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FIRST DECADE OF THE 21ST CENTURY AND CORPORATE GOVERNANCE—SUCCESS OR FAILURE—WHICH MARKED THE 2000–2010 PERIOD?

This year will mark the 10th anniversary of two dramatic events that helped to define the start of the second decade of the 21st century and that had lasting impact on business, finance, politics, and the American culture. The September 11, 2001 attacks on the World Trade Center complex in New York City—in the heart of the US capital markets—brought trading and other financial activities to a halt for almost a week at the New York Stock Exchange, while other firms ceased operations completely. Almost 3,000 people lost their lives in the attacks, many of whom worked in finance and banking in downtown Manhattan offices. Property damage totaled in the tens of billions, and the loss of business over the following years is incalculable. This was not a natural disaster; terrorists in the Middle East planned and carried out the attacks on New York City and Washington, D.C.

As the second event occurred, seemingly overnight, the company ranked #7 on the *Fortune 500* list [of largest companies in revenues] collapsed; in a flash, Enron Corporation was gone, bankrupt, operations ceased, employees terminated, and energy customers left stranded. On December 2, 2001 in the largest bankruptcy filing corporate to date—at $65 billion in listed assets—the high-flying and much-admired "new business model" enterprise was no more. Investors saw their $90 per share valuation (in mid-2000) slide to $1.00, and then on to delisting and zero value (with billions of their funds wiped out).

Another related anniversary to be quietly observed by some is the collapse, soon after of the venerable accounting and auditing firm Arthur Andersen, which also ceased to exist in early 2002. One of the Big Five firms—the others were Ernest & Young, Deloitte Touche Tohmatsu, PricewaterhouseCoopers, and KPMG—Arthur Andersen was embroiled in the Enron financial scandal and, as its global partners began leaving, the Big Five became today's Big Four. (When Andersen closed the doors, 28,000 U.S. and 80,000 non-U.S. employees went job-searching; large corporate clients had to scramble to engage new accountants and auditors.)

The presidency of George W. Bush had just begun earlier in the year 2001 (he was popularly known as #43; his father, George H.W. Bush was #41). Both father and son had close ties to the Enron leadership, including CEO Kenneth Lay. Vice President Richard Cheney also had close ties to Enron leadership; he was formerly CEO of Halliburton, a prominent oil field service company and a champion for the interests of the energy industry in Washington, D.C. The collapse would be an embarrassment to the new president and federal regulators. (The Bush family is Houston-centric; Enron was headquartered in Houston.)

President George W. Bush moved quickly to address the Enron and Arthur Andersen crises events as the ripple effects moved through Corporate America, banking, Wall Street interests, and Capitol Hill, where members of the House of Representatives and the U.S. Senate were

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competing for air time to comment on the spectacular failure of corporate governance. The president assigned his secretary of commerce, John Snow, the former CEO of a major railroad, and the attorney general of the U.S., John Ashcroft, to head the Corporate Fraud Task Force[1] that would look into the Enron financial meltdown and suggest possible actions to prevent similar corporate failures in the future.[2, 3]

The task force continues in business; the initial members included federal departments cabinet posts of labor and energy; the Federal Commodities Trading Commission (FCTC); Securities & Exchange Commission (SEC); US Postal Inspection Service; and the Office of Housing Enterprises Oversight (OFHEO). (More agencies have been added over the years.) Soon after convening, the task force sent the president a series of preliminary corporate governance reform recommendations, some of which made their way into Executive Orders and statutes passed by the Congress.

THE TROUBLES AT ENRON, WORLDCOM AND ARTHUR ANDERSEN TURNED OUT TO BE PRECURSORS OF MAJOR ISSUES AFFECTING LARGE-CAP AMERICAN COMPANIES LATER IN THE DECADE.

As the task force continued its work, another dramatic event occurred: one of the largest telecommunications firms (and a major U.S. employer) collapsed as MCI WorldCom filed for protection on July 22, 2002 under the bankruptcy laws; its assets comprised a *new* record at $107 billion (with $40 billion-plus in debt). The company had improperly booked almost $4 billion in expenses; the CEO would later be sentenced to prison.[4]

Congressional response—Sarbanes-Oxley

Senator Paul Sarbanes (D-Maryland), chairman of the U.S. Senate banking committee, quickly drafted legislation for broad-based "corporate governance reform." The bill languished and was even declared dead at the end of June 2002 by *The New York Times* news writers in Washington. The fallout from the series of corporate failures resulted in rising demands for action by constituents and members of congress began to look seriously at "reform." Congressman Michael Oxley (R-Ohio) took charge of the legislation in the House of Representatives to create "Sarbanes-Oxley," a package of 11 titles of legislation that mainly updated the 1933 and 1934 securities laws.[5]

As the reverberations from the WorldCom collapse echoed through Capitol Hill and in congressional districts, the draft of Sarbanes-Oxley ("SOX" or "SARBOX") sailed through both houses and was rushed to the White House for the president's signature on July 30, 2002. Some provisions took effect immediately; others were phased in over the following year or two.

And so, the vexing problems in corporate governance at the start of the decade were addressed and resolved—or were they? The troubles at Enron, WorldCom and Arthur Andersen turned out to be precursors of major issues affecting large-cap American companies later in the decade.

Corporate governance—reformed . . . or not? Looking at the *Enron* case

As the company unraveled and the true condition of its finances became known, it was determined that Enron had structured over time more than 3,000 "special purpose entities" (SPEs) or special purpose vehicles (SPVs) to conceal debt and/or to move debt off the balance sheet to other entities. (These had interesting names such as Raptor and ChewCo; SPVs can be structured as LLCs, trusts, corporate entities, or take other forms.) Since Enron, of course, guaranteed all of this debt, it was a foregone conclusion (in retrospect) that the company's financial failures would be spectacular. SPVs can be used for special circumstances or more usually for corporations to issue structured debt. The practice began in earnest years earlier (in the 1980s) as government-sponsored entities (GSEs) especially, such as Freddie Mac and Fannie Mae, issued debt secured by the assets (residences) of the borrowers, their long-term mortgages.

Falling between the cracks of regulation

Even as SOX legislation moved through the regulatory process with public comment, rule-making, and implementation, another crisis was brewing—on a scale that was unimaginable even for most of the corporate executives involved and their boards: the financial crisis of 2007-2009. We might say that this was a mimicking of the SPVs of Enron—on steroids. Where mortgage lenders—especially traditional regulated banking institutions—formerly held the mortgage in portfolio for the long-term, even as SOX-mandated measures were being implemented, FDIC- and OCC- regulated banks (many part of bank holding companies) were rapidly securitizing their assets and SEC-regulated Wall Street firms were marketing them to investors. This had the effect of moving the assets off the books of the banking institution and into the SPV and then on to investor portfolios. (These SPVs were purchased by public employee pension funds and mutual funds by the billions of dollars, for example. The role of unregulated players in all of this could comprise a commentary of this size by itself.)

THE GOVERNANCE-RELATED PROFESSIONAL MEMBERSHIP ASSOCIATIONS WERE BUSY ASSISTING THEIR MEMBERS AS COMPLIANCE WITH SARBANES-OXLEY PROVISIONS WERE POSING COMPLIANCE CHALLENGES.

This set up an interesting dynamic even as publicly-traded corporations and trading and investment banking firms were adjusting to SOX, and accountants and auditors were busily establishing procedures and protocols for the stringent auditing requirements of the legislation, the actions of financial service companies were setting in motion events that some experts would call the greatest failure in corporate governance in decades.

The governance-related professional membership associations were busy assisting their members as compliance with Sarbanes-Oxley provisions were posing compliance challenges; this included National Investor Relations Institute (NIRI), National Association of Corporate Directors (NACD), Corporate Secretaries and Corporate Governance Professionals (CSCGP), and Financial Executives Institute (FEI, the corporate finance professionals' trade group). A cottage industry of service providers proffered their assistance: Glass-Lewis; Governance Metrics International (GMI); Proxy Governance; and Institutional Shareholder Services (ISS), which would be acquired by RiskMetrics, which would then be acquired by MSCI.

SOX provisions assigned accounting rule changes to just two organizations: The SEC and the Financial Accounting Standards Board (FASB), which had been created in the early 1970s. Even as the SEC and FASB were addressing changes in accounting and aligning accounting, auditing and final reporting for compliance with SOX, the coming financial crisis loomed large if somewhat hidden from view.

2001–2010: The tumultuous decade

The regulatory framework to implement SOX was largely in place by 2003–2004 and large-cap company managements were prepared for compliance (at additional cost, most financial executives noted; the estimate was around $5 million for initial compliance for companies). One of the key provisions of SOX was put in motion by President Bush and his task force before SOX passage, what is commonly referred to as Section 404, the affirmation by CEO and CFO that the financial reporting is correct (violations being subject to civil and criminal penalties for false statements, an answer to the Enron *et al* accounting frauds). All but a few of the 900-plus large-caps met the August 2002 deadline for reporting. Over the next few years, many companies filed "re-statements" of previous accounting results. Surprisingly for governance reform advocates, there were not severe penalties meted out for this.[6]

As SEC-regulated corporate reporting more or less came in line with the expectations of the congressional reformers and securities regulators, largely non-regulated entities (such as hedge funds) and instruments (all manner of collateralized debt instruments) were expanding the "possibilities" for asset managers and owners (such as public pension funds). Regulated banks (overseen by the state banking commissions, Federal Reserve, Federal Deposit Insurance Corporation, or Office of Comptroller of the Currency) fundamentally changed their business model to move loans and outstanding credit off their books and into these non-regulated instruments (collateralized debt instruments of various kinds) for sale to investors. Investor Warren Buffett characterized these as instruments of mass destruction.

SOX—Not a preventive factor?

Over the last half of the decade, SOX provisions had little influence on the expansion of this debt structuring "off the books" of the banks and onto the books of SPVs ambitiously marketed by financial firms and eagerly snapped up by asset owners and managers. Collateralized debt obligations were created in the 1980s and widely used to package debt secured by assets. In the early 2000s , banks and financial services firms profoundly changed the residential mortgage market with their CDO use. By early 2007 the subprime CDOs (bonds) reached $800 billion and "Alt-A" mortgage bonds totaled $700 billion.[7] As the market for these seized up due to requirements to quarterly mark-to market and other factors, sales by mid-year had soured; sales dropped from $42 billion to $9 billion by July 2007.[8] By year-end, the residential mortgage-based products were clearly out of favor with investors and the "credit crisis" was affecting banks and non-bank corporations.

BANKS AND FINANCIAL SERVICES FIRMS PROFOUNDLY CHANGED THE RESIDENTIAL MORTGAGE MARKET WITH THEIR CDO USE.

Investor losses—money and trust

Estimates of investor losses from the financial crisis that began early in 2007 when credit market auctions seized up have ranged up to $7 trillion and more as the second decade of the new century got underway. There was an equally large loss for investors—of trust in the capital markets and in financial institutions involved in the subprime and exotic SPVs. Corporate credibility had also been lost in many instances. The two big Wall Street houses that dominated packaging of mortgage CDOs—the pools—spectacularly failed, Enron-style; Lehman Bros was out of business and Bear Stearns was sold at fire sale prices to JPMorgan Chase.

A federal commission was convened to determine the causes of the financial collapse—the Financial Crisis Inquiry Commission. Its lengthy public report in early 2011[9] would be seen as an indictment of governance and oversight of major banks and financial service companies by boards, executives, and regulators. Financial institutions had become, as frequently described, "too big to fail" and "too interconnected to fail," so, the U.S. government was forced to intervene in 2008, injecting hundreds of billions of dollars in the financial system (the U.S. Treasury's TARP or Troubled Assets Relief Program).

There is much more to comment on for the period of 2004-2011. Critics have assailed corporate boards of directors, federal banking, and securities regulators, investors (such as pension fund managers), and the Wall Street "whiz kids" (Ph.D.s) who created the array of CDOs marketed to investors in the U.S. and in Europe, Asia, and other regions. It was noted that many of the instruments Wall Street marketed were not regulated by SEC or FDIC or other regulations; credit insurance marketed to financial service companies was not really insurance, or regulated as such.

Dodd-Frank—more governance regulation, more expectations

Near the end of the decade, the Congress of the United States passed a massive regulatory package—2,000 pages and more—known as "Dodd-Frank."[10] At this writing, the many regulations intended by the statutes are being formulated, new agencies created, duties of existing agencies modified, and accounting and reporting rules altered. Corporations—especially banks and financial services firms—are again adjusting to regulatory schemes designed so "this will never happen again."

Recently, this writer attended a corporate directors' trade association meeting—the discussion centered on governance issues. Boards have devoted hundreds of hours to the discussion of their companies' governance. Several of the panel members remarked that, as directors, they still are concerned about what "they don't know about what they don't know." Directors in the audience agreed. What corporate governance surprises may be in store during the second decade of the 2000s? What don't corporate governance experts know "that they don't know?" Corporate governance remains a top priority for boards and executives—and regulators—and given the events of the past decade, it seems that most of us don't know yet what we don't know and should be looking at. ■

NOTES

[1]Information about the federal governments Corporate Fraud Task Force: http://www.justice.gov/archive/dag/cftf.

[2]The first year's report of the task force: http://www.justice.gov/archive/dag/cftf/first_year_report.pdf.

[3]Report of the President's Task Force on Corporate Fraud: July 20, 2004: http://www.justice.gov/archive/dag/cftf/2nd_yr_fraud_report.pdf.

[4]The MCI WorldCom announcement, *The New York Times*, breaking news: http://www.nytimes.com/2002/07/22/us/worldcom-s-collapse-the-overview-worldcom-files-for-bankruptcy-largest-us-case.html.

[5]See Corporate Finance Review, Sarbanes-Oxley Law Creating a Challenging Operating Environment for Corporate Finance Professionals *(March/April 2003—Volume 7—Number 5)* by this author.

[6]*A Closer Look at Financial Statement Restatements Analyzing the Reasons Behind the Trend* By Lynn E. Turner and Thomas R. Weirich, published in the CPA Journal of New York State: http://www.nysscpa.org/cpajournal/2006/1206/infocus/p12.htm,

[7]Information on Seeking Alpha: www.seekingalpha.com.

[8]*Ibid*

[9]The Financial Crisis Inquiry Report–details at: http://www.gpoaccess.gov/fcic/fcic.pdf.

[10]Dodd-Frank–Brief Summary of *the Dodd-Frank Wall Street Reform and Consumer Protection Act* from the US Senate: http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf.