CORPORATE GOVERNANCE

CORPORATE GOVERNANCE IN 2003: FORCES CONVERGE TO FURTHER REFORMS

Hank Boerner

The year 2002 will be viewed in retrospect as a period of intense examination of corporate behavior and financial performance, and the particular time when public sentiment shifted strongly in favor of significant reforms to address the governance issues of publicly owned companies. Two clear examples of this new public mood were the passage of the Sarbanes-Oxley Act by Congress, and the adoption of stringent governance rules for listed companies by the New York Stock Exchange.

Just one year ago, Enron, the former number seven company in the *Fortune* 500 rankings was in financial free fall; much has happened since, with public and private sectors, self-regulatory organizations (SROs), and non-governmental organizations (NGOs) announcing one initiative after another to address corporate governance reform.

What is ahead in 2003? For starters, many of the initiatives launched, or in the case of existing practices, further shaped in 2002, will evolve into major influences on corporate behavior. The Sarbanes-Oxley legislation is moving through required rule making to formal adoption of new rules and regulations for accountants and public companies, and the Public Company Accounting Oversight Board has begun operations. The New York Stock Exchange's new rules for listed companies will result in important changes in board structure and operation for most listed companies throughout the year. The Financial Accounting Standards Board (FASB) is taking back control of the accounting rule development process, which could streamline the development.

Sniffing a once-in-a-lifetime opportunity, for-profit and non-profit corporate raters and rankers are racing to expand their services in profiling public companies. Financial officers will be faced with an ocean of rankings and opinions that will challenge them as they seek to rebuild trust and confidence with investors—and to attempt to boost equity valuations.

"[The] Enron [experience] is bringing about the most sweeping structural changes in governance that have ever occurred," Donald Jacobs, former dean of Northwestern University's Kellogg School of Business, told *Business Week.* These changes present opportunities to package and sell information, and there will be many corporate governance watchers with new or expanded power working to shape the perceptions of public companies as they gauge each company's reaction to and compliance with the new operating rules. Their influence on investors should not be underestimated.

HANK BOERNER is managing director of the New York office of Rowan & Blewitt, an issues management consulting organization. A former head of communications for the New York Stock Exchange, he is a long-term observer of corporate governance and accountability trends. The views expressed are his own. He can be reached at hank@pb.net.

RATINGS, RANKINGS, SCORES, AND OPINIONS

There are several ways in which each company could be impacted by this trend: new, expanded, or newly important rankings, ratings, scores, and opinions or reports could illuminate the good and bad about each company; and, new operating rules of the road could put each enterprise on the good or bad side of the ledger, in such areas as enhanced financial reporting, impact of the business on the community, and furtherance of shareholder democracy in each corporate governance process. Another factor, growing in importance, is the company's real or perceived treatment of stakeholders, as these are being defined by NGOs, socially oriented investors, and shareholder advocates.

In 2003, each company likely will be further poked, scanned, screened, ranked, rated, scored, compared [to peers], and ultimately judged quite critically by corporate governance and financial performance monitors. Through this process, each company could be subject to greater scrutiny and held to higher standards in terms of corporate behavior, financial performance, and internal structure and governance. What is unknown today is just how influential these factors will be in the ultimate valuation of each enterprise in the capital markets.

Given the breadth of financial and governance pulse-taking, the odds favor each company showing up (or being conspicuously absent from) important rankings or ratings that really do count with investors. With or without such scoreboards, each company's financial reporting process will be directly affected by changes in new regulations. Here's a preview of what to expect in the year to come.

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The SEC Wants Mutual Fund Managers to Reveal Secrets

The SEC has a new rule in the works that if adopted will require investment advisers (managers of mutual funds) "that exercise voting authority over client proxies to adopt and implement policies and procedures to reasonably ensure that the adviser votes those proxies in the best interest of clients." The funds would disclose to clients—individual and institutional shareholders—the fund family's information on its voting policies and how the adviser voted the clients' proxies in each contest.

This full and fair disclosure in proxy voting will result in previously unpublicized conflicts of interest being revealed. Many mutual fund families (advisers) also manage captive corporate 401K plans and other employee investment vehicles, usually for large companies. How will the adviser vote against one of these corporate clients in a heated proxy contest? What if public opinion is firmly against management?

The SEC thinks the enormity of the mutual fund advisory company gives advisers "significant ability, collectively, and often, individually, to affect the outcome of shareholder votes and to substantially influence the governance of corporations." In this instance, think Fidelity, Putnam, and so on. This proposal got its initial push from Amy Domini, who runs the socially responsible mutual funds bearing her last name. It is a short step to seeing the lists of shareholder activists' targeted companies expanded to include the positions taken by large fund families on specific proxy issues.

The SEC is taking this position because, given the howls raised by the American public about analyst-investment banker conflicts, it moved to address real or potential conflicts of interest between advisers and their clients. Advisers (or their affiliates) now manage assets, administer employee benefit plans, and provide brokerage, underwriting, insurance, or banking services to companies whose management is actively soliciting the support of the adviser (e.g., their support of management positions or board candidates via the proxy vote). Some advisers also manage money for employee groups—which may be opposed to their own company board or management positions on issues, creating a very complicated conflict of interest. (Who is the client?)

Under the 1940 Investment Advisers Act, advisers with material conflicts of interest must fully disclose these before casting votes. Advisers have generally ignored these rules in the past. Given the present climate for reform, the SEC is moving to change Rule 206(4)-6 to make violations fraudulent and punishable. Mutual fund advisors manage $19 trillion in assets, including huge holdings in the equities markets, making them the most powerful force in institutional investing.

The Harmonization of the FASB and IASB

There are signs of increased cooperation on harmonization of accounting rules between the FASB and the International Accounting Standards Board (IASB). The two powerful rulemaking organizations have agreed to make a serious attempt to harmonize U.S. and European accounting standards by 2005, which is the deadline for public companies in the European Union to adopt IASB EU-wide standards (vs. their own government's country rules).

The difference in the two sets of rules? "FASB rules are more specific and rule-oriented," notes Wharton University accounting professor David Larcker, "while IASB pronouncements tend to consist of more general guidance. There is a debate over just how much integration between the sets of standards is really necessary."

As FASB enters its 30th year of operation in 2003, the non-profit body is re-asserting its authority over the U.S. accounting rule process. Now, only two organizations will issue rules: SEC and FASB. The Emerging Issues Task Force (EITF) rules will come through FASB and the American Institute of Certified Public Accountants (AICPA) rulemaking will be diminished.

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The Socially Responsible Investing Movement Is Gaining Strength

Throughout the 1990s, investors flush with cash and armed with intention to invest in socially responsible companies moved into socially responsible investment (SRI) mutual funds; it is estimated today that $1 of every $8 invested in equity funds is in one of almost 200 SRI funds. It helps that these mutual funds fared well in the 1990s bull market, and are holding up (competitively) in the post-crash environment as well. Companies may find themselves being included in—and being excluded from—important indices, rankings, and other selections designed for SR investors.

For example, the FTSE Group launched four new global indices for trading in July 2001—the FTSE4Good Index Series for socially responsible investing—with published ratings now posted on the FTSE Web site and distributed worldwide to investors. In 2003, companies considered for these indexes will need to meet new and more comprehensive environmental measures as well as existing standards on universal human rights and positive relations with stakeholders. (The human rights standards will be strengthened in 2003.)

Candidates for the indices are drawn from the FTSE 100 (the 100 largest cap stocks traded on the London Exchange, roughly equivalent to the S&P 500) and the FTSE All-World Index of 2,300 stocks, representing all global regions.

Companies in the FTSE4Good indexes are rated in three categories to describe the impact of their business on the environment: high, medium, and low. Four benchmark indices and four tradable indices (USA, global, UK, and Europe) make up the FTSE4Good Index Series. Institutional investors use these indices for investment analysis, performance measurement, asset allocation, and for creating index-tracking funds. Recent listings for U.S. companies included Black & Decker, CSX, and Ford Motor Company.[1]

The SRI Domini 400 Social Index Bears Watching in 2003

The SRI movement often relies on the well-known Domini 400 Social Index for guidance. Domini Social Investments LLC—manager of the Domini Social Equity Fund—bases its investments on the index. In recent years, Domini managers have become active in corporate proxy contests, and the firm's resolutions are watched closely by both SRI and mainstream investors. It's worth a look for finance managers as well to detect trends that could affect their companies.[2]

Faith-Based Investor Activism

The Interfaith Center on Corporate Responsibility (ICCR), a coalition of 275 faith-based investors, including major denominations, pension funds, religious orders, foundations, and healthcare systems, represents institutional holdings in excess of $100 billion. Shareowner power is exercised through the individual member funds. In 2002, ICCR members sponsored 145 resolutions to 101 companies, often acting as co-sponsor with other activists. (The public employee pension funds of New York City, Connecticut, New York State, Minnesota, and other states are regular allies.)

ICCR's issues are focused in these major areas: energy and environmental; equality; global

corporate accountability, global finance, and community economic development; international health (and tobacco); militarism and violence; and corporate governance (democracy). The desired outcome of these campaigns, ICCR notes, are as relevant as when the group was organized in 1981: achieving social justice and economic fairness.[3]

The Importance of New NYSE Rules

In August 2002, the board of the New York Stock Exchange (NYSE) approved sweeping rules on corporate governance for listed companies, which will impact on the board room and executive suite in almost every company traded on the Big Board in 2003. NYSE Chairman Dick Grasso said the adoption of the new rules "was the most significant corporate governance initiative in the Exchange's 210-year history." As an SRO, the NYSE can impose drastic penalties for non-compliance, including de-listing of a company's stock.

The NYSE's Corporate Accountability and Listing Standards Committee recommendations to the board included new rules that a majority of the listed company board be clearly independent, listed companies adopt and enforce a code of business conduct and ethics, shareholders be given the opportunity to vote on all stock option plans, and other important process changes for NYSE companies.[4] These rules have been adopted.

New Environment for Corporate Legal Counsel in 2003

Major changes are coming for corporate in-house lawyers in 2003 as well: The Sarbanes-Oxley Act will require them to report evidence of material violations of securities law or breaches of fiduciary duty to a company's general counsel or CEO. And if they don't respond appropriately, the lawyer must report the incident to the board of directors and/or its audit committee. The question of where attorney-client privilege begins and ends takes on greater significance as the actual regulations are promulgated (a process underway at press time).

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Responding to changes in the public company environment in 2002, the American Bar Association (ABA) established a Corporate Responsibility Task Force; the group's first report suggested the ABA's Model Rules of Professional Conduct be changed to provide better guidance to corporate lawyers who may learn of wrongdoing by insiders.

For example, Rule 3.4 of the Model Rules prohibits counseling another person to "destroy or conceal a document or other material having a potential evidentiary rule." Lawyers believed this rule is so sacred, notes ABA Ethics Counsel George Kuhlman that hardly anyone ever discussed it before. After the highly publicized Arthur Andersen-Enron shredding marathon, everyone is talking about it.

The new rules could change the relationship between corporate legal counsel and corporate finance officers in 2003.

CEO and CFO Certification—Not a One-Time Event

The first deadline loomed large in August 2002: The CEOs and CFOs of nearly 1,000 major U.S. companies had to file certifications with the SEC—under a rule imposed by the Agency in the wake of corporate failures—that current and one year prior financial filings were accurate as originally filed. Investors held their breath, awaiting a flood of re-statements, but in the end, only a handful of companies did not file or had to re-state prior filings.

The media coverage was intense, and then died down immediately. However, the filing requirement did not go away, and filings are required for future quarters. Also, the filing and disclosure process is expanding to include many more companies than the initial (largest) firms.

In 2003, there could be occasional announcements of re-stated financials by mid-cap and small-cap firms as these companies comply for the first time with the SEC rule. Such pronouncements could affect public confidence if given attention in the media, or if the filings seem epidemic because a number of firms announce their re-statements on filing deadlines.

New CGQ Ratings May Affect Many Companies

The commercial investor services organization Institutional Shareholder Services (ISS) launched its Corporate Governance Quotient (CGQ) ratings in the summer of 2002. Finance executives should anticipate the CGQ ratings for public corporations becoming more widely used by investors in evaluating companies. The initial listings covered the Russell 3000 companies; eventually, 9,500 pub-

licly traded companies will be assigned a score.

Seven core topics comprise the CGQ rating: board structure and composition; charter and bylaw provisions; laws of the state of incorporation; executive/director compensation; qualitative factors, including financial performance; directors and officers (D&O) stock ownership; and director education. Companies are scored as high as 100, based on 51 measurements.

The CFRA May Play an Important Role in Corporate Valuation

The quietly influential Center for Financial Research and Analysis (CFRA), headed by Dr. Howard Schilit, a former accounting professor, will launch the "CFRA Diagnostic Reports," online for institutional subscribers in the first quarter of 2003. The quality of earnings for very S&P 500 company—especially clean corporations—will be reported by CFRA to clients. Until now, CFRA reports have usually pointed to financial shenanigans on the part of traded companies, detected through proprietary screens created by Dr. Schilit and his analysts. Since the initial opinions are distributed only to subscribers, institutional clients can work on portfolios quietly with the benefit of the insights and analyses for 30 days, and then the public has paid access to the reports.

The new CFRA Diagnostic Reports, which will include compact analyses of financial statement trends and quality of earnings issues, will expand CFRA's coverage of public companies considerably; coverage of all the S&P 500 companies will be the first step, with release of quarterly reports on companies following mandated 10-Q and 10-K filing dates.

Notes Dr. Schilit: "Our clients have been asking for insights on more companies than we've covered with our full research reports, which we have prepared only on a subset of the companies we researched. If a company comes up clean, we often don't write it up. But that conclusion is every bit as important to investors as our write-ups on the specific concerns we raise. So now we will provide insights on every S&P 500."[5]

MORE TO COME IN 2003

These are but a portion of the reforms being imposed on publicly owned companies by the government, SROs, NGOs, shareholder activists, standards-setters, and other organizations, as the American public continues to react to the events of 2002.

One potential, major countervailing force to consider as governance reforms are discussed is the makeup of the new Congress. With the Republican Party taking control of both houses, and the chairs of powerful committees likely to be more conservative and laissez-faire in their approach to regulation, some of the reform movement momentum could be slowed. No matter the course of politics, corporate governance reform will continue to be a powerful force to be reckoned with in corporate finance offices in 2003. ■

Notes

1. Information on these new indices is available from Jayn Harding, Director of Corporate Social Responsibility in London, jayn.harding@ftse.com; information is available for U.S. companies from Michael Gormley at michael.gormley@ftse.com.
2. Information on Domini Social Equity Fund's shareholder activism and proxy voting initiatives are available at www.domini.com; there you can view the firm's 7th annual booklet.
3. The ICCR publishes lists of targeted companies and provides ample details on the nature of the issues surrounding its investments. See www.iccr.org for positions on issues and current corporate targets (especially for details on various proxy contests).
4. You can check the rules and compare your company's current processes at www.nyse.org
5. Information on the Center for Financial Research and Analysis is available at www.cfra.com.