IRRC

Corporate Governance BULLETIN

— Covering Shareholder Issues Worldwide —

Volume XX, Number 1 **February - May 2002**

Government vs. Governance: A Clear Verdict

IRRC is pleased to publish the first of what will be a continuing series of articles written by guest authors, in order to provide corporate governance experts an opportunity to shares their views and to give our readers different perspectives on important issues.Our first contributor is Roger Raber, president and CEO of the National Association of Corporate Directors, who has played an active role advocating governance reforms in the wake of Enron. Those interested in contributing an article for publication in the Corporate Governance Bulletin, should contact the editor, Rosemary Lally at 202/833-0700, ext. 170.

The December 2, 2002, bankruptcy filing of Enron Corporation, once the nation's seventh largest company, has revived a classic dichotomy for the American corporate community—the old "government vs. governance" debate.

Some argue that the Enron bankruptcy shows a need for stronger government regulations, and reveals the weakness of self-governance as a solution.(Governance is dead, they say; long live government.) They want to strengthen or expand existing federal rules governing various aspects of corporate life, ranging from auditor independence rules to more stringent disclosure rules.

These themes and others appear in a package of reforms proposed on March 7 by President George Bush. They also appear in a bill introduced to the House on February 28 by Hon. John LaFalce (D-N.Y.), a high-ranking member of the Financial Services Committee, along with Hon. Richard Gephart (D-Mo.), the leader of the House Democrats. This bill, The Comprehensive Investor Protection Act of 2002 (H.R. 3818), summarizes the problems that have allegedly occurred in the Enron situation, and proposes specific regulatory solutions for each one.

Others doubt the value of comprehensive government solutions. They say that the Enron case proves the need for stronger self-governance, and exposes the weakness of government-imposed solutions. Governance advocates assert that the Enron catastrophe happened, despite the great number of carefully constructed rules and regulations governing corporations in this country, because the key participants—auditors, attorneys, executives, and directors— failed to govern themselves. These pro-governance voices call for continued efforts to strengthen good governance within corporations. The National Association of Corporate Directors, helped rally the troops for this side of the debate in our February 6, 2002, testimony to Congress, and in a March 1, 2002, statement to the Securities and Exchange Commission.

Who is right? It is easy to argue both sides of this debate. Certainly it is tempting to consider the "government" solution — even from where we sit at the NACD. We, too, can get tired of waiting for "governance" to take its evolutionary effect in all boardrooms. Who should know better than we how slow progress can be? For over a quarter century, the NACD has published a regular flow of practical guidance on governance basics, yet we have to admit that not enough directors are listening and learning.

On the other hand, there is much (and indeed, in our view, more) to be said for governance over and above government. Even the most hardened government bureaucrat has to admit that the "governance" solution makes sense, because some things simply cannot be legislated — for example, common sense and integrity, the bedrocks of

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Published by IRRC's Corporate Governance and Global Shareholder Services

In the news

Corporate Governance Bulletin is published four times a year by IRRC's Corporate Governance and Global Shareholder Services. The Corporate Governance Service tracks U.S. corporate governance issues and financial performance. The Global Shareholder Service tracks international corporate governance issues in 60 markets. For more information, contact IRRC at:

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ISSN 1053-5489

IRRC

good governance. We know this from experience. We have seen first hand time and again the power of effective governance when independent directors exercise their duty of care.

In the end, we have to recognize that both government and governance are needed. Purely "governance" solutions may at times rely too heavily on human virtues, while a purely "government" solution ignores and even stunts those virtues. Governance solutions need government to give them teeth, and government solutions need good governance to give them life.

That is why, in responding to a request from Hon. W. J. "Billy" Tauzin (D-La.), the Chairman of the House Committee on Energy and Commerce, we are calling for a solution that is both governance-based and government-backed.

We are asking the SEC to endorse a set of basic board practices, and we propose for consideration 10 — ranging from board independence to ongoingdirector education. These solutions, developed by more than 200 corporate directors and others serving on our eight Blue Ribbon Commission groups over the past decade, can work. In fact, they already are working for the companies that have used them to strengthen their board performance, and, ultimately, corporate performance. The following recommendations on best board practices were presented to the SEC for consideration. The NACD believes that the SEC has the authority to take action on these without the need for further action by Congress.

NACD's Recommendation for 10 Basic Board Practices

1. A substantial majority of the board should be "independent" directors.
2. Key committees—including audit, compensation, and governance/nominating—should consist entirely of independent directors, and should be free to hire independent advisors.
3. Each key committee should have a board-approved written charter detailing its duties.
4. Boards should consider formally designating an independent director as chairman or lead director.
5. Independent directors should regularly and formally evaluate the performance of the CEO, other senior managers, the board as a whole, and individual directors.
6. Boards should review the adequacy of their companies' compliance and reporting systems at least annually.
7. Boards should hold periodic sessions of independent directors only.
8. Audit committees should meet independently with both the internal and independent auditors.
9. Boards should constructively engage with management to ensure the appropriate development, execution, monitoring, and modification of company strategies.
10. New directors should participate in an orientation program to learn about the company's business, industry trends, and recommended corporate governance practices, and directors should be continually updated on these matters.

1. Boards should be comprised of a substantial majority of "independent" directors. At a minimum, these directors should meet the definition of "independent director" as defined under relevant SRO standards, although boards may consider adopting even more stringent standards of independence. Furthermore, boards should formulate and adhere to clear conflict of interest policies applicable to all board members.

2. Boards should require that key committees—including but not limited to audit, compensation, and governance/nominating—be composed entirely of independent directors, and are free to hire independent advisors as necessary.

3. Each key committee should have a board-approved written charter detailing its duties. Audit committee duties should include not only assurance of financial reporting quality, but also oversight of risk. Compensation committee duties should include performance goals that align the pay of managers with the long-term interests of shareholders. Governance/nominating committee duties should include setting board and committee performance goals and nominating directors and committee members with the qualifications and time to meet these goals.

4. Boards should consider formally designating an independent director as chairman or lead director. If they do not make such a designation, they should designate, regardless of title, an independent member to lead the board in its most critical functions, including setting board agendas with the CEO, evaluating CEO and board performance, holding executive sessions, and anticipating and responding to corporate crises.

5. Boards should regularly and formally evaluate the performance of

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the CEO, other senior managers, the board as a whole, and individual directors. Independent directors should control the methods and criteria for this evaluation.

6. Boards should review the adequacy of their companies' compliance and reporting systems at least annually. In particular, boards should ensure ethical behavior and compliance with laws and regulations, approved auditing and accounting principles, and internal governing documents. In addition to meeting the current requirements for disclosure of management compensation, boards should disclose the total value of each director's compensation, including the value of any stock options or grants awarded during the year.

7. Boards should adopt a policy of holding periodic sessions of independent directors only. These meetings should provide board and committee members the opportunity to react to management proposals and/or actions in an environment free from formal or informal constraints.

8. Audit committees should meet independently with both the internal and independent auditors.

9. Boards should be constructively engaged with management to ensure the appropriate development, execution, monitoring, and modification of their companies' strategies. The nature and extent of the board's involvement in strategy will depend on the particular circumstances of the company and the industry or industries in which it is operating.

10. Boards should provide new directors with a director orientation program to familiarize them with their companies' business, industry trends, and recommended corporate governance practices. Boards should also ensure that directors are continually updated on these matters.

Acknowledging a role for government, we do want the SEC to require disclosure of these practices by all public companies. Furthermore, we want the New York Stock Exchange, American Stock Exchange, and Nasdaq to ask for proof of ongoing director education for all listed companies.

Regulation alone is not the answer and overregulation is never the answer; the burden of change is on the boardroom. There are times, however, that government can be helpful in placing it there. In the case of Government vs. Governance, the verdict is clear. The custody of corporate America is in the hands of governance, but government has visiting rights. Governance solutions — if backed by government support — can usher in the reforms that Corporate America so desperately needs.

Roger W. Raber
President and CEO
National Association of Corporate Directors

Devil is in the Details of Post-Enron Legislation, Recommendations

The Enron debacle sounded a call to corporate governance reform on all fronts. The Securities and Exchange Commission, the stock exchanges, the Bush administration, Congress, the Council of Institutional Investors, the financial community and large pension funds have answered that call and are offering specific suggestions on how to prevent another monumental corporate collapse. Because the SEC is the federal agency with the direct purview and the most power to institute reforms quickly, its recommendations are the most likely to be implemented soon. What portion of the reforms being proposed by the other sectors will be put in place is difficult to predict. The political landscape is sure to have a strong influence on the details of what is adopted. All sectors and parties appear to agree on the general direction that the reforms should take, but it is the devilish details that have led to debate across sectors and along party lines.

Rep. John LaFalce (D-N.Y.), whose bill was defeated just before an alternative less stringent Republican one, H.R. 3763, was passed by the House of Representatives, predicts that "Given the disposition of the president, the majority of the House and those Democrats beholden to special interests, I am not sanguine about the prospects for meaningful legislation being passed." He also points out that although President Bush proposed a 10-point plan for reform in the wake of Enron, the administration never sent any follow-up legislation to Capitol Hill.

Ken Bertsch, director of corporate governance for TIAA-CREF, is more optimistic about the prospects for reform, but he thinks that most of the real changes will take place at the company level. “These changes are the most important, but they also are the most informal and hard to measure,” he says.“A lot of changes already have occurred at the board level, such as companies establishing the right types of relationships with their auditors, companies giving audit committees the responsibility to approve the contracts with auditors, companies increasing the independence of their boards and management asking more tough questions. No one wants to find themselves in the same situation as the Enron directors,” he says. Bertsch also says it is important to note that the SEC has improved the timeliness and thoroughness of critical disclosures. In addition, the commission has indicated that it is serious about obtaining disgorgements of the short-term profits that executives make while misleading the public about their companies’ financials. Overall, Bertsch said, Enron has led to “a lot more focus on the long-term interests of shareholders.”

Although most of the sectors weighing in on post-Enron issues support the creation of an auditing oversight body, debate persists over how much representation the accounting profession should have on such a panel. The Bush administration is being criticized for pushing for too many seats at the table for delegates from the major accounting firms. The Council of Institutional Investors has urged that the opinions of “all interested parties—not simply the Big Five accounting firms—be considered before any new oversight model is proposed.” In addition, there is disagreement across sectors over what powers such a board should wield. TIAA-CREF has said that such a board needs to have more power than SEC Chairman Harvey Pitt’s proposal gives it.

The Bush administration and Bush appointee Pitt are viewed by some as being protective of the accounting industry. Some believe this bias has manifested itself in the fact that neither has recommended placing restrictions on the types of nonaudit services that auditors should be allowed to provide to their audit clients. Other sectors do support restrictions on some non-audit services, but disagree over where to draw the line. Some are calling for a ban on all non-audit services while others are saying the restriction should be on certain services, such as financial systems design.

Options scrutinized, too

Another area where there is a general consensus on the issue, but disagreements on the details, is the issue of stock options. This type of equity compensation attracted attention in the wake of Enron because some charged that Enron executives, who held a generous number of stock options, were motivated to manipulate financial statements to increase the amount they could reap from their options. While a general consensus is forming over the need for shareholder approval of stock option plans, disagreements still exist over which types of plans should be exempted from shareholder votes. Some, such as TIAA-CREF, are vocal advocates of shareholder approval of all equity-based plans with “material” dilution; others are calling for the creation of a dilution standard to determine which plans must be subject to shareholder consideration. Still others, such as the New York Stock Exchange and Nasdaq, continue to stand by requiring that only plans for executives and directors be put to a shareholder vote.

The issue of the accounting treatment of stock options also is controversial. Currently, companies are not required to treat stock option compensation as a corporate expense. While President Bush recently said this accounting treatment should continue, several senators have introduced a bill that would require companies to deduct stock option costs from their revenue if they intend to take a tax deduction.

Even in the area of disclosure, which everyone agrees needs to be improved, the Council of Institutional Investors says Pitt’s proposal to improve the timeliness of disclosures falls short. The council argues that the SEC needs to go beyond making disclosure of information more timely and move toward “meaningfully updating disclosure requirements.”

The Enron collapse turned “corporate governance reform” into an agenda item for every sector—corporate, investor and political. The remainder of this article will review the major actions and proposals emanating from each sector’s response to what some have called a crisis in corporate governance.

The SEC’s response

In its first effort aimed at quelling the Enron firestorm, the Securities and Exchange Commission on January 17 unveiled a plan to form a new body to oversee how accountants perform audits.

“This commission cannot and, in any event it will not, tolerate this pattern of growing restatements, audit failures, corporate failures and massive investor losses,” he said. “Somehow we have got to put a stop to a vicious cycle that has now been in evidence for far too many years.” He said the commission would explore addressing these problems with private, regulatory and legislative actions.

Public accountancy board

The new Public Accountancy Board will be “dominated by public mem-

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bers" and will be responsible for discipline and quality control, he said. "At its core, we believe the board should be composed predominantly of independent public members, unaffiliated with the accounting profession," he added. At the same time, Pitt recommended that a small minority of the members from the accounting profession be included because, "They bring necessary expertise and an understanding of current accounting issues," and it would be ill advised to exclude them completely. Pitt proposed that the SEC select the initial members of the board and appoint the chairperson. From then on, the board should be responsible for appointing new members and new chairmen, he said. Those selections would then be subject to SEC approval. He recommended that the chairperson always be selected from among the independent public members.

The disciplinary body will perform investigations, bring disciplinary proceedings, publicize disciplinary actions taken, and restrict individuals and firms that have failed to meet ethical or competence standards from auditing public companies. All of the disciplinary actions and decisions will be subject to SEC oversight. The board would possess powers almost equal to subpoena powers because it could threaten to revoke or suspend for a time member firms' or individuals' registration with the PAB.

Mandatory membership in the PAB would aid the board's disciplinary powers. "If individual and firm membership in the PAB is a prerequisite to conducting audits of public companies, the temporary or permanent removal of an accountant or firm from the PAB's membership would operate to prevent the accountant or firm from practicing before the commission," said Pitt.

The SEC would make the decision whether questionable conduct would be pursued as violations of law, in which case the SEC would handle the matter, or pursued as violations of ethical and/or competence standards, in which case the matter would be referred to one of the private sector regulatory bodies.

This disciplinary body will oversee a separate body charged with quality control. This subgroup will be responsible for a new process that willreplace the current triennial firm-on-firm peer review with more frequent monitoring of audit quality and competence. The staff of this body will be composed of "knowledgeable people, who are not affiliated with accounting firms," said Pitt. Quality control reviews of audit firms would be conducted by PAB staff. He said the PAB should be staffed to facilitate this, but it also should be feasible for the board to draw upon professional auditors to assist in the reviews, as long as they are under the direction of the PAB. The PAB should draft standards for the quality control process, publish them for public comment and subject them to SEC approval.

The proposed rules would mandate accelerated reporting by companies of trades in company stock by senior executives and faster filing of quarterly and annual reports.

The PAB will be able to impose membership fees on accounting firms and their members. Additional funding for the board should come from companies that file financial statements with the SEC. "Broad-based funding from all users of audit services would protect the PAB from even the appearance of undue influence," he said. To ensure that auditors cannot circumvent the PAB's requirements and disciplinary measures, the SEC would make membership in the PAB a condition for certifying financial statements.

The SEC Chairman also said the commission will work with the appropriate congressional committees to draft a final proposal on these changes, but he said Congress would have to decide if legislation was necessary to enact the proposal.

Improved disclosure

In another effort to instill confidence in the markets, the SEC proposed new rules for faster corporate disclosure. The commission voted to approve the proposals on April 11, and currently is accepting comments on them. The proposed rules would mandate accelerated reporting by companies of trades in company stock by senior executives and faster filing of quarterly and annual reports. These actions were intended to provide "significant actions quickly," said Pitt. In the future, the SEC will propose further reforms covering financial reporting and disclosure requirements, accounting standard setting, regulation of the auditing process and profession, and corporate governance.

In terms of disclosure on trading activities by executive officers, the commission supports dramatically shortening the amount of time required before such a trade must be publicly reported. Generally, reports of transactions or loans with an aggregate value of $100,000 or more would be due within two business days. Reports of transactions under $100,000 and some categories of transactions would be due by the close of business on the second business day of the following week after they are granted. However, reports of transactions and loans with an aggregate value less than $10,000 would be deferrable until the aggregated cumulative value of unreported events for the same director or executive officer exceeds $10,000. Now, trades must be reported by the tenth day of the month following the month in which the trades occur. In the meantime, the SEC is seeking ways to provide for electronic filings of reports on insider transactions. It is considering an approach that would require companies to file electronically information that they receive from insiders.

Shareholder approval of stock option plans

Stock option plans, and other equity compensation plans for officers and directors, should be approved by shareholders, said SEC Chairman Harvey Pitt in two recent speeches.

In March 21 testimony before the Senate Banking Committee, Pitt asked Congress for help in passing legislation to mandate that all national securities exchanges and national securities associations adopt listing rules in the next six months that require companies to seek shareholder approval for plans that allow corporate officers or directors to acquire company securities. He said he believed the exchanges would proceed in implementing such a policy, but "We would like to make this a matter of law, rather than a matter of choice."

In an April 4 speech before the Kellogg Graduate School of Management and Northwestern Law School Pitt said the SEC needs to work with the private sector to get corporations to adhere to a set of governance best practices, ethics and integrity, "Out primary concern is to ensure that management's interests are aligned with shareholders' interests," Pitt said. "This is tougher than it sounds," he added. To help align these two interests and to ensure that management does not receive unearned windfalls while shareholders suffer, Pitt offered the following recommendations.

- Full disclosure of equity compensation plans, and shareholders should have to approve all such plans.

- A committee of independent directors should be responsible for deciding whether to grant options to senior management.

- Boards should require that officers demonstrate sustained long-term growth before they are allowed to exercise any of their options. "This would help abolish perverse incentives to manage earnings, distort accounting or emphasize short-term stock performance," he added.

Higher profile for audit committees

In his speech before the Kellogg School, Pitt also discussed the role of audit committees in preventing future Enrons. Audit committees should be improved even more than they have been under recent reforms, he said. Specifically, Pitt recommended that audit committee members be required to understand the company's critical accounting principles and how they are applied and to urge continuous improvement to systems of internal control. The SEC Chairman also recommended that directors sitting on audit committees be allowed to hire their own independent counsel and accounting experts in instances where they believe corporate disclosure needs to be improved. He also suggested that the SEC consider making the audit committee responsible for recommending auditors to the shareholders for ratification. "While shareholder approval of outside auditors is now a well established part of corporate governance, I believe we should also explore whether the audit committee should be vested with the initial decision about which firm is recommended to the shareholders," Pitt said. (Note that IRRC data indicate that in 2001, only 62 percent of more than 3,600 company meetings reviewed included an auditor ratification proposal.) Pitt also believes that "audit committees should have the authority to fire outside auditors or to prevent management from firing them." Along these lines, the SEC has asked the NYSE and Nasdaq to consider whether audit committees should be vested with the sole authority for assessing the quality and independence of their companies' outside auditors, including the extent to which their audit firms can perform other functions.

No restrictions on audit services

In Pitt's March 21 testimony before the Senate Banking Committee, the SEC chairman also said he opposed restricting accounting firms from offering consulting services to clients that they audit. Instead, he said the framework adopted by the SEC in 2000 to govern the types of non-audit services that audit firms can perform "will, over time, serve investors better than would a blanket ban on the receipt of non-audit services from the auditor that certifies the financial statement." In addition, he said, "An 'audit-only' firm would be more dependent, not less on their audit clients, and a single large audit client could exert far more influence on such a firm than is the case with firms that have multiple sources of revenue."

Pitt also expressed reservations

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about restricting accountants from becoming employees at their clients' companies. He said that for smaller companies that have more limited options for hiring experienced accounting personnel, such a ban would present a serious hardship.

Barring executives and directors from serving

Another high ranking official at the SEC, Director of Enforcement Stephen Cutler, has suggested several other corporate governance reforms to prevent another Enron, including efforts to bar directors and officers who violate certain federal securities laws from serving at public companies.

"Monetary penalties, often paid by O[fficer] and D[irector] insurance policies or which are otherwise insignificant to wealthy wrongdoers, are not always sufficient to achieve the deterrence we seek," Cutler told those attending Glasser LegalWorks' 20th Annual Federal Securities Institute in Florida on February 15. "Accordingly, the division intends to expand its use of a remedy that, in my view, has been sought too infrequently by the commission, has been imposed on too limited a basis by the courts, and is needed now, more than ever, to respond to large financial frauds, which no longer seem rare. That remedy is the officer and director bar."

Congress provided the commission with the authority to impose such bars in 1990. Under the Securities Enforcement Remedies and Penny Stock Reform Act, the SEC can bar directors and officers who violate certain federal securities laws and whose conduct shows them to be unfit to serve on any board. The prerequisite that a person be unfit "has spawned a burdensome and overly restrictive test for imposing officer and director bars," said Cutler. Because the act itself does not provide a definition of "unfit," the one that is commonly used was drafted by a law professor. That definition imposes a six-part test. "The result has been, unbelievably, that in some cases, courts have refused to impose permanent officer and director bars on individuals who have engaged in egregious—even criminal—misconduct," Cutler said.

To remedy the situation, Cutler says the courts should begin barring individuals who engage in serious securities fraud and commit a serious breach of the public trust and Congress should grant the commission the authority to impose officer and director bars in administrative proceedings. "By subjecting corporate wrongdoers to restrictions on their ability to serve in high-paying positions of authority and respect, I believe we will succeed in causing others to think twice about crossing the line," Cutler said.

Under the Securities Enforcement Remedies and Penny Stock Reform Act, the SEC can bar directors and officers who violate certain federal securities laws.

NYSE and Nasdaq begin process of competitive reform

The New York Stock Exchange responded to pleas from the SEC chairman to reexamine the exchange's corporate governance listing requirements by appointing a special committee of its board of directors to review these.

The committee, which is called the Corporate Accountability and Listing Standards Committee, is co-chaired by H. Carl McCall, Comptroller of the State of New York; Gerald Levin, former CEO of AOL Time Warner; and Leon Panetta, director of the Panetta Institute for Public Policy. The committee is reviewing corporate governance and shareholder accountability issues such as the composition of corporate boards and committees, disclosure requirements and the role of independent audit committees. It plans to issue a report on its findings as early as June 2002.

NYSE Chairman and CEO Dick Grasso emphasized that the committee will work in tandem with legislative and regulatory bodies as well as other exchanges. "Competition among markets must be put aside to restore public confidence," he said.

In April, the committee disclosed that it was considering a rule that would require companies to get approval from shareholders for plans that grant stock options to executives. NYSE Chairman Richard Grasso, along with co-presidents of the exchange, Catherine Kinney and Robert Britz, held a press conference April 9 to discuss some of the items considered by the group. Previously, Grasso has said that if the NYSE proceeded in instituting this approval requirement and Nasdaq did not follow suit, the exchange would be at a competitive disadvantage. Now, he said, "these are far too important issues to let pedestrian competition interfere."

The panel also discussed the possibility of requiring that only independent directors sit on audit and compensation committees, requiring that the positions of CEO and chairman of the board be held by two different individuals, changing what constitutes an 'independent' director, requiring boards to evaluate auditors every four or five years and drafting a code of conduct for internal auditors.

Just days after Grasso said the NYSE would proceed with plans to institute reforms even if Nasdaq failed to follow suit, Nasdaq approved initial recommendations to improve corporate governance requirements for its listed companies. The recommendations, which were sent to Pitt for review include the following:

- Further limit the economic relationship between an audit committee member and a company by tightening the definition of "independence."Currently Nasdaq rules generally provide that the following relationships would preclude independence: employment with the listed company, compensation paid to directors for other services to the company, familial relationships with officers, payments between the listed company and a company with which the director is associated, and relationships arising from interlocking service on another company's compensation committee. Nasdaq is considering adding other relationships that might impair independence, such as being a former employee of a company's auditor.

On a related note, the exchange specifies that executive officers of all listing markets should not be permitted to serve on the boards of their listed companies. (It should be noted that NYSE Chairman Grasso serves on the boards of X NYSE-listed companies.) Nasdaq also is examining whether its current rules addressing the qualifications of audit committee members go far enough to ensure that these committees function well. The exchange plans to conduct a survey of its listed companies to review the qualifications of audit committee members.

- Require that all stock option plans that include officers or directors be approved by shareholders. (Currently the exchange does not require shareholder approval of broadly based plans even though some of these allow executive and director participation as long as the majority of options go to non-executive employees.)

- Require audit committees to recommend the selection or replacement of the independent auditor. The exchange is recommending that this be coupled with the SEC requirement that each company disclose in its annual report whether the board disagreed with any recommendations of its audit committee regarding the selection or replacement of independent auditors.

- Establish a best practice for the continuing education of board members.

- Require that all companies adopt a code of best practices, and that boards approve procedures for compliance.

- Require non-U.S. companies to disclose whether they have received a waiver of a corporate governance standard from Nasdaq. (The exchange also is considering improving its listing standards for foreign issuers to ensure that the spirit of U.S. corporate governance practices is met, even when foreign rules differ.)

Bush administration addresses CEO abuses

At the beginning of March, President George W. Bush released a proposal to address the corporate failings that became evident as a result of Enron. His proposal includes: a requirement that the CEOs sign statements attesting to the veracity of the financial information contained in each of their companies' quarterly financial statements; the creation of board to oversee the accounting profession; a requirement that corporate executives return a portion of their bonus compensation if their company commits financial fraud; and speedier financial disclosure when company executives or directors buy or sell company stock.

Although the president did not address the accounting treatment of options in his proposal, in an April 10 interview with The Wall Street Journal, Bush advocated continuing their current "zero expense" treatment. But, he told The Journal, "I think once options are 'in the money,' they ought to be calculated in the dilution, that they ought to be dilutive in their earnings-per-share calculations."

Congress responds with avalanche of bills

Legislators on Capitol Hill continue to draft dozens of bills addressing the corporate governance issues surrounding Enron's collapse. At press time, only one had been passed by the full House; the others remain in committee.

Three of the most comprehensive Enron-related bills proposed in the 107th Congress are H.R. 3763, which was introduced by Reps. Michael Oxley (R-Ohio) and Richard Baker (R-La.), H.R. 3818, which was introduced by Rep. John La Falce (D-N.Y.) and S. 2004, which was introduced by Sen. Christopher Dodd (D-Conn.).

On April 22, the House in a 334-to-90 vote passed the Oxley-Baker bill, H.R. 3673, the Corporate and Auditing Accountability, Responsibility and Transparency Act. This legislation would:

- create a new auditor oversight board (referred to as a public regu-

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latory organization);

• place restrictions on auditors providing internal audits and financial systems designs;

• give the SEC the direct power to ban directors who have been convicted of wrongdoing from serving on the boards of other companies (currently the SEC must seek court action to impose such a bar);

• grant the SEC the authority to write rules requiring corporate officers to give up their "profits" if their companies restate their financial statements with the SEC;

• prohibit corporate executives from buying or selling company stock during any period when employee retirement plan participants are unable to buy or sell such securities;

• direct the President's Working Group on Financial Markets to study current corporate governance standards to see if they are sufficiently serving and protecting investors;

• improve financial disclosure to investors; and

• increase the SEC's budget from $480 million to $776 million, to enable it to perform the additional tasks and oversight required by the bill.

The public regulatory organization, or PRO, that the legislation would create to oversee accountants would have five members. Three of the members could not have ever have worked as accountants while the other two members could not have worked as practicing accountants for at least two years. The PRO would be under the direct authority of the SEC. Any accountant wishing to audit the financial statements of public companies would have to be certified by the PRO. In addition, publicly traded companies would be responsible for ensuring that their accounting firms were in good standing with the PRO. An accountant or accounting firm disqualified by the PRO could be prohibited from certifying financial statements. The PRO also would have the statutory authority to punish accountants who violate securities laws or standards of ethics, competency or independence.

The bill that was considered to be the Democratic alternative to H.R. 3763, The Comprehensive Investor Protection Act of 2002 or H.R. 3818, was not passed by the House. By, most accounts that bill contained much stronger "teeth" than the Oxley-Baker legislation. Its provisions would have:

• Prohibited auditors from performing non-audit services for audit clients.

• Established a Public Accounting Regulatory Board to draft audit quality standards, review public accounting firms and individual audits, conduct disciplinary and investigation proceedings, and suspend or revoke auditors' registration for non-compliance.

• Permitted state licensing boards to participate in such proceedings and impose sanctions.

• Authorized the SEC to oversee the board.

• Subjected foreign accounting firms that already fall within SEC jurisdiction to board jurisdiction.

• Prohibited insider trading during pension fund blackout periods.

• Increased financial disclosure of off-balance-sheet transactions, insider transactions, relationships between SEC registrants and philanthropic organizations, insider controlled affiliates and provision of service by related persons.

• Mandated electronic disclosure of affiliate transactions.

• Amended law to establish liability for aiding and abetting securities violations.

• Mandated preservation of audit records for seven years.

• Required preservation of records during shareholder litigation.

• Directed the SEC to study and report to congressional committees on credit rating agencies and analyst conflicts of interest.

Rep. John LaFalce (D-N.Y.), who introduced this bill, is extremely critical of the Republican version, H.R. 3763, which the House did pass. At the National Association of Corporate Directors' conference in Washington, D.C. on April 29, LaFalce said that the Republicans' bill "does little, and, in fact, takes a step backward." For instance, he said, it gives the SEC the power that it already possesses to establish an audit oversight body and allows the SEC to designate the board's powers. LaFalce said that the powers should be specified in the legislation, and that the composition should not be decided by the SEC, but should be "representative of the investing public." He also noted that the Oxley-Baker bill fails to address the issue of executive responsibility. "The president's proposal would increase executives' responsibility by requiring that the CEO or CFO certify as to the veracity and accuracy of the financials, but the bill is silent on this issue," he said. LaFalce said the legislation also fails to address the issue of Wall Street analysts' conflicts of interest. "There are no fire walls in securities firms between the research side and the banking side, and this must stop because until it does we will not get unbiased advice." The congressman also criticized the bill for not putting enough restrictions on the services that audit firms can provide to their audit clients. "The bill purports to limit the services that auditors can supply to audit clients, but it actually codifies the existing limits on service," he said.

Senator Carl Levin (D-Mich.) introduced a post-Enron bill that covers a lot of ground, addressing issues ranging from accounting practices to auditor independence to topics for shareholder proposals. Two provisions in the bill stand out as being new issues not specifically addressed in other legislation or best practices recommendations. The first says the SEC may not exclude certain types of shareholder proposals that are permitted under state law. The other provision gives board audit committees new responsibilities to help oversee the auditor and ensure the accuracy and clarity of the company's financial statements.

Specifically, the legislation contains the following provisions.

- Directs the SEC not to "prohibit" shareholder proposals that are permitted under state law to remove or replace a director, to retain or replace the company auditor, to ensure director independence, to require the audit committee chairman or company auditor to attend the annual meeting to answer questions, or to obtain disclosure of compensation information for any director or company executive. In Delaware, where the majority of U.S. companies are incorporated, the state law does not specifically address the inclusion of any of these types of proposals.
- Requires the audit committee to oversee the accounting practices and policies of the company. Also requires the committee to evaluate the relationship between the company and the auditor, to obtain and evaluate financial information from the company and the auditor, and to provide the accountant with periodic opportunities outside the presence of management to express any concerns about practices, policies, statements or reports. In addition, makes the audit committee responsible for evaluating the quality, acceptability and clarity of the company's financial statements and for ensuring adequate public disclosure of the company's accounting practices and principles.
- Requires shareholder approval of any compensation plans that provide stock options to directors, officers or employees and that "do not require such stock options to be treated as an expense for the purpose of ascertaining income, profit or loss in companies' financial statements and reports."
- Establishes an independent source of funding for the new non-governmental body that the SEC is going to establish to replace the Financial Accounting Standards Board and to oversee accounting standards. Funding will come mainly from companies and public accountants. All members of the body will have expertise in accounting. One member will be nominated by the SEC and at least one-third of the members will represent investors and will not have been employed recently by a public accounting firm.
- Requires the independent accounting standards body to resolve pending accounting and reporting matters in a prompt manner with due process and public participation. For any matter left unresolved after two years, the SEC is authorized to require action by a certain date or to resolve the matter itself.
- Prohibits audit firms from providing non-audit services to their audit clients during the duration of the audit contracts and for two years following their engagements with these clients.
- Prohibits those employed by audit firms from serving as employees, directors or consultants at the firms they audited during the duration of the auditing contract and for two years afterward.
- Requires companies to provide auditors with all of the pertinent information they need to perform the audit.
- Prohibits directors, executives and employees from trying to "influence, coerce, manipulate or mislead" any independent public accountant engaged in an audit.
- Directs the SEC to issue rules barring companies in cases of bankruptcy from providing preferential treatment on compensation benefits to company directors or officers compared to other employees or creditors of the company. Directs SEC to issue rules requiring improved disclosure of company loans to directors and executives and company contributions.

At press time, Senate Banking Committee Chairman Sen. Paul Sarbanes (D-Md.) was expected to introduce legislation that contains some of the same types of governance provisions found in the Levin bill, but also includes President George Bush's recommendation that chief executives and chief financial officers certify their company's audit report and financial statements.

Another bill with a fairly wide scope, S. 2004, the Investor Confidence in Public Accounting Act of 2002, authorizes the SEC to create an Independent Public Accounting Board, subject to SEC oversight, that would exercise regulatory jurisdiction over public accounting firms. The IPAB would be responsible for establishing and enforcing auditor

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quality control and auditing standards and for establishing record retention criteria.

The bill also contains the following provisions:

- Prohibits a registered independent public accounting firm from providing non-audit services to its audit clients.
- Prohibits an auditing firm from performing audit services for a company if any management-level personnel of that company had been an employee during the two-year period preceding the audit.
- Makes it unlawful for any officer, director or affiliated person registered with the SEC to make material representations to an audit firm.
- Increases the number of SEC professional accountant positions to provide more oversight of auditors.
- Mandates prompt electronic disclosure of affiliate transactions.
- Directs the SEC to submit recommendations to the IPAB regarding the treatment of stock options.

S. 1940, a bill introduced by Senators Carl Levin (D-Mich.), Mark Dayton (D-Minn.), Richard Durbin (D-Ill.), Peter Fitzgerald (R-Ill.) and John McCain (R-Ariz.), would require companies to deduct stock option costs from their revenue if they take a tax deduction for option profits (which the IRS considers compensation when it taxes optionees on those amounts). The legislation, which was introduced in mid-February, would not directly require companies to expense stock option pay, but would require companies to treat stock options on their financial statements the same way they treat them on their tax returns. In other words, if a company does not declare a stock option expense on its books, then the company would not be able to deduct that amount in the same year on its tax return.

"Stock options were a driving force behind management decisions at Enron that focused on increasing Enron's stock price rather than the solid growth of the company," says Levin. He also notes that Enron apparently avoided paying taxes on its $1.8 billion in reported income during four of the past five years by claiming large stock option tax deductions. "At the same time, Enron never reported this $600 million as an expense on its financial statements—an expense which, had it been reported, would have reduced Enron's income by one-third," Levin explained.

He also pointed out that 10 years ago the Financial Accounting Standards Board attempted to close the 'stock option loophole' that Enron used, but FASB's efforts were torpedoed by corporations and audit firms that conducted a strong lobbying campaign. In the end, the only concession that FASB managed to get was a requirement that companies include a footnote in their proxy statements noting pro forma earnings per share if options were treated as an expense, based on their "fair value" at grant. Some observers speculate that closing this loophole could be easier now because it has the backing of Arthur Andersen and Deloitte & Touche, as well as the International Accounting Standards Board.

Several other bills introduced in the 107th Congress focus on more specific reforms.

H.R. 3795, the Investor, Shareholder and Employee Protection Act of 2002—Establishes within the SEC an independent regulatory agency, the Federal Bureau of Audits, which would conduct an annual audit of the financial statements submitted to the SEC by companies. Requires the president to appoint the director of the bureau, by and with the advice of the Senate. Prohibits bureau employees from receiving employment of compensation from companies audited by the bureau, or any accountant that provides audit-related services to a bureau-audited issuer for 10 years after employment with the bureau. Requires the SEC to establish standards for audits. Directs the SEC to assess and collect a fee from each company that submits a financial statement to be audited by the bureau.

H.R. 3693—(No Title Given) Directs the SEC to prohibit allowing auditors to provide non-audit services to their audit clients.

H.R. 3617, the Accountability for Accountants Act of 2002—Makes liable auditors 1) who have been found by a jury to have failed to detect and report illegal acts of the issuer of securities that are the subject of a class action; and 2) who have performed non-audit functions for companies during the time within which an alleged violation of securities occurred. Mandates maintenance of company audit records and imposes criminal sanction for noncompliance. Requires auditors to report to the SEC on their decisions to divest themselves of interests in non-audit businesses and to stop providing non-audit services to companies they audit. Mandates preservation of records during shareholder litigation.

S. 1896, Auditor Independence Act of 2002—Prohibits an independent public accountant who performs auditing or related services for a client from also providing to such client during the calendar year in which such services were provided: 1) management consulting services, 2) any other service that is not related to the audit, 3) any other service that could result in a potential conflict of interest or otherwise impair auditor independence.

H.R. 3745, the Corporate Charitable Disclosure Act of 2002—Mandates disclosure of: 1) corporate charitable contributions with a value exceeding that made by the company during the previous year to any nonprofit organization of which a director, officer, or controlling person of the company (or a spouse of such person) was a director or trustee, 2) the name of such nonprofit organization and the value of contribution, 3) the total value of contributions made by the issuer to nonprofit organizations during its previous fiscal year, and 4) the organization name and the value of contributions if the value to any one organization exceeds the amount designated by SEC rule.

H.R. 3736, the Financial Accuracy in Reporting Act of 2002—Directs the SEC to revise auditor independence rules governing non-audit services for an audit client to establish standards pertaining to fiscal period audits as of October 1, 2002, that are consistent with, and at east as stringent as, those established in the revisions of the Government Auditing Standards by the Comptroller General on January 25, 2002.

H.R. 3769, the Insider Trading Full Disclosure Act of 2002—Requires that mandatory disclosures pertaining to the sale of securities by an officer or director or other affiliated person of the issuer of those securities shall be made available in electronic form: 1) to the SEC by the affiliated person before the end of calendar day immediately following the calendar day on which the transaction occurs, 2) to the public by the commission, and 3) in any case in which the company maintains a corporate web site that is accessible only internally, on that internal web site, before the end of the calendar day immediately following the calendar day on which the transaction occurs.

CII offers detailed recommendations

At a February news conference on Capitol Hill, the Council of Institutional Investors called for a package of comprehensive reforms to the U.S. auditing and corporate governance systems, "designed to ensure that another Enron won't happen." Specifically in letters sent to congressional committees investigating the Enron case and to SEC Chairman Harvey Pitt, the council suggested seven steps "that would go a long way toward improving current investor safeguards." They include:

- **Reform auditor independence standards by prohibiting auditors from providing any non-audit services to their audit clients**—a position the SEC backed off from in 2000 under heavy pressure from the accounting industry and some members of Congress. The SEC might also consider requiring companies to rotate their outside auditors every few years as the AFL-CIO has recommended, imposing "cooling-off" periods before audit firm employees could work for audit clients, and prohibiting outside accountants from providing any internal audit services to audit clients, the council suggested.

- **Radically reform the oversight of auditors.** Noting that "it's clear that the accounting profession's current system of self-oversight is not working," the council urged that the opinions of "all interested parties—not simply the Big Five accounting firms—be considered before any new oversight model is proposed." New ideas, such as the creation of a new, independent auditing entity, should be considered and publicly debated, the council recommended.

- **Require enhanced disclosure of director links to companies.** Current disclosure rules are inadequate, the council said. "Some very basic, yet material information, about director relationships does not have to be disclosed under current rules. And companies aren't volunteering to provide those details," said the letter. More than four years ago, the council submitted a rulemaking petition to the SEC to toughen the disclosure rules so that investors would have access to information necessary to evaluate the potential for relationships that could interfere with a director's independent judgment. "It's time for the commission to act on this important disclosure rule," the council said.

- **Toughen the stock exchanges' listing standards on board independence and board composition. "**While some changes affecting board audit committees were adopted several years ago, they fell far short of standards endorsed by a 'blue ribbon' commission, the council, its members and even the Business Roundtable," the letter said. The council believes the exchanges should adopt a definition of independent director that matches its own or comparable definitions endorsed by TIAA-CREF, the California Public Employees' Retirement System or other major investors. It also believes the exchanges should require that a substantial majority of the board (at least two-thirds) and all audit committee members qualify as independent directors. Current standards for board independence are inadequate, with the NYSE re-

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quiring only two outside directors and the Nasdaq and AMEX requiring only a sufficient number of independent directors to satisfy the audit committee requirements, the council noted.

• **Do not soften the SEC's stance on enforcement.** The council believes tough enforcement efforts—and criminal prosecutions whenever possible—are the most effective deterrents to criminal activity, and it is distressed by Chairman Pitt's recommendation when he first assumed the chairmanship that the agency take a "kinder, gentler" approach with the accounting profession and other possible wrongdoers, the letter said. "Behind-closed-doors discussions and settlements set no examples for others nor offer any deterrent benefits."

• **Restore integrity to the proxy voting system by eliminating the stock exchanges' "broker may vote" rule,** which allows brokers to vote on so-called "routine" proposals, including the election of directors and the ratification of auditors. "As Enron has shown, these proposals are not 'routine.' In fact, they may be two of the most important votes cast by shareholders," the council's letter said.

The exchanges say the purpose of the 70-year-old "broker may vote" rule is to ensure that companies meet quorum requirements. But, the council says, recent studies have concluded that this argument is a red herring, and that nearly all U.S. companies satisfy quorum requirements without the broker votes. Permitting broker votes amounts to "ballot stuffing for management," the letter said. It recommended that the SEC work with the exchanges to prohibit brokers from voting on any ballot items without express instructions from the beneficial owners.

• **Meaningfully update disclosure requirements for financial and other critical information.** "Meaningfully" is the key to this recommendation; simply switching to more current disclosure, as Chairman Pitt has proposed, is not enough, the council said. "We urge you to consider views from all interested parties, including investors, corporations and accounting firms, as you move forward with reforming the disclosure requirements and with considering other reforms, including changes to accounting standards," said the letter.

While making these recommendations, Teslik cautioned that legislation focusing only on audit reform will be ineffective.

In its letters, the council also said it is concerned that the current "frenzy surrounding the Enron meltdown—while generating voluminous media coverage—may fail to result in any meaningful reforms to a system clearly in need of improvements."

"As tragic as the Enron case may be, it is also an opportunity for regulators and legislators to take a close look at the painful failure of some safety nets intended to protect investors and to make meaningful changes," wrote council Executive Director Sarah A.B. Teslik.

Teslik, also gave members of the Senate Banking Committee an earful when she testified March 20. "People will behave badly to get great wealth if the stock exchanges don't stop them. If the SEC doesn't deter them. If FASB [Federal Accounting Standards Board] and AICPA [American Institute of Certified Public Accountants] enable them. If prosecutors rarely go after them. And if you legislate loopholes," she told the committee.

She suggested that, in terms of auditor reforms, Congress should pass legislation that 1) requires the board's audit committee, not the managers, to hire the auditors; 2) fixes FASB's and AICPA's accounting and audit standard-setting systems with guaranteed funding and better accountability to investors; 3) requires CEOs, audit committee members and outside auditors to sign the financials as true and accurate; 4) removes nontrivial conflicts of interest; 5) comes down hard on individuals, not just companies, who break the law.

While making these recommendations, Teslik cautioned that legislation focusing only on audit reform will be ineffective. The current system that allows executives to pick the boards who are supposed to police them is a "fundamental misalignment that is more important to fraud prevention than auditor independence because a board's responsibilities are more critical to a company's health," Teslik said. She then offered eight examples of how the current system of corporate governance places shareholders at a disadvantage when it comes to submitting proposals and voting on those proposals.

She emphasized that protecting investors in this misaligned system should not be left up to the New York Stock Exchange. "The NYSE is a private sector corporation. It gets money from corporate executives—listing fees. Never expect private sector bodies to act against those who fund them—they won't do it," Teslik said to the committee.

She also advised Congress to pass legislation requiring better and immediate information about companies' executive compensation practices and about directors' and CEOs' buying, selling, borrowing and hedging activities. In addition, Teslik recommended that investors be given more ways to control this compensation through votes on all stock option plans and the ability to put up board candidates "if existing boards are giving away the shop."

Finally, she argued for better enforcement. "There is too little enforcement and too much of it targets companies and not human wrongdoers. When you punish companies, you punish innocent shareholders, the victims," Teslik said. She concluded her testimony by telling committee members, "A CEO or a director going to jail would be a corporate governance shot heard around the world."

AICPA puts faith in private sector

The American Institute of Certified Public Accountants also offered Congress advice on how to restore faith in the financial reporting system and to reassure investors by improving audit quality and corporate accountability.

Chairman of the AICPA James Castellano told members of the Senate Banking Committee on March 21 that the group's recommendations "strike an appropriate balance between the need for government oversight and the efficiency of the private sector." He recommended four initiatives:

1. Create a new private sector regulatory body. "The time is right to create new systems for performing quality reviews of the practices of public company auditors and for disciplining those auditors. Accordingly, we support moving from public oversight to public participation, from self-regulation to public regulation for these important processes. We further believe that these processes should be subject to SEC oversight."

2. Reform the financial reporting process. Castellano suggested a move toward more timely—and ultimately, real time—disclosures and reports containing a broader "bandwith of information. Investors should know about plans, opportunities, risks, uncertainties and the drivers of future success," he said.

3. Establish new rules for corporate governance. "Audit committee members should have auditing, accounting or financial experience. Periodically, audit committees should hold separate executive sessions with management, the independent auditor and the internal auditors. We also believe the audit committee should be involved in hiring and firing the independent auditor."

4. Support corporate truthfulness. Castellano urged Congress to make it unlawful to improperly influence or mislead the auditor. "Make it a felony for anyone in a company or anyone else involved in the financial reporting process to lie to their auditor," he said.

From the corporate corner

Financial Executives International, an organization comprised of CFOs and other senior financial executives, released a set of 12 recommendations to address industry reform. The set, which was developed by a task force comprised of CFOs and senior financial executives from prominent public companies, was sent to Congress, the SEC and the stock exchanges. As might be expected from a group comprised of a group comprised of senior financial executives, few of these executives would implement significant reforms beyond what has become generally accepted since Enron.

"To restore the foundation of trust in a checks-and-balances system of corporate governance, immediate action must be taken to correct the weaknesses exposed by Enron," said FEI Board Chair David A. Young, who also serves as CFO at Adaptec.

The group recommended adoption of the following reforms.

1. Have financial executives adhere to a specialized code of ethical conduct. A revised FEI Code of Ethical Conduct now calls on financial professionals to acknowledge their affirmative duty to proactively promote ethical conduct in their organizations.

2. Provide means for employees to surface concerns and actively promote ethical behavior. Mechanisms should include a written code of conduct, employee orientation and training, a hotline or helpline that employees can use to raise compliance concerns without fear of reprisal, and procedures for voluntary disclosure of violations.

3. Designate the principal financial officer and principal accounting officer as defined in the Securities Act of 1933. The principal financial officer should report to the CEO and the principal accounting officer to the principal financial officer. One or both should meet quarterly with the audit committee to review significant financial statement issues, including key judgments, estimates and disclosure matters.

4. Create a new oversight body for the accounting profession. The SEC should sponsor an independent body with members experienced in accounting and finance but indepen-

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dent of public accounting firms or other accounting industry organizations.

5. Place restrictions on certain non-audit services supplied by the independent auditor. Any instance where services could present conflict-of-interest questions should be avoided. In addition to internal audit services and consulting on computer systems used for financial accounting and reporting, these would include services where the audit firm could be put in a position of relying on their own work product.

6. Restrict hiring of senior personnel from the external auditor. Corporations should adopt policies restricting the hiring of engagement audit and tax partners or senior audit or tax managers.

7. Reform the Financial Accounting Standards Board. Form a blue ribbon committee to recommend within three months FASB reforms in the areas of organization, financial statement content and timeliness of standard setting.

8. Modernize financial reporting. Steps here include developing best practices for Management Discussion and Analysis (MD&A), implementing plain English financial reporting, and providing web site access to key performance measures.

9. Require the stock exchanges to include in their listing agreement a mandate that at least one member of a public company's audit committee be a "financial expert," as recommended by the 1999 Blue Ribbon Panel. In setting higher standards for "financial expertise," the NYSE and Nasdaq should require explicit knowledge of GAAP obtained through education or experience and require experience in the preparation or audit of financial statements for a company of similar size, scope and complexity.

10. Require continuing professional education for audit committee members. Companies should disclose in the audit committee report whether members have undertaken such training.

11. Periodically consider rotation of the audit committee chair. Corporations should evaluate the need to rotate the individual holding the audit committee chair position approximately every five years.

12. Disclose corporate governance practices. Public companies should provide a report of key corporate governance practices. Current best practice is to have a governance and nominating committee made up of independent directors.

TIAA-CREF comes out swinging

TIAA-CREF Chairman and CEO John Biggs focused on three specific areas that need reform when he testified before the Senate Banking Committee on February 27: stock options; auditor independence; and oversight of the accounting profession.

Stock option accounting should be reconsidered

Biggs believes that the way that most companies treat fixed price options as "free" and performance options as potentially very expensive creates many negative results. This has led to an explosive growth in the use of stock options since 1995. In turn, he said, this growth has created a serious distortion of earnings statements so that some companies report large earnings at the same time they pay no taxes; an unprecedented focus on the stock price by all the employees of the company, to the point where serious ethical dilemmas are posed for employees; a dramatic decline in dividends; stock options replacing pension plans; and an almost exclusive use of fixed price stock options rather than performance-triggered options in employee compensation plans.

To counteract all of these negative effects, the accounting methods used for stock options should be reexamined by a private sector entity, such as the Financial Accounting Standards Board, the Government Accounting Standards Board or the International Accounting Standards Board, he recommended. "Some expression of support by your committee, or by the full Senate or House of Representatives—the form of which you understand better than I—might make it possible for the IASB to study the issue, and for the FASB to reopen the question," Biggs told the Senate Banking Committee.

Prohibit non-audit work

Increasing auditor independence also will help prevent future Enrons, according to Biggs. Audit firms should not do any consulting or even tax work for the companies that they audit. In addition, Biggs recommended that companies rotate their auditors every five to 10 years. "Rotation reduces dramatically the financial incentives for the audit firms to placate management," he said. "If the audit firm has a kind of virtual perpetuity of millions in fees every year (from whatever source), the present value of that relationship is enormous: in the Enron case, probably over a half-billion dollars, given that the total fees paid to Arthur Andersen for fiscal year 2000 were $52 million. That amount could be even higher if one considers the potential growth in 'cross sold' services," Biggs added. He also pointed out that rotation eliminates the revolving door problem, where former auditors become the top financial officers at the companies they once audited, hiring their former colleagues who continue to conduct audits.

Biggs strongly endorses auditor rotation, but he does not believe it will become a generally accepted practice without "explicit action by Congress."

Create a powerful, autonomous oversight body

Congress needs to help create a better regulatory body to oversee the accounting profession, said Biggs. "Elements of [SEC] Chairman Harvey Pitt's proposal [for a public accountancy board] certainly move in the right direction, but I believe the proposed entity needs more authority. And that authority can come only from Congress," he told the committee. The types of authority that should be granted to such an entity should be clear cut and separate from the SEC. In addition, the body must have access to the information needed to conduct an investigation, but have the ability to keep that information out of the hands of litigators. He also told the panel that the body should be able to discipline firms and individuals and have licensing authority beyond that of the states.

Biggs stressed that such an entity should not have to rely on voluntary contributions from the accounting profession. He suggested a fee on stock market transactions, or registrations, or some other financial activity that would be devoted to paying for auditing oversight, the work of the Financial Accounting Foundation and a share of the IASB's American needs.

"If these goals are reached, I believe we may look back on Enron as being a short-term financial tragedy for its employees and the holders of its securities, but a major long-run benefit for the U.S. capital markets," he said in summation.

—Rosemary Lally

Auditor Independence Emerges as the Hit Issue of the 2002 Proxy Season

In these strange days when arcane corporate governance terminology graces the front pages of major newspapers it is, perhaps, acceptable to use the language of Hollywood to describe a shareholder proposal. In that case, clearly the "sleeper hit" of the proxy season has been the auditor independence proposal submitted by union funds.

The resolution, which seeks to limit the non-audit work a company's auditors can perform, was initially submitted to 31 companies by funds affiliated with the United Brotherhood of Carpenters and Joiners, the International Brotherhood of Electrical Workers, the United Association of Plumbers and Pipefitters and the Sheet Metal Workers International Association. The timing of the proposal could not have been better – it premiered in the proxy statement at Walt Disney, which was first published in early January. That same week, the House Financial Services Committee heard testimony from Arthur Andersen's Chief Executive Joseph F. Berardino, defending his firm's failure to catch Enron's problems. Also testifying at that hearing was AFL-CIO Secretary-Treasurer Richard L. Trumka who told the committee, "You had an audit firm that was dependent on Enron management for higher-margin consulting services, purporting to provide independent review on behalf of investors of transactions, some of which they, themselves, may have designed and charged a fee for."

Initial reviews of the proposal glowed. "There could not be a more timely issue, even though the proponents introduced it before the Enron story broke," said Ann Yerger, director of research for the Council of Institutional Investors said. "[The proponents] should get the ESP award for corporate governance this proxy season."

A high vote at Disney–42 percent of votes cast favored the proposal–seemed to be a clear indication of box office success. "It's hugely consequential," Bill Patterson, director of the office of investment at the AFL-CIO, told *The Washington Post*. "The whole system is on autopilot. For this vote to take place is extraordinary. This is just the beginning of a show of force for these reform proposals."

Many companies responded by entering into serious negotiations with the proponents. Nineteen companies have made change to their policies regarding the hiring and monitoring of outside audit firms, partly in response to this proposal. From the outset it was not clear if the proposal would achieve such stature. The auditor independence proposal was inspired by concerns that lucrative consulting contracts may jeopardize auditor independence.

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The information that provided ammunition for that concern became available in 2001, when companies were required for the first time to include in their proxy statements information on audit fees. IRRC conducted a study of audit versus non-audit fees and discovered that many companies were paying much higher fees for non-audit services. Representatives from union funds, including Ed Durkin, director of special projects at the Carpenters, also were surprised to discover the extent of fees paid for non-auditing services. The Carpenters discovered that there were at least five companies in their portfolio—Apple Computer, Best Buy, Bristol-Myers Squibb, Delphi Automotive Systems, and Kmart—that had non-audit fees that comprised more than 89 percent of the total fees paid.

Union funds initially submitted a total of 29 auditor conflict proposals, with the most—17—filed by Carpenters' funds, including to the five companies mentioned above. "Our funds submitted shareholder proposals on the auditor conflict issue in order to protect the integrity of the audit process," says Durkin. "The widespread and significant consulting relationships between corporations and their audit firms revealed in recent corporate disclosures threaten to undermine investor confidence in the independence of audit firms and the financial reporting system. The shareholder proposals provide an opportunity for investors, not just regulators, to speak loud and clear on this issue."

Because the Disney annual meeting date was the earliest, that company was the first to appeal to the SEC's Division of Corporation Finance for no-action relief, saying it planned to exclude the proposal submitted by the United Association of Journeymen and Apprentices of the Plumbing and Pipe Fitting Industry funds on the grounds that it related to the company's ordinary business. The company argued that because the auditor firm's familiarity with the company "can substantially enhance its ability to provide needed support in an effective and cost-efficient manner" the firm should be allowed to continue to perform non-audit services.

In its response, the Plumbers' fund suggested that, "The fund submits that those same types of arguments could have been used in the various audit scandals that have occurred in recent years that spurred the SEC to require the disclosure of payments to accountants."

The Plumbers' fund asserted that this proposal does not interfere with the company's ordinary business, writing that, "the company has confused the ordinary business of 'selecting' auditors... with the broad policy sought in the proposal to ensure that whoever the company selects to be its independent accountant is truly 'independent' by removing the potential for conflicts of interest that is created if the accountant renders 'other' services to the company in addition to its audit service."

The Securities and Exchange Commission refused to grant Disney no-action relief. In its ruling, the SEC said, "In view of the widespread public debate concerning the impact of non-audit services on auditor independence and the increasing recognition that this issue raises significant policy issues, we do not believe that Disney may omit the proposal from its proxy materials in reliance on rule 14a-8(i)(7)." Similar rulings at Ameren and Motorola soon followed.

Although the proposal now could go forward at these companies, which had challenged the proposal only on ordinary business grounds, there were still other hurdles to be crossed at the SEC. The proposal had been challenged, by various companies, on the following six grounds.

- (i)(1) The proposal would be a violation of state law, since California law gives the board the role of hiring auditors (Apple Computer).
- (i)(2) The proposal would require the company to violate federal law since federal law includes requirements about documents the auditors need to sign (Dominion Resources).
- (i)(3) The proposal is false and misleading, particularly in its reference to the recent SEC rulemaking on auditors.
- (i)(6) The company lacks the power to implement the proposal.
- (i)(9) The proposal is counter to a management proposal (since the company's nomination for auditor will appear on the company's proxy statement).
- (i)(10) The proposal already has been substantially implemented – auditors are already independent.

The Division of Corporation Finance ruled that the proposal cannot be omitted under (i)(2) or (i)(3). The Commission did concur with PG&E that portions of the proposal's supporting statement could be construed as misleading, and required that the proponent revise the proposal to provide "accurate citation to a specific source."

Disney was also the earliest test case for the vote. The proposal submitted by the Plumbers and Pipefitters received 42 percent of the votes cast at the company's February 19 annual meeting. This is a high vote for any first-time proposal, but it is an especially strong show of support given that Disney announced just several weeks before the meeting that it no longer would allow its independent auditor, PricewaterhouseCoopers, to perform any consulting or any other non-audit work for the company. Disney paid the accounting firm $8.7 million in audit fees and $42.9 million in non-audit fees last year.

The success of the proposal may have helped spur more serious negotiations between companies and proponents. Since the Disney vote, at least 11 proposals have been withdrawn after companies agreed to new policies. Carpenters' pension funds withdrew proposals at Apple Computer, Best Buy, Bristol-Myers Squibb, FirstEnergy, Equitable Resources, Viacom and Dominion Resources after reaching settlements with the companies. The Sheet Metal Workers International Union withdrew the proposal at Johnson & Johnson. IBEW has withdrawn the proposal at Ameren, McGraw Hill and TXU.

The core policy agreed to by most of these companies has three components:

1) A limitation on services
- No consulting, no financial information services, no internal audit work

2) Changes to internal processes and procedures
- Pre-authorization of every engagement at the management level
- Dissemination of new policy throughout the organization
- An agreement that the audit committee will meet four times a year and that it will receive an itemized description of the auditor's work and fees at each meeting

3) Enhanced disclosure
- Better itemization
- Inclusion of policy in audit committee report
- Inclusion in the proxy statement of "an affirmative statement that the engagement of the auditor to perform work other than the audit work has not impaired the auditor's independence."

The intention of the negotiations was to take a more "comprehensive and broader approach" than simply seeking elimination of consulting services by auditors, although that remains a critical part of each agreement, Durkin says. Each settlement is a bit different: for some companies the alterations means changes in the charter, at other companies they mean a different review process.

The success of the proposal may have helped spur more serious negotiations between companies and proponents.

For example, Bristol-Myers Squibb agreed that the audit committee will have to pre-approve the use of the auditor for tax work based on an estimate of aggregate fees, while FirstEnergy agreed that the audit committee will have to pre-approve the use of the audit firms to perform any audit-related work when the engagement contract exceeds $100,000. Durkin expects that approximately one-third of the 30 companies facing this proposal will settle.

Even at firms where the proposal will be, or has been, voted on, a number of companies are making changes. IRRC is aware of eight companies facing the audit proposal that adopted new policies (see chart). Halliburton, for example, included with its proxy statement a two-page appendix entitled "Corporate Policy: Services of Principal Independent Auditors" that details the conditions under which the auditors will be hired to complete specific tasks.

As we go to press, there are only a few preliminary votes available. The highest was at PG&E, where the proposal reportedly received support of 47 percent of the votes cast.

It also seems reasonable to expect that more of these proposals will be filed next year. The Enron scandal did not erupt until most companies' filing deadlines had passed, but not quite all. The Carpenters have filed four additional proposals at companies with later meeting dates: Automatic Data Processing, Fedex, Nike and Sara Lee. The proposal also has been picked up by an individual investor, W. Engstrom, who filed it at Sepracor in late December.

The Amalgamated Bank's Longview Fund filed two proposals at companies with late deadlines, Albertson's and Labor Ready, where the fund specifically raised the Enron issue. "The recent collapse of Enron Corporation has once again shone a spotlight on the role of independent auditors, as previously happened after disclosures of accounting fraud at Sunbeam, Cendant and Waste Management. The failure of Enron Corporation has raised questions about what Enron's auditors knew, when they knew it, and what facts they saw fit to certify to the SEC and to shareholders," the LongView proposal states.

—Rosanna Landis Weaver

Company	Proponent	Company's Challenge at SEC	Status as of 5/30/02
Albertson's	LongView	none known	06/06 meeting date – expected to go to a vote
Allegheny Energy	Carpenters	none known	05/09 meeting date – expected to go to a vote The company announced will no longer use auditors for new financial systems design and implementation projects, but believes it should retain the flexibility, with audit committee oversight, to retain auditors for other matters.
Ameren	IBEW	company asked for an exclusion: (i)(7) ordinary business SEC ruled against ommission	Withdrawn—Company adopted a policy of more disclosure (including an itemized breakdown) and will describe internal monitoring processes in report. Proponent allowed audit-related fees as long as disclosure and monitoring were in place.
American Power Conversion	Carpenters	none known	06/11 meeting date—expected to go to a vote
Apple Computer	Carpenters	company asked for an exclusion: (i)(7) ordinary business (i)(l) violation of state law (CA law gives board role of hiring auditors) (i)(9) counter to a management proposal (company's nomination of auditors) (i)(10) already substantially implemented—auditors already independent	Withdrawn—company adopted a new auditor independence policy, which prohibits its auditors from performing non-financial consulting services, such as information technology consulting and internal audit services. The policy also mandates that an annual budget for both audit and non-audit services be approved by the audit committee in advance, and that the audit committee be provided with quarterly reporting on actual spending. The policy requires non-audit services to be approved by the director of technical accounting and the CFO.
Automatic Data Processing	Carpenters	none known	Submitted in April
Avon Products	Carpenters	none known	05/02 meeting date – preliminary results show 12.5 percent support for proposal. In 2002, Avon amended its existing policy to prohibit the hiring of its independent auditors for non-audit services, except for cetain audit-related services, such as statutory audits required in certain international locations, and certain tax consulting services that the audit committee has approved.
Best Buy	Carpenters	none known	Withdrawn—company agreed to adopt core agreement.

Company	Proponent	Company's Challenge at SEC	Status as of 5/30/02
Boston Properties	Carpenters	none known	06/01 meeting date – expected to go to a vote
Bristol Myers Squibb	Carpenters	none known	Withdrawn—Company agreed to adopt code agreement. Bristol-Myers Squibb agreed that the audit committee will have to pre-approve the use of the auditor for tax work based on an estimate of aggregate fees.
Constellation Energy Group	IBEW	none known	05/24 meeting date—expected to go to vote
Delphi Automotive	Carpenters	none known	05/01 meeting date – expected to go to a vote. Delphi reports that "the audit committee has instucted the company to refrain from engaging in any future consulting services with its independent auditor."
Dominion Resources	Carpenter	company asked for an exclusion: (i)(2) require to violate federal laws (i)(6) lacks the power to implement (i)(7) ordinary business agreed to adopt policy	Withdrawn—company agreed to adopt policy
Duke Energy	United Association	Company asked for an exclusion (i)(7) ordinary business (i)(9) conflicts with management proposal	04/25 meeting date—preliminary results: 36 percent support for proposal. In late 2000, company adopted additional restrictions beyond those imposed by the SEC's auditor independence rules, prohibiting Deloitte & Touche from providing internal auditing services or financial information systems design implementation services.
Emmis Communications	Carpenters	none known	June meeting date—expected to go to a vote
Equitable Resources	Carpenters	none known	Withdrawn
Fedex	Carpenters	none known	Submitted in April
First Energy	Carpenters	none known	Withdrawn - adopted core policy. FirstEnergy also agreed that the audit committee will have to pre-approve the use of the audit firm to perform any audit-related work when the engagement contract exceeds $100,000.

Company	Proponent	Company's Challenge at SEC	Status as of 5/30/02
Halliburton	United Association	none known	05/15 meeting date – expected to go to a vote. Halliburton adopted a policy that limits, but does not forbid, the provision of non-audit services by the company's outside auditors. The policy permits the company's outside auditors to provide non-audit services that facilitate the performance of the audit, improve the financial reporting process and internal controls environment, and relate to tax consulting or advice. The policy sets stipulations of conditions that must be met before the auditor can provide these non-auditing services.
Johnson & Johnson	Sheet Metal Workers	none known	Withdrawn – Company agreed to adopt core agreement
K-Mart	Carpenters	bankruptcy/no longer listed	Company filed for Chapter 11
Labor Ready	Longview	none known	06/19 meeting date – expected to go to a vote.
Lafarge North America	Carpenters	none known	05/07 meeting date. Preliminary results show proposal received 14.3 percent support.
Liz Claiborne	Carpenters	none known	05/16 meeting date. The company's new policy prohibits its independent auditor from performing any internal audit services or any consulting services related to the company's financial information systems. The audit committee reviews any proposed non-audit assignments in advance.
Manpower	Carpenters	none known	04/30 meeting date. Preliminary voting results show proposal received 18.1 percent support. In March the company adopted a new policy regarding non-audit services that prohibits the company's independent auditors from providing any financial information systems design and implementation services, information technology, systems consultation, and internal audit services, including internal control services.
Marriott International	United Association	company asked for an exclusion: (i)(7) ordinary business (i)(10) substantially implemented — shareholder already get to vote (i)(3) and (I)(6) vague and false	05/03 meeting date—expected to go to a vote.
McGraw-Hill	IBEW	none known	Withdrawn. "They created a policy that was close to what we wanted," says the IBEW.

Company	Proponent	Company's Challenge at SEC	Status as of 5/30/02
Motorola	Sheet Metal Workers	company asked for an exclusion: (i)(7) ordinary business SEC refused to grant no action	05/06 meeting date. Preliminary results show proposal received 39.4 percent support. In 2001, Motorola adopted a policy that KPMG would not provide IT consulting, internal audit, or financial transaction services in the future.
Nike	Carpenters	Submitted in April	
PG&E	Carpenters	company asked for an exclusion: failed to comply with eligibility require (i)(7) ordinary business (i)(3) false and misleading – improper citation of rules	04/17 meeting date. Preliminary results show proposal received 46.5 percent support.
Reliant	Carpenters		06/05 meeting date – expected to go to a vote.
Safeway	United Association	company asked for an exclusion: (i)(7) ordinary business (i)(1) under Delaware law, not proper matter for stockholder action (i)(9) conflicts with management proposal (i)(10) already substantially implemented	05/16 meeting date—expected to go to a vote.
Sara Lee	Carpenters	none known	Submitted in April
TXU	IBEW	none known	Withdrawn. Company is improving disclosure and monitoring.
VF	IBEW	none known	04/23 meeting date. Preliminary results show proposal received 33.2 percent support. The audit committee has adopted a policy to prohibit the retention of its auditors for services related to internal auditing functions and the design and implementation of financial information systems. The audit committee has also adopted a policy to require pre-clearance from audit committee members for substantial non-audit engagements by its auditors. Specifically, the audit committee chairman must approve any engagement that is expected to generate fees of $250,000 or more, and the full audit committee must approve any engagement expected to generate fees of more than $1 million.
Viacom	Carpenters	withdrawn – eligibility	Withdrawn- adopted core agreement
Walt Disney	United	ordinary business challenge SEC declined to omit proposal, citing widespread public debate on the issue.	Went to a vote February 19 and received support of 41 percent of shareholders voting. Disney announced, before the meeting,that it would no longer hire auditors as consultants.

Legislation Guides French Firms on Improving Governance Framework

In keeping with the French capital market's efforts to embrace sound corporate governance practices, recent changes to French law help provide a framework within which companies can work to improve the ways in which they currently operate. The adoption last year of the New Economic Regulations Act (NER) was seen by many as the logical legislative consequence to a gradual but steady institutionalization of many Anglo-Saxon-style governance practices within France's equity market. The practices were first espoused by the Viénot Committee, led by well known businessman Marc Viénot, which drafted the country's first corporate governance report in 1995. Viénot's principles, as well the work of several French shareholder organizations such as Proxinvest, and AFG-ASFFI (an association that represents France's asset management industry) in advocating for improved corporate governance, all helped pave the way for many of the landmark governance measures spelled out in the NER.

The NER addresses a number of key areas including disclosure of director remuneration, board of directors, and proxy voting, as well as less critical issues such as taxation of incentive plans. Though considered to be far reaching for a continental European market, the legislation falls short, according to some, particularly in the area of proxy voting.

The New Economic Regulations Act, ratified on 15 May 2001, is an amendment to the Commercial Code of 18 September 2000. The act principally is aimed at improving corporate disclosure in France. Proposed by the former Finance Minister, Christian Sautter, the purpose of the new regulations "is to create a safe and transparent financial environment and to place [the country] among the best in matters of corporate governance."

Board practices: a key element

One of the legislation's key components concerns director pay and board practices. The NER calls on companies to reveal the total remuneration granted to either the top five or ten highest paid directors, depending on the size of the company. Public companies that exceed 200 employees should disclose the top ten best paid directors, while companies with fewer than 200 employees should report the top five.

The size of the board should be between three and 18, says the NER. Members of either the board of directors (one-tiered boards) or the supervisory, or nonexecutive, boards (two-tiered boards) can only serve up to six years and are only allowed to hold director positions simultaneously in a total of five boards. For two-tiered boards, members of the management, or executive, board would have terms of between two and six years and are not allowed to hold any other director positions simultaneously.

In addition, the NER advocates that the chairman and CEO posts be separated, and that no director should be chairman of more than two companies at a time. On the executive side, no CEO or general manager should hold the same position at another firm.

Market observers believe that many French companies will implement a large number of these provisions this year, including disclosure of the highest paid directors. Some of the companies that have already disclosed individual directors' remuneration include Alcatel, Crédit Lyonnais, and Renault. Also, of the CAC 40 companies that IRRC has covered so far, about 16 companies have made amendments to their company bylaws in order to comply with the new provisions of the NER. Some of the companies include AXA, BNP Paribas, Bouygues, Cap Gemini, Danone, L.V.M.H., Société Générale, Suez, Total Fina Elf, and Vivendi Univeral.

NER falls short on proxy voting reform

Aside from board structure and qualifications, the NER attempts to address concerns regarding proxy voting procedures. Over the past two years, non-French institutional investors have had a difficult time lodging their votes, as French issuers used a loophole within existing laws to require that proxy ballots be signed by beneficial owners before they are deemed valid. The extra time required to secure a beneficial owner's signature resulted in a number of non-French institutions failing altogether to cast their votes, and French issuers scrambling to head off an investor relations nightmare and meet quorum requirements.

The NER was meant to alleviate this cumbersome process for investors but decidedly favors companies since issuers still retain a great deal of latitude when determining which votes can and cannot be accepted. The legislation, for example, grants companies the right to request that custodian banks, or other financial institutions that are acting as third parties, pass on the name, nationality, date of birth or establishment, the addresses and the amount of shares held by a beneficial owner. Failure to comply with the company's demands can result in the cancellation of voting rights and/or the suspension of dividend payments for up to five years. And as the shareholder activist group Proxinvest states: "The legal protection of investors is not at all insured since the issuer can change [his/her] mind anytime about the quality of the investor's identification as shareholder." As for wet signatures, the latest issue of Global Proxy Watch indicates that the French government was unable to implement the changes regarding the signatures of the beneficial owners in time; therefore, foreign investors are most likely to face proxy difficulties.

Burdensome proxy voting procedures are not the only issue that the NER fails to address, say shareholder activists. Still permitted under the legislation are double voting rights, an archaic takeover defense which persists at some French companies. Double voting rights are assigned to certain registered shareholders that have held their shares continuously for at least two years. The law also stipulates that registered shareholders are entitled to receive double voting rights when management increases the company's share capital through the incorporation of reserves. Only registered shareholders who are French nationals or citizens of other European Union countries are entitled to double voting rights, however, thereby discriminating against other shareholders and underscoring the NER's failure to mete out equal treatment.

—Cristina Yen

European Union Seeks Consensus As New Code Takes Shape

The European Commission is poised to resubmit for parliamentary approval legislation designed to standardize takeover regulations among the 15 countries that are members of the European Commission. An earlier version of the code was vetoed by parliamentarians last summer, but the code's proponents and architects – who have spent more than a decade crafting the legislation – are determined to see something come of their efforts. The redrafting of the code is receiving support from both within and outside the EU, and governance observers suggest it may be ready for parliamentary approval before year's end. However, others suggest the redraft's chances for approval are slim at best because Germany, the Netherlands and Sweden have launched a strong lobbying effort against the redraft.

Last July, the EU voted down the original version of its much anticipated takeover code, which would have unraveled longstanding takeover defenses that are common amongst most EU members. Germany, in particular, lobbied against the takeover code fearing it would pave the way for hostile takeovers of German companies by foreign firms. The code's shelving meant German companies, as Berlin had sought, could employ a wide range of defensive measures to ward off unwelcome bids.

Much of the German unease with a common, transnational takeover code stemmed from lingering discomfort over London-based Vodafone's hostile takeover of Mannesmann, a German telecommunications giant, in 2000. Workers at Mannesmann believed they were not consulted fully before management approved the deal, and demanded legislation that would give them more of say in the face of takeover bids. Union advocates argued that the EU's proposed takeover directive did not give an adequate voice to workers' concerns. In the wake of the Mannesmann takeover, German companies sought the right to ask shareholders for a blanket authority to issue a antitakeover device on an annual basis, for up to 18 months, even before a takeover bid is made. This too was the major sticking point in the EU legislation, which spelled out that companies could only convene shareholder meetings only after a takeover bid had been made.

On the heels of the code's defeat, the European Commission announced late last summer that it would begin the process of redrafting legislation to standardize takeover regulations. The goal was to make the original version palatable to all, and proponents of a common code felt the slim margin of defeat – just one vote – meant odds for future approval were favorable.

A seven-member panel of experts was convened by the EC to spearhead the redrafting process and address major sticking points. The committee of academics, industrialists and lawyers is headed by Jaap Winter, an academic and legal advisor to the Anglo-Dutch group, Unilever. Commenting on the panel's mandate, the EC's internal markets commissioner, Frits Bolkestein, said the initiative, "demonstrates the commission's determination to come forward as soon as possible in 2002 with a new proposal that takes account of the broadest range of views."

In January, the panel issued a set of recommendations designed to undergird a final takeover code draft. Those key recommendations, according to the weekly governance publication *Global Proxy Watch*, address the following five areas.

- **Disclosure.** All listed EU companies should face a common requirement to reveal often undisclosed defenses, such as pyramidal share structures, cross-holdings and change-of-control provisions.

- **Shareowner powers.** Investors should have a vote on any takeover defense, and such a defense must be specific to a bid—not a general authority. Panel head Jaap Winter also urges one vote per share in such cases.

- **Defenses.** A bidder winning 75 percent of a company's common stock should be able to override any "golden share" or other takeover defense and gain control.

- **U.S. bids.** U.S. boards have wide authority to adopt poison pills. To level the playing field, the panel leaves open the possibility that EU companies could install equivalent takeover defenses—but only for hostile bids by American firms.

- **Price.** A successful bidder would have to buy out remaining investors at the highest price the shares hit in previous months.

The influential International Corporate Governance Network, which is comprised of 250 members who represent investment organizations and corporations with $12 trillion under management, came out in favor of the panel's recommendations, giving it much needed support from the institutional investor community.

The ICGN concurs with the panel's call that only shareholders – not regulators or political bodies – determine the success or failure of a takeover bid; and, that "one share, one vote" should apply to small and large shareholders, allowing each individual or institution to vote in proportion to the financial interest they own in the company.

Sweden and the Netherlands have joined Germany in lobbying to water down the code's provisions, reports The Financial Times.

Assessing the framework for a new takeover code, ICGN Chairman Peter Clapman voiced the governance group's strong opposition to unequal voting rights for certain classes or groups of shareholders, emphasizing that differences among various EU member states on this issue helped derail a previous effort to create uniform takeover procedures. Referring to so-called "golden shares," Clapman said, "The logical remedy is to abolish them everywhere."

While the ICGN publicly has given a future code based on the January recommendations its strong backing, others groups have been working behind the scenes to derail efforts to resurrect a common EU takeover directive. Sweden and the Netherlands have joined Germany in lobbying to water down the code's provisions, reports *The Financial Times.* Observers say the three governments are keen on seeing the EC create another high-level panel to offer further recommendations on the final shape of the takeover code. Those further recommendations, says one observer, would effectively "ensure that Winter's recommendations do not go unrevised." Unequal voting rights are common at firms based in Germany, the Netherlands and Sweden, and used by firms as the primary defense to ward off foreign takeover attempts.

German opposition to a common takeover code is particularly strong, because Berlin, corporate Germany and labor groups all worry that industry giant Volkswagen could fall prey to a foreign suitor under provisions of a new code. In its current form, the code would not allow the government of Lower Saxony, with its 18.6 percent stake in the automaker, to continue to retain its power to veto corporate decisions. This particular issue has proved emotive for many Germans, and Chancellor Gerhard Schroeder, facing re-election in the fall, is unlikely to back any EU legislation that could jeopardize Volkswagen's standing as a symbol of pride for German industry.

Until Germany can get its political act together, the chances for approval of a common, EU takeover code appear slim. In the words of one pundit, "A European takeover directive is dead in the water, at least until the next German elections in September."

— *Subodh Mishra*

Shareholder Proposals Old and New Are Registering High Votes in 2002

As the vote tallies for 2002 shareholder proposals begin to stream in, all indications are that a substantial number of proposals addressing a wide range of corporate governance issues are registering higher votes this year than in years past.

Auditor independence

The much publicized proposal that asks companies to adopt a policy ensuring that any public accounting firm used by a company for outside audit services not be retained to provide other services to the company has been garnering some strong support. Union pension funds drafted and submitted the first-time proposal this proxy season. The average level of support for the nine proposals that IRRC has obtained voting results for so far is 30.6 percent, a strong showing for a proposal that is just out of the gate. The highest vote recorded so far on an "auditor independence" proposal was at PG&E, where the proposal received 46.5 percent of the votes cast. Earlier in the year, an auditor independence proposal at Walt Disney garnered the support of 41.2 percent of the votes cast. That count was viewed as particularly high in light of the fact that the company agreed before the annual meeting no longer to hire auditors as consultants.

Golden parachutes

Proposals aimed at curbing what is viewed as excessive executive compensation are proving quite popular with shareholders in 2002. In particular, the average level of support has risen for proposals asking companies to allow shareholders to vote on future severance agreements with senior executives—either all such agreements or those that exceed a specified level (e.g. such as those in an amount exceeding two times the sum of the executive's base salary plus bonus). So far this year, IRRC has voting results for 11 of these golden parachute proposals, and average support stands at 39.2 percent of the votes cast. In 2001, IRRC tracked 13 golden parachute proposals that came to a vote and average support for these registered at 31.8 percent of the votes cast.

One vote on this issue that made headlines took place at Bank of America, where 50.7 percent of the votes cast favored a golden parachute proposal. In 2001, an almost identical proposal submitted by the same proponent, the Teamsters, received 40.7 percent of the votes cast. This year, when asked if his company would act on the slim majority vote, Bank of America CEO Ken Lewis responded, "Absolutely."

Similar proposals submitted by the Amalgamated Bank's LongView Collective Investment Fund garnered strong support. LongView says its proposal at Sprint received 50 percent of the votes cast, one at Raytheon garnered 44.4 percent of the votes cast and another at Massey Energy received 46.7 percent of the votes cast.

Board independence

Shareholders also appear to be throwing support behind proposals asking for more independent directors on boards. So far, IRRC has voting results for three of these proposals, and average support stands at 32 percent. A proposal submitted by Walden Asset Management that asked EMC to increase the number of independent directors on its board garnered the most support, receiving 56 percent of the votes cast, according to preliminary results. In 2001, average support for seven proposals that came to a vote was just 22.5 percent, and the highest support was 31.9 percent (at America International Group).

Antitakeover provisions

Shareholder proposals addressing such standard antitakeover issues as poison pills and classified boards, which historically have registered high votes, continue to do so in 2002. At press time, IRRC has obtained voting results for 21 proposals asking companies to repeal their classified boards, and average support for these registers at 63.7 percent of the votes cast. By contrast, the 46 classified board shareholder proposals IRRC tracked in 2001 that came to a vote received average support of 52.4 percent of the votes cast. So far in 2002, the highest level of support for a classified board proposal was recorded at Airborne, where a proposal submitted by the Teamsters, garnered 84.5 percent of the votes cast.

Proposals asking companies to redeem their existing poison pills and/or allow shareholder votes on future pills also remain popular. IRRC had obtained voting results for 31 poison pill proposals at press time, and average support for these stands at 60.3 percent. The highest vote recorded so far in 2002 was again at Airborne, where a proposal submitted by John Chevedden garnered 91.4 percent of the votes cast, according to preliminary results. In 2001, the 22 poison pill proposals tracked by IRRC that came to a vote received average support of 57 percent of the votes cast.

—Rosemary Lally