ranging consequences for companies perceived to be laggards—from lower stock prices to higher insurance premiums to an inability to access equity or debt financing. Senior management needs to place a priority on ensuring compliance with the new rules and creating an effective investor relations strategy to communicate the company's governance policies. Leadership in applying best practices will enhance corporate reputations and bolster long-term stock performance.

Strong Rules, Vibrant Markets

The United States has arguably the best corporate governance, financial reporting and securities market systems in the world. While recent experiences of company misconduct tend to obscure the facts, this country's capital markets have been operating for 200 years and have generated unrivaled access to capital for corporations and an unmatched breadth of individual participation. Noisy, democratic, enthusiastic—U.S. markets reflect our boisterous, optimistic national temperament. America's comprehensive accounting and securities rules were created largely as a check on the inherent tendency of markets to swing periodically towards excess, based on experiences with past transgressions.

Looking back to the Great Crash of 1929 and ensuing depression, we find that shareholder value had eroded and investor confidence had reached a nadir. Many investors who fled the markets in the aftermath of the crash never again

returned to equity investing. Congress stepped in to hold a series of hearings and determined that the remedy to restore the public's trust in our capital markets was to provide more structure and government oversight with the Securities Act of 1933. Often referred to as the "truth in securities" law, the Securities Act of 1933 was designed with two basic objectives:

1. require that investors receive financial and other significant information concerning securities being offered for public sale; and
2. prohibit deceit, misrepresentations, and other fraud in the sale of securities.

The Securities Act of 1933, the formation of the Securities and Exchange Commission (SEC) and the subsequent updates and additions to the capital market rules and regulations have proven relatively effective over the years. But events of the past twelve months have revealed yawning cracks in this regulatory framework: managers at some of the most respected U.S. companies who treated the stock market as a game to be rigged for their personal enrichment; audit firms that consistently overlooked fraudulent accounting; directors who failed to exercise oversight until the corporate ship was on the rocks. Unfortunately, the actions of these errant companies have, once again, decimated stock prices and public confidence in the integrity of the markets. Over 70 years after the Great Crash, the markets and legislative system are seeking to restore the public's trust and confidence through landmark reforms in corporate governance.

In order to rectify the current state of affairs, the government, the SEC and the various market systems have proposed sweeping reforms. The rules and regulations are only a starting point—within this framework, corporations are expected to operate with integrity and to act in the interest of shareholders. This paper is intended to serve as a reference point for the new corporate governance and accountability guidelines and to assist management in its efforts to identify and actualize best practices in corporate governance.

Landmark Reforms in Corporate Governance and Accountability

In recent months, there has been a flood of proposed new regulations that have garnered attention and controversy. Below we cover the most significant rules that are on track to become law.

The Sarbanes-Oxley Act

On July 30, President Bush signed the Sarbanes-Oxley Act of 2002, which provides legislation for accounting regulation, corporate responsibility, new protections and new criminal penalties for securities fraud. The accounting regulation includes the creation of the Public Accounting Oversight Board, prohibition on certain non-auditing consulting services by public company auditors and a requirement that auditors report on management's assessment of its accounting controls. However, the focus of the Sarbanes-Oxley Act is legislation affecting corporate governance, including provisions that:

- require CEOs and CFOs to certify financial reports;
- require companies to immediately disclose "in plain English" material changes to their financial condition;
- prohibit executives from selling company stock during blackout periods,
- require insiders to report all company stock trades within two days;
- require executives to forfeit profits and bonuses when earnings are restated due to securities fraud;
- prevent executives from receiving company loans unavailable to outsiders; and

- increase responsibilities of audit committee to include appointment and oversight of auditors, resolution of management and auditor disputes and establishing procedures for complaints.

The Sarbanes-Oxley Act gives the SEC stronger enforcement authority and provides new protections including increased civil and criminal penalties for false certifications, fraud and document destruction and increased defense for whistleblowers. The statute of limitations for securities fraud has been extended to five years, and debt arising under these claims will no longer be dischargeable in bankruptcy proceedings. Attorneys are required to report securities violations and breaches of fiduciary duties to the audit committee.

In addition to the new requirements, the Sarbanes-Oxley Act mandates a number of studies, which may indicate further legislative initiatives. Topics of these studies include mandatory auditor rotation, special-purpose entities, the role and function of credit agencies, SEC enforcement actions, consolidation in the accounting industry, the role of investment banks in earnings manipulation and sentencing guidelines.

While some of the provisions, such as the CEO and CFO certification of periodic reports, will become effective immediately, a number of the provisions require proposal and issuance of specific rules by the SEC. The following table summarizes the effective dates of the provisions of the Sarbanes-Oxley Act and areas where further consideration will be required.

Effective Dates of Sarbanes-Oxley Act Provisions

Effective Immediately	90-Day Triggers	270-Day Triggers
CEO and CFO certifications	SEC to propose rules on qualifications for audit committee (and issue rules within 180 days)	SEC to issue rules requiring audit committees to hire and oversee auditors
Forefeiture of profits due to securities fraud	SEC to propose rules on code of ethics for executives (and issue rules within 180 days)	SEC to determine whether Public Company Accounting Oversight Board is organized and able to carry out requirements of Act
Prohibition of new loans to executives	SEC to propose rules on breaches of fiduciary responsibility (and issue rules within 270 days)	
Protection of whistleblowers		
Grants SEC authority to approve board members		
Requires SEC to review company filings every three years	180-Day Triggers	One-Year Triggers
Requires SEC to issue "rapid and current" disclosure rules	Executives prohibited from selling company stock during blackout periods	SEC reports to be filed electronically and published on internet within one business day
Non-discharge in bankruptcy of fraud-related debts	SEC to issue rules requiring attorneys to report breaches of fiduciary responsibility	Completion of study on special purpose entities within one year of adoption of off-balance sheet disclosure rules
Extension of statute of limitations on securities fraud	SEC to issue rules prohibiting disclosure of pro forma financial data not reconciled with GAAP	SEC to adopt rules addressing analyst conflict of interest
Creation of new criminal offenses for securities fraud	SEC to issue rules requiring disclosure of all material off-balance sheet transactions	Completion of study on mandatory rotation of auditing firms
Directive to U.S. Sentencing Commission to amend sentencing guidelines	U.S. Sentencing Commission to review and amend federal sentencing guidelines	
30-Day Triggers		
SEC to issue rules on CEO and CFO certifications		
Acceleration of insider filing to two days		

SEC Reforms and Proposed Rules

The SEC has also been active in corporate governance reforms, with a new requirement of one-time sworn certifications of past financial results from the CEO and CFO of the 947 largest companies in the U.S. and proposed rules for accelerated filing dates and expanded definitions of materiality. According to SEC Chairman Harvey Pitt, the one-time certification, which was due August 14th, was intended to assure that senior corporate executives are taking personal responsibility for their companies' filings and personally stand behind the accuracy of their companies' reported numbers.¹ In addition to the certification, the SEC has proposed several new rules, which are expected to be clarified in relation to the provisions of the Sarbanes-Oxley Act. In brief, the SEC has proposed:

- ongoing CEO and CFO certifications;
- company reporting of insider transactions;
- disclosure of critical accounting policies; and
- an expanded list of 8-K disclosure items.

The SEC recently approved and implemented several of the new rules, including an accelerated disclosure policy, certification of the financial results and a requirement that insiders report all company stock trades within two days. The accelerated filing changes, which require quarterly reports to be filed within 35 days of the end of the period and 60 days after the end of the year, will be phased in over 2003 and 2004. The change applies only to domestic companies that have a minimum market value of \$75 million, have filed at least one annual report and have been under SEC regulation for no less than one year.

Summary of Adopted Market Reforms

The New York Stock Exchange (NYSE), American Stock Exchange (AMEX) and National Association of Securities Dealers Automated Quotations (NASDAQ) have all adopted separate recommendations to ensure board independence and strengthening of corporate governance. While the scope of the recommendations is slightly different, as the NYSE is more stringent, the reforms are fairly similar.

The NYSE, AMEX and NASDAQ market recommendations:

- require that a majority of board members be independent;
- mandate that shareholders vote on stock option plans;
- require audit, nominating and compensation committees to consist solely of independent

directors (NYSE) or a majority of independent directors (AMEX and NASDAQ), with a requirement that the chair of the audit committee have accounting or financial management experience;

- increase the responsibilities of board audit committees;
- require the CEO to attest to the accuracy, completeness and understandability of information provided to investors; and
- mandate that listed companies adopt and publish corporate governance guidelines and a code of business conduct and ethics.

The SEC is expected to review and act on the recommendations of the various market systems this fall.

Governance and Shareholder Value

Numerous studies suggest that good corporate governance practices translate into superior long-term stock performance. And recent market examples such as at Enron, WorldCom and Global Crossing have convincingly shown that that poor corporate governance often leads to the radical destruction of shareholder value. In 2001, Harvard Business School published an index showing a significant correlation between corporate governance and stock returns. The study concluded that investors purchasing companies with the highest provisions of shareholder rights based on its index would have earned abnormal returns of 8.5% during the sample period and companies with weaker shareholder rights, or corporate governance, were associated with lower profits, lower sales growth, higher capital expenditures and a tendency towards dilutive corporate acquisitions.²

With the markets at record levels over the past several years, the pressure on managers to perform, often at the expense of high ethical standards, has been extremely high. As stock prices became detached from economic reality, financial gamesmanship became a virtue. Analysts, investment bankers, institutional investors and managers all had a strong incentive to see that companies "made their numbers" – even if this required selective presentation of the facts. According to an ethics survey by *Controllers Update*, 67% of CFOs have had to fight off other executives requests to misrepresent results and 12% of these respondents actually yielded to the pressure to manage earnings.³ Although managing earnings is most often done within GAAP guidelines, and therefore technically legal, recent examples show that there is a slippery slope leading from aggressive earnings management to outright fraud.

As a result of this inability to trust the financial results, non-financial measures have become increasingly important indicators in investment decisions and shareholders are taking more of an active role in their investments. According to a study by Ernst & Young, approximately 35% of an investment decision is based on non-financial data and of this data, strategy execution and management credibility are the two most important measures.⁴

Investors are no longer confident in relying only on quantitative results and are placing increasing importance on qualitative measures. Earnings *quality* is now at least as important as earnings *consistency*. This encompasses both transparent, operations-oriented financial reporting and management's ability to articulate and execute on its business strategy. As a result, many companies are providing greater detail on their critical accounting policies and investors are demanding that reporting clearly reconciles reported earnings to cash flows. Companies even suspected of gaming their results are being placed in the penalty box or driven into distress.

Governance Report Card

Given investors' heightened interest in disclosure, it was perhaps inevitable that a standardized rating system would emerge. The Corporate Governance Quotient (CGQ)TM was developed by Institutional Shareholder Services (ISS), the leading proxy advisory service to institutional investors. The quotient is located on the front page of the ISS proxy analysis and is comprised of the following seven topics:

1. board composition and structure;
2. charter and bylaw provisions;
3. laws of the state of incorporation;
4. executive and director compensation;
5. qualitative factors, such as financial performance;
6. director and officer stock ownership;
7. and director education.

The CGQTM ratings will be provided to ISS institutional clients and will enable investment managers to evaluate relative performance of companies based on their governance structures. Initially, ISS plans to develop CGQTM ratings for all of the companies in the Russell 3000 Index, and then extend it to all listed companies. Public companies would be well advised to see how they measure up according to the index and make adjustments to their governance policies before their institutional shareholders make buy-sell decisions.

Upswing in Shareholder Activism

Investors are not only applying corporate governance data to making investment decisions, but are also taking a more active role in monitoring and participating in the governance of companies. The Investor Responsibility Research Center (IRRC), which tracks votes for shareholder proposals, noted that voters were particularly active in this year's annual meeting season. IRRC's research shows that shareholders are looking to put more independent directors on boards, allow shareholders to vote on executive pay and to prohibit a company's auditor to do consulting work for the firm.⁵

Teachers Insurance and Annuity Association College Retirement Equity Fund (TIAA-CREF), which controls \$275 billion in investments, has long set an example as a major voice for shareholder rights and improved corporate governance. Prior to the creation of the Sarbanes-Oxley Act, representatives from the fund lobbied Congress and appeared before the House Financial Services Committee to urge them to consider a wide range of corporate governance reforms. Similarly, the California Public Employees' Retirement System (CalPERS) has indicated it will actively and publicly oppose certain audit committee and auditor proposals. And a new breed of activist, hedge fund investors are agitating for change at what they perceive to be underperforming companies with passive boards.

Governance and Corporate Liability

Another indicator of the growing importance of corporate governance is the current environment for insurance underwriting for directors and officers (D&O) insurance policies, with exposure to claims against directors and officers on the rise. Insurers are now thoroughly examining a company's corporate governance policy, accounting policies and disclosure practices before extending coverage. In many instances premiums have doubled or tripled; in other instances insurers are refusing to provide coverage to cover "high risk" companies at any price. Absent adequate D&O insurance, it is effectively impossible to recruit qualified officers or convince directors to serve on a board.

Governance Best Practices

Most public companies will need to make a number of changes in order to meet the new corporate governance and accountability requirements. In addition to a legal obligation, these changes should be viewed as an opportunity to clearly identify the company as one that provides transparent business reporting and is managed

for the benefit of its shareholders. Here are several tangible recommendations as to how a company can work towards compliance of the new regulations and be a leader in increasing management credibility and shareholder value.

1. Lead by *Example*

Companies will have to work diligently to rebuild the public's confidence, but the starting point for an ethical and transparent company is with the CEO. The CEO is the role model and sets the code of conduct that often permeates the entire organization. Discussions of every important business decision should be framed by the question: "Do we believe that this action will ultimately advance the interests of our shareholders?" If the CEO consistently applies high, clear standards of conduct then formal rules and policies become largely redundant. Ken Langone, member of the NYSE Corporate Accountability and Listing Standards Committee, counsels that a CEO should continually ask him or herself "whether I would object to what I'm doing right now being on the front page of the newspapers." ⁶

2. Examine Board Composition

Management should examine its existing board to determine if the composition meets the proposed requirements by the market on which the company's stock trades. Issues to consider include whether a majority of the board members are independent, whether the audit, nominating and compensation committees are comprised of independent directors and whether they are qualified to meet their responsibilities. In many instances, CEOs are in the unique position of selecting their own superiors. Separating the function of Chairman and CEO can send a strong signal that the system of corporate checks and balances is taken seriously. With the burdens and perceived liability of being a board member increasing, companies will have to work harder to find qualified directors. In this environment it is crucial to ascertain that each board member has a willingness to serve on the company's board and will take an active and constructive role in working to increase shareholder value.

3. Establish Policy for Addressing Requirements

Every company should have a policy and process for addressing the new Sarbanes-Oxley Act, SEC, exchange and NASDAQ listing requirements and

ensuring that the rules are applied. Management should create a process to make sure that the company is in compliance with regulations, including channels for certification of SEC filings; complying with disclosure rules; adding required data, such as committee charters, to the company's website; and putting new certification language in SEC filings. Companies should also put channels in place to explore and consider rules that have been proposed and may be required in the future, such as expensing stock options, permitting direct nomination of board members by shareholders and requiring institutional investors to report voting policies and votes in corporate elections.

4. Explain Company Policies and Code of Ethics

The next step to enhancing credibility is to clearly define the company's policies and the code of ethics. Any statement of principles should be accurate, complete and understandable by each executive, employee and shareholder. According to the Sarbanes-Oxley Act, the statement of principles must be published on the company's website. However, companies are judged not only by what they say, but also by what they do. The actions must support the message in order to develop and enhance management's credibility. The same principle applies to financial information. Companies are now expected to not only disclose *what* accounting policies they apply, but *why* they believe these figures most accurately portray their operating results and financial condition. "Black box" business reporting is no longer an acceptable approach.

5. Educate Employees and Investment Community

Once the message has been defined, the next step is to educate the employees and investment community. We suggest a discussion of governance principles be woven into every investor presentation, every annual report and every new employee orientation. Management should be prepared to explain the company's compensation policy and describe the role played by the board in reviewing strategic decisions and financial statements. Companies seeking shareholder approval for stock option plans should clearly and specifically explain why they will be additive to shareholder value and then meet in person with significant investors. By informing and educating the investment

community, the company can present a strong case for why a proposal should be approved and make it significantly more likely they will garner the required support to pass.

Education extends to the board of directors as well. In the U.K., it has been a long-standing tradition to send directors to directors' training programs and the idea is beginning to be implemented in the U.S. Even directors with decades of business experience may not have the accounting and legal backgrounds to effectively discharge their duties.

6. **Ensure Compliance and Handle Transgressions**

Being in compliance with the new corporate governance requirements doesn't end with the implementation of the rules. In order to ensure that that executives and employees consistently adhere to the policies and that there are clear procedures for handling complaints. We would advise appointing one of the independent directors as chair of this initiative and setting up a direct communication channel for complaints to reach this director. This will avoid the situation in which employees who are aware of transgressions feel that they have no place to take the information. Any compliance problems that may arise should be dealt with in a proactive and public manner so that the misbehavior and consequences are well known within the organization and, therefore, less likely to occur again.

Summary

The process of corporate governance reform will be fluid, ongoing and sometimes imperfect. Alan Greenspan, of the Federal Reserve Board, said that "...rules cannot substitute for character."⁷ Regulations are by their nature blunt instruments that may fall short of or overshoot their mark. But the essence of the changes will be to increase investor confidence in the public markets and to improve long-term shareholder value. Companies need to focus not only on complying with the new requirements, but applying the highest standards of excellence and integrity to the way in which they make business decisions and communicate those decisions to the company's owners, their shareholders —and in time, the public's confidence will return and share prices will improve.



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¹ "SEC Staff Completes Processing of CEO, CFO Statements" U.S. Securities and Exchange Commission, August 20, 2002. Available on <http://www.sec.gov/news/press/2002-125.htm>

² "Corporate Governance and Equity Prices," Paul A. Gompers et al, Harvard University and University of Pennsylvania, July 2001.

³ "Restoring Confidence," Working Council for Chief Financial Officers teleconference presentation, Corporate Executive Board, August 2002, page 7.

⁴ "Measures that Matter," Amy Biltz et al, Ernst & Young LLP, 1997.

⁵ "IRRC Tally Shows Record Support for Shareholder Proposals in 2002," Investor Responsibility Research Center, June 14, 2002.

⁶ "Recommendations of the Corporate Accountability & Listing Standards Committee," NYSE committee members, June 6, 2002. Available on http://www.nyse.com/about/corp_gov_a.html

⁷ "Corporate Governance," Remarks by Federal Reserve Board Chairman Alan Greenspan at the Stern School of Business, New York University, New York, New York, March 26, 2002. Available on <http://www.federalreserve.gov/boarddocs/speeches/2002/200203262/default.htm>