NYSE

New York Stock Exchange Corporate Accountability and Listing Standards Committee

June 6, 2002

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We are very grateful for the support we received from the officers and employees of the NYSE. In particular, we wish to recognize the assistance we received from Robert G. Britz and Catherine R. Kinney, each of whom is Executive Vice Chairman, President and Co-Chief Operating Officer of the NYSE, and Richard P. Bernard, Executive Vice President and General Counsel of the NYSE. We would also like to recognize James L. Cochrane, Senior Vice President, Strategy & Planning, of the NYSE, who served as liaison between the Committee and the NYSE. We are grateful for Mr. Cochrane's valuable contributions to the work of the Committee. We further recognize the work of: Suzette Crivaro, Noreen M. Culhane, James F. Duffy, Joyce Goldzman, Edward A. Kwalwasser, Janice O'Neill, Charlotte Smaldone, and Glenn Tyranski, each of the NYSE. Additionally, we wish to thank David C. Karp, Laura A. McIntosh and Erin E. Quinn of Wachtell, Lipton, Rosen & Katz, which served as special counsel to the Committee. Finally, we thank the many individuals and organizations that gave us their views throughout our hearing process. These individuals and the organizations they represent are listed in the Appendix of this Report.

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This Report of the NYSE Corporate Accountability and Listing Standards Committee was submitted to the NYSE's Board of Directors on Thursday, June 6, 2002. Following a two-month public comment period, the Board expects to take final action on the Report at its August 1, 2002 meeting.

Introduction

The New York Stock Exchange has long pioneered major advances in corporate governance. The NYSE has required companies to comply with listing standards for nearly 150 years, and has periodically amended and supplemented its listing standards when the evolution of our capital markets has demanded enhanced governance standards or disclosure. Now, in the aftermath of the "meltdown" of significant companies due to failures of diligence, ethics and controls, the NYSE has the opportunity – and the responsibility– once again to raise corporate governance and disclosure standards.

On February 13, 2002, SEC Chairman Harvey Pitt asked the NYSE to review its corporate governance listing standards. In conjunction with that request, the NYSE appointed this Corporate Accountability and Listing Standards Committee to review the NYSE's current listing standards, along with recent proposals for reform, with the goal of enhancing the accountability, integrity and transparency of the Exchange's listed companies.

We believe we can best fulfill this goal by building upon the strength of the NYSE and its listed companies in the areas of corporate governance and disclosure. Our approach recognizes that new prohibitions and mandates, whether adopted by the NYSE, the SEC or Congress, cannot guarantee that directors, officers and employees will always give primacy to the ethical pursuit of shareholders' best interests. Our system depends upon the competence and integrity of corporate directors, as it is their responsibility to diligently oversee management while adhering to unimpeachable ethical standards. We have sought to strengthen checks and balances and give the legions of diligent directors better tools to empower them and encourage excellence. In seeking to empower and encourage the many good and honest people that serve NYSE-listed companies and their shareholders as directors, officers and employees, we have sought to avoid recommendations that would undermine their energy, autonomy and responsibility.

In short, our recommendations are designed to further the ability of honest and well-intentioned directors, officers and employees to perform their functions effectively. Our recommendations will also allow shareholders to more easily and efficiently monitor the performance of companies and directors in order to reduce instances of lax and unethical behavior.

Among the important changes to the NYSE listing standards that we propose are:

- **Increasing the role and authority of independent directors.**

– Independent directors must comprise a majority of a company's board.

– Boards must convene regular executive sessions in which the non-management directors meet without management.

– Listed companies must have an audit committee, a nominating committee and a compensation committee, each comprised solely of independent directors.

– The chair of the audit committee must have accounting or financial management experience.

– Audit committees must have sole responsibility for hiring and firing the company's independent auditors, and for approving any significant non-audit work by the auditors.

- **Tightening the definition of "independent" director and adding new audit committee qualification requirements.**

– For a director to be deemed "independent," the board must affirmatively determine that the director has no material relationship with the listed company.

– In addition, there is a five-year "cooling-off" period for former employees of the listed company, or of its independent auditor; for former employees of any company whose compensation committee includes an officer of the listed company; and for immediate family members of the foregoing.

– Director's fees must be the sole compensation an audit committee member receives from the listed company; further, an audit committee member associated with a major shareholder (one owning 20% or more of the listed company's equity) may not vote in audit committee proceedings.

- **Fostering a focus on good corporate governance.**

– Listed companies must adopt corporate governance guidelines, as well as charters for their audit, compensation and nominating committees.

– Listed companies must adopt a code of business conduct and ethics.

- **Giving shareholders more opportunity to monitor and participate in the governance of their companies.**

– Shareholders must be given the opportunity to vote on all equity-based compensation plans; brokers may only vote customer shares on proposals for such plans pursuant to customer instructions.

– Listed companies must publish codes of business conduct and ethics, and key committee charters. Waivers of such codes for directors or executive officers must be promptly disclosed.

– Listed foreign private issuers must disclose any significant ways in which their corporate governance practices differ from NYSE listing standards.

- **Establishing new control and enforcement mechanisms.**

– Each listed company's CEO must certify annually that the company has established and complied with procedures for verifying the accuracy and completeness of information provided to investors and that he or she has no reasonable cause to believe that the information provided to investors is not accurate and complete. The CEO must further certify that he or she has reviewed with the board those procedures and the company's compliance with them.

– CEOs must also certify annually that they are not aware of any company violations of NYSE listing standards.

– Upon finding a violation of an Exchange listing standard, the NYSE may issue a public reprimand letter to any listed company and ultimately suspend or de-list an offending company.

We further recommend that the NYSE encourage all listed companies to establish an orientation program for new board members. In addition, we recommend that the NYSE, in conjunction with leading authorities in corporate governance, develop a Directors Institute that would offer continuing education forums around the United States for both current and newly-elected directors.

We also make several recommendations for reforms that other institutions are better suited to implement. These recommendations include reforms in: (1) accounting and auditing, to ensure meaningful, accurate and credible financial reporting; (2) disclosure requirements, to ensure that material information is clearly and promptly disclosed; and (3) methods of holding officers and directors of public companies more accountable to their shareholders.

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In preparing this Report, we had the benefit of the testimony of 17 witnesses and written submissions from 21 organizations or interested individuals. We also examined the excellent governance practices that many NYSE-listed companies have long followed. In addition, we reviewed extensive commentary recommending improvement in corporate governance and disclosure, statements by the President of the United States and members of his Cabinet, as well as pending SEC proposals and legislation introduced in Congress. In forming our recommendations, we took all these proposals into account, accepting those that we believe will accomplish the objectives we have outlined and rejecting those that we believe would be counterproductive.

Before moving to a more detailed discussion of our recommendations, we wish to explicitly note two sets of proposals that we have rejected and that we strongly urge policymakers to avoid: (1) imposing additional liability on directors, or reducing the protections currently available through director and officer liability insurance and state law exculpation provisions, and (2) repealing or weakening the Private Securities Litigation Reform Act.

As discussed above, we believe the most crucial element of effective corporate governance is the service of competent, ethical people as directors of public companies. Our recommendations endeavor to encourage and empower such individuals; their service is an essential resource for our listed companies and our nation's economy. By the same token, no action should be taken that would deter good and responsible people from serving as directors. In our judgment, the two sets of proposals noted above would cause harm by discouraging such people from serving.

We discuss our recommendations and related matters below. We divide the discussion into two parts: reforms that the NYSE itself can implement[1] and reforms that other institutions are better suited to implement.

[1] We expect that following an appropriate comment period and final approval of the recommendations in this Report, the NYSE Board will direct the staff to draft and submit to the SEC one or more conforming rule-making filings. In that process it is our further expectation that technical issues, such as transition rules and exceptions for specialized securities such as exchange-traded funds (ETFs) and closed-end funds, will be addressed as appropriate.

Recommendations to the NYSE Board of Directors

We make the following recommendations to the NYSE Board of Directors, for implementation by the NYSE:

1. Require listed companies to have a majority of independent directors.

Effective boards of directors exercise independent judgment in carrying out their responsibilities. We believe requiring a majority of independent directors will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest.[2]

We recognize that companies that do not already have majority-independent boards will need time to recruit qualified independent directors. We believe that two years should be ample. Accordingly, we recommend that all currently listed companies be required to achieve majority-independence within 24 months of this rule's enactment. Companies newly listing must comply within 24 months. Additionally, given the importance of majority-independent boards, a company must publicly disclose when it becomes compliant with this requirement.

2. Tighten the NYSE definition of "independent director."

- **No director qualifies as "independent" unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company). Companies must disclose these determinations.**

- **In addition:**

  – **No director who is a former employee of the listed company can be "independent" until five years after the employment has ended.**

[2] Existing NYSE listing standards require three independent directors on each listed company board. *See* NYSE Listed Company Manual Section 303.01(B)(2)(a) (Composition/Expertise Requirement of Audit Committee Members).

- **No director who is, or in the past five years has been, affiliated with or employed by a (present or former) auditor of the company (or of an affiliate) can be "independent" until five years after the end of either the affiliation or the auditing relationship.**

- **No director can be "independent" if he or she is, or in the past five years has been, part of an interlocking directorate in which an executive officer of the listed company serves on the compensation committee of another company that employs the director.**

- **Directors with immediate family members in the foregoing categories must likewise be subject to the five-year "cooling-off" provisions for purposes of determining "independence."**

It is not possible to anticipate, or explicitly to provide for, all circumstances that might signal potential conflicts of interest, or that might bear on the materiality of a director's relationship to a listed company.[3] Accordingly, we think it best that boards making "independence" determinations broadly consider all relevant facts and circumstances. In particular, when assessing the materiality of a director's relationship with the company, the board should consider the

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[3] Existing NYSE listing standards define "independence" solely for audit committee members. *See* NYSE Listed Company Manual Section 303.01(B)(2)(a) (Composition/Expertise Requirement of Audit Committee Members) and 303.01 (B)(3) (Independence Requirement of Audit Committee Members). The existing definition of "independence" precludes any relationship with the company that may interfere with the exercise of a director's independence from management and the company. In addition, the NYSE listing standards prohibit an employee of the company or any of its affiliates from serving on the audit committee until three years after termination of employment. (Note, however, that one director who is a former employee (or family member of a former employee) may serve within three years of employment termination, provided that the board determines, in its business judgment, that the individual's membership on the audit committee would be in the best interests of the company. The board must disclose the nature of the individual's relationship, and the reasons for its "best interests" determination, in the company's next annual proxy statement. *See* NYSE Listed Company Manual Section 303.02(D) (Independence Requirement of Audit Committee Members)). Additionally, a director who is an immediate family member of an executive officer of the company (or any of its affiliates) may not serve on the audit committee until three years after the termination of the officer's employment. Currently, a director who has a direct or indirect business relationship with the company may serve on the audit committee only if the Board of Directors determines, in its business judgment, that the relationship does not interfere with the director's exercise of independent judgment. No such determination is required once the relationship has been terminated for three years.

issue not merely from the standpoint of the director, but also from that of persons or organizations with which the director has an affiliation. Material relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships (among others). The basis for a board determination that a relationship is not material should be disclosed in the company's annual proxy statement.

We believe present employees of a company, or of the company's present auditor, have a material relationship with the company and cannot be deemed "independent." Former employment with the company itself, former employment with the company's present auditor, or present employment with its former auditor, in our view should not be *per se* bars to an "independence" finding after the passage of a five-year "cooling-off" period. We view compensation committee interlocks as warranting the same treatment. We do not view ownership, or affiliation with the owner, of a less than controlling amount of stock as a *per se* bar to an independence finding.

3. Empower non-management directors to serve as a more effective check on management.

- **The non-management directors of each company must meet at regularly scheduled executive sessions without management.**

- **The independent directors must designate, and publicly disclose the name of, the director who will preside at the executive sessions.**

To promote open discussion among the non-management directors, companies must schedule regular executive sessions in which those directors meet without management participation. Regular scheduling of such meetings is important not only to foster better communication among non-management directors, but also to prevent any negative inference from attaching to the calling of such executive sessions. The name of the director who will preside at these meetings must be disclosed in the annual proxy statement so as to facilitate communications by employees or shareholders directly with the non-management directors. The presiding director may be a non-executive chairman of the board, if one exists, or another director.[4]

[4] There are no existing NYSE listing standards on this topic.

4. **Require listed companies to have a nominating/corporate governance committee composed entirely of independent directors.**

A nominating/corporate governance committee is central to the effective functioning of the board. New director and board committee nominations are among a board's most important functions. Placing this responsibility in the hands of an independent nominating/corporate governance committee can enhance the independence and quality of nominees. The committee is also responsible for taking a leadership role in shaping the corporate governance of a corporation.

The nominating/corporate governance committee must have a written charter that addresses:

- **the committee's purpose – which, at minimum, must be to: identify individuals qualified to become board members, and to select, or to recommend that the board select, the director nominees for the next annual meeting of shareholders; and develop and recommend to the board a set of corporate governance principles applicable to the corporation.**

- **the committee's goals and responsibilities – which must reflect, at minimum, the board's criteria for selecting new directors, and oversight of the evaluation of the board and management.**

- **an annual performance evaluation of the committee.**

We believe the nominating/corporate governance committee charter should also address the following items: committee member qualifications; committee member appointment and removal; committee structure and operations (including authority to delegate to subcommittees); and committee reporting to the board. In addition, the charter should give the nominating/corporate governance committee sole authority to retain and terminate any search firm to be used to identify director candidates, including sole authority to approve the search firm's fees and other retention terms.[5]

[5] Existing NYSE listing standards do not require a nominating or governance committee.

5. Require listed companies to have a compensation committee composed entirely of independent directors.

We believe it is essential that each listed company have a compensation committee, and that the committee's membership be confined to independent directors.

The compensation committee must have a written charter that addresses:

- **the committee's purpose – which, at minimum, must be to discharge the board's responsibilities relating to compensation of the company's executives, and to produce an annual report on executive compensation for inclusion in the company's proxy statement, in accordance with applicable rules and regulations.**

- **the committee's duties and responsibilities – which, at minimum, must be to:**

– **review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals and objectives, and set the CEO's compensation level based on this evaluation.** In determining the long-term incentive component of CEO compensation, the committee should consider the company's performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies, and the awards given to the listed company's CEO in past years.

– **make recommendations to the board with respect to incentive-compensation plans and equity-based plans.**

- **an annual performance evaluation of the compensation committee.**

We believe the compensation committee charter should also address the following items: committee member qualifications; committee member appointment and removal; committee structure and operations (including authority to delegate to subcommittees); and committee reporting to the board.

Additionally, if a compensation consultant is to assist in the evaluation of director, CEO or senior executive compensation, the compensation committee charter should give that committee sole authority to retain and terminate the consulting firm, including sole authority to approve the firm's fees and other retention terms.[6]

6. Add to the "independence" requirement the following new requirements for audit committee membership at listed companies:

- **Director's fees are the only compensation an audit committee member may receive from the company.**
- **A director who meets the definition of "independence" mandated for all audit committee members, but who also holds 20% or more of the company's stock (or who is a general partner, controlling shareholder or officer of any such holder) cannot chair, or be a voting member of, the audit committee.**
- **The audit committee chair must have accounting or related financial management expertise.**

While it is not the audit committee's responsibility to certify the company's financial statements or to guarantee the auditor's report, the committee stands at the crucial intersection of management, independent auditors, internal auditors and the board of directors. We support additional directors' fees to compensate audit committee members for the significant time and effort they expend to fulfill their duties as audit committee members, but we do not believe that any member of the audit committee should receive any compensation other than such director's fees from the company.[7]

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[6] Existing NYSE listing standards do not require a compensation committee.

[7] Normal directors' fees (including equity-based awards) include the typical additional amounts paid to chairs of committees and to members of committees that meet more frequently or for longer periods of time. Additionally, if a director satisfies the definition of "independent director" (as provided in Recommendation 2), then his or her receipt of a pension or other form of deferred compensation from the company for prior service (provided such compensation is not contingent in any way on continued service) will not preclude him or her from satisfying the requirement that director's fees are the only form of compensation he or she receives from the company.

Because of the audit committee's demanding role and responsibilities, and the time commitment attendant to committee membership, we urge each prospective audit committee member to evaluate carefully the existing demands on his or her time before accepting this important assignment. Additionally, if an audit committee member simultaneously serves on the audit committee of more than three public companies, and the NYSE-listed company does not limit the number of audit committees on which its audit committee members serve, then in each case, the board must determine that such simultaneous service would not impair the ability of such member to effectively serve on the listed company's audit committee and disclose such determination in the annual proxy statement.

A director who is associated with a holder of 20% or more of a company's voting stock and who has been determined by the board to be "independent" may serve as an audit committee member but may not chair the committee or participate in its votes. We believe that allowing such a director to be a non-voting committee member fairly balances the value of significant shareholder participation in committee discussions against the risk that significant shareholders may have interests diverging from those of other shareholders.

Existing NYSE listing standards require that all audit committee members be financially literate, and that at least one member have accounting or related financial management expertise.[8] We believe that requiring the committee's chair to have this expertise will better enable the committee to evaluate independently the information it receives, to recognize problems, and to seek appropriate solutions. While all members of the audit committee should play a vigorous role, it is particularly important that the chair have the background and seasoning to assure that the committee itself retains control over its agenda. Further, a chair with the requisite accounting/financial background, which includes current or former senior executive officers of corporations, is also more likely to develop direct lines of communication with key audit personnel, both from within the company and from the company's independent accountants.

[8] *See* NYSE Listed Company Manual Section 303.01(B)(2) (Composition/Expertise Requirement of Audit Committee Members).

7. **Increase the authority and responsibilities of the audit committee, including granting it the sole authority to hire and fire independent auditors, and to approve any significant non-audit relationship with the independent auditors.**

   The audit committee must have a written charter that addresses:

   - **the committee's purpose – which, at minimum, must be to: (a) assist board oversight of (i) the integrity of the company's financial statements, (ii) the company's compliance with legal and regulatory requirements, (iii) the independent auditor's qualifications and independence, and (iv) the performance of the company's internal audit function and independent auditors; and (b) prepare the report that SEC rules require be included in the company's annual proxy statement.**[9]

   - **the duties and responsibilities of the audit committee – which, at minimum, must be to:**

   – **retain and terminate the company's independent auditors (subject, if applicable, to shareholder ratification).** In connection with this requirement, the audit committee must have the sole authority to approve all audit engagement fees and terms, as well as all significant non-audit engagements with the independent auditors.[10] This requirement does not preclude the committee from obtaining the input of management, but these responsibilities may not be delegated to management.

   – **at least annually, obtain and review a report by the independent auditor describing: the firm's internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the**

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[9] Existing NYSE listing standards require the audit committee charter to specify the scope of the committee's responsibilities and its manner of carrying out those responsibilities, including the committee's structure, processes, and membership requirements. *See* NYSE Listed Company Manual Section 303.01 (Audit Committee), Subsection B(1)(a) (Formal Charter).

[10] Existing NYSE listing standards state that the audit committee charter must specify that the selection, evaluation and firing of the independent auditor is subject to the "ultimate" authority of the audit committee (consisting solely of independent directors) and the board of directors. *See* NYSE Listed Company Manual Section 303.01 (Audit Committee), Subsection B(1)(b) (Formal Charter).

firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (to assess the auditor's independence) all relationships between the independent auditor and the company. After reviewing the foregoing report and the independent auditor's work throughout the year, the audit committee will be in a position to evaluate the auditor's qualifications, performance and independence. This evaluation should include the review and evaluation of the lead partner of the independent auditor. In making its evaluation, the audit committee should take into account the opinions of management and the company's internal auditors (or other personnel responsible for the internal audit function). The audit committee should further consider whether, in order to assure continuing auditor independence, there should be regular rotation of the lead audit partner, or even of the audit firm itself. We do not mandate periodic rotation of auditors because we believe that mandatory rotation may undercut the effectiveness of the independent auditor and the quality of the audit. The transitions between auditors could disrupt the audit process, deprive auditors of "institutional memory," and make the new auditors more dependent on management for information. The audit committee should make its own decision as to whether the company is obtaining high-quality audits and whether rotation of the auditor would be helpful for the particular company.[11] The audit committee should present its conclusions with respect to the independent auditor to the full board.[12]

[11] The Committee acknowledges the view of our Co-Chairman, H. Carl McCall, Comptroller of the State of New York and Sole Trustee, Common Retirement Fund of the State of New York, that mandatory rotation may improve auditor independence and therefore should be mandated.

[12] Existing NYSE listing standards state that the audit committee charter must specify that the audit committee must engage in a dialogue with the independent auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor, and must ensure that the independent auditor periodically submits to the audit committee a formal written statement delineating all relationships between the auditor and the company. The charter must also specify that the audit committee is responsible for recommending that the board take appropriate action in response to the independent auditor's report to satisfy itself of the auditor's independence. *See* NYSE Listed Company Manual Section 303.01 (Audit Committee), Subsection B(1)(c) (Formal Charter).

– **discuss the annual audited financial statements and quarterly financial statements with management and the independent auditor, including the company's disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations."**

– **discuss earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies.**

– **as appropriate, obtain advice and assistance from outside legal, accounting or other advisors.** In the course of fulfilling its duties, the audit committee may wish to consult with independent advisors. The audit committee must be empowered to retain these advisors without seeking board approval.

– **discuss policies with respect to risk assessment and risk management.** While it is the job of the CEO and senior management to assess and manage the company's exposure to risk, the audit committee must discuss guidelines and policies to govern the process by which this is handled. The audit committee should discuss the company's major financial risk exposures and the steps management has taken to monitor and control such exposures.

– **meet separately, at least quarterly, with management, with internal auditors (or other personnel responsible for the internal audit function), and with independent auditors.** To perform its oversight functions most effectively, the audit committee must have the benefit of separate sessions with management, the independent auditors and those responsible for the internal audit function. We expect all NYSE-listed companies to have an internal audit function. These separate sessions, which must occur at least quarterly, may be more productive than joint sessions in surfacing issues warranting committee attention.

– **review with the independent auditor any audit problems or difficulties and management's response.** The audit committee must regularly review with the independent auditor any difficulties the auditor encountered in the course of the audit work, including any restrictions on the scope of the independent auditor's activities or on access to requested information, and any significant disagreements with management. Among the items the audit committee may want to review with the auditor are: any accounting adjustments that were noted or proposed by the auditor but were "passed" (as immaterial or otherwise); any communications between the audit team and the audit firm's national office respecting auditing or accounting issues presented by the engagement; and any "management" or "internal control" letter issued, or proposed to be issued, by the audit firm to the company. The review should also include discussion of the responsibilities, budget and staffing of the company's internal audit function.

– **set clear hiring policies for employees or former employees of the independent auditors.** Employees or former employees of the independent auditor are often valuable additions to corporate management. Such individuals' familiarity with the business, and personal rapport with the employees, may be attractive qualities when filling a key opening. However, the audit committee should set hiring policies taking into account the pressures that may exist for auditors consciously or subconsciously seeking a job with the company they audit.

– **report regularly to the board of directors.** The audit committee should review with the full board any issues that arise with respect to the quality or integrity of the company's financial statements, the company's compliance with legal or regulatory requirements, the performance and independence of the company's independent auditors, or the performance of the internal audit function.

- **an annual performance evaluation of the audit committee.**

While the fundamental responsibility for the company's financial statements and disclosures rests with management and the independent auditor, the audit committee must review: (a) major issues regarding accounting principles and financial statement presentations, including any significant changes in the company's selection or application of accounting principles, and major issues as to the adequacy of the company's internal controls and any special audit steps adopted in light of material control deficiencies; (b) analyses prepared by management and/or the independent auditor setting forth significant financial reporting issues and judgments made in connection with the preparation of the financial statements, including analyses of the effects of alternative GAAP methods on the financial statements; (c) the effect of regulatory and accounting initiatives, as well as off-balance sheet structures on the financial statements of the company; and (d) earnings press releases (paying particular attention to any use of "pro forma," or "adjusted" non-GAAP, information), as well as financial information and earnings guidance provided to analysts and rating agencies.[13]

8. Increase shareholder control over equity-compensation plans.

- **Shareholders must be given the opportunity to vote on all equity-compensation plans.**

- **A broker may not vote a customer's shares on any equity-compensation plan unless the broker has received that customer's instructions to do so.**

Equity-compensation plans can help align shareholder and management interests, and equity-based awards have become very important components of employee compensation. In order to provide checks and balances on the process of earmarking shares to be used for equity-based awards, and to provide shareholders a voice in the resulting dilution, we believe that all equity-compensation plans, and any material revisions to the terms of such plans (including for purposes of repricing existing options), should be subject to stockholder approval.[14] Additionally, we recommend that the SEC be asked to

[13] Existing NYSE listing standards provide that the board of directors must adopt and approve a formal written charter for the audit committee, and that such charter must be reviewed annually. *See* NYSE Listed Company Manual Section 303.01 (Audit Committee), Subsection B(1)(a) (Formal Charter). The audit committee charter must be reviewed at least annually, and the company must provide an annual certification to the NYSE affirming that the committee reviewed and reassessed the adequacy of the charter.

[14] Existing NYSE listing standards require shareholder approval of equity-compensation plans in which officers or directors may participate, but provide exceptions to the shareholder approval requirement: No shareholder approval is required for any broadly-based plan, or for any plan that provides (a) that no single officer or director may acquire under such plan more than one percent of the shares of the issuer's common stock outstanding at the time such plan is adopted, and (b) that, together with all other non-exempt plans of the issuer, does not authorize the issuance of more than five percent of the issuer's common stock outstanding at the time such plan is adopted. *See* NYSE Listed Company Manual Section 312.03 (Shareholder Approval).

consider requiring inclusion in the proxy statement of additional quantitative information regarding the potential valuation of awards that may be made under such plans.

We further recommend that the NYSE preclude its member organizations from giving a proxy to vote on equity-compensation plans unless the beneficial owner of the shares has given voting instructions.[15]

We have also considered the views of a wide variety of constituents as to the accounting treatment of stock options. While we recognize that the accounting treatment of options is within the exclusive province of the Financial Accounting Standards Board (FASB) and the SEC, we note that guaranteeing shareholder control over plans may ameliorate some of the concerns of those in favor of changing the existing accounting treatment of stock options.

9. Require listed companies to adopt and disclose their corporate governance guidelines.

No single set of guidelines would be appropriate for every company, but certain key areas of universal importance include: director qualifications and responsibilities; responsibilities of key board committees; and director compensation. Given the importance of corporate governance, each listed company's website must include its corporate governance guidelines, the charters of its most important committees (including at least the audit, compensation and nominating

[15] Existing NYSE listing standards permit a broker to give a proxy to vote stock if the broker (a) has not received voting instructions from the beneficial owner by the date specified in the statement accompanying the proxy material, and (b) has no knowledge of any contest as to the action to be taken at the meeting, provided that such action is adequately disclosed to shareholders and does not include authorization for a merger, consolidation or any matter which may affect substantially the rights or privileges of such stock. *See* NYSE Listed Company Manual Section 402.08 (Giving a Proxy to Vote Stock). Existing NYSE listing standards prohibit a broker from giving a proxy to vote without instructions from the beneficial owner when the matter to be voted upon authorizes issuances of stock, or options to purchase stock, to directors, officers or employees in an amount which exceeds five percent of the total amount of the stock outstanding; when a plan is amended to extend its duration, the NYSE factors into the calculation the number of shares that remain available for issuance, the number of shares subject to outstanding options and any shares being added. Should there be more than one plan being considered at the same meeting, all shares are aggregated. *See* NYSE Rule 452 and NYSE Listed Company Manual Section 402.08(B)(12).

committees) and the company's code of business conduct and ethics (*see* Recommendation 10 below). Each company's annual report must state that the foregoing information is available on its website, and that the information is available in print to any shareholder who requests it. Making this information publicly available should promote better investor understanding of the company's policies and procedures, as well as more conscientious adherence to them by directors and management.[16]

The following subjects should be addressed in the corporate governance guidelines:

- **Director qualification standards.** These standards should, at minimum, reflect the independence requirements set forth in Recommendations 1 and 2 above. We encourage companies to address other substantive qualification requirements, including policies limiting the number of boards on which a director may sit, and director tenure, retirement and succession.

- **Director responsibilities.** These responsibilities should clearly articulate what is expected from a director, including basic duties and responsibilities with respect to attendance at board meetings and advance review of meeting materials.

- **Director access to management and, as necessary and appropriate, independent advisors.**

- **Director compensation.** Director compensation guidelines should include general principles for determining the form and amount of director compensation (and for reviewing those principles, as appropriate). The board should be aware that questions as to directors' independence may be raised when directors' fees and emoluments exceed what is customary. Similar concerns may be raised when the company makes substantial charitable contributions to organizations in which a director is affiliated, or enters into consulting contracts with (or provides other indirect forms of compensation to) a director.

[16] There is no existing NYSE listing standard regarding a company's adoption of corporate governance guidelines.

The board should critically evaluate each of these matters when determining the form and amount of director compensation, and the independence of a director.

- **Director orientation and continuing education.**

- **Management succession.** Succession planning should include policies and principles for CEO selection and performance review, as well as policies regarding succession in the event of an emergency or the retirement of the CEO.

- **Annual performance evaluation of the board.** The board should conduct a self-evaluation at least annually to determine whether it and its committees are functioning effectively.

10. Require listed companies to adopt and disclose a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors or executive officers.

No code of business conduct and ethics can replace the thoughtful behavior of an ethical director, officer or employee. However, we believe such a code can focus the board and management on areas of ethical risk, provide guidance to personnel to help them recognize and deal with ethical issues, provide mechanisms to report unethical conduct, and help to foster a culture of honesty and accountability.[17]

Each code of business conduct and ethics must require that any waiver of the code for executive officers or directors may be made only by the board or a board committee and must be promptly disclosed to shareholders. This disclosure requirement should inhibit casual and perhaps questionable waivers, and should help assure that, when warranted, a waiver is accompanied by appropriate controls designed to protect the company. It will also give shareholders the opportunity to evaluate the board's performance in granting waivers.

Each code of business conduct and ethics must also contain compliance standards and procedures that will facilitate the effective operation of the code. These standards should ensure the prompt and consistent action against violations of the code.

[17] There is no existing NYSE listing standard regarding a company's adoption of such a code.

Each company may determine its own policies, but all listed companies should address the most important topics, including the following:

- **Conflicts of interest.** A "conflict of interest" occurs when an individual's private interest interferes in any way – or even appears to interfere – with the interests of the corporation as a whole. A conflict situation can arise when an employee, officer or director takes actions or has interests that may make it difficult to perform his or her company work objectively and effectively. Conflicts of interest also arise when an employee, officer or director, or a member of his or her family, receives improper personal benefits as a result of his or her position in the company. Loans to, or guarantees of obligations of, such persons are of special concern. The company should have a policy prohibiting such conflicts of interest, and providing a means for employees, officers and directors to communicate potential conflicts to the company.

- **Corporate opportunities.** Employees, officers and directors should be prohibited from (a) taking for themselves personally opportunities that are discovered through the use of corporate property, information or position; (b) using corporate property, information, or position for personal gain; and (c) competing with the company. Employees, officers and directors owe a duty to the company to advance its legitimate interests when the opportunity to do so arises.

- **Confidentiality.** Employees should maintain the confidentiality of information entrusted to them by the company or its customers, except when disclosure is authorized or legally mandated. Confidential information includes all non-public information that might be of use to competitors, or harmful to the company or its customers, if disclosed.

- **Fair dealing.** Each employee should endeavor to deal fairly with the company's customers, suppliers, competitors and employees. No employee should take unfair advantage of anyone through manipulation, concealment, abuse of privileged information, misrepresentation of material facts, or any other unfair-dealing practice.

- **Protection and proper use of company assets.** All employees should protect the company's assets and ensure their efficient use. Theft, carelessness and waste have a direct impact on the company's profitability. All company assets should be used for legitimate business purposes.

- **Compliance with laws, rules and regulations (including insider trading laws).** The company should proactively promote compliance with laws, rules and regulations, including insider trading laws. Insider trading is both unethical and illegal and should be dealt with firmly.

- **Encouraging the reporting of any illegal or unethical behavior.** The company should proactively promote ethical behavior. The company should encourage employees to talk to supervisors, managers or other appropriate personnel when in doubt about the best course of action in a particular situation. Additionally, employees should report violations of laws, rules, regulations or the code of business conduct to appropriate personnel. To encourage employees to report such violations, the company must ensure that employees know that the company will not allow retaliation for reports made in good faith.

11. **Require listed foreign private issuers to disclose any significant ways in which their corporate governance practices differ from those followed by domestic companies under NYSE listing standards.**

Both SEC rules and NYSE policies have long recognized that foreign private issuers differ from domestic companies in the regulatory and disclosure regimes and customs they follow, and that it is appropriate to accommodate those differences. For this reason, the NYSE has permitted listed non-U.S. companies to follow home-country practices with respect to a number of corporate governance matters, such as the audit committee requirement and the NYSE shareholder approval and voting rights rules.[18] While the NYSE should continue to respect different approaches, listed foreign private issuers must make their U.S. investors aware of the significant ways in which their home-country

[18] *See* NYSE Listed Company Manual Section 303.00 (Corporate Governance Standards).

practices differ from those followed by domestic companies under NYSE listing standards. We also suggest that the NYSE work with its counterparts throughout the world to strive for harmony in corporate governance principles, with the goal of establishing global principles to be implemented by global companies no matter where those companies are based.

12. Require each listed company CEO to certify to the NYSE each year:

- **that the company has established procedures for verifying the accuracy and completeness of the information provided to investors; that those procedures have been carried out; and that, based upon the CEO's assessment of the adequacy of those procedures and of the diligence of those carrying them out, the CEO has no reasonable cause to believe that the information provided to investors is not accurate and complete in all material respects. The CEO must further certify that he or she has reviewed with the board those procedures and the company's compliance with them.**

- **that he or she is not aware of any violation by the company of NYSE listing standards.**

Reporting accurate, complete and understandable information about a listed company's business, earnings and financial condition is an absolute requirement of listing on the NYSE. The annual CEO certification to the NYSE proposed here will focus the board and the CEO on this requirement.[19] Similarly, the CEO's annual certification to the NYSE that he or she is unaware of any violation by the company of NYSE listing standards will focus the CEO and senior management on the company's compliance with the listing standards.[20]

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[19] No existing NYSE listing standard requires such a CEO certification. However, a similar certification is required of member organizations in the context of insider trading. *See* NYSE Rule 351.

[20] No existing NYSE listing standard requires a CEO certification to the company's adherence to NYSE listing standards. However, current NYSE listing standards do provide for a similar affirmation by the company each year with respect to its compliance with the NYSE audit committee requirements. *See* NYSE Listed Company Manual Section 303.02 (Application of Standards), Subsection C (Written Affirmation).

13. Enable the NYSE to issue a public reprimand letter to any listed company that violates an NYSE listing standard.

Suspending trading in or delisting a company can be harmful to the very shareholders that the NYSE listing standards seek to protect; the NYSE must therefore use these measures sparingly and judiciously. We believe that the NYSE should have the ability to apply a lesser sanction to deter companies from violating its corporate governance (or other) listing standards.

The NYSE should be able to issue a public reprimand letter to a company that it determines has violated an NYSE listing standard. For companies that repeatedly or flagrantly violate NYSE listing standards, suspension and delisting remain the ultimate penalties.

Recommendations to Other Institutions

Reforms implemented by the NYSE alone will not be enough to repair the damage done to investor confidence by recent instances of illegal and unethical behavior. As a step toward coordinating our efforts with those of other institutions, we believe that the NYSE Board of Directors should make the following recommendations.

1. **The SEC should require public accountants to be regulated by a new private-sector organization governed and funded independently of the accounting industry.**

The SEC has proposed (as have several bills in Congress) a system of "private sector" regulation to oversee the quality of the audits of public companies. This private, independent body would review the quality controls of accounting firms and discipline auditors for incompetent or unethical conduct. The SEC would oversee the organization's membership, rules and activities to ensure that it is independent of the accounting industry. We support the creation of this new organization.

2. **The SEC should require CEOs to certify to shareholders that, to their best knowledge and belief, their companies' financial statements and disclosures fairly present the information that reasonable investors should have to make informed investment decisions.**

We agree with the President and the SEC that it is unacceptable for the CEO of a company to disclaim responsibility for company disclosures. To avoid potentially pernicious private litigation based on this certification, the SEC should have exclusive authority to enforce the requirement of a CEO certification.

3. **The SEC should require companies, in all public or shareholder communications, to report complete GAAP-based financial information before any reference to "pro forma" or "adjusted" financial information. Any pro forma information should be reconciled to the GAAP information.**

Companies increasingly (and in a non-uniform way) use "pro forma" or "adjusted" financial information in their press releases and other public statements. While such information can give investors important operating information, this non-uniform, "adjusted" information can be presented in such a way that makes it difficult for investors to evaluate the company's performance. The SEC should require each company to report its GAAP-based financial information before any pro forma information, and more prominently than the latter information, in all its public releases. Companies should also be required clearly and concisely to reconcile pro forma information to GAAP results, so that investors can see and understand the effects of "adjusting" the information.

4. **The SEC should prohibit relationships between independent auditors and audit clients that may impair the effectiveness of audits.**

There is a careful balance to be struck between an auditor's familiarity with its client, which will help the auditor do its job, and unhealthy entanglements, which may interfere with a fair and objective audit. The SEC should pursue its review of its basic guidelines for permitted and prohibited relationships between auditors and audit clients.

5. **The SEC should exercise more active oversight of the FASB to improve the quality of GAAP and the speed of FASB actions.**

In general, the SEC looks to the FASB, of which it has oversight, to establish and improve accounting principles. Unfortunately, the FASB's process for reviewing and setting new standards has, at times, been impeded by a desire to address the particular issues of too many constituencies. This has resulted in an often slow standard-setting process that produces overly specific and complex accounting standards. This process is often lengthy, inefficient and overly political. The SEC should focus on improving the overall quality of GAAP (to reduce "check the box" accounting) and on ensuring that the FASB promptly responds to investor needs.

6. **The SEC should improve Management's Discussion and Analysis (MD&A) disclosure.**

The SEC has proposed rules requiring companies to discuss, in the MD&A section of annual reports, registration statements and proxy and information statements, accounting estimates resulting from the application of critical accounting policies and the initial adoption of accounting policies that have a material impact on the company's financial presentation. Companies would also be required to disclose in the MD&A in their quarterly reports any new critical accounting estimates or material changes to the prior disclosure. We support the SEC's proposal requiring clear and understandable disclosure of the critical accounting alternatives and assumptions that shape the bottom line.

7. **The SEC should require prompt disclosure of insider transactions.**

President Bush has stated that companies should be required to disclose the purchase and sale of company stock by officers and directors within two business days, and the SEC has proposed a rule requiring companies to promptly disclose insider transactions. Currently, corporate leaders can delay for as long as a year or more disclosing personal transactions with the company, and as long as 40 days for open-market transactions. We support the SEC's proposal; accelerating disclosure will discourage the potential for abusive trades, encourage fair dealing by insiders and provide important information to shareholders. We further recommend that the SEC consider requiring companies to promptly disclose loans or similar accommodations made to officers and directors, as well as the forgiveness of such loans.

8. **The SEC should evaluate the impact of Regulation F-D on corporate behavior and the capital markets in general, including potentially unintended pressures to provide regular public earnings guidance.**

Although the disclosure of regular earnings guidance adds, near-term, to the store of available investor information, this practice may work against the ultimate goal of full and fair disclosure by creating pressure on management to "manage" reported earnings in order to meet or exceed market expectations formed as the result of such "expected earnings" previews. The SEC should evaluate the effects of Regulation F-D on the provision of earnings guidance and consider whether reforms are warranted.

9. Congress should allocate additional resources to the SEC as necessary to enable it to increase its monitoring and enforcement activities.

Additional funding is necessary to enable the SEC to fulfill its watchdog role, and we encourage Congress to provide increased resources to the SEC. In particular, we strongly encourage funding "pay parity." At this critical time for the nation's financial markets, the SEC must be able to attract good people and retain its most experienced, talented, valuable and productive employees. The only way it can do that is to provide staff with pay at levels comparable to those at the other federal financial regulatory agencies.

10. Congress should give the SEC the authority to bar officers and directors of public companies from holding these positions after they have failed to fulfill their responsibilities.

Once an officer or director of a public company has failed the public trust, he or she should not have the opportunity to do so again. Congress should give the SEC the authority to bar officers and directors who violate their duties to shareholders through an administrative process rather than going through the lengthy judicial process that is currently required.

11. Congress should create a public/private panel to review stock concentration in 401(k) plans.

Some in Congress and elsewhere have proposed addressing diversification of stock holdings in 401(k) plans. To ensure that investors receive proper protection, we support the creation of a public/private panel, appointed at the highest levels of national government, to review concentration in 401(k) plans.[21]

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[21] This proposed panel should be as comprehensive as the "Greenspan Social Security Commission," formed in December 1981, with five members appointed by the President, five by the Senate Majority Leader (in consultation with the Minority Leader) and five by the Speaker of the House (in consultation with the Minority Leader). The Greenspan Social Security Commission presented its report "The National Commission on Social Security Reform" in January 1983.

Conclusion

While we may never modulate the “boom and bust” cycles of our capital markets, U.S. investors have every right to expect that the system of SEC-registered, exchange-traded equities can weather such cycles without significant companies “melting down” due to failures of diligence, ethics and controls. Thus, the NYSE is committed to strengthening that system by drawing lessons from those failures and assuring that shareholders, directors, officers, employees and outside professionals are empowered and encouraged to discharge their responsibilities – and are held accountable if they do not. We believe that adoption of these recommendations will achieve that goal.

We end with a word about director education. It is not enough that, through our recommendations and otherwise, directors be given the tools they need to do their jobs. Rather, steps must be taken to assure that directors will actually know how to use all the instruments in their toolboxes. We therefore recommend that the NYSE encourage all public companies to establish orientation programs for their new directors. Each company is unique, and an executive or directorial background with one company may not adequately prepare a person for a directorship with another company. An effective orientation program will familiarize new directors with the company’s strategic plans; its significant financial, accounting and risk-management issues; its compliance programs; its conflict policies and other controls; its principal officers; and its internal and independent auditors. Through such orientation programs, directors can be fully informed as to their responsibilities and the means at their disposal for the effective discharge of those responsibilities.

We recommend that the NYSE and the New York Stock Exchange Foundation enhance their existing support to continuing education programs for corporate directors and officers at universities such as those at Duke University, New York University and Stanford University. In addition, we recommend that the NYSE develop an institute offering continuing education forums around the United States for both current and newly-elected directors. We envision an NYSE Directors Institute giving presentations in major cities throughout the country, with the participation of experienced directors, academic experts in corporate governance, and organizations with relevant expertise (*e.g.,* the American Bar Association, the Business Roundtable, the Conference Board, the Investor Responsibility Research Center, and the National Association of Corporate Directors).

We are confident that adoption of our recommendations, in conjunction with the new NYSE listing standards addressing analyst conflicts of interest and requiring prompt disclosure by listed companies of any complaints they submit to the NYSE or the SEC about trading in their stock, will help restore investors' confidence in our capital markets.

We respectfully submit this Report with the hope that its adoption by the Board and its implementation through NYSE listing standards will empower and encourage directors, officers and employees alike to strive for and achieve the excellence that has for so long been a hallmark of New York Stock Exchange companies.

Appendix

The Committee is grateful for the helpful appearances and written comments provided by the following organizations and individuals:

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A-5	AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS Damon A. Silvers, Associate General Counsel
A-9	AMERICAN SOCIETY OF CORPORATE SECRETARIES, INC. Kathleen M. Gibson, Director and Former Chairman of the Corporate Practices Committee (and Associate General Counsel and Assistant Secretary of Becton, Dickinson and Company)
A-13	ASSOCIATION FOR INVESTMENT MANAGEMENT AND RESEARCH Patricia Doran Walters, Senior Vice President, Professional Standards and Advocacy
A-23	BUSINESS ROUNDTABLE CORPORATE GOVERNANCE TASK FORCE Franklin D. Raines, Chairman (and Chairman and CEO, Fannie Mae) Patricia Hanahan Engman, Executive Director
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A-51	THE COUNCIL OF INSTITUTIONAL INVESTORS Ann Yerger, Director of Research
A-61	FIDELITY MANAGEMENT AND RESEARCH COMPANY Eric D. Roiter, Senior Vice President and General Counsel
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A-81	THE INSTITUTE OF INTERNAL AUDITORS William G. Bishop III, President LeRoy E. Bookal, Senior Vice Chairman

The Committee is also grateful for the helpful appearance of:

U. S. SECURITIES AND EXCHANGE COMMISSION
Alan L. Beller, Director, Division of Corporation Finance and Senior Counselor to the Commission
Robert K. Herdman, Chief Accountant

In addition, the Committee is grateful for the helpful written comments provided by:

TESTIMONY OF DAMON A. SILVERS
ASSOCIATE GENERAL COUNSEL
AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

PRESENTATION TO THE NEW YORK STOCK EXCHANGE
SPECIAL COMMITTEE ON
CORPORATE ACCOUNTABILITY AND LISTING STANDARDS
MAY 23, 2002

Good morning, Mr. Chairman, my name is Damon Silvers, and I am an Associate General Counsel of the American Federation of Labor and Congress of Industrial Organizations. I would first like to convey President Sweeney's gratitude for the Committee's efforts to accommodate his schedule and his apologies for not being able to arrange to appear before the Committee personally. The AFL-CIO believes your efforts are an essential part of a much needed effort at comprehensive reform of the capital markets. We commend the New York Stock Exchange for launching this effort and recognizing the key role the Exchange can play as a self-regulatory organization in improving the governance of NYSE listed companies.

The AFL-CIO is the federation of America's labor unions, representing more than 66 national and international unions and their membership of more than 13 million working women and men. Union members participate in the capital markets as individual investors and through a variety of benefit plans. Union members' benefit plans have over $5 trillion in assets. Union-sponsored pension plans account for over $400 billion of that amount. Worker-owners and their benefit funds have become increasingly active participants in corporate governance in the last fifteen years—in 1999 sponsoring a majority of the shareholder proposals that themselves received majority votes.

Worker funds are currently leading a number of important corporate governance initiatives, ranging from the AFL-CIO's opposition to the renomination of Enron directors, to the Laborers and Machinists Unions' opposition to companies seeking to reincorporate in Bermuda, to the Sheetmetal Workers' National Pension Fund's successful effort at Disney to end that company's auditor's involvement in consulting work for Disney.

The labor movement views corporate governance as a web of relationships. These relationships should work toward getting companies to make smart, long term focused decisions that lead to sustainable benefits for all who participate in the company. Unfortunately, Enron is a window into a set of pervasive conflicts of interest that defeat the purposes of corporate governance and threaten the retirement security of America's working families. At Enron the management, the board of directors, the outside auditors and the sell-side analysts all failed to protect investors. Similar events have occurred at Global Crossing, Cendant, Computer Associates, Waste Management, McKesson, Worldcom, Reliant, Adelphia, Qwest, El Paso Energy, Halliburton, Dynegy, and more. The AFL-CIO believes that a critical source of these failures lie in the unregulated conflicts of interest that permeate the relationships between the management of these companies and the people who were supposed to be protecting investors.

The AFL-CIO urges this Committee take up the task of a comprehensive revision of the NYSE's listing standards aimed at addressing these conflicts of interest. You may have heard in prior hearings from those who have benefited and continue to benefit from these conflicts as to why they must be allowed to continue, from those who would lull you to sleep with the lullaby that everything will be alright if you just do nothing. That may be the view from some peoples' offices. But it is not how things look for thousands of working families in Houston and Portland, Oregon and Rochester, New York who have lost their retirement savings and in some cases their jobs and their health care because they believed what they were told—by their employers, their employers' accountants and the analysts that interpreted the accountants' numbers. And I cannot believe it is the view here at the heart of financial markets that stubbornly refuse to rebound, in part many believe because of investors lack of confidence in the integrity of the markets.

Let me then address what a comprehensive reform package requires.

Corporate governance starts with boards of directors. Public company boards need strong independent directors who are accountable to investors. Part of the problem at Enron was that Enron touted directors as independent who really had significant ties to Enron management, ties that Enron did not have to disclose. So investors first need complete disclosure of all ties between board members, the company and company management. This standard is currently embodied in the Oxley bill passed by the House of Representatives.

Relatedly, the New York Stock Exchange should tighten its independence requirements for certain board committees. Currently, the NYSE requires listed companies have audit committees whose members are not employees of the firm, but who may under certain circumstances have economic links to the firm. There are no such requirements of compensation or nominating committees. We believe there should be similar independence requirements of compensation and nominating committees, and that for all these committees the independence requirements should be tightened.

First, the types of economic links that should be regulated should include all consulting relationships as well as any contributions made by the listed company to a charity which has a board interlock with the issuer or which is the employer of the issuer's board member. Second, board members with these economic ties to the listed company should not be serving on board's audit, compensation and nominating committees absent extraordinary circumstances.

With genuine independence from management must come genuine accountability to shareholders. Currently, management's nominees to the board of directors have access to the corporate treasury to cover the costs of their campaign, including most importantly the costs of legalizing, printing and mailing the basic proxy solicitation. Shareholders, no matter how many they are or how much of the ownership of the company they represent, must bear all the expenses of nominating a candidate themselves. In most circumstances this is a prohibitive barrier to the election of shareholder-nominated directors. The NYSE could, as a listing standard, require listed companies to give shareholders representing a certain percentage of shares, say 10%, access to the proxy for their director nominee in non-takeover contexts. Such a reform would create real accountability and foster genuinely independent directors without subjecting listed companies to frivolous expenditures.

In addition, as some of you may know, under the SEC's Rule 14a-8, shareholders are entitled to have their proposals included in management's proxy materials if those proposals meet a series of requirements. Some of the requirements get the SEC involved in making substantive judgment calls about the proposals—such as whether they constitute ordinary business. We believe that in general this process while imperfect serves both investors and issuers well.

However, this process does not and cannot do a good job of distinguishing between when something like an accounting practice, which usually is ordinary business, rises to a nonordinary business level, as certainly accounting practices have at Enron and many other companies. The way to make these types of distinctions and give shareholders a meaningful voice in extraordinary matters is to create an override—access to the proxy for any legal proposal sponsored by a significant percentage of shareholders—say 5%. Again, like access to the proxy for independent director candidates, this reform could be accomplished through listing standards. Together these two measures would measurably add to investor voice in corporate governance.

The second area in need of reform is the practice of public accounting. There are three issues here—independence, oversight, and the process by which the accounting rules are made. On independence, the simple fact is that you cannot be a public auditor with an obligation to get the numbers right for a public audience and also be a consultant whose aim is to advise executives on how to optimize the numbers. The tension between those goals is too severe and the rewards for compromising the public audit responsibility are too great. It's just too easy for an auditor seeking to blend those roles to end up like Arthur Andersen at Enron, structuring SPE's as a consultant and auditing those same structures as an auditor.

This issue has been viewed primarily as one of regulating the accounting profession. The NYSE is in a position to regulate these conflicts through regulating issuer conduct. The NYSE could enact as part of its listing standards the same limits on auditor consulting that we have proposed in our rulemaking petition to the Securities and Exchange Commission dated December 11, 2001, that were embodied in then SEC Chairman Arthur Levitt's original auditor independence initiative, and that were part of both Representative La Falce's Comprehensive Investor Protection Act and are now part of Senator Sarbanes' proposed legislation.

The next issue after independence is oversight. Former SEC Chair Arthur Levitt has outlined what we believe are the key characteristics of a much needed auditor oversight body—members independent of the public accounting profession, full investigative and disciplinary powers, and independent funding. While the NYSE cannot create such a body, its voice in support of the key elements an effective body must have would be a welcome contribution to the current debate.

Finally, there is the rulemaking process. Anyone familiar with the political pressures brought to bear on FASB around accounting for executive stock options in the mid-1990's, not to mention the decade long paralysis on SPE accounting, knows that FASB is too open to pressures from issuers and those beholden to issuers. Here there are a variety of options available for how to make FASB more independent—ranging from merging with a public auditor oversight body to closer ties with the SEC. Again this is an area where the NYSE cannot act directly but where the views of this committee would make a substantial contribution to the public policy debate and could help ensure that the SEC and Congress take the steps necessary to restore investor confidence in both audited financial statements and the market pricing they underpin.

There is a related area where the NYSE has been particularly active in recent years, and that is the governance standards related to stock options. In the recent past this issue has languished as the NYSE and the NASD each point to the other's inaction as an excuse for their own. The AFL-CIO has long supported putting all option plans which the directors or the top five officers participate in to a shareholder vote. That position has recently been adopted by the Business Roundtable. This is an area where the NYSE could act today and adopt the recommendation embodied in the BRT Best Practices.

However, we believe that for such a vote to be conducted with adequate information, issuers should have to value the options they are proposing to grant using the Black-Scholes method with appropriate modifications to address the differences between executive options and exchange-traded options.

Then there are the Wall Street analysts. These people play a vital role in our markets—they interpret the numbers. But analysts have become captive to the investment banking side of their firms. That's why part of a comprehensive package of reforms must be a provision banning basing analyst compensation not just on specific investment banking transactions, but also barring tying analyst compensation to investment banking performance generally.

This is an area where the NYSE and the NASD frankly have failed. The recent rule adopted by the NYSE and approved by the SEC does nothing more than codify a laughably weak SIA guideline that appears to have been designed to facilitate the continued subordination of analysts' judgments and clients' interests to the dictates of their firms' investment bankers. At the SEC's recent investor summit, Chairman Pitt indicated he saw this recent rulemaking as a first step. We strongly urge the NYSE to move immediately to the second step—banning all direct links between analyst pay and investment banking performance and removing analysts from marketing investment banking services.

The settlement negotiated between New York State and Merrill Lynch this week does end the involvement of investment bankers at Merrill Lynch in evaluating and compensating analysts, and we applaud both parties for that step. But the agreement does not deal with the involvement of analysts in investment banking roadshows—a practice the AFL-CIO sought to end in the shareholder proposal we filed with Merrill Lynch last year.

We are looking to achieve the full set of reforms here both by dialogue with the Wall Street firms and with the Securities and Exchange Commission. We frankly believe it would be better for our regulatory system for the SRO's to take this step than to have it imposed on the Street through a series of consent decrees negotiated with Eliot Spitzer. But if no one else will do what is necessary, we strongly support the Attorney General filling the void.

In closing, I wish to strongly emphasize the labor movement does not view what happened at Enron as the product of a few bad people at Enron or any other company, for that matter. While those individuals who have been given the responsibility to manage workers' and the public's money need to be held to a single high standard, we see believe at the heart of what happened at Enron are systemic problems that need systemic solutions. The AFL-CIO welcomes the opportunity to continue to work with the New York Stock Exchange and with this Committee as you take up this challenge. Thank you.

AMERICAN SOCIETY OF
ASCS
CORPORATE SECRETARIES

New York Stock Exchange
Special Committee on Corporate Accountability and Listing Standards

These comments are being submitted by the American Society of Corporate Secretaries, an organization whose membership includes over 3,800 individuals whose professional responsibilities are focused on corporate governance and board-related matters.

The Society sincerely appreciates the opportunity to provide input to the Committee. Our goal is to provide the Committee with a practical viewpoint based on our members' collective experience in interacting with corporate boards.

We would like to preface our comments with the observation that we believe there is no substitute in the corporate governance arena for diligence and integrity. Unfortunately, no regulation can guarantee these intangible qualities. We also recognize the current necessity of providing additional regulatory guidance related to corporate governance in order to bolster investor confidence in our corporations and our boardrooms. However, we believe the appropriate goal of new regulation should be to prevent and detect fraud. We urge the Exchange to be cautious that new regulations do not significantly increase the risk of serving on an audit committee or make it increasingly more difficult to attract and retain quality directors of diverse backgrounds.

The task of restoring investor confidence will require a multi-faceted approach focused on the auditing profession, corporate disclosure, corporate governance and audit committees. Based on the Society's area of expertise, our input will focus on corporate governance and audit committee issues.

The following are some initial thoughts for the Committee to consider on the following topics:

- Board independence;
- Audit committee independence;
- Private meetings with the independent auditor and the internal auditor;
- Number of audit committee meetings;
- Audit committee financial literacy requirements;
- Audit committee training;
- Audit committee rotation; and
- Mandatory rotation of independent auditors.

In many of these areas, we recommend that the Exchange endorse "best practices" guidance for listed companies rather than mandating specific listing requirements.

Board Independence

We continue to support the Exchange's current definition of independence that allows corporate boards to view the totality of the circumstances in determining whether a board member is independent. We suggest that the Committee recommend as a "best practice" that its listed companies' boards should be comprised of a majority of independent directors using the Exchange's current definition. According to a survey of our member companies (which includes privately held companies), 71% responded that their boards had a majority of independent directors.

How to define “independence” has been a matter of public debate for some time. As a result, public companies have to satisfy a number of different definitions of independence – i.e., Section 16 of the Securities Exchange Act; Section 162(m) of the Internal Revenue Code and the Exchange’s definition of “independence” for audit committees. Therefore, we feel strongly that the Exchange retain its general definition of independence for purposes of recommending that boards of listed companies should be comprised of a majority of independent directors.

Audit Committee Independence

While the Exchange’s current definition of independence for audit committee members has several disqualifying categories (such as serving as a consultant) it leaves the decision to the board to determine whether a business relationship would impair a director’s ability to exercise independent judgment. In light of the recent public debate involving charitable contributions by corporations to organizations with ties to a board member, we recommend that the Exchange’s definition of independence for audit committee members be revised to have the Board review not only business relationships between a company and a director but also other relationships, such as the receipt of charitable contributions. We feel strongly that the ultimate decision regarding the impact of charitable contributions or business relationships on a director’s independence be left to the Board’s discretion. Specific dollar limits that have been proposed in the legislative arena, such as $10,000, are simply not practical given the vast array of factual circumstances that may arise.

Private Meetings with Independent Auditor and Internal Auditor

In order to further promote candid discussion between the audit committee and each of the independent auditor and the chief internal auditor, we would support a listing requirement that audit committees meet privately with the independent auditor and the internal auditor at least once a year. Our sense is that this is a widely followed “best practice” that is appropriate to institute as a requirement.

Number of Audit Committee Meetings

Given the recent increase in expectations of audit committees, we would support a requirement that audit committees meet at least four times a year.

Audit Committee Financial Literacy Requirements

In 1998, the Society expressed its view to the Blue Ribbon Committee that the role of the audit committee is one of oversight. Management and the independent auditor are responsible for the preparation and auditing of the financial statements of a company. Despite recent unfortunate events, the role of the audit committee continues to be one of oversight.

An effective audit committee member – and indeed an effective board member – does not need to be intimately familiar with the latest pronouncement from FASB. While having one or more individuals on a board who have finance acumen is desirable, we believe it is impractical and unwise to revise the Exchange’s current requirements regarding financial management expertise to a level suggested by some commentators.

The Exchange's current requirements leave the determination to the board's discretion as to whether an audit committee member is financially literate or has financial management expertise. We would support the Exchange recommending as a "best practice" that a board consider the Blue Ribbon Committee's definitions of financial literacy and financial expertise in making its determination. We believe this would continue to give boards the necessary flexibility in recruiting directors with broad backgrounds and experience, rather than trying to fill one slot with a "super accountant."

Audit Committee Training

We would support the Exchange recommending as a "best practice" that audit committees receive continuing education. We believe that the appropriate amount and subject matter of continuing education is most appropriately determined on a company specific basis. Many of our member companies routinely provide updates to the audit committee on significant accounting rule changes and also provide periodic reports to the committee on topics that may be significant to the company – such as revenue recognition. Increasingly, companies will provide tutorials to audit committees on critical accounting policies. While it is possible that a cottage industry may develop to provide training courses to audit committee members, we believe that the most effective and tailored education should be left to the discretion of the board. Board members should not be required to attend outside courses. Certainly they may choose to do so.

Audit Committee Rotation

Many of our member companies strongly oppose specific mandatory rotation requirements for audit committees. It may be preferable for the Exchange to recommend as a "best practice" that there be periodic rotation of audit committee members, including the chairman and leave the timing of the rotation to the discretion of the Board. Periodic rotation is an appropriate goal, but specifying the number of years limits the discretion of the board in the committee succession process.

Mandatory Rotation of Independent Auditor

There has been much public debate about requiring that a company change its independent auditor every 5 to 7 years. We believe that having a mandatory requirement to change auditors on a regular basis would be costly and inefficient. The decision to change auditors is most appropriately left to the discretion of the board. However, the Exchange may consider recommending as a best practice that the partner in charge of an audit engagement be rotated on a periodic basis.

Concluding Remarks

Again, we appreciate the opportunity to provide input to the Committee. The Society would be happy to assist the Committee in any way possible, such as surveying members on a particular topic.

AIMR®
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10 April 2002

Mr. James L. Cochrane
Senior Vice President
Strategy & Planning
New York Stock Exchange
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By fax: 1.212.656.2081

Mr. Cochrane:

On behalf of the Association for Investment Management and Research® (AIMR®), I am pleased to provide my thoughts to the Special Committee ("the Committee") of the Board of Directors of the New York Stock Exchange (NYSE) on the issues of corporate accountability and NYSE listing standards.

With headquarters in Charlottesville, Va., and regional offices in Hong Kong and London, AIMR is a non-profit professional association of 54,000 financial analysts, portfolio managers and other investment professionals in 107 countries. AIMR's membership also includes 106 local professional societies and chapters in 29 countries. AIMR is internationally renowned for its rigorous Chartered Financial Analyst® (CFA®) curriculum and examination program, which has more than 100,000 candidates from 143 nations enrolled for the June 2002 exams. In addition, AIMR is recognized internationally for its investment performance standards, which investment firms use to calculate and report investment results, as well as for its *Code of Ethics* and *Standards of Professional Conduct.* AIMR was formed in 1990 from the combination of the Financial Analysts Federation (established 1947) and the Institute of Chartered Financial Analysts (incorporated 1962).

General Comments

Corporate governance is an elusive concept that describes the relationships between a company's management, its board of directors, its shareholders, and its other stakeholders. According to the report of the Organization for Economic Cooperation and Development's (OECD) Ad Hoc Task Force on Corporate Governance, corporate governance "provides a structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined." More simply, corporate governance can be defined as the system by which a company is directed and controlled. Regardless of the definition in use, we concur with the OECD that good corporate governance provides "proper incentives for the board and management to pursue objectives that are in the interests of [both] the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently" and effectively. We wish to emphasize that, although the corporate governance relationship is between management and shareholders, company objectives must serve and forward the interests of shareholders and the company, not company management.

We believe that shareholders have a right to expect good corporate governance practices from the companies whose equity they own. Increasingly, we see investors including information on a company's corporate governance practices into their investment decision-making. Institutional investors are also exercising their right and fiduciary responsibility to vote proxies and participate actively in the corporate governance process.

While there may be no single model of good corporate governance, as the OECD report suggests, important principles can be identified upon which good corporate governance structures and processes can be based. We support the following principles that are presented in the OECD report:

(1) Recognize and protect the rights of shareholders.

(2) Treat shareholders equitably, including minority and foreign shareholders; provide effective processes and procedures for the redress of violations of these rights; and prohibit insider trading.

(3) Recognize and protect the rights of other stakeholders and develop mechanisms for informed stakeholder participation in the governance process.

(4) Make timely, accurate, and transparent disclosure of all material matters regarding the company, including financial situation, performance, ownership, and governance.

(5) Hold the board of directors accountable to the company and the shareholders, require them to exercise due diligence and care, and to put the interests of the shareholders and the company before their own or management's interests.

Not all legal systems support these principles. Even where the principles are supported "in spirit," in practice, the extent to which they are implemented varies widely. We support the efforts of the NYSE, regulatory bodies, and other self-regulatory organizations to require companies within their jurisdictions to implement structures that can ensure these principles are recognized and applied.

Often stock exchanges, and the NYSE is no exception, are perceived to be advocates for their corporate clients, rather than the ultimate investors who use exchanges to invest. We are gratified to see that the NYSE is interested in the views of investors, and the investment professionals on whom they rely, in their efforts to improve the corporate governance structures of its listed companies. We recommend that, in deliberating enhancements to its listing requirements, the NYSE Board strive to identify and incorporate the "best practices" for each of these principles.

In addition, regardless of the changes that are made, we believe that listing requirements must be applied uniformly to all listed companies. If the principles of good corporate governance that we outlined above are valid, then, regardless of their country of domicile, all companies have the same responsibility for, and all investors have the same right to, good corporate governance.

Responsibilities of Institutional Investors

The *AIMR Standards of Practice Handbook* details the *Code of Ethics* and *Standards of Professional Conduct* to which all AIMR members must adhere. In 1999, to provide guidance to members on some of their responsibilities with respect to voting of proxies, the Topical Study: Corporate Governance was added. Corporate governance was then, and continues to be, important to AIMR because, in many instances, security holders and account owners delegate their right to vote proxies to the investment professionals who manage their investments. These investment professionals must, therefore, adopt procedures to ensure that proxy issues are sufficiently noted, analyzed, and considered so that their fiduciary duty to their clients is met. AIMR believes that it has the responsibility to provide adequate guidance to its members in support of that duty. The recommendations in the topical study are designed to help AIMR members and other investment professionals to establish and implement a sound proxy voting policy. Although institutional investors should follow clear and transparent general voting guidelines, available to all investor-clients, in voting their proxies, they must also recognize the need to review all votes individually and not permit minority shareholders to be treated unfairly.

AIMR Global Task Force on Corporate Governance

AIMR recognizes that providing guidance on proxy voting is just the beginning of its responsibility to its members and their investing clients on the issue of corporate governance. More than 80% of AIMR members are employed by institutional investors or private-client investment management firms. As a group, these investors hold about 50% of all listed corporate equity in the United States (about 60% in the largest 1,000 corporations). The largest 25 pension funds account for 42% of the foreign equity held by all U.S. investors.

Institutional investors increasingly realize the potential power and influence that they, representing millions of individuals, can wield over the companies in which they hold interests is staggering. These investors are in effect "permanent shareholders" and their responsibilities to their investing clients must go beyond merely voting proxies on management proposals. Institutional investors have a right and a responsibility to participate in and vote on corporate decisions that affect the performance of the investments of their clients and to advocate improvements to corporate governance structures. To support its members and their investing clients in this endeavor, AIMR has recently initiated a project with the goal of making broader recommendations on "best practices" for corporate governance structures worldwide.

We believe that institutional investors should play an active role in corporate governance. The fiduciary duty of pension fund sponsors and trustees and mutual fund managers entails duties of care and loyalty to their investors and clients. It entails an obligation to add value to clients' investments and protect their interests in the long-term health of the companies in which they invest. This is particularly important for passive or index fund managers who may have significant positions in a company's securities but do not have the flexibility to influence corporate management by simply selling shares. As the founder of Deutsche Bank, George Siemens once said, "If one can't sell, one must care." We do not believe that simply voting proxies fulfills that duty.

We recommend that institutional investors assume a role that ensures that corporate policies serve the best interest of a corporation's investor-owners. Although we would not expect that institutional investors would seek involvement in the day-to-day operations of the companies in which they invest, we believe that institutional investors should recognize the need for conscientious oversight of, and input into, management decisions that may affect a company's value.

Therefore, we recommend that the NYSE adopt listing requirements that would not only permit, but facilitate, an active role by investors, particularly institutional investors. For example, we support strict approach with respect to share-based compensation plans that requires shareholder approval, with very limited exceptions, for every plan in which directors and officers participate. With respect to plans that have the potential to dilute the value of shareholders' earnings, we support a requiring shareholder approval, even when directors and officers do not participate, if the plan has the potential to dilute shareholder interests by ten percent. We endorse the treatment of "potential dilution" adopted by the NYSE which is defined as "the maximum aggregate number of shares of stock currently authorized for issuance including both the number of shares of stock available for grants and the number of shares underlying outstanding grants (i.e., unexercised and unexpired)." We believe that these requirements recognize the right of shareholders to exercise their voice on corporate governance matters that have a direct and substantial impact on equity interests.

AIMR Advocacy to Improve Financial Reporting and Disclosure

Corporate governance should foster transparency: full disclosure of the conditions – risks and opportunities – to which investors in a particular market, or a particular company, are subject. At the macro level, these conditions encompass a market's various legal, financial reporting and disclosure, regulatory, and supervisory standards and regimes. At the micro level, these conditions include an individual company's financial performance and outlook, as well as full disclosure of how a company is governed, and the qualifications, responsibilities and compensation of its board of directors.

AIMR understands, as did its predecessor organization the Financial Analyst Federation, the importance of high quality financial accounting standards. Our advocacy efforts are active in this regard. In the United States, the Financial Accounting Policy Committee provides input to, and responds to initiatives of, the Financial Accounting Standards Board, the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants and the Security and Exchange Commission, among others, with the goal of improving the information that all investors have available to them for investment decision-making. In Canada, the Financial Reporting Subcommittee of the Canadian Advocacy Committee accepts that responsibility and the Global Financial Reporting Advocacy Committee works with the International Accounting Standards Board. Members of AIMR management support member volunteers in these endeavors. We serve on the International Financial Reporting Interpretations Committee and the Canadian Accounting Standards Oversight Council. These advocacy efforts reflect the importance that financial reporting information has to AIMR members' professional responsibilities. AIMR comment letters on a wide variety of financial reporting issues are available on the AIMR website: http://www.aimr.org.

We believe that the NYSE should include issues related to financial reporting and disclosure in its project on corporate governance. This issue has widespread influence and affects not only existing shareholders, but also prospective shareholders who may be relatively disadvantaged in acquiring information.

Although there are many areas of financial reporting that warrant improvement. There are several key areas with deficient rules that we believe must be addressed immediately if investor needs are to be met. If the NYSE does not believe that addressing these deficiencies is within its purview, we urge it to support the efforts of standard setters and regulators to address them. We believe that this would be an important opportunity for the NYSE to support investor interests.

We offer the following examples:

- *Consolidations and off-balance sheet assets or liabilities*

  For the past 20 years, AIMR has advocated that *all* off-balance sheet activities be reported in the parent company's financial statements. This includes activities such as leasing transactions as well as consolidation of subsidiaries, special purpose entities, joint ventures, and partnerships. Current accounting rules are inadequate because they have "bright lines" that allow companies to tailor their transactions to be on- or off-balance sheet. For example, subsidiaries are not consolidated unless the company owns more than 50%. Consolidation on an SPE requires more than 97% ownership. Partnerships and joint ventures can escape consolidation altogether. Rules for recognition of liabilities under leasing arrangements allow companies to keep significant assets and liabilities off the balance sheet and can distort the reporting of operating cash flows and earnings.

- *Financial assets and liabilities*

  As the market in derivatives and other complex financial instruments has grown, we have argued for reporting of financial assets and liabilities at fair value, rather than historic cost. Given the volatility of these instruments, we believe that reporting these assets or liabilities at their fair value is the only way to understand their risks and rewards. Corporate objection to this change has been fierce. The resulting standards require some instruments to be recorded at fair value but others not; some changes in value are recorded in earnings but others not. Even when fair value changes are recorded in earnings, companies need not disclose in what income statement item they appear. This situation turns financial analysis into an impossible game of hide-and-seek.

  Investors also need more informative disclosures regarding financial assets and liabilities. In response to rule proposals by the Securities and Exchange Commission (SEC), AIMR argued for disclosure of sensitivity analysis to allow investors to understand fully the potential risks of these instruments to changing market conditions. Companies lobbied heavily against improved disclosures. The Senate Committee on Banking, Housing, and Urban Affairs held hearings at which the FASB, SEC and AIMR testified in support of the SEC rule proposal, but corporate issuers opposed the improved disclosures. The regulations that were implemented give companies too much flexibility in the type of disclosure. They are generally so simplistic as to be all but useless to investors.

- *Share-based Compensation*

  Stock options and other equity-based compensation have become an important part of executive compensation in the U.S., particularly in new and growing industries. Such compensation should be a way to align management and shareowner interest, but unfortunately has led to earnings manipulation to improve share price. Contrary to what managements would have investors believe, stock options are not "free" or of "little or no value." If so, why would management accept them in lieu of cash? In fact, exercise of executive stock options reduces external shareholder interest and increases management's interest, generally on unfavorable terms to shareholders. Nor do these options better align management and shareholder interests, since research shows that managers are more apt to sell the shares they receive when options are exercised.

In 1994, to its credit, the FASB was prepared to issue a new rule to require recognition of compensation expense for stock options. Heavy corporate lobbying and legislative intervention, however, led FASB to allow footnote disclosure rather than recognition. Disclosure is no substitute for recognition and measurement. A recent AIMR survey shows that 83% of responding fund managers and analysts support recognition and believe that current disclosures are inadequate and difficult to use.

- *Pro Forma Earnings*

  Another creative way in which managements mislead investors and manipulate investor expectations is by communication of "pro forma earnings," company-specific variations of earnings, or "earnings before the bad stuff." With all its deficiencies, we believe that earnings data based on Generally Accepted Accounting Principles (GAAP) are still the most useful starting point for analysis of a company's performance. Analysts and other investors at least know how GAAP earnings are computed and, hence, there is some comparability across companies. We believe that GAAP earnings should always be displayed more prominently than non-GAAP earnings data.

  Unfortunately, just the opposite seems to be the norm, particularly in press releases where *pro forma* earnings get the most emphasis and GAAP earnings may not be mentioned at all. GAAP earnings and associated balance sheet may only become available to investors in SEC filings one to two weeks after *pro forma* earnings are announced. While *pro forma* earnings can be helpful supplemental information for analysts, the practice of providing *pro forma* earnings is widely abused. Companies selectively exclude all sorts of financial reporting items, including depreciation, amortization, payroll taxes on exercises of options, investment gains and losses, stock compensation expenses, and acquisition-related and restructuring costs. John Bogle, the respected investment professional, recently noted in a speech to the New York Society of Securities Analysts, "In 2001, 1,500 companies reported pro forma earnings – what their earnings *would* have been if bad things hadn't happened." We recommend that either the FASB or SEC curtail this practice or ensure that *pro forma* earnings data never have more prominence than GAAP earnings in company communications.

Finally, we recommend that the NYSE vigorously enforce existing financial reporting and disclosure standards for its listed companies. Enforcement of these standards is a vital element of a high quality financial reporting regime. We believe that the Securities and Exchange Commission has insufficient resources to enforce these standards effectively. It is certainly within the ability of the NYSE to demand no less of its listed companies than adherence to the financial reporting and disclosure standards required under the United States securities laws, regardless of a company's country of domicile.

Boards of Directors

A good corporate governance framework must encompass the duties, responsibilities and powers of the board of directors, the procedures for selecting members of the board, and the process for making those decisions that materially impact a company's value. Such decisions include whether to merge with a competitor, to divest certain assets, or to repurchase equity. Essentially, frameworks or codes for corporate governance must be designed to help boards fulfill their fiduciary duty – doing the right thing, even when no one is looking – thereby earning the trust, confidence and capital of investors, especially outside investors. A good corporate governance framework must also provide evidence to shareholders and potential investors of the independence of the board of directors.

We believe that best practice frameworks exist and can be applied. Describing these best practices in detail is part of the charge of the AIMR Global Task Force on Corporate Governance mentioned previously. We believe that, even markets, such as the United States, that already recognize the need for good corporate governance can benefit from improvement to their frameworks.

Even before the Task Force completes its work, we can recommend several best practices with respect to boards of directors and shareholder voting rights:

- At least half of the directors should be independent, non-executive officers of the corporation, even if one group owns the majority of outstanding equity shares. (We recommend that the NYSE strengthen its definition of an "independent director.")
- Shareholder voting rights and meeting rights should ensure that one share has one vote, and decisions are not made by a show of hands.
- The following three independent committees should be appointed by the Board, and not management:

  – Audit
  – Nominations
  – Compensation

Standard-setting bodies increasingly recognize that, to govern effectively, board members need to have a relatively high level of knowledge of the corporation's business activities, as well as its financial condition. For example, the National Association of Corporate Directors has issued a set of new guidelines for enhancing the professionalism of board members. We support the following qualifications and responsibilities for directors and recommend their adoption:

- Directors should be active participants and decision-makers in the boardroom, not merely passive advisers or "rubber stamps" for management proposals.
- Directors should limit their number of board memberships.
- Directors should limit their length of service on a board to 10 to 15 years so that new directors with fresh insights and a renewed independence can be elected.
- Directors should immerse themselves in both the company's business and its industry while staying in touch with senior management.
- Directors should know how to read a balance sheet and income statement and understand the use of financial ratios so they can do their own analysis of the company's performance and detect early warning signs of emerging problems.
- Directors should own a significant equity position in the company.

Audit Committees

The AIMR Financial Reporting Advocacy Committee (FAPC) responded to requests for comments on the Blue Ribbon Committee report, *Improving the Effectiveness of Audit Committees.* We believe that the FAPC's comments are pertinent to the NYSE in reviewing their definition of an independent director and the requirement for independence of those directors who serve on the audit committee.

The members of the FAPC discussed at some length the concept of "independence" and those factors that constitute an independent director. They believe that "independent" may not be the appropriate term to describe the relationship that must exist between management and the directors who sit on the audit committee, and recommend instead that directors be characterized as either "non-management" and "management" or "outside" and "inside" directors. In addition, FAPC members believe there is a critical distinction between financial and intellectual independence. For example, they believe that it is extremely difficult, if not impossible, to ensure that directors retain a level of intellectual independence throughout their tenure. A director may begin his or her term of office with little or no relationship to corporate management or other directors on the audit committee. However, intellectual relationships between management and directors are healthy, and ongoing dialogues between these two groups are often essential to completing the relevant tasks assigned to them. Directors are also responsible for evaluating management. In order to assess properly the effectiveness of corporate managers, directors must have a keen understanding of their function, style, and value to the enterprise; they must, in essence, know management. Such intellectual relationships are necessary and should not be discouraged. However, audit committee members should not be dependent on management when assessing accounting issues or practices and recommend that the various relationships be reevaluated on a regular basis to prevent possible "tainting".

The FAPC wishes to emphasize, and we concur, that audit committee directors must distance themselves financially from corporate management, retain their objectivity, and be able to comment on issues without affecting their self-interests. Financial independence is, however, in direct contrast to the intellectual independence discussed above and must not be breached. A breach may occur if, for example, the directors appointed to the audit committee were (1) family members of corporate management or (2) major suppliers, customers, or consultants. Under these circumstances, directors' biases may influence their decision-making ability; a level of objectivity may be compromised due to the conflicts of interest that may ensue.

We also believe that all members of the Board of Directors should be financially literate, but that a background in accounting or finance should not be the "necessary and sufficient" criteria for qualification. Formal degrees are only loosely correlated with knowledge. All members of the Board should be able to understand a company's financial statements. However, a formal degree in finance or accounting is not essential in that regard. Many individuals without these formal, academic credentials can be as insightful (or in some cases more so) than those with a strict, academic background in finance and accounting. For instance, many corporations have effective internal training centers or affiliations with independent executive institutes. These resource facilities can provide fine educations to employees, managers and directors. In addition, many individuals garner a level of experience and practical knowledge that cannot be matched solely by an understanding of theoretical concepts.

We also believe that shareholders have the right to assess independently the extent of the relationships between directors and management. The only effective way to accomplish this assessment is through full and fair disclosure of these relationships (including relationships with director nominees), preferably in the annual report to shareholders. This information is material to investment decision-making and should include specific and detailed information about personal, professional, and financial relationships.

Concluding Remarks

We believe that effecting substantive changes to corporate governance generally ideally requires a private-public partnership of investors, financial industry participants, self-regulatory organizations, and government regulators that would unite to help eliminate market barriers by establishing, implementing and maintaining corporate governance standards that mandate transparency, timeliness and accuracy of corporate financial reporting. For these standards to work and offer real investor protection, there must also be enforcement of fiduciary laws and standards through effective market monitoring and surveillance by regulators as well as self-regulatory organizations, such as the NYSE. The standards and their enforcement work together to create a level playing field for all market participants – foreign and domestic – and to encourage competition in the market. The end result is better protection for investors, instilling them with confidence, and giving them more and better investment choices and increased access to opportunities.

We wish to thank the NYSE for the opportunity to present our thoughts on its listing requirements to improve corporate governance and shareholder accountability. I look forward to discussing these views with the NYSE Board. If you, the Board or a member of your staff has any questions on these views, please contact me by phone at 1.434.951.5315 or by email at patricia.walters@aimr.org.

Respectfully,

/s/ Patricia Doran Walters

Patricia Doran Walters, PhD, CFA
Senior Vice President
Professional Standards & Advocacy

Statement by Franklin D. Raines
Chairman, Corporate Governance Task Force
of The Business Roundtable
Before the New York Stock Exchange Special Committee on
Corporate Accountability and Listing Standards
April 4, 2002

My name is Franklin Raines, and I am Chairman and Chief Executive Officer of Fannie Mae. I am here today as Chairman of the Corporate Governance Task Force of The Business Roundtable, and I appreciate this opportunity to express the views of The Business Roundtable.

Before I do that, I would like to take a moment to recognize the New York Stock Exchange's important contributions in the area of corporate governance. The Exchange has long been at the forefront of corporate governance, raising and addressing issues of corporate responsibility long before Enron's collapse once again brought these issues to national attention. The Business Roundtable looks forward to working with the Exchange in your ongoing efforts to bolster public confidence in our capital markets.

The Business Roundtable is recognized as an authoritative voice on matters affecting American business corporations and, as such, has a keen interest in corporate governance. As leaders of some of our nation's largest businesses, the Roundtable's members have the strongest interest in corporate governance practices that secure the confidence of stockholders, employees, policymakers and other constituencies.

The Roundtable has been involved in corporate governance issues since 1978. In 1997, we published our Statement on Corporate Governance, which suggested best practices regarding such matters as board structure, composition and operations, and stockholders' meetings. We are pleased with the number of large corporations that have adopted those practices and with the favorable comments received from investor groups and others.

In light of recent events, the Roundtable has undertaken an expedited review of the 1997 Statement, and we expect to issue a new statement on the subject later this Spring.

This past February 11th, the Roundtable issued a statement addressing issues related to Enron's bankruptcy. In that statement, we expressed our views of Enron's collapse and outlined a set of principles we believe should guide the discussion of proposed changes in practices, regulations and laws.

This afternoon, I would like to summarize what The Business Roundtable believes should be the guiding principles of corporate governance. I discussed a number of these issues in testimony on behalf of the Roundtable before the U.S. House Committee on Financial Services this past March 20th.

With respect to Enron, The Business Roundtable believes that a number of the actions and behaviors revealed in the report of the special committee of the Enron Board of Directors that apparently contributed to the collapse of the company are unacceptable.

The report describes a pervasive breakdown in the norms of ethical behavior, corporate governance and corporate responsibility to external and internal constituencies. As we said in our February statement, the Enron situation appears at this point to have derived fundamentally from a massive breach of trust.

The United States has the best corporate governance, financial reporting and securities markets systems in the world. These systems work because of the adoption of best practices by public companies within a framework of laws and regulations.

The collapse of Enron is a profound and troubling exception to the overall record of success. Other, less dramatic exceptions also may exist among the thousands of United States public corporations. But these are exceptions in systems that generally have worked very well.

In light of the public interest in issues growing out of the Enron situation, The Business Roundtable has articulated several principles that we believe should guide corporate governance. We submit that any changes you consider in the listing standards of the Exchange should be developed in accordance with these core principles.

First, the paramount duty of the board of directors of a public corporation is to select and oversee competent and ethical management to run the company on a day-to-day basis.

Second, it is the responsibility of management to operate the company in a competent and ethical manner. Senior management is expected to know how the company earns its income and what risks the company is undertaking in the course of carrying out its business. Management should never put personal interests ahead of or in conflict with the interests of the company.

Third, it is the responsibility of management, under the oversight of the board and its audit committee, to produce financial statements that fairly present the financial condition of the company and make sufficient disclosures to investors to permit them to assess the financial and business soundness of the company.

Fourth, it is the responsibility of the board and its audit committee to engage an outside auditor to audit the financial statements prepared by management and to issue an opinion on those statements based on Generally Accepted Accounting Principles. The board, its audit committee and management must be vigilant to ensure that the corporation or its employees do not take any actions that compromise the independence of the outside auditor.

Fifth, it is the responsibility of the outside auditor to ensure that it is in fact independent, is without conflicts of interest, employs highly competent staff, and carries out its work in accordance with Generally Accepted Auditing Standards. It is also the responsibility of the outside auditor to inform the board, through its audit committee, of any concerns it may have about the appropriateness and quality of significant accounting treatments, business transactions, and about any weaknesses in internal control systems. The outside auditor should do so in a forthright manner and on a timely basis, whether or not management has communicated to the board or the audit committee on the same matters.

Finally, the company has a responsibility to deal with its employees in a fair and equitable manner. Employee benefit plans, once established, should be operated in a manner that is fair and equitable to all employees.

These core responsibilities are critical to the functioning of the modern public corporation. We believe that no law, regulation or listing standard alone can be a substitute for the voluntary adherence to these principles by corporate directors and management.

American businesses already are responding to lessons drawn from Enron's collapse. Corporate boards of directors are taking steps to assure themselves, stockholders, employees and the public that Enron-like failures will not occur at their companies. In addition, directors are insisting that corporate managers and outside auditors carefully review the quality of corporate financial disclosures and the effectiveness of internal controls.

Several thoughtful proposals have been offered to create new regulations or laws addressing what appear to be breaches of trust and failures of responsibility at Enron. The President recently announced his ten-point plan to improve corporate accountability, and Members of Congress have introduced legislation with the same goal in mind. SEC Chairman Pitt, in his letter of February 12 to the chief executives of the major securities markets, has asked that specific listing standard enhancements be considered. Your committee may propose these or other revisions.

The Business Roundtable agrees that some regulatory or listing standard changes may be necessary or advisable. At the same time, however, we must take care that our responses to the unusual circumstances presented by Enron do not inhibit the ability of U.S. public corporations to compete, create jobs and generate economic growth.

We would also caution against regarding the establishment of new processes or procedures as a panacea; instead, we would recommend that focus be on setting forth broad principles of corporate governance.

The Business Roundtable looks forward to working closely with the Exchange and other policymakers to help strengthen corporate governance. On behalf of The Business Roundtable and its member companies, thank you for the opportunity to participate in these important deliberations.

Statement of The Business Roundtable
On Corporate Governance Principles
Relating to the Enron Bankruptcy

February 11, 2002

The Business Roundtable (BRT) believes that the actions and behaviors, revealed in the report of the special committee of the Enron Board of Directors, which contributed to the collapse of the company, are unacceptable. The report describes a pervasive breakdown in the norms of ethical behavior, corporate governance and corporate responsibility to external and internal stakeholders. The Enron situation appears at this point to derive fundamentally from a massive breach of trust.

The United States has the best corporate governance, financial reporting, and securities markets systems in the world. These systems work because of the adoption of best practices by public companies within a framework of laws and regulations. The collapse of the Enron Corporation is a profound and troubling exception to the overall record of success. Other less dramatic exceptions may also exist among the thousands of United States public corporations – but they are exceptions in systems that have generally worked very well.

Since 1990, the BRT has been an authoritative voice on issues of corporate governance. Most recently, in 1997, the BRT published its Statement on Corporate Governance, which suggests best practices in areas such as the functions of the board of directors, board structure and operations, and stockholders meetings. Over the years large corporations have increasingly adopted these practices. In light of recent events, the BRT will expedite an updating of the Statement to deal with many of the issues currently under discussion.

In light of the public interest in issues growing out of the Enron situation, we believe it is necessary to restate here our understanding of some guiding principles of corporate governance that should form the basis for considering any proposed changes in practices, regulations and laws.

First, the paramount duty of the board of directors of a public corporation is to select and oversee competent and ethical management to run the company on day-to-day basis.

Second, it is the responsibility of management to operate the company in a competent and ethical manner. Senior management is expected to know how the company earns its income and what risks the company is undertaking in the course of carrying out its business. Management should never put personal interests ahead of or in conflict with the interests of the company.

Third, it is the responsibility of management, under the oversight of the board and its audit committee, to produce financial statements that fairly present the financial condition of the company and make sufficient disclosures to investors to permit them to assess the financial and business soundness of the company.

Fourth, it is the responsibility of the board and its audit committee to engage an independent accounting firm to audit the financial statements prepared by management and to issue an opinion on those statements based on Generally Accepted Accounting Principles. The board, its audit committee and management must be vigilant to ensure that no actions are taken by the corporation or its employees that compromise the independence of the independent accounting firm.

Fifth, it is the responsibility of the independent accounting firm to ensure that it is in fact independent, is without conflicts of interest, employs highly competent staff, and carries out its work in accordance with Generally Accepted Auditing Standards. It is also the responsibility of the independent accounting firm to inform the board, through its audit committee, of any concerns it may have about the appropriateness and quality of significant accounting treatments, business transactions, and about any weaknesses in internal control systems. The firm should do so in a forthright manner and on a timely basis, whether or not management has communicated to the board or the audit committee on the same matters.

Sixth, the company has a responsibility to deal with its employees in a fair and equitable manner. Employee benefit plans, once established, should be operated in a manner that is fair and equitable to all employees.

These responsibilities, and others, are critical to the functioning of the modern public corporation. No law or regulation alone can be a substitute for the voluntary adherence to these principles by corporate directors and management and by the accounting firms retained to serve American corporations.

Many proposals will no doubt be offered to create new regulations or laws to deal with what appear to be breaches of trust and failures of responsibility at Enron. We must all take care that responses to the unusual circumstances presented by Enron do not inhibit U.S. public corporations' ability to compete, create jobs and generate economic growth. The Business Roundtable is reviewing corporate governance principles and procedures and will work closely with policymakers to help ensure that any necessary changes to laws and regulations are effective and efficient.

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The Business Roundtable is an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees in the United States and $3.5 trillion in revenues. The chief executives are committed to advocating public policies that foster vigorous economic growth and a dynamic global economy.

Principles of Corporate Governance

May 2002

THE BUSINESS ROUNDTABLE
AN ASSOCIATION OF CHIEF EXECUTIVE OFFICERS COMMITTED TO IMPROVING PUBLIC POLICY

Principles of Corporate Governance

A White Paper from The Business Roundtable

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Foreword and Introduction

The Business Roundtable is recognized as an authoritative voice on matters affecting American business corporations and, as such, has a keen interest in corporate governance. The Business Roundtable is an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees in the United States and $3.5 trillion in revenues. The chief executives are committed to advocating public policies that foster vigorous economic growth, a dynamic global economy, and a well-trained and productive U.S. workforce essential for future competitiveness.

Past publications of The Business Roundtable that have addressed corporate governance include our Statement on Corporate Governance (September 1997); Executive Compensation/Share Ownership (March 1992); Corporate Governance and American Competitiveness (March 1990); Statement on Corporate Responsibility (October 1981); and The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation (January 1978). We are pleased to note that, in the five years since our 1997 Statement was published, many of the practices we suggested at that time have become common.

The United States has the best corporate governance, financial reporting, and securities markets systems in the world. These systems work because of the adoption of best practices by public companies within a framework of laws and regulations. While there have been exceptions to the overall record of success, generally the systems have worked very well.

Given the accelerated nature of change, innovation and progress in the U.S. and global markets, and in light of notable exceptions to a system that has generally worked well, The Business Roundtable believes it is appropriate to restate our guiding principles of corporate governance. These principles, we believe, should help to guide the continual advancement of corporate governance practices, and so advance the ability of U.S. public corporations to compete, create jobs and generate economic growth.

The Business Roundtable supports the following guiding principles:

First, the paramount duty of the board of directors of a public corporation is to select a Chief Executive Officer and to oversee the CEO and other senior management in the competent and ethical operation of the corporation on a day-to-day basis.

Second, it is the responsibility of management to operate the corporation in an effective and ethical manner in order to produce value for stockholders. Senior management is expected to know how the corporation earns its income and what risks the corporation is undertaking in the course of carrying out its business. Management should never put personal interests ahead of or in conflict with the interests of the corporation.

Third, it is the responsibility of management, under the oversight of the board and its audit committee, to produce financial statements that fairly present the financial condition and results of operations of the corporation, and to make the timely disclosures investors need to permit them to assess the financial and business soundness and risks of the corporation.

Fourth, it is the responsibility of the board and its audit committee to engage an independent accounting firm to audit the financial statements prepared by management and to issue an opinion on those statements based on Generally Accepted Accounting Principles. The board, its audit committee and management must be vigilant to ensure that no actions are taken by the corporation or its employees that compromise the independence of the outside auditor.

Fifth, it is the responsibility of the independent accounting firm to ensure that it is in fact independent, is without conflicts of interest, employs highly competent staff, and carries out its work in accordance with Generally Accepted Auditing Standards. It is also the responsibility of the independent accounting firm to inform the board, through the audit committee, of any concerns the auditor may have about the appropriateness or quality of significant accounting treatments, business transactions that affect the fair presentation of the corporation's financial condition and results of operations, and weaknesses in internal control systems. The auditor should do so in a forthright manner and on a timely basis, whether or not management has also communicated to the board or the audit committee on these matters.

Sixth, the corporation has a responsibility to deal with its employees in a fair and equitable manner.

These responsibilities, and others, are critical to the functioning of the modern public corporation and the integrity of the public markets. No law or regulation alone can be a substitute for the voluntary adherence to these principles by corporate directors and management and by the accounting firms retained to serve American corporations.

The Business Roundtable continues to believe that the most effective way to enhance corporate governance is through conscientious and forward-looking action by a business community that focuses on generating long-term stockholder value with the highest degree of integrity.

The principles discussed here are intended to assist corporate management and boards of directors in their individual efforts to implement best practices of corporate governance, and also to serve as guideposts for the public dialogue on evolving governance standards.

I. Key Corporate Actors

Effective corporate governance requires a clear understanding of the respective roles of the board and of senior management and their relationships with others in the corporate structure.

Effective corporate governance requires a clear understanding of the respective roles of the board and of senior management and their relationships with others in the corporate structure. The relationships of the board and management with stockholders should be characterized by candor; their relationships with employees should be characterized by fairness; their relationships with the communities in which they operate should be characterized by good citizenship; and their relationships with government should be characterized by a commitment to compliance.

Senior management, led by the Chief Executive Officer, is responsible for running the day-to-day operations of the corporation and properly informing the board of the status of such operations. Management's responsibilities include strategic planning, risk management, and financial reporting.

The board of directors has the important role of overseeing management performance on behalf of stockholders. Its primary duties are to select and oversee a well qualified and ethical CEO who, with senior management, runs the corporation on a daily basis, and to monitor management's performance and adherence to corporate standards. Effective corporate directors are diligent monitors, but not managers, of business operations.

Stockholders necessarily have little voice in the day-to-day management of corporate operations, but have the right to elect representatives (directors) to look out for their interests, and to receive the information they need to make investment and voting decisions.

Effective corporate governance requires a proactive, focused state of mind on the part of directors, the CEO and senior management, who all must be committed to business success through maintenance of the highest standards of responsibility and ethics. Good governance is far more than a "check-the-box" list of minimum board and management policies and duties. Even the most thoughtful and well-drafted policies and procedures are destined to fail if directors and management are not committed to enforcing them in practice. A good corporate governance structure is a working system for principled goal-setting, effective decision-making and appropriate monitoring of compliance and performance. Through such a vibrant and responsive structure, the CEO, the management team and the board of directors can interact effectively and respond quickly to changing circumstances, within a framework of solid corporate values, to provide enduring value to the stockholders who invest in the enterprise.

II. The Roles of the Board of Directors and Management

An effective system of corporate governance provides the framework within which the board and management address their respective responsibilities.

The Board of Directors

- The business of a corporation is managed under the direction of the corporation's board. The board delegates to the CEO, and through him or her to other senior management, the authority and responsibility for managing the everyday affairs of the corporation. Directors monitor management on behalf of the corporation's stockholders.

The selection, compensation and evaluation of a well qualified and ethical CEO is the single most important function of the board.

- The selection, compensation and evaluation of a well qualified and ethical CEO is the single most important function of the board. The board also appoints or approves other members of the senior management team.

- Directors bring to the corporation a range of experience, knowledge and judgment. Directors should not represent the interests of particular constituencies.

- Effective directors maintain an attitude of constructive skepticism; they ask incisive, probing questions and require accurate, honest answers; they act with integrity; and they demonstrate a commitment to the corporation, its business plans and long-term stockholder value.

- In performing its oversight function, the board is entitled to rely on the advice, reports and opinions of management, counsel, auditors and expert advisors. The board should assess the qualifications of those it relies on and hold managers and advisors accountable. The board should ask questions and obtain answers about the processes used by managers and advisors to reach their decisions and recommendations and about the substance of the advice and reports received by the board.

- Given the board's oversight role, stockholders and other constituencies can reasonably expect that directors will exercise vigorous and diligent oversight over a corporation's affairs. However, they should not expect the board to micromanage the corporation's business by performing or duplicating the tasks of the CEO and the senior management team.

- The board's oversight function carries with it a number of specific responsibilities in addition to that of selecting the CEO. These include responsibility for:

  - *Planning for management succession.* The board should plan for CEO and senior management succession and, when appropriate, replace the CEO or other members of senior management.

  - *Understanding, reviewing and monitoring implementation of the corporation's strategic plans.* The board has responsibility for overseeing and understanding the corporation's strategic plans from their inception through their development and execution by management. Once the board reviews a strategic plan, the board should regularly monitor implementation of the plan to determine whether it is being implemented effectively and whether changes are needed.

  - *Understanding and reviewing annual operating plans and budgets.* The board has responsibility for overseeing and understanding the corporation's annual operating plans and for reviewing the annual budgets presented by management. The board should monitor implementation of the annual plans to assess whether they are being implemented effectively and within the limits of approved budgets.

The board and its audit committee should take reasonable steps to be comfortable that the corporation's financial statements and other disclosures accurately present the corporation's financial condition and results of operations to stockholders, and that they do so in an understandable manner.

  - *Focusing on the integrity and clarity of the corporation's financial statements and financial reporting.* While financial reports are primarily the responsibility of management, the board and its audit committee should take reasonable steps to be comfortable that the corporation's financial statements and other disclosures accurately present the corporation's financial condition and results of operations to stockholders, and that they do so in an understandable manner. In order to do this, the board, through its audit committee, should have a broad understanding of the corporation's financial statements, including why the accounting principles critical to the corporation's business were chosen, what key judgments and estimates were made by management, and how the choice of principles, and the making of such judgments and estimates, impacts the reported financial results of the corporation.

- *Engaging outside auditors and considering independence issues.* The board, through its audit committee, bears responsibility for engaging an outside auditor to audit the corporation's financial statements and for ongoing communications with the outside auditor. The board, through its audit committee, should periodically consider the independence and continued tenure of the auditor.

- *Advising management on significant issues facing the corporation.* Directors can offer management a wealth of experience and a wide range of perspectives. They provide advice and counsel to management in formal board and committee meetings and are available for informal consultation with the CEO and senior management.

- *Reviewing and approving significant corporate actions.* As required by state corporate law, the board reviews and approves specific corporate actions, such as the election of executive officers, declaration of dividends and appropriate major transactions. The board and senior management should have a clear understanding of what level or types of decisions require specific board approval.

- *Nominating directors and committee members and overseeing effective corporate governance.* It is the responsibility of the board and its corporate governance committee to nominate directors and committee members and to oversee the composition, structure, practices and evaluation of the board and its committees.

The CEO and Management

- It is the responsibility of the CEO, and of senior management under the CEO's direction, to operate the corporation in an effective and ethical manner.

- The governance model followed by most public corporations in the United States has historically been one of individual, rather than group, leadership. U.S. corporations have traditionally vested responsibility in the CEO as the leader of management rather than diffusing high-level responsibility among several individuals. The Business Roundtable believes that this model has generally served corporations well.

The CEO and senior management run the corporation's day-to-day business operations.

- The CEO should be aware of the major risks and issues that the corporation faces and is responsible for supervising the corporation's financial reporting processes. For example, the CEO is responsible for providing stockholders and others with information that the CEO believes is important to understanding the corporation's business. Of course, the CEO necessarily relies on the expert advice of others on technical questions and legal requirements.

- As part of its operational responsibility, senior management is charged with:

  - *Operating the corporation.* The CEO and senior management run the corporation's day-to-day business operations. With a thorough understanding of how the corporation operates and earns its income, they carry out the corporation's strategic objectives within the annual operating plans and budgets reviewed by the board.

  - *Strategic planning.* The CEO and senior management generally take the lead in strategic planning. They identify and develop strategic plans for the corporation; present those plans to the board; implement the plans once board review is completed; and recommend and carry out changes to the plans as necessary.

  - *Annual operating plans and budgets.* With the corporation's overall strategic plans in mind, senior management develops annual operating plans and annual budgets for the corporation, and the CEO presents those plans and budgets to the board. Once board review is completed, the management team implements the annual operating plans and budgets.

  - *Selecting qualified management and establishing an effective organizational structure.* Senior management is responsible for selecting qualified management and for implementing an organizational structure that is efficient and appropriate for the corporation's particular circumstances.

  - *Identifying and managing risks.* Senior management identifies and manages the risks that the corporation undertakes in the course of carrying out its business. It also manages the corporation's overall risk profile.

  - *Good financial reporting.* Senior management is responsible for the integrity of the corporation's financial reporting system. It is senior management's responsibility to put in place and supervise the operation of systems that allow the corporation to produce financial statements that fairly present the corporation's financial condition and thus permit investors to understand the business and financial soundness and risks of the corporation.

The CEO should be a person of integrity who takes responsibility for the corporation adhering to the highest ethical standards.

- The CEO and senior management are responsible for operating the corporation in an ethical manner. They should never put individual, personal interests before those of the corporation or its stockholders. In carrying out this function, The Business Roundtable believes that corporations should have:

  - *A CEO of integrity.* The CEO should be a person of integrity who takes responsibility for the corporation adhering to the highest ethical standards.

  - *A strong, ethical "tone at the top."* Senior management, and particularly the CEO, should set a "tone at the top" that establishes a culture of legal compliance and integrity communicated to personnel at all levels of the corporation.

- *Internal controls.* A corporation should have an effective system of internal controls providing reasonable assurance that the corporation's books and records are accurate, that its assets are safeguarded and that it complies with applicable laws. The internal controls system should be periodically evaluated and updated so that it continues to be effective in a changing environment.

A corporation should have a code of conduct with effective reporting and enforcement mechanisms.

- *Codes of conduct.* A corporation should have a code of conduct with effective reporting and enforcement mechanisms. Employees should have a means of alerting management and the board to potential misconduct without fear of retribution, and violations of the code should be addressed promptly and effectively.

III. How the Board Performs Its Oversight Function

Publicly owned corporations employ diverse approaches to board structure and operations, and no one structure is right for every corporation. Nevertheless, The Business Roundtable believes that the corporate governance "best practices" set forth in the following sections provide an effective approach for corporations to follow.

Board Composition and Leadership

- Boards of directors of large, publicly owned corporations vary in size from industry to industry and from corporation to corporation. In determining board size, directors should consider the nature, size, and complexity of the corporation as well as its stage of development. The experience of many Roundtable members suggests that smaller boards are often more cohesive and work more effectively than larger boards.

- The Business Roundtable believes that having directors with relevant business and industry experience is beneficial to the board as a whole. Directors with such backgrounds can provide a useful perspective on significant risks and competitive advantages and an understanding of the challenges facing the business. Because the corporation's need for particular backgrounds and experiences may change over time, the board should monitor the mix of skills and experience that directors bring to the board to assess, at each stage in the life of the corporation, whether the board has the necessary tools to perform its oversight function effectively.

- The board of a publicly owned corporation should have a substantial degree of independence from management. Board independence depends not only on directors' individual relationships – personal, employment or business – but also on the board's overall attitude toward management. Providing objective independent judgment is at the core of the board's oversight function, and the board's composition should reflect this principle.

  A substantial majority of directors of the board of a publicly owned corporation should be independent of management, both in fact and appearance.

- *Board independence.* A substantial majority of directors of the board of a publicly owned corporation should be independent of management, both in fact and appearance, as determined by the board.

- *Assessing independence.* An independent director should be free of any relationship with the corporation or its management that may impair, or appear to impair, the director's ability to make independent judgments. The listing standards of the major securities markets relating to audit committees provide useful guidance in determining whether a particular director is "independent." These standards focus primarily on familial, employment and business relationships. However, boards of directors should also consider whether other kinds of relationships, such as close personal relationships between potential board members and senior management, may affect a director's actual or perceived independence.

- *Relationships with not-for-profit organizations.* Some observers have questioned the independence of directors who have relationships with non-affiliated not-for-profit organizations that receive support from corporations. The Business Roundtable believes that such relationships and their effect on a director's independence should be assessed by the board or its corporate governance committee on a case-by-case basis, taking into account the size of the corporation's contributions to the not-for-profit organization and the nature of the director's relationship to the organization. Independence issues are most likely to arise where a director is an employee of the not-for-profit organization and where a substantial portion of the organization's funding comes from the corporation. By contrast, where a director merely serves on the board of a not-for-profit organization with broad community representation, there may be no meaningful independence issues.

Most American corporations are well served by a structure in which the CEO also serves as chairman of the board.

- Most American corporations are well served by a structure in which the CEO also serves as chairman of the board. The CEO serves as a bridge between management and the board, ensuring that both act with a common purpose. Some corporations have found it useful to separate the roles of CEO and chairman of the board to provide continuity of leadership in times of transition. Each corporation should make its own determination of what leadership structure works best, given its present and anticipated circumstances. The board should have contingency plans to provide for transitional board leadership if questions arise concerning management's conduct, competence, or integrity or if the CEO dies or is incapacitated. An individual director, a small group of directors, or the chairman of a committee may be selected by the board for this purpose.

Board Organization

- Virtually all boards of directors of large, publicly owned corporations operate using committees to assist them. A committee structure permits the board to address key areas in more depth than may be possible in a full board meeting.

- Decisions about committee membership should be made by the full board, based on recommendations from a committee responsible for corporate governance issues. The board should designate the chairmen of the various committees, if this is not done by the committees themselves.

- Committees should apprise the full board of their activities on a regular basis. Processes should be developed and monitored for keeping the board informed through oral or written reports.

- The Business Roundtable believes that the functions generally performed by the audit, compensation and corporate governance committees are central to effective corporate governance. The Business

Roundtable does not believe, however, that a particular committee structure is essential for all corporations. What is important is that key issues be addressed effectively by the independent members of the board. Thus, the references below to the functions performed by particular committees are not intended to preclude corporations from allocating these functions differently.

- Other committees, such as executive or finance committees, also may be used. Some corporations find it useful to establish additional committees to examine special problems or opportunities in greater depth than would otherwise be feasible.

- The responsibilities of each committee should be clearly defined and understood. A written charter approved by the board, or a board resolution establishing the committee, is appropriate.

Audit Committee

Every publicly owned corporation should have an audit committee comprised solely of independent directors.

- *Every publicly owned corporation should have an audit committee comprised solely of independent directors.*

- Audit committees typically consist of 3 to 5 members. The listing standards of the major securities markets require audit committees and require that an audit committee have at least 3 members and that all members of the audit committee qualify as independent under the applicable listing standards, subject to limited exceptions.

- Audit committee members should meet minimum financial literacy standards, and at least one of the committee members should have accounting or financial management expertise, as required by the listing standards of the major securities markets. However, more important than financial expertise is the ability of audit committee members, as with all directors, to understand the corporation's business and risk profile, and to apply their business experience and judgment to the issues for which the committee is responsible with an independent and critical eye.

- The audit committee is responsible for oversight of the corporation's financial reporting process. The primary functions of the audit committee are the following:

  - *Risk profile.* The audit committee should understand the corporation's risk profile and oversee the corporation's risk assessment and management practices.

The selection of an outside auditor should involve an annual due diligence process in which the audit committee reviews the qualifications, work product, independence and reputation of the proposed outside auditor.

  - *Outside auditors.* The audit committee is responsible for supervising the corporation's relationship with its outside auditor, including recommending to the full board the firm to be engaged as the outside auditor, evaluating the auditor's performance, and considering whether it would be appropriate for the outside auditor periodically to rotate senior audit personnel or for the corporation periodically to change its outside auditor. The selection of an outside auditor should involve an annual due diligence process in which the audit committee reviews the qualifications, work product, independence and reputation of the proposed outside auditor. The audit committee should base its decisions about selecting and possibly changing the outside auditor on its assessment of what is likely to lead to more effective audits. Based on its due diligence, the audit committee should make an annual recommendation to the full board about the selection of the outside auditor.

- *Independence.* The audit committee should consider the independence of the outside auditor and should develop policies concerning the provision of non-audit services by the outside auditor. The provision of some types of audit-related and consulting services by the outside auditor may not be inconsistent with independence or the attestation function. In considering whether the outside auditor should provide certain types of non-audit services, the audit committee should consider the degree of review and oversight that may be appropriate for new and existing services. When making independence judgments, the audit committee should consider the nature and dollar amount of all services provided by the outside auditor.

- *Critical accounting judgments and estimates.* The audit committee should review and discuss with management and the outside auditor the corporation's critical accounting policies and the quality of accounting judgments and estimates made by management.

- *Internal controls.* The audit committee should understand and be familiar with the corporation's system of internal controls and on a periodic basis should review with both internal and outside auditors the adequacy of this system.

- *Compliance.* Unless the full board or another committee does so, the audit committee should review the corporation's procedures addressing compliance with the law and important corporate policies, including the corporation’s code of ethics or code of conduct.

- *Financial statements.* The audit committee should review and discuss the corporation's annual financial statements with management and the outside auditor and, based on these discussions, recommend that the board approve the financial statements for publication and filing. Most audit committees also find it advisable to implement processes for the committee or its designee to review the corporation's quarterly financial statements prior to release.

- *Internal audit function.* The audit committee oversees the corporation's internal audit function, including review of reports submitted by the internal audit staff, and reviews the appointment and replacement of the senior internal auditing executive.

- *Communication.* The audit committee should provide a channel of communication to the board for the outside auditor and internal auditors and may also meet with and receive reports from finance officers, compliance officers and the general counsel.

- *Hiring auditor personnel.* Under audit committee supervision, some corporations have implemented "revolving door" policies covering the hiring of auditor personnel. For example, these policies may impose "cooling off" periods prohibiting employment by the corporation in senior financial management positions of members of the audit engagement team for some period of time after their work as auditors for the corporation. The audit committee should consider whether to adopt such a policy. Any policy on the hiring of auditor personnel should be flexible enough to allow exceptions, but only when specifically approved by the audit committee.

Audit committee meetings should be held frequently enough to allow the committee to appropriately monitor the annual and quarterly financial reports.

- Audit committee meetings should be held frequently enough to allow the committee to appropriately monitor the annual and quarterly financial reports. For many corporations, this means four or more meetings a year. Meetings should be scheduled with enough time to permit and encourage active discussions with management and the internal and outside auditors. The audit committee should meet with the internal and outside auditors, without management present, at every meeting and communicate with them between meetings as necessary. Some audit committees may decide that specific functions, such as quarterly review meetings with the outside auditor or management, can be delegated to the audit committee chairman or other members of the audit committee.

Corporate Governance Committee

- *Every publicly owned corporation should have a committee that addresses corporate governance issues.* A corporate governance committee (often combined with, or referred to as, a nominating committee) is central to the effective functioning of the board. Traditionally, the corporate governance/nominating committee's role was to recommend director nominees to the full board and the corporation's stockholders. Over time, the committee's role has expanded so that, today, it typically provides a leadership role in shaping the corporate governance of a corporation.

A corporate governance committee should be comprised solely of independent directors.

- *A corporate governance committee should be comprised solely of independent directors.* While the CEO typically works closely with the corporate governance committee, a committee made up exclusively of independent directors reinforces the idea that the governance processes of the corporation are under the control of the board, as representatives of the stockholders.

- *A corporate governance committee performs the core function of recommending nominees to the board. The committee also recommends directors for appointment to committees of the board.* These responsibilities include establishing criteria for board and committee membership, considering rotation of committee members, reviewing candidates' qualifications and any potential conflicts with the corporation's interests, assessing the contributions of current directors in connection with their renomination, and making recommendations to the full board. The committee also should develop a process for considering stockholder suggestions for board nominees. While it is appropriate for the CEO to meet with potential director nominees, the final responsibility for selecting director nominees rests with the board.

- *A corporate governance committee should monitor and safeguard the independence of the board.* The Business Roundtable believes that an important function of a corporate governance committee, related to its core function of recommending nominees to the board, is to ensure that a substantial majority of the directors on the board are, in both fact and appearance, independent of management.

- *A corporate governance committee should oversee and review the corporation's processes for providing information to the board.* A corporate governance committee should assess the reporting channels through which the board receives information, and the quality and timeliness of information received, so that the board obtains appropriately detailed information in a timely fashion.

- *A corporate governance committee should develop and recommend to the board a set of corporate governance principles applicable to the corporation.* These principles should be communicated to the corporation's stockholders and should be readily available to prospective investors and other interested persons.

- *A committee comprised of independent directors should oversee the evaluation of the board and management.* Specifics concerning the evaluation process are discussed below under "Board and Management Evaluation."

Compensation Committee

- *Every publicly owned corporation should have a committee comprised solely of independent directors that addresses compensation issues.* A compensation committee has two interrelated responsibilities: overseeing the corporation's overall compensation programs, and setting CEO and senior management compensation.

  A compensation committee should look . . . at the overall compensation structure of the enterprise to determine that it establishes appropriate incentives for management and employees at all levels.

- *Overall compensation structure.* In addition to reviewing and setting compensation for management, a compensation committee should look more broadly at the overall compensation structure of the enterprise to determine that it establishes appropriate incentives for management and employees at all levels. In doing so, the committee should understand that incentives are industry-dependent and are different for different categories of people. All incentives should further the corporation's long-term strategic plan and should be consistent with the culture of the corporation and the overall goal of enhancing enduring stockholder value.

- *A diverse mix of compensation for the board and management can foster the right incentives and prevent a short-term focus or a narrow emphasis on particular aspects of the corporation's business.*

  - *Trend toward equity compensation for directors and management.* In recent years, many corporations have increasingly moved toward compensating directors and management with stock options and other equity compensation geared to the corporation's stock price. While this trend may align director and management interests with stockholder value, equity compensation should be carefully designed to avoid unintended incentives such as an undue emphasis on short-term market value changes.

  - *Management compensation.* Management compensation practices will necessarily differ for different corporations. Generally, however, an appropriate compensation package for management includes a carefully determined mix of long- and short-term incentives. Management compensation packages should be designed to create a commensurate level of risk and opportunity based on business and individual performance. The structure of management compensation should directly link the interests of management, both individually and as a team, to the long-term interests of stockholders.

  - *Management benefits.* A compensation committee should consider whether the benefits provided to senior management, including post-employment benefits, are proportional to the contributions made by management.

Board Operations

- Serving on a board requires significant time and attention on the part of directors. Directors must participate in board meetings, review relevant materials, serve on board committees, and prepare for meetings and for discussions with management. They must spend the time needed and meet as frequently as necessary to properly discharge their responsibilities. The appropriate number of hours to be spent by a director on his or her duties and the frequency and length of board meetings depend largely on the complexity of the corporation and its operations. Longer meetings may permit directors to explore key issues in depth, whereas shorter but more frequent meetings may help directors stay up-to-date on emerging corporate trends and business and regulatory developments. When arranging a meeting schedule for the board, each corporation should consider the nature and complexity of its operations and transactions, as well as its business and regulatory environment.

Directors should be incentivized to focus on long-term stockholder value.

- Directors should be incentivized to focus on long-term stockholder value. Including equity as part of directors' compensation helps align the interests of directors with those of the corporation's stockholders. Accordingly, a meaningful portion of a director's compensation should be in the form of long-term equity. Corporations may wish to consider establishing a requirement that, for as long as directors remain on the board, they acquire and hold stock in an amount that is meaningful and appropriate to each director.

- The Business Roundtable does not endorse a specific limitation on the number of directorships an individual may hold. However, service on too many boards can interfere with an individual's ability to perform his or her responsibilities. Before accepting an additional board position, a director should consider whether the acceptance of a new directorship will compromise the ability to perform present responsibilities. It also is good practice for directors to notify each board on which they serve before accepting a seat on the board of another business corporation, in order to avoid potential conflicts. Similarly, the corporation should establish a process to review senior management service on other boards prior to acceptance.

Independent directors should have the opportunity to meet outside the presence of the CEO and any other management directors.

- Independent directors should have the opportunity to meet outside the presence of the CEO and any other management directors.

- Many board responsibilities may be delegated to committees to permit directors to address key areas in more depth. Regardless of whether the board grants plenary power to its committees with respect to particular issues or prefers to take recommendations from its committees, committees should keep the full board informed of their activities. Corporations benefit greatly from the collective wisdom of the entire board acting as a deliberative body, and the interaction between committees and the full board should reflect this principle.

- The board's agenda must be carefully planned, yet flexible enough to accommodate emergencies and unexpected developments. The chairman of the board should be responsive to individual directors' requests to add items to the agenda, and open to suggestions for improving the agenda. Importantly, the agenda and meeting schedule must permit adequate time for discussion and a healthy give-and-take between board members and management.

- Management presentations should be scheduled to allow for question-and-answer sessions and open discussion of key policies and practices. Board members should have full access to senior management. Generally, the CEO should be advised of significant contacts between board members and senior management.

- The board must have accurate, complete information to do its job; the quality of information received by the board directly affects its ability to perform its oversight function effectively. Directors should be provided with, and review, information from a variety of sources, including management, board committees, outside experts, auditor presentations, and analyst and media reports. The board should be provided with information before board and committee meetings with sufficient time to review and reflect on key issues and to request supplemental information as necessary.

- Many corporations provide new directors with materials and briefings to permit them to become familiar with the corporation's business, industry and corporate governance practices. The Business Roundtable believes that it is appropriate for corporations to provide additional educational opportunities to directors on an ongoing basis to enable them to better perform their duties and to recognize and deal appropriately with issues that arise.

- From time to time, it may be appropriate for boards and board committees to seek advice from outside advisors independent of management with respect to matters within their responsibility. For example, there may be technical aspects of the corporation's business – such as risk assessment and risk management – or conflict of interest situations for which the board or a committee determines that additional expert advice would be useful. Similarly, a compensation committee may find it useful to engage separate compensation consultants. The Business Roundtable believes that board and committee access to outside advisors in such cases is an important element of an effective corporate governance system.

Board and Management Evaluation

The board should have an effective mechanism for evaluating performance on a continuing basis.

- *The board should have an effective mechanism for evaluating performance on a continuing basis.* Meaningful board evaluation requires an assessment of the effectiveness of the full board, the operations of board committees and the contributions of individual directors.

    - *The performance of the full board should be evaluated annually, as should the performance of its committees.* The board should conduct periodic – generally annual – self-evaluations to determine whether it and its committees are following the procedures necessary to function effectively.

    - *The board should have a process for evaluating whether the individuals sitting on the board bring the skills and expertise appropriate for the corporation and how they work as a group.* Board positions should not be regarded as permanent. Directors should serve only so long as they add value to the board, and a director's ability to continue to contribute to the board should be considered each time the director is considered for renomination.

Planning for the departure of directors and the designation of new board members is essential.

- *Planning for the departure of directors and the designation of new board members is essential.* The board should establish procedures for the retirement or replacement of board members. Such procedures may, for example, include a mandatory retirement age, a term limit, and/or a requirement that directors who change their primary employment tender a board resignation, providing an opportunity for the corporate governance committee to consider the desirability of their continued service on the board.

- *Planning for management succession is also critical.* The board or its corporate governance committee should identify, and periodically update, the qualities and characteristics necessary for an effective CEO. With these principles in mind, the board or committee should periodically monitor and review the development and progression of potential internal candidates against these standards. Advance planning for contingencies such as the departure, death or disability of the CEO or other top executives is also critical so that, in the event of an untimely vacancy, the corporation has in place an emergency succession plan to facilitate the transition to both interim and longer-term leadership.

- *Under the oversight of a committee comprised of independent directors, the board should annually review the performance of the CEO and should participate with the CEO in the evaluation of members of senior management.* All non-management members of the board should participate with the CEO in senior management evaluations. The results of the CEO's evaluation should be promptly communicated to the CEO by representatives of the non-management directors.

IV. Relationships with Stockholders and Other Constituencies

Corporations are often said to have obligations to stockholders and to other constituencies, including employees, the communities in which they do business, and government, but these obligations are best viewed as part of the paramount duty to optimize long-term stockholder value. The Business Roundtable believes that stockholder value is enhanced when a corporation treats its employees well, serves its customers well, maintains good relationships with suppliers, and has a reputation for civic responsibility and legal compliance.

Stockholders and Investors

The goal of stockholder communications should be to help stockholders understand the business, risk profile, financial condition, and operating performance and trends of the corporation.

- Corporations have a responsibility to communicate effectively and candidly with stockholders. The goal of stockholder communications should be to help stockholders understand the business, risk profile, financial condition, and operating performance and trends of the corporation.

- Corporations communicate with investors and other constituencies not only in proxy statements, annual and other reports and formal stockholder meetings, but in many other ways. All of these communications should provide consistency, clarity and candor.

- In planning communications with stockholders and investors, corporations should consider:

    - *Candor*. Directors and management should never mislead or misinform stockholders about the corporation's operations or financial condition.

- *Need for timely disclosure.* In an age of instant communication, there is an increasing need for corporations to disclose significant information closer to the time when it arises and becomes available. The Business Roundtable supports the beneficial trend toward prompt disclosure of significant developments, while recognizing that a current disclosure regime must allow time to reasonably assure accuracy and should not be a basis for new liabilities.

- *Ultimate goal of stockholder communications.* Whatever the substance of the communication, the corporation's ultimate goal should be to furnish information that is honest, intelligible, meaningful, timely and broadly disseminated, and that gives investors a realistic picture of the corporation's financial condition and results of operations through the eyes of management.

Corporations should obtain stockholder approval of new stock option and restricted stock plans in which directors or executive officers participate.

- Because stockholders have a particular interest in the amount and nature of equity compensation paid to directors and senior management, corporations should obtain stockholder approval of new stock option and restricted stock plans in which directors or executive officers participate.

Employees

- It is in a corporation's best interest to treat employees fairly and equitably.

- Corporations should have in place policies and practices that provide employees with compensation, including benefits, that is appropriate given the nature of the corporation's business and employees' job responsibilities and geographic locations.

- When corporations offer retirement, healthcare, insurance and other benefit plans, employees should be fully informed of the terms of those plans.

- Corporations should have in place mechanisms for employees to alert management and the board to allegations of misconduct without fear of retribution.

- Corporations should communicate honestly with their employees about corporate operations and financial performance.

- Technology makes communicating with employees quicker, easier and less expensive. Corporations should take advantage of technological advances to enhance dissemination of information to employees.

Communities

- Corporations have obligations to be good citizens of the local, national and international communities in which they do business. Failure to meet these obligations can result in damage to the corporation, both in immediate economic terms and in longer-term reputational value.

- A corporation should be a good citizen and contribute to the communities in which it operates by making charitable contributions and by encouraging its directors, managers and employees to form relationships with those communities. A corporation also should be active in promoting awareness of health, safety and environmental issues, including any issues that relate to the specific types of business in which the corporation is engaged.

Government

- Corporations, like all citizens, must act within the law. The penalties for serious violations of law can be extremely severe, even life-threatening, for corporations. Compliance is not only appropriate; it is essential. Management should take reasonable steps to develop, implement and maintain effective legal compliance programs and the board should periodically review such efforts to gain reasonable assurance that they are effective.

- Corporations have an important perspective to contribute to the public policy dialogue and should be actively involved in discussions about the development, enactment and revision of the laws and regulations that impact their businesses and that affect the communities in which they operate and their employees reside.

Corporate Accountability and Listing Standards Committee
NYSE
Statement of Nell Minow
Editor, The Corporate Library
April 15, 2002

I am very grateful for the opportunity to meet with you today to discuss the role that the NYSE can play in strengthening the credibility of its listed companies.

As I have reviewed reform proposals from more than a dozen sources, directed at state, federal, and regulatory bodies, it has seemed to me that it is the Exchanges that are in the best position to make changes that are meaningful without being unnecessarily disruptive. I am well aware that it was not the SEC or Congress or state law that brought about one of the most significant improvements in corporate governance, the independent audit committee of the board. It was the NYSE, through its listing standards. I take that as a model for us to aspire to now.

We must keep in mind, however, three caveats. The first is that structural solutions are easily subverted. Enron had an audit committee that appeared from the outside to meet not just the NYSE's minimum standards but best practices. Tinkering with the definition of "independent director" or removing non-independent directors on various committees will have no real impact. "Independent" can mean "indifferent." While it is tempting to impose new requirements about who should be on what committees and how many meetings they should have, that would have little impact on substance. As Shakespeare said,

> "We must not make a scarecrow of the law, setting it up to fear the birds of prey, and let it keep one shape, till custom make it their perch and not their terror." (*Measure for Measure,* Act 2, Scene 1, Line 1)

The second caveat is to consider the law of unintended consequences. We do not want to turn minimum standards into safe harbors. We have to be careful in crafting the listing standards so that instead of imposing obstacles to innovation, they reward it. I believe that the best way to address these two concerns is to change the rules on disclosure rather than structure.

The third caveat is that all of the reform proposals I have seen so far focus on what I call the "supply side" of corporate governance, on what corporations must do. The NYSE must consider these issues from the perspective of the "demand side" to make sure that barriers to shareholder oversight are eliminated.

And one last general point – as we consider reform, we should take advantage of changes in technology that make it easier for management and directors to communicate with investors and investors to communicate with each other.

With that in mind, these are some of the changes I would like to see:

1. Listed companies should be required to include their corporate governance policies and conflict of interest policies in their proxy statements. If they waive those policies at any time, that should be disclosed, along with the reasons for the waiver.

The policies should include provisions governing the sale of company stock (including cashless exercise of options), the schedule of executive session board and committee meetings (meetings without any executives or other representatives of management present), and the procedures for finding new directors.

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

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

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

3. Any online proxy voting system should be required to include all proxies circulated by all parties. Both sides in a proxy contest should have access to the cheaper and more accurate system for counting votes available through ADP. All votes should be counted the same way, especially if there is any form of shareholder initiative, from a proposal to a contest.

4. Companies that exceed minimum standards should benefit, perhaps through some program of certification or a rating system.

5. Improvement of the system for distributing proxy materials is long overdue. Over the years, this system has grown into a cumbersome, complicated and technologically-outdated process. The current fee structure, which is set by the NYSE and approved by the SEC, along with ADP's contracts (some longer than 10 years) with nearly all major brokerage houses ensures the continuation of the current cumbersome system — essentially a self-regulated monopoly. This is especially treacherous in matters like determination of what is and is not "contested." Should it require use of ADP to be considered "contested" if ADP is the entity making the determination? Technology advances should significantly transform this important process.

Finally, I want to endorse the recommendations of the Council of Institutional Investors, particularly those regarding clarifying the definition of independent director, repealing the broker vote provisions, and requiring shareholder approval of all stock option plans.

I thank you again for the opportunity to appear and I hope to be able to continue to work with you on strengthening the trustworthiness of companies that share the honor of a listing on the New York Stock Exchange.

COUNCIL OF INSTITUTIONAL INVESTORS

TESTIMONY
Council of Institutional Investors
April 15, 2002

The Council of Institutional Investors is an organization of some 250 pension funds and investment-related firms responsible for more than $2 trillion of pension assets. A list of Council members is [not] attached. Council members, who are responsible for investing and safeguarding the retirement benefits for tens of millions of individuals, invest most of their pension assets in the U.S. markets. On average, they invest about 45 percent of their portfolios in domestic stocks—many of which are traded on the New York Stock Exchange.

The Council recognizes that it is vitally important for the U.S. capital markets—the model for the rest of the world—to be as competitive, efficient and effective as possible. And we applaud the NYSE's efforts to ensure that it provides a high quality and cost effective marketplace.

But the integrity of the U.S. equities markets is also of paramount importance. And as we've been painfully reminded in recent weeks, a critical component of market effectiveness is investor confidence. Part of that confidence comes from knowing that there are adequate rules—including accounting, disclosure and listing standards—and other safeguards in place to protect investors.

The Enron collapse—the latest in a long line of fraudulent accounting cases in recent years—is another example of the failure of certain safety nets intended to protect investors. The Council believes that strengthening the governance standards mandated by the NYSE is an important, and necessary, step toward repairing some of these frayed safety nets. In several areas, we believe the exchange has been remiss by allowing antiquated and weak corporate governance standards that do not offer adequate protections to investors to continue in place.

According to your listed company manual, a listing on the NYSE is "internationally recognized as signifying that a publicly owned corporation has achieved maturity and front-rank status in its industry—in terms of assets, earnings and shareholder interest and acceptance." We believe that a Big Board listing should also signify that a publicly traded company is complying with the highest possible corporate governance standards.

We urge the NYSE to re-evaluate and update its listing standards in the following areas:

- the definition of independent director;
- the standard for board independence;
- the standard for audit committee independence;
- the rules addressing when shareholders must vote on stock option plans;
- the rules addressing when brokers may vote without instructions from beneficial owners.

These suggested changes will not impede the capital raising process nor will they impose burdensome costs on listed companies. These changes may, however, help restore investors' confidence that the NYSE is committed to ensuring that its listed companies are held to the highest corporate governance standards.

The NYSE should toughen its definition of "independent" director.

The NYSE's current definition of "independent" director only excludes directors employed by the company within the past three years, immediate family members of executives and certain interlocking directorships. A director with a direct or indirect business relationship with the company or its executives may be deemed independent if the board of directors—in its sole discretion—decides that the relationship doesn't interfere with the director's exercise of independent judgment.

This standard falls far short of ones endorsed by the Council, the California Public Employees' Retirement System, TIAA-CREF, the Blue Ribbon Commission on Improving the Effectiveness of Corporate Audit Committees, a panel established by the NYSE and the NASD in 1998 at the urging of former SEC chairman Arthur Levitt, and even the AMEX/NASD.

We agree that the board of directors should retain some responsibility for deciding whether certain relationships may impair a director's independence. However, this discretion should not be absolute. We believe that certain relationships, no matter how small, may compromise a director's objectivity and loyalty to shareholders, and these relationships should be included with those that automatically disqualify a director as "independent."

The Council urges the NYSE to reevaluate its definition of "independent" director and add tougher, standardized approaches—similar to ones endorsed by the Council and the Blue Ribbon Commission (copies attached)—for evaluating direct and indirect relationships between directors and companies.

The NYSE should modernize its current requirement that listed companies must only have as few as two "outside" directors on their boards.

The NYSE's standard, in place since 1956, is inadequate and in need of updating. Today most corporate governance supporters, even including The Business Roundtable, the nation's premier association of corporate CEOs, advocate that a substantial majority of directors should be outsiders. As noted by The Business Roundtable in its September 1997 Statement on Corporate Governance, "the overall result should be a board that, as a whole, represents the interests of stockholders with appropriate independence."

The Council, TIAA-CREF, CalPERS and other institutional investors generally hold boards to a higher standard, endorsing that a substantial majority of directors should not only be outsiders, but they should also be independent. One of the Council's five "core" corporate governance policies states that at least two-thirds of a board's directors should qualify as independent.

We urge the NYSE to reassess and modernize its standard by requiring listed companies to have boards composed of a substantial majority of independent directors. Such a standard would give investors confidence that boards of NYSE-listed companies are adequately independent and representing the interests of investors.

The NYSE should toughen its standard for audit committee independence and adopt new standards for nominating and compensation committees.

The NYSE standards currently only address audit committees, and they allow companies to include certain non-independent directors on audit committees under "exceptional and limited circumstances."

In contrast, the Council and many leading investors in the corporate governance community, including CalPERS and TIAA-CREF, call for all-independent audit, nominating and compensation committees.

We encourage the NYSE to amend its listing standards to require companies to have audit, compensation and nominating committees consisting solely of independent directors.

The NYSE should change its rules governing when shareholders must be given a vote on stock option plans.

Current NYSE rules give companies tremendous latitude to adopt stock option plans without shareholder approval. As you are aware, the current rules have been the subject of significant debate and discussion.

Council members believe that shareholder approval of stock option programs is critical for several reasons. First, these programs raise the specter of self dealing, a problem that is unavoidable whenever directors and officers approve their own compensation plans without shareholder oversight.

Second, because options transfer wealth directly from shareholders to option holders, require no payment of corporate cash or any expensing on corporate income statements, the temptation for companies to abuse them is unchecked.

Third, not only do option programs represent a significant potential conflict of interest between optionholders and their shareholders, but they also may represent a significant financial cost to shareholders. Excessive use of options can harm shareholders through massive dilution.

The Council and other investors have spent the past four years urging the NYSE to adopt tougher rules governing when shareholders must vote on stock option plans. Most recently, Harvey Pitt, chairman of the Securities and Exchange Commission, has urged the exchange to move with alacrity to reform its standards in this area.

Even though a task force created by the NYSE and composed of representatives from the corporate and investor communities recommended substantial changes to the current NYSE rule, no changes have been made yet.

We urge the NYSE to move forward and adopt tougher rules governing when shareholders must be given a vote on stock option programs.

The NYSE should restore integrity to the proxy voting system by reconsidering its "broker may vote" policies.

Current NYSE and AMEX rules allow brokers to vote on certain "routine" proposals—including the uncontested election of directors, the ratification of auditors, and most stock compensation plans—if the beneficial owner hasn't provided voting instructions at least 10 days before a scheduled meeting. This "ten-day rule" was adopted in 1937.

The Council believes this rule—now more than 60 years old—is out of date and unfair to shareholders, and we have repeatedly called on the NYSE to repeal this rule. The Council believes that there is no public policy justification for the current "broker may vote" policy. We base this position on a variety of market realities:

1. Broker votes are no longer necessary for quorum purposes, as concluded in a working paper by Jennifer Bethel and Stuart Gillan that we've shared with staff at the NYSE.
2. In today's market environment, no ballot item submitted for shareholder approval is so "routine" that brokers should have the ability to vote on the matter without instructions from the beneficial owners.
3. Broker voting taints the integrity of the process by giving brokers—who have no fiduciary obligation to vote the shares in the best interests of the beneficial owner—the ability to stuff the ballot box for management.

The Council urges the NYSE to carefully reconsider this rule. If the exchange is unwilling to abolish it, we urge the NYSE to correct the most problematic aspects of the rule. In particular, we believe the exchange's definition of a "contest" should be revised, and its classification of most stock compensation proposals as "routine" should be changed.

Definition of Contest

The NYSE currently limits "contests" to those situations when shareholders solicit against management by mailing separate proxy cards to other shareholders. Automatic Data Processing—the nation's dominant proxy delivery firm—also uses this definition when it determines whether an item qualifies for broker voting.

This definition is problematic for several reasons. First, it fails to classify "just vote no" campaigns—when shareholders urge others to withhold votes from directors—and other exempt solicitations as "contests." Second, it fails to recognize the use of the Internet as a means of contesting management. Third, it places ADP in an inappropriate and severely conflicted role by ensuring that shareholders must mail materials—and as a result, pay ADP—before ADP will declare their efforts "contests." And fourth, it is not consistent with current securities laws, which were amended in 1992 to recognize the validity of exempt solicitations.

The Council recommends that the NYSE change its interpretation to classify as "contested" any situations in which investors file definitive proxy materials with the Securities and Exchange Commission or which qualify as "exempt solicitations" under Rule 14a-2(b)(1) of the Securities Exchange Act of 1934.

Stock Compensation Programs

The NYSE currently declares as "routine," any stock compensation proposal authorizing less than 5 percent of the outstanding shares. The Council suspects that when this definition was adopted, these plans were few in number and very modest in size.

Times have changed. This definition is outdated and fails to recognize that investors now examine dilution on a much broader scale. What is important is the cumulative dilution represented by all stock-based compensation plans—not simply the dilution represented by individual plans. The NYSE is familiar with this approach—it uses a total dilution approach when it evaluates proposed extensions to the duration of existing plans.

The current definition means that the exchange will classify as "routine" a proposal reserving less than 5 percent of the outstanding shares—even if the company sponsors several other option programs with cumulative dilution exceeding 50 percent. We believe this is flawed.

The easiest solution to this problem is for the NYSE to no longer consider any stock-based compensation plan as "routine" and eligible for broker votes. We believe this is the most appropriate approach.

Another alternative is for the NYSE to change how it evaluates compensation plans, by adopting a 5 percent "total dilution" approach—that takes into consideration proposed new shares, shares available for award and outstanding awards—for evaluating all proposals, not simply proposed extensions of existing plans.

Finally, the NYSE should amend its rules to mandate governance changes. It should not produce a list of "best practices."

Best practices are best left to associations such as the Council, the Business Roundtable, the National Association of Corporate Directors, and other entities interested in promoting improved corporate governance standards.

The New York Stock Exchange, as a self-regulator, should ensure that companies aren't simply volunteering to adopt best practices. The exchange should mandate that its listed companies comply with the highest possible corporate governance standards.

— EXPLANATORY NOTES TO CORE POLICIES —

(INDEPENDENT DIRECTOR DEFINITION)

An independent director is someone whose only nontrivial professional, familial or financial connection to the corporation, its chairman, CEO or any other executive officer is his or her directorship.

NOTES: Independent directors do not invariably share a single set of qualities that are not shared by non-independent directors. Consequently no clear rule can unerringly describe and distinguish independent directors. However, members of the Council of Institutional Investors believe that the promulgation of a narrowly drawn definition of an independent director (coupled with a policy specifying that at least two-thirds of board members should meet this standard) is in the corporation's and all shareholders' ongoing financial interest because:

- independence is critical to a properly functioning board,

- certain clearly definable relationships pose a threat to a director's unqualified independence in a sufficient number of cases that they warrant advance identification,

- the effect of a conflict of interest on an individual director is likely to be almost impossible to detect, either by shareholders or other board members, and,

- while an across-the-board application of *any* definition to a large number of people will inevitably miscategorize a few of them, this risk is sufficiently small that it is far outweighed by the significant benefits.

Stated most simply, an independent director is a person whose directorship constitutes his or her only connection to the corporation. The definition approved by members of the Council contains this basic formulation. It then adds to it a list of the relationships members believe pose the greatest threat to a director's independence. The existence of any such relationship will remove a director from the independent category.

The following notes are supplied to give added clarity and guidance in interpreting the specified relationships.

A director will not generally be considered independent if he or she:

(a) is, or in the past five years has been, employed by the corporation or an affiliate in an executive capacity;

NOTES: The term "executive capacity" includes the chief executive, operating, financial, legal and accounting officers of a company. This includes the president, treasurer, secretary, controller and any vice-president who is in charge of a principal business unit, division or function (such as sales, administration or finance) or performs a major policymaking function for the corporation.

An "affiliate" relationship is established if one entity either alone or pursuant to an arrangement with one or more other persons, owns or has the power to vote more than 25 percent of the equity interest in another, unless some other person, either alone or pursuant to an arrangement with one or more other persons, owns or has the power to vote a greater percentage of the equity interest. For these purposes, equal joint venture partners meet the definition of an affiliate, and officers and employees of equal joint venture enterprises are considered affiliated.

Affiliates include predecessor companies. A "predecessor" of the corporation is a corporation that within the last ten years represented more than 80 percent of the corporation's sales or assets when such predecessor became part of the corporation. Recent merger partners are also considered predecessors. A recent merger partner is a corporation that directly or indirectly became part of the corporation or a predecessor within the last ten years and represented more than 50 percent of the corporation's or predecessor's sales or assets at the time of the merger.

A subsidiary is an affiliate if it is at least 80 percent owned by the corporation and accounts for 25 percent of the corporation's consolidated sales or assets.

(b) is, or in the past five years has been, an employee or owner of a firm that is one of the corporation's or its affiliate's paid advisers or consultants;

NOTES: Advisers or consultants include, but are not limited to, law firms, accountants, insurance companies and banks.

(c) is, or in the past five years has been, employed by a significant customer or supplier;

NOTES: A director shall be deemed to be employed by a significant customer or supplier if the director:

– is, or in the past five years has been, employed by or has had a five percent or greater ownership interest in a supplier or customer where the sales to or by the corporation represent more than one percent of the sales of the customer or supplier or more than one percent of the sales of the corporation,

– is, or in the past five years has been, employed by or has had a five percent or greater ownership interest in one of the corporation's debtors or creditors where the amount owed exceeds one percent of the corporation's or the third party's assets,

Ownership means beneficial or record ownership, not custodial ownership.

(d) has, or in the past five years has had, a personal services contract with the corporation, its chairman, CEO or other executive officer or any affiliate of the corporation;

NOTES: Council members believe that even small personal services contracts, no matter how formulated, can threaten a director's complete independence. This includes any arrangement under which the director borrows or lends money to the corporation at rates better (for the director) than those available to normal customers — even if no other services from the director are specified in connection with this relationship.

(e) is, or in the past five years has been, an employee, officer or director of a foundation, university or other non-profit organization that receives significant grants or endowments from the corporation or one of its affiliates;

NOTES: This relationship includes that of any director who is, or in the past five years has been, an employee, officer or director of a non-profit organization to which the corporation or its affiliate gives more than $100,000 or one percent of total annual donations received (whichever is less), or who is, or in the past five years has been, a *direct* beneficiary of *any* donations to such an organization.

(f) is, or in the past five years has been, a relative of an executive of the corporation or one of its affiliates;

NOTES: Relatives include spouses, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, aunts, uncles, nieces, nephews and first cousins. Executives include those serving in an "executive capacity."

and

(g) is, or in the past five years has been, part of an interlocking directorate in which the CEO or other executive officer of the corporation serves on the board of another corporation that employs the director.

Approved 3/26/01

Recommendation I

The Committee recommends that both the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) adopt the following definition of independence for purposes of service on the audit committee for listed companies with a market capitalization above $200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD):

> Members of the audit committee shall be considered independent if they have no relationship to the corporation that may interfere with the exercise of their independence from management and the corporation. Examples of such relationships include:

- a director being employed by the corporation or any of its affiliates for the current year or any of the past five years;
- a director accepting any compensation from the corporation or any of its affiliates other than compensation for board service or benefits under a tax-qualified retirement plan;
- a director being a member of the immediate family of an individual who is, or has been in any of the past five years, employed by the corporation or any of its affiliates as an executive officer;
- a director being a partner in, or a controlling shareholder or an executive officer of, any for-profit business organization to which the corporation made, or from which the corporation received, payments that are or have been significant* to the corporation or business organization in any of the past five years;
- a director being employed as an executive of another company where any of the corporation's executives serves that company's compensation committee.

A director who has one or more of these relationships may be appointed to the audit committee, if the board, under exceptional and limited circumstances, determines that membership on the committee by the individual is required by the best interests of the corporation and its shareholders, and the board discloses, in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination.

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* The Committee views the term "significant" in the spirit of Section 1.34(a)(4) of the American Law Institute Principles of Corporate Governance and the accompanying commentary to that section.

NEW YORK STOCK EXCHANGE
COMMITTEE ON ACCOUNTABILITY AND LISTING STANDARDS

Statement of Eric D. Roiter
Senior Vice President and General Counsel
Fidelity Management and Research Company

May 8, 2002

I appreciate the opportunity to present to this Committee Fidelity's views on corporate governance. In the wake of Enron, as lawmakers and regulators consider ways to strengthen the roles and responsibilities of corporate boards, outside auditors, governmental overseers and self-regulatory bodies such as the New York Stock Exchange, Fidelity Investments has an important stake in the debate. Fidelity manages the savings of over 17 million customers invested in over 260 mutual funds. As of April 30, 2002, our mutual funds held aggregate assets of over $794 billion.

Despite the collapse of Enron, we should remind ourselves that this nation's capital markets remain strong, vibrant and resilient. Through the interplay of governmental regulation, industry self-regulation, and the forces of free and open competition, our capital markets are among this nation's most important assets. However, the Enron debacle and other highly publicized cases involving irregularities in financial reporting and corporate governance are calling into question the basic integrity of our capital markets and the efficacy of our regulatory system. Improvements to that system, including changes to the rules of corporate governance, must be made to maintain the confidence and trust placed in our markets by the millions of investors who supply the capital that is the lifeblood of our nation's economic growth.

The NYSE plays an important role in fashioning the corporate governance standards of its listed companies. Historically, the NYSE, through its listing standards, has sought to elevate the corporate governance practices of companies above the bare minimum requirements dictated by state corporate and federal securities law. A listing on the NYSE has been seen to signify an acceptance by a listed company of the high standards of fairness and fiduciary responsibility that the NYSE has sought to further through its marketplace. The NYSE, along with NASDAQ, must play a part in improving corporate governance practices of its listed companies and should take the initiative in implementing change, rather than wait for others to act.

My remarks today are divided into three parts. I will first offer some general views on the objectives of corporate governance from the perspective of an institutional shareholder. I will then speak to the institutional shareholder role played by Fidelity and other mutual fund managers engaged in the active management of customers' assets. Finally, I will address three categories of current proposals that are important to Fidelity and relevant to the NYSE's corporate governance standards-setting: (1) improving corporate disclosure, (2) expanding shareholder voting on stock option plans and repricing of options, and (3) strengthening the role of a company's compensation and nominating committees.

Corporate Governance Objectives

As lawmakers attempt to identify the corporate governance fault lines that contributed to Enron's collapse, a wide range of measures are being proposed to prevent the next Enron from happening. With so much in flux, it may be useful to identify the key objectives which corporate governance ought to advance. In Fidelity's view, there are three.

Accountability The first objective of corporate governance is accountability. Given the division of ownership and control in our nation's publicly-held companies, effective means must be in place to hold accountable those entrusted with running a company's business. Management of a company must be accountable to its board of directors and the board, in turn, must be accountable to shareholders. Promoting accountability can take many forms, including enforcing rules and laws imposing duties on officers and directors, protecting shareholder voting rights, ensuring rigorous scrutiny of a company's financial statements by independent, outside auditors, and maintaining free and open markets to allow for the re-allocation of capital and transfers of corporate control.

Alignment of Management and Shareholder Interests A second objective of corporate governance should be to align the interests of a company's management and board, on one hand, and the company's shareholders, on the other. While accountability may be viewed as the "stick" of corporate governance, proper alignment of management and shareholder interests often involves the "carrot." In this regard, issues surround the forms of compensation paid to management, the fairness and effectiveness of stock option grants and other equity-based compensation, and the repricing of out-of-the-money stock options.

Effective Disclosure The third objective is to promote timely disclosure of important information about a company's business operations and financial performance to allow diligent investors, individual and institutional alike, to reach informed decisions on when to buy, sell or hold a company's securities. Certainly, the proposals recently announced by the SEC to shorten the lag time between the end of a fiscal period and the subsequent filing of annual or quarterly financial reports hold out the prospect for improving the current state of disclosure. Given the complexities and accounting judgments underlying the financial statements of many companies, a focused effort to enhance informed investor decision-making should also take into account the role played by buy side institutions, including mutual fund managers such as Fidelity, on behalf of their retail investors, to ferret out information and fill out the interstices of mandated corporate disclosure.

Fidelity as an Institutional Shareholder

How does corporate governance fit within the broader focus that we bring to bear in managing our mutual funds? At Fidelity, we start with the overriding importance of fundamental research in arriving at investment decisions from the "bottom up," on a company-by-company basis. We seek to understand what drives a company's business. A key element of our work is to assess the quality of a company's management. Is management fully engaged, deeply committed to leading the company in the face of stiff competition? Do a company's leaders demonstrate far-sightedness, integrity, sound judgment, and receptivity to new ideas?

We often find a correlation between the quality of a company's management and sound corporate governance. Recent studies indicate that investors will pay a premium for the stocks of companies with strong corporate governance practices. Many examples can be drawn from the NYSE's listed companies list. A company's corporate governance practices, however, are not ends in themselves. They reveal management's responsiveness to shareholders and commitment to serving the interests of shareholders. For at the end of the day, the overarching duty of management is to maximize shareholder value and to place shareholders' interests first.

It is our strong view, as a shareholder, that improvements in corporate governance can be made without impeding the ability of a company's senior officers to manage the business of the company. Fidelity recognizes that management must retain sufficient latitude to run the day-to-day operations of the company as well as engage in longer term strategic planning that is subject to the active and informed oversight of the company's board of directors. Shareholders, however, must retain the ultimate power to judge how well management and boards of directors are performing their duties, and actions that implicate shareholders' rights and ownership interests should not be taken without obtaining the consent of shareholders.

Sound corporate governance principles should reflect this allocation of roles and responsibilities among a company's officers, board of directors and shareholders. Fidelity, as an institutional shareholder investing in several thousand companies on behalf of its mutual funds, does not seek to manage or control any of them. Indeed, given practical and regulatory constraints under the Investment Company Act of 1940, mutual fund managers cannot do so.

The proxy voting guidelines that we follow in voting shares in portfolio companies held in our mutual funds – guidelines approved by the funds' Board of Trustees – are designed to promote the accountability of management and the board. The Fidelity funds' guidelines generally call for the funds to vote in support of management's proposals. The guidelines, however, recognize that certain matters touch directly upon the interests of shareholders or raise potential conflicts of interest for management and, accordingly, prescribe standards for how we are to vote. The guidelines, in this regard, deal with three types of proposals presented to shareholders raising corporate governance concerns. These deal with: (1) anti-takeover measures (such as poison pill plans, staggered boards, super-majority votes for mergers, and golden parachutes), (2) shareholder rights (such as the right to call special meetings, initiate changes in corporate bylaws or act by written consent) and (3) executive compensation (most notably, stock option and restricted share award plans).

As a shareholder, Fidelity, of course, retains the ability to invoke the "Wall Street rule" – selling shares of a company – when in disagreement with the policies or directions being taken by a company's management. On a daily basis, the marketplace offers an immediate "ballot" for shareholders to signal their confidence, or lack of confidence, in a company's stewards. For this reason, no system for corporate governance can be complete or effective without liquid and transparent markets to sustain active trading in a company's outstanding securities. This is a point that bears directly on the importance that the NYSE plays as a marketplace for transfer of share ownership in our country's major corporations.

Improving Financial Disclosure

The SEC's proposal to shorten the deadlines for the filing of annual reports (from 90 to 60 days) and quarterly reports (from 45 to 30 days) are eminently sensible and ought to be promptly adopted. The SEC would exclude from this requirement companies that have been publicly-held for less than one year and have a float of less than $75 million. It is not clear that this exclusion is necessary. Indeed, the shortened reporting deadlines in some cases are apt to prove at least as important for shareholders of these smaller companies as for their counterparts of larger companies.

The SEC stopped short of requiring that companies post periodic reports on their websites concurrent with filing at the SEC. If the SEC declines to require this, the NYSE should do so for its listed members for all periodic reports (including current reports on Form 8-K) as well as insider trading reports.

The SEC has also proposed to close the reporting time gap for securities sales by corporate insiders by imposing a disclosure obligation upon the companies themselves. Companies must make 8-K filings within two business days if aggregate transactions by executive officers and directors equal or surpass $100,000. Transactions under this threshold (but over $10,000) must be reported within no later than six business days. The SEC proposal would pick up derivative transactions by insiders that are not necessarily covered by current reporting rules and would also cover loans made or guaranteed to insiders by their companies. These are salutary proposals that would promote transparency and also should be promptly adopted.

While the SEC disclosure proposals would bring some improvement, more needs to be done. SEC Chairman Pitt has made known the SEC's plans to expand the types of events that trigger an obligation upon companies to make prompt disclosures on Form 8-K. The SEC proposes to add 12 items, including changes in credit ratings, private securities offerings, waivers of corporate ethics and conduct rules for officers and directors, withholding of an auditor's consent to the use of an audit opinion in an SEC filing and the start of any lock-out period under a company's employee benefit plans. These also will be useful changes to the disclosure system.

The SEC also plans to require companies to explain in the MD&A section of their annual reports and elsewhere the critical accounting policies that underlie their financial statements. While the SEC has not yet published its proposal, we endorse the call already made by others to require companies who release pro forma earnings numbers to reconcile those numbers with financial results contained in GAAP financial statements. Such reconciliation should be contemporaneous, so that companies choosing to release pro forma numbers can do so only if accompanied by GAAP financials.

Another step the SEC plans to take is to require a company's CEO personally to certify to shareholders, when the company files a disclosure document (including any financial statement) with the SEC, that all significant information of which he or she is aware has been disclosed and that the disclosures made are not misleading, inaccurate or false. We support this approach, which will enhance a CEO's accountability to shareholders. We would add a requirement that the CEO represent that he or she has undertaken reasonable efforts to remain informed of all significant information, including information contained in the company's financial statements.

How can the NYSE supplement the efforts being undertaken by the SEC? We suggest that the NYSE require that all of its listed companies maintain websites and post all SEC filings (other than filings for which confidential treatment is sought) as soon as they are filed with the SEC. The NYSE should require its listed companies to reconcile to GAAP any pro forma results released to the public and to do so at the time pro forma numbers are released to the public. Any changes that the NYSE adopts should be mandatory for its listed companies and should take the form of revisions to its listing standards submitted to the SEC for approval after opportunity for comment by the public. As a body entrusted with self-regulatory powers under the federal securities laws, the NYSE should not seek to effect change through voluntary "best practices" guidelines.

Shareholder Voting on Stock Option Plans and Repricing of Options

Having served on the NYSE's Task Force on Stock Option Plans and Shareholder Voting Rights, I endorsed two years ago the recommendation of the Task Force that the NYSE amend its listing standards to require that shareholders be afforded the opportunity to vote on most stock option plans, whether limited to officers or directors or broadened to included non-officer employees. Given the developments of the last two years, and the increasingly higher levels of dilution embedded in the stock option plans of publicly-traded companies, the NYSE should now require its listed companies to put all stock option plans, without exception, before shareholders for approval. There should be no distinction between plans that include officers or directors and those that do not. Nor should a requirement for approval by shareholders turn on the amount of dilution that a stock option plan (alone or together with other plans) would produce.

One is hard pressed to identify any other aspect of corporate governance which raises more immediate, and serious, issues of accountability and proper alignment of interests between management and employees, on one hand, and shareholders, on the other, than do stock option plans. When a company sells shares to its officers exercising their stock options, it is reallocating corporate ownership between existing shareholders and management. The ownership interests of shareholders are necessarily diluted because those exercising company stock options are not paying a price proportionate to the corporate ownership rights they acquire. The company, in a very real economic sense, is paying its officers out of the share ownership of other shareholders, rather than solely out of corporate coffers.

Aligning the interests of management and shareholders should also lead the NYSE to amend its listing standards to require shareholder approval of any proposal to reprice outstanding options (including the cancellation of options and issuance of new options at lower exercise prices six months and one day later). The requirement that option plans must gain shareholder approval would be circumvented if companies after issuing options can unilaterally change their exercise prices. Unless option repricings are based upon some notion of a value-for-value exchange and are circumscribed in other respects, the underlying purpose of stock option plans – to link compensation to performance – is compromised.

Although the NYSE has been prepared over the last two years to expand shareholder voting rights over stock option plans of its listed companies, the NYSE has not acted for fear of suffering a competitive disadvantage in attracting new listings in competition with NASDAQ, which did not evidence a willingness to adopt similar changes to its listing standards. Today, this country's securities markets should not be caught up in the trap of self-regulatory arbitrage, which impedes initiatives to strengthen corporate governance among the country's leading companies.

The stalemate between the NYSE and NASDAQ on shareholder voting rights over stock option plans points to a structural defect that should be remedied in the laws governing the SEC's oversight of securities market self-regulators. The NYSE, given its leadership role in corporate governance matters, should advocate a solution. In the *Business Roundtable* case in 1988, the federal appeals court in Washington, D.C. interpreted the federal securities laws to withhold from the SEC authority to require changes in exchange listing standards to promote corporate governance ends, such as restricting the listing of classes of common stock with inferior voting rights. Although the NYSE and other exchanges must still submit any changes to their listing standards to the SEC for approval, the SEC, in light of the *Business Roundtable* decision, cannot initiate changes or require the exchanges to do so. It also is not clear, after *Business Roundtable*, what standards the SEC may properly apply under the Securities Exchange Act of 1934 in passing upon proposed changes to an exchange's listing standards.

If the SEC had the power to require the exchanges to amend their listing rules, the agency could have stepped in through rulemaking to break the self-regulatory deadlock between the NYSE and NASDAQ that has stalled for over two years any enhancement of shareholder voting rights over stock option plans. The NYSE should advocate a change to the securities laws to restore this authority to the SEC and to specify the corporate governance standards that the SEC may apply in approving or disapproving exchange listing standards.

Composition of Board Committees

Three years ago, the NYSE implemented most of the recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees. Importantly, the NYSE amended its rules to require that its listed companies, subject to a narrow exception, establish audit committees consisting entirely of independent directors. The NYSE also strengthened the test of independence by taking into account prior business relationships, interlocking board and management positions between companies and sources of compensation of independent directors. The NYSE should now amend its listing standards that apply to the composition of compensation and nominating committees to require, in each case, at least a majority of independent directors. A compensation committee having a majority of independent directors is in a position to represent solely the interests of the company and its shareholders in structuring the compensation – including equity-based compensation – of management. The NYSE's listing rules should also specify that the compensation committee should have authority to retain its own outside experts in the field of executive compensation.

For similar reasons, the nomination of persons to serve as independent directors should be left to a nominating committee consisting of at least a majority of independent directors. This would enhance the likelihood that persons selected to serve as independent directors will not only meet the black letter test of "independence" under the NYSE's listing rules, but also will serve with an independence of mind. Independent directors elected to the board through this process are unlikely to be beholden to management for their positions, and are more likely to maintain their independent-mindedness throughout their tenure on the board, guided by the interests of shareholders.

Conclusion

The NYSE should play a leadership role to improve the corporate governance practices of our nation's leading companies. The strategy underlying the regulatory framework that Congress settled upon nearly 70 years ago depends upon the ability and willingness of the NYSE and other self-regulatory bodies to act with vision, judgment and far-sightedness to promote the interests of investors and safeguard the integrity of this nation's securities markets. Self-regulation can produce improvements in corporate governance that cannot be as readily achieved directly by legislation or administrative rules. By amending its listing rules to promote accountability, alignment of management and shareholder interests, and greater levels of disclosure, the NYSE will help restore confidence in our markets.

financial executives
international

Philip B. Livingston
President and CEO

April 4, 2002

Members of the NYSE Special Committee:

I look forward to the opportunity to discuss NYSE listing requirements and certain matters involving corporate governance.

FEI is the leading professional association of senior financial officers. Our 15,000 members include chief financial officers, controllers and treasurers from around the world. We are an active participant in public policy and regulatory matters relating to corporate finance and accounting.

Senior financial officers hold an important and elevated role in corporate governance. They are unique in that they deal with all the key participants in the process – auditors, legal counsel, board members, audit committees, investors and analysts, as well as internal operating management and external customers. The breadth of this involvement heightens our interest in your efforts.

On March 20, 2002, we published our recommendations for improving financial management, financial reporting and corporate governance. Those recommendations are attached. Thursday we propose to discuss the following critical matters that the NYSE should address:

- Recommendation #1 – All financial executives should adhere to a specialized code of ethical conduct.
- Recommendation #3 – Qualifications of the principal financial officer and principal accounting officer.
- Recommendation #9 – Effective implementation of the 1999 Blue Ribbon Panel recommendations regarding audit committee financial experts.
- Our letter to the NYSE of December 10, 2001, supporting broad shareholder approval of stock option plans.

In addition, we will briefly discuss:

- Recommendation #10 – Continuing professional education for audit committee members.
- Recommendation #11 – Periodic consideration of audit committee chair rotation.
- Recommendation #12 – Disclosure of corporate governance practices.

Thank you for your continuing leadership of the most efficient and liquid capital markets. I look forward to your questions and comments.

Sincerely,

/s/ Philip B. Livingston

Philip B. Livingston

March 2002

FEI Observations and Recommendations

Improving Financial Management,
Financial Reporting and Corporate Governance

Overview

Presented here are the views of Financial Executives International (FEI) on reforms aimed at strengthening financial management, reporting and corporate governance. We believe that most companies are governed and managed ethically and are fulfilling their fiduciary obligations to their stakeholders. However, the investing public and FEI share a common concern over the problems highlighted by the recent failures of corporate management, financial reporting, corporate governance, audit committees and independent audits. The U.S. capital markets are based, in large part, on trust in a checks-and-balances control system fundamental to good corporate governance. The weaknesses exposed in the system are highlighted in public documents, testimony before Congress, press interviews and special reports. We believe these revelations point to certain systemic issues and call for reform. FEI supports a clear and coordinated look at all areas of possible improvement. It is our intention to assist in this effort by making the following observations and recommendations.

We believe the following factors may have contributed to the recent problems observed in the areas of corporate governance, ethical management, financial reporting and external audits:

- Lack of ethical conduct and inappropriate "tone at the top"
- Failure of effective board oversight
- Lack of financial expertise on audit committees
- External audit failure due to compromised independence and failed quality control procedures
- Overly complex accounting standards
- Opaque financial reporting
- Emphasis on form over substance in applying accounting standards

We offer recommendations in four areas:

Strengthening financial management and commitment to ethical conduct

Rebuilding confidence in financial reporting, the accounting industry and the effectiveness of the audit process

Modernizing financial reporting, and reforming the accounting standards-setting process

Improving corporate governance and the effectiveness of audit committees

Recommendations

Strengthening Financial Management and Commitment to Ethical Conduct

Recommendation 1: All financial executives should adhere to a specialized code of ethical conduct.

FEI recommends that all senior financial professionals be required to adhere to a strong ethical code of conduct. For many years, members of FEI have signed such a code, thus committing to its principles. That code has been updated recently to include a call for all financial executives to acknowledge their affirmative duty to proactively *promote* ethical conduct in their organizations.

Whether or not they are members of FEI, all finance professionals should adhere to a code of ethical conduct containing all the elements of the FEI Code of Ethics. The Code states, for example, that financial arrangements involving actual or apparent conflicts of interest should be avoided.

FEI recommends that all senior financial officers, accounting officers, controllers, treasurers and chief investor relations officers annually sign a code containing all the elements of the FEI Code of Ethics and deliver it to their board or the board's designated committee. Further, we expect that best practice in this area will be that **all** finance, accounting, tax and investor relations personnel annually sign such a code.

The FEI Code is attached to this document as Appendix A.

FEI strongly recommends that Congress and the SEC implement regulations that call for stock exchanges and markets to implement this recommendation through listing agreements.

Recommendation 2: Companies should actively promote ethical behavior and provide employees with the means to report perceived violations of ethical standards without fear of reprisal.

FEI strongly endorses practices by which all companies adopt a code of conduct for their employees and conduct regular training sessions to assure understanding and compliance. We believe companies should provide support and broad protection to employees reporting code of conduct violations. Under such a framework, companies should:

- Adopt a written code of conduct for all employees
- Conduct employee orientation and training with respect to the code
- Provide employees with a mechanism (such as a hotline or help-line) to surface concerns about compliance with laws and regulations
- Adopt procedures for voluntary disclosure of violations of laws
- Participate in best practices forums
- Inform the public of the active commitment to implement these steps

We encourage all companies to set up "hotline" channels, providing employees with the means to report perceived violations of the code or of the law without fear of reprisal. Additionally, employees should be made aware of these lines of communication and be assured that the source of all calls will be kept confidential. Calls should go directly to a person, facilitator or committee specifically identified by the company's board. That designated person or entity should screen each call and initiate appropriate action within the company. The company's board of directors should be informed of calls made and their disposition on a regular basis.

Recommendation 3: Qualifications of the principal financial officer and principal accounting officer.

Management, in support of the audit committee and board of directors, should designate a principal financial officer and a principal accounting officer as those terms are used in the Securities Act of 1933. FEI believes the qualifications and roles of such persons should include the following:

- The principal financial officer should be that person with overall responsibility for the finance function within the reporting company, and should have knowledge in all areas of finance including, at a minimum, the requisite knowledge proposed for the financial experts of audit committees. The principal financial officer should be responsible for upholding compliance with ethical standards within the finance function.

- The principal accounting officer should be a licensed public accountant or possess equivalent knowledge and experience, and should be current and knowledgeable in the understanding of GAAP and the SEC's rules and regulations governing the preparation and audit of financial statements.

- The principal financial officer should report to the chief executive officer, and the principal accounting officer should report to the principal financial officer. It is further recommended that the principal financial officer and/or the principal accounting officer meet with the audit committee periodically (quarterly) to review significant financial statement issues, including key judgments, estimates and disclosure matters.

Rebuilding Confidence in Financial Reporting, the Accounting Industry and Effectiveness of the Audit Process

Recommendation 4: Create a new oversight body for the accounting profession staffed with finance and accounting professionals.

Enhanced oversight of public accounting firms by an independent body would increase public confidence in the audit process and effectiveness of the audit quality control process. This oversight board should be sponsored by the SEC and, recognizing the technical nature involved and the need to adequately understand the audit process, the majority of its members should be executives with knowledge in accounting and finance. These individuals should be clearly independent of public accounting firms or other audit industry organizations. We do not believe that a majority of members should be drawn from the audit profession.

This oversight board should oversee the peer review quality control process of the audit firms. Furthermore, the peer reviewers should be accountable to the oversight board for the scope of review, findings, recommendations and corrective actions.

We further recommend that a focused mission and scope will enhance the effectiveness of this body. Therefore, this new body should be principally tasked with the job of audit industry oversight and discipline. As FEI continues to support private-sector accounting standard setting, we believe that a separate and independent body should continue to oversee the FASB.

Recommendation 5: Place restrictions on certain non-audit services supplied by the independent auditor.

Even the appearance of a potential conflict of interest may now undermine an auditor's effectiveness. Therefore, we believe confidence in the integrity of the audit would be enhanced if certain non-audit services were prohibited for audit clients. In this regard:

- The independent auditor should no longer provide audit clients with internal audit services or consulting on computer systems used for financial accounting and reporting.
- Advisory services should be prohibited wherever the audit firm could be put in a position of relying on the work product resulting from such services.
- Tax advisory and compliance services, acquisition due diligence, audits of employee benefit plans and other statutory audits should be acceptable services for audit clients as they would not normally raise questions of conflict of interest. In the unusual instance where such services could present questions of a conflict of interest, such services should not be provided.

Importantly, in addition to the foregoing, we suggest that audit committees approve substantially all large non-audit services. In so doing, the audit committee should consider the impact of such services on the overall independence of the audit firm.

FEI also recommends that the SEC redefine the current classifications of audit and non-audit services to assure that the guidance is clear and that the distinction conveys a complete and meaningful picture to investors in regard to the proper characterization of audit and non-audit activities.

Recommendation 6: Restrict the hiring of senior personnel from the external auditor.

FEI recommends that companies adopt policies that restrict the hiring of engagement audit and tax partners, or senior audit and tax managers, who have worked on the company's audit for a period specified by the board of directors. FEI believes that this period should be no shorter than two years.

Modernizing Financial Reporting and Reforming the Accounting Standards-Setting Process

Recommendation 7: Reform the Financial Accounting Standards Board (FASB).

FEI recommends that a "Blue Ribbon Committee" be formed to address FASB reform. While we support continuing private-sector standard setting through the FASB, substantive process and structural changes are long overdue. The Blue Ribbon Committee should complete its work promptly and produce initial recommendations within three months of its formation. The Committee should be guided by the basic principle of advancing financial reporting, notwithstanding divergent political interests. The Committee should address the following issues:

- FASB Organization
  - Board mission statement
  - Size of board
  - Length of board member terms
  - Voting majority
  - Staff effectiveness, accountability and structure
  - Restrictions on board member meetings ("Sunshine Rules")

- Timely Standard Setting
  - Timely standard setting with clearly defined priorities, objectives and milestones
  - Agenda management and accountability

- Financial Statement Content
  - A process for defining clear long-term objectives for financial statements produced under GAAP
  - Fair value accounting, in particular, needs to be addressed, given the absence of market values in many areas and the potential for such accounting concepts to create financial statement volatility

- Financial Accounting Standards
  - Reassess the conceptual framework as the basis for standard setting
  - Assure practical implementation of principle-based standards vs. specific, bright-line rules; examples of standard application and financial interpretations based on principles underlying standard
  - Impact of planned globalization of accounting standards
  - Review existing standards and disclosures
  - Address the need to increase the participation of the user and investment community and decrease tension with the preparer community

Recommendation 8: Modernize financial reporting.

FEI expresses strong support for the following improvements in financial reporting and recommends that committees be formed promptly to address these matters.

- Improve Management's Discussion and Analysis (MD&A)
  - FEI should take the lead in developing best practices for MD&A disclosure utilizing 2001 annual reports as a primary source for data.

- Implement "Plain English" financial reporting as the new language of professionals involved in investor relations and financial statement preparation.

- Promote voluntary disclosures of business performance metrics
  - FEI recommends that companies consider providing Web-based reporting of key performance measures used by management and specific to the industry on a quarterly basis. (A possible source for additional key performance measures is information shared at analyst presentations.)
  - In order to encourage the expansion of reporting additional measures, it is essential that safe harbor rules be strengthened to specifically encompass the additional reporting.

- Develop and complement Web-based financial reporting
  - Internet delivery of hierarchical financial reporting that employs scorecards, current key performance indicators and analytical tools offering differing accounting standards is the future. Industry,

users and the SEC should move ahead aggressively to develop models of such reporting frameworks without reducing access for investors in the short term.
- Mandatory Internet access to financial reports — public companies should make the information available on their Web sites concurrent with SEC filings.
- Voluntary business performance reporting, discussed above, may be more easily implemented through Web-based reporting.

- Expanded use of reports on Form 8-K
  - Items typically included in these filings could be expanded; however, the SEC's revised guidance should be "principle-based" and the current list of additional items to be disclosed should be presented only as "examples."

- Enhance filing requirements for foreign filers
  - Many foreign filers currently provide quarterly financial statements on a voluntary basis. FEI recommends that the SEC require foreign filers to file quarterly.

- Assess transition impact on paper documents
  - FEI does not suggest that hard copy mailings be eliminated in the near term. However, the content of paper mailings to shareholders should be examined to determine what modifications can be made and over what timeframe.
  - Financial disclosure to shareholders via paper documents has vastly exceeded a user's ability to digest it. The availability of public filings on the Web and analysis of information accessed by users should assist in identifying what is considered important. The resulting information could serve as a basis to expand the disclosures most often accessed and reduce those disclosures that are of little or no interest. This should improve understanding and communication while reducing costs to corporations and, ultimately, to the shareholders.

Improving Corporate Governance and the Effectiveness of Audit Committees

Recommendation 9: Effective implementation of the 1999 Blue Ribbon Panel Recommendations re: audit committee financial experts.

In 1999, the *Blue Ribbon Panel on Audit Committee Effectiveness* called for all audit committee members to be financially literate and for each committee to have at least one financial expert.

FEI recommends that the NYSE and the NASDAQ set **higher standards** for audit committee "financial experts." These criteria should call for explicit experience requirements in the credentials of such experts. A financial expert should possess:

- An understanding of Generally Accepted Accounting Principles (GAAP) and audits of financial statements prepared under those principles. Such understanding may have been obtained either through education or experience. We believe it is important for someone on the audit committee to have a working knowledge of those principles and standards.

- Experience in the preparation and/or the auditing of financial statements of a company of similar size, scope and complexity as the company on whose board the committee member serves. The experience would generally be as a chief financial officer, chief accounting officer, controller or auditor of a similar entity. This background will provide a necessary understanding of the transactional and operational environment that produces the issuer's financial statements. It will also bring an understanding of what is involved in appropriate accounting estimates, accruals, reserve provisions, etc., and an appreciation of what is necessary to maintain a good internal control environment.

- Experience in the internal governance and procedure of audit committees, obtained either as an audit committee member, a senior corporate manager responsible for answering to the audit committee or an external auditor responsible for reporting on the execution and results of annual audits.

FEI strongly recommends that Congress and the SEC implement regulations that call for stock exchanges and markets to implement this recommendation through listing agreements.

Recommendation 10: Continuing professional education for audit committee members.

FEI recommends that all audit committee members attend continuing education in areas of financial reporting, risk management and/or accounting. Training can be "in-house" or via an outside provider. FEI, the National Association of Corporate Directors or an equivalent entity should establish the minimum content to be covered. Companies should disclose in the annual audit committee report whether members have undertaken such training. Non-audit committee directors are also urged to attend these sessions.

Recommendation 11: Periodic consideration of audit committee chair rotation.

FEI recommends that boards of directors periodically evaluate the need to rotate the individual holding the audit committee chair. Such evaluation may be done approximately every five years. FEI recognizes that outstanding audit committee chairs are valuable and difficult to replace. Yet there is also benefit in developing successors and additional financial experts on the audit committee. Therefore, rotation and successor development may further strengthen the overall governance mechanisms within the board.

Recommendation 12: Disclosure of corporate governance practices.

FEI recommends that all companies annually report their key corporate governance practices. Current best practice in many companies is to have a governance and nominating committee made up of independent directors.

Closing

FEI formed a task force of members to assemble this set of recommendations. The task force also had significant input from FEI's Committee on Corporate Reporting. These recommendations were then reviewed and approved by FEI's Executive Committee led by FEI Chairman David Young, CFO of Adaptec, Inc., and FEI Vice Chairman Ridge A. Braunschweig, CFO of Orion Corporation. FEI wishes to acknowledge and thank those involved in the preparation of this report.

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John P. Jessup
E.I. du Pont de Nemours & Company
VP Finance and Controller

Philip B. Livingston
Financial Executives International
President and CEO

Dennis D. Powell
Cisco Systems, Inc.
Vice President and Corporate Controller

J. Pedro Reinhard
Dow Chemical
EVP and Chief Financial Officer

Bryan R. Roub
Harris Corporation
Senior Vice President and Chief Financial Officer

David L. Shedlarz
Pfizer, Inc.
EVP and Chief Financial Officer

David H. Sidwell
J.P. Morgan Chase & Co.
Chief Financial Officer - Investment Bank

APPENDIX A: Code of Ethics of Financial Executives International

FEI CODE OF ETHICS

FEI's mission includes significant efforts to promote ethical conduct in the practice of financial management throughout the world. Senior financial officers hold an important and elevated role in corporate governance. While members of the management team, they are uniquely capable and empowered to ensure that all stakeholders' interests are appropriately balanced, protected and preserved. This Code provides principles to which members are expected to adhere and advocate. They embody rules regarding individual and peer responsibilities, as well as responsibilities to employers, the public and other stakeholders. Violations of FEI's Code of Ethics may subject the member to censure, suspension or expulsion under procedural rules adopted by FEI's Board of Directors.

All members of FEI will:

✓ Act with honesty and integrity, avoiding actual or apparent conflicts of interest in personal and professional relationships.

✓ Provide constituents with information that is accurate, complete, objective, relevant, timely and understandable.

✓ Comply with rules and regulations of federal, state, provincial and local governments, and other appropriate private and public regulatory agencies.

✓ Act in good faith, responsibly, with due care, competence and diligence, without misrepresenting material facts or allowing one's independent judgment to be subordinated.

✓ Respect the confidentiality of information acquired in the course of one's work except when authorized or otherwise legally obligated to disclose. Confidential information acquired in the course of one's work will not be used for personal advantage.

✓ Share knowledge and maintain skills important and relevant to constituents' needs.

✓ Proactively promote ethical behavior as a responsible partner among peers, in the work environment and the community.

✓ Achieve responsible use of and control over all assets and resources employed or entrusted.

financial executives
international

December 10, 2001

Catherine R. Kinney
Group Executive Vice President
New York Stock Exchange, Inc.
20 Broad Street
New York, NY 10005

Re: Request for Comment on Shareholder Approval Issues

Dear Ms. Kinney:

The Committee on Corporate Reporting (CCR) of Financial Executives International (FEI) appreciates the opportunity to comment on the proposed changes to shareholder approval requirements for employee stock option plans being considered by the NYSE and NASDAQ. FEI is a leading international organization of 15,000 members including Chief Financial Officers, Controllers, Treasurers, Tax Executives, and other senior financial executives. The Committee on Corporate Reporting (CCR) is a technical committee of FEI, which reviews and responds to research studies, statements, pronouncements, pending legislation, proposals, etc., from domestic and international agencies and organizations.

Summary

FEI's Committee on Corporate Reporting enthusiastically supports the proposed revision to the rules requiring shareholder approval of stock option plans being considered by the NYSE and NASDAQ. We firmly believe that the matter of employee stock option issuance is a corporate governance matter, and that it is "best practice" to obtain shareholder approval of all such plans.

Recent studies have reported a significant growth in the use of employee stock option programs by companies both in the U.S. and internationally. The National Center for Employee Ownership has estimated that ten times as many employees (10 million) will receive stock options in 2001 compared with those who received them in 1992 (1 million). We believe this is because corporations find employee stock option plans to be effective tools for recruiting and retaining talented employees, and to be among the most effective tools available for aligning management interests with those of shareholders.

As stock option programs have proliferated, increased attention has been focused on the issue of how to properly control their use. The new International Accounting Standards Board has recently begun a project to change stock option accounting, proposing to assign all employee stock options a hypothetical charge to be recorded against corporate earnings. We believe this approach is misguided. Instead, we believe that a properly administered corporate governance program can do a better job of effectively balancing the benefits these plans have to offer against their potential dilutive effects. We therefore strongly support adoption of this shareholder approval proposal, which in our view will contribute to improved corporate governance.

Discussion
FEI/CCR strongly supports the portion of this proposal that would require shareholder approval of broad-based employee stock option plans in which directors and officers participate. We believe such a requirement would help eliminate the possible appearance of self-dealing on the part of the officers and directors of a company. Although we cannot point to any specific cases of abuse, we are aware of the attention that certain executive stock option awards have received in the media where questions of their propriety have been raised. It is therefore important, we believe, that shareholders approve all such plans that allow awards to directors and officers. We believe that this practice is currently being followed by most "best practice" companies.

FEI/CCR further supports that portion of the proposal that would require shareholder approval of plans where there is no officer or director participation. We believe that because such plans have the potential for diluting the ownership interest of existing shareholders, existing shareholders should have the right to approve them. We believe that shareholders have the ability and should be given the right to act in their own best interests in this regard. Furthermore, we note that according to statistics developed by the Investor Responsibility Research Center, the vast majority (over 96%) of all stock plan proposals voted on by shareholders in the past two years were passed, supporting the view that shareholders agree that broad-based stock option plans are positive influences on creating shareholder value.

FEI/CCR agrees with the provision of this proposal allowing unapproved awards to be made from a 10% "basket" as defined by the proposal (10% of the total plan options granted, unexpired and unexercised or available for grant covered by shareholder-approved option plans). We believe this is a valuable and necessary feature of the proposal, providing an "emergency reserve" to tide companies over until they can arrange for the approval of a new plan or plan revision with a vote of shareholders at the next annual meeting.

Disclosure Enhancements
We understand the need to enhance current disclosure requirements involving outstanding employee stock option plans, particularly since certain deficiencies in current disclosure make it difficult to determine when shareholder approval of a plan will be required under the proposed rule. There is, however, a significant amount of disclosure already required on employee stock option plans in financial statement footnotes, as required by Statement of Financial Accounting Standard No. 123. We therefore caution against asking that similar, but slightly different, information be provided in proxy statements. We recommend that proxy statement disclosure rely as much as possible on incorporated by reference from these annual report footnotes to minimize duplication. We also believe that requiring companies to individually list detailed information on each outstanding plan could, in some cases, result in an excessive volume of information. We suggest that companies with a large number of plans be allowed to aggregate their information so as to comply with the intent of the disclosure without overloading the proxy statement with unnecessary detail.

Conclusion
In summary, we strongly support the proposal that the NYSE and NASDAQ adopt listing standards that would require shareholder approval for all option plans that include officers and directors. In addition, we support the proposal to apply a dilution standard requiring shareholder approval of all broad based plans when they exceed 10% of the "basket" as defined in the proposal. We support the exclusions contained in the NYSE proposal for the following types of plans:

1. Plans intended to meet the requirements of Sections 401(a) or 423 of the Internal Revenue Code.
2. Arrangements under which options or shares are issued to a person not previously employed by the company as a material inducement to the person's commencing employment with the company.
3. Arrangements for the issuance of warrants or rights issued generally to the company's security holders; and
4. Options issued to new employees in order to effect an acquisition or merger.

Finally, we urge that the proposed proxy disclosure requirements relating to stock option plans be modified to compliment the existing disclosures required by SFAS No. 123 so that much of that disclosure can be incorporated by reference into the proxy rather than being duplicated or re-disclosed in a slightly different manner.

In transitioning to these new approval requirements, we believe that because some companies have relied upon the current exemption for broad based plans, any change in the exemption should allow existing plans to be administered in accordance with the prior exemption for a reasonable period of time. We also suggest grandfather protection against required shareholder approval be afforded options granted under this prior exemption and that these shares not be subject to the 10% basket or counted against the shares in that basket.

If you would like to further discuss these comments, please feel free to contact Brad Goodwin, Chair of the Stock Option Subcommittee at (650) 303-2003 or Dean Krogman, FEI's VP of Technical Activities at (973) 898-4607.

Sincerely,

/s/ Philip D. Ameen

Philip D. Ameen
Chair, Committee on Corporate Reporting
Financial Executives International

THE INSTITUTE OF INTERNAL AUDITORS
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William G. Bishop III, CIA
President

Professional Development

Research Foundation

Certified Internal Auditor®

March 28, 2002

Mr. James L. Cochrane
Senior Vice President, Strategy & Planning
New York Stock Exchange
11 Wall Street
New York, NY 10005

RE: Corporate Accountability and Listing Standards

Dear Mr. Cochrane:

Thank you for your invitation to appear before the Special Committee of the Board of Directors of the New York Stock Exchange during its review of listing requirements and matters involving corporate governance. As the principal voice of the internal auditing profession, The Institute of Internal Auditors (IIA) strongly believes that we can offer unique insights into issues related to improving corporate governance, risk management, and control processes.

The Institute believes that internal auditors, together with boards, senior management, and external auditors, are the cornerstones of the foundation on which effective corporate governance must be built. I have enclosed a paper that provides the position of the IIA's recommendations on several matters related to corporate governance processes and the role of internal auditing within these processes. We believe that adoption of the recommendations outlined in this paper would be of significant value in strengthening corporate governance and maintaining the public trust in the integrity of financial reporting systems.

I would be honored to appear before the Special Committee on Thursday, April 4, to discuss these issues with the members of the Special Committee, as well as to offer any other assistance that might be helpful to the Committee during its deliberations. I will be accompanied by LeRoy Bookal, the chairman-elect of the Institute and recently retired chief audit executive of Texaco.

Established in 1941, The IIA is an international professional association with world headquarters in Altamonte Springs, Florida. The IIA has over 75,000 members in internal auditing, governance, internal control, IT audit, education, and security. With representation from more than 120 countries, the Institute is the acknowledged leader in standards, certification, education, research, and technological guidance for the internal auditing profession.

Thank you again for allowing The IIA to provide our comments on these important issues. If The IIA can provide further assistance, please feel free to call me.

Sincerely,

/s/ William G. Bishop III

William G. Bishop III, CIA

Enclosure

RECOMMENDATIONS FOR IMPROVING CORPORATE GOVERNANCE

PRESENTED TO THE NEW YORK STOCK EXCHANGE BY THE INSTITUTE OF INTERNAL AUDITORS

APRIL 4, 2002

The recent highly publicized corporate governance failures in the United States and other countries underscore the need for fast, decisive action to require more accountability at publicly held companies. Internal auditors, the board of directors, senior management, and external auditors are the cornerstones of the foundation on which effective corporate governance must be built. As the principal voice of the internal auditing profession, the Institute of Internal Auditors (IIA), with more than 75,000 members worldwide, strongly believes it can offer unique insights into issues related to improving the corporate governance, risk management, and control processes. And it is from the internal auditors' unique position as a participant in corporate governance, yet a critical, independent observer of that process, that the IIA offers the following recommendations for governance improvement:

1. The New York Stock Exchange, the American Stock Exchange, and the Nasdaq should jointly issue a uniform set of corporate governance principles for publicly held companies. Moreover, the board of directors of public companies should be required to disclose in their annual reports the extent to which they are in compliance with those principles.

2. The boards of directors of all publicly held companies should be required to publicly disclose an assessment of the effectiveness of internal controls within their organizations. Such disclosures should address internal controls broadly, rather than being limited to accounting controls over the recording and reporting of financial information.

3. All publicly held companies should establish and maintain an independent, adequately resourced, and competently staffed internal auditing function to provide management and the audit committee with ongoing assessments of the organization's risk management processes and the accompanying system of internal control. If an internal auditing function is not present, the board of directors should be required to disclose in the company's annual report why the function is not in place.

Following are expanded comments in support of each of the Institute's recommendations.

<u>**Corporate Governance Principles**</u>

The New York Stock Exchange, the American Stock Exchange, and the Nasdaq should jointly issue a uniform set of corporate governance principles for publicly held companies. Moreover, public companies should be required to disclose in their annual reports the extent to which they are in compliance with those principles.

The Institute believes that promulgating a strong, uniform code for corporate governance and requiring board reporting on the extent of compliance with this code are vital steps toward strengthening corporate governance, improving transparency, and restoring investor confidence. Generally accepted governance principles would be of significant value as benchmarks against which to measure and report on the fulfillment of fiduciary duties by all parties in the governance process. A uniform code of corporate governance would also help foster the high levels of integrity expected of officials of all public companies.

The National Association of Corporate Directors has recommended that the Securities and Exchange Commission require public companies to disclose the extent to which they meet endorsed standards developed by the listing exchanges.[1] Codes of governance in the United Kingdom,[2] Canada,[3] South Africa,[4] and other countries already require disclosure of conformity to certain recommended governance practices.

In the United States, governance policies and practices vary considerably from state to state and from company to company. Investors, analysts, and other stakeholders would be better served if uniform corporate governance guidelines were put in place nationwide. Requiring disclosure of compliance with such guidelines would significantly enhance governance processes without imposing inflexible board-practices requirements.

While many models could serve as the starting point for the development of sound corporate governance principles, the 21st Century Governance Principles for U.S. Public Companies,[5] recently issued by the Corporate Governance Center at Kennesaw State University in Kennesaw, Georgia, appear to the Institute to be particularly appropriate. These principles are:

1. <u>Interaction</u> – Sound governance requires effective interaction among the board, management, the external auditor, and the internal auditor.

2. <u>Board Purpose</u> – The board of directors should understand that its purpose is to protect the interests of the corporation's stockholders while considering the interests of other stakeholders (e.g., creditors, employees, etc.).

3. <u>Board Responsibilities</u> – The board's major areas of responsibility should be monitoring the CEO, overseeing the corporation's strategy, and monitoring risks and the corporation's control system. Directors should employ healthy skepticism in meeting these responsibilities.

4. <u>Independence</u> – The major stock exchanges should define an "independent" director as one who has no professional or personal ties (either current or former) to the corporation or its management other than service as a director. The vast majority of the directors should be independent in both fact and appearance so as to promote arms-length oversight.

5. <u>Expertise</u> – The directors should possess relevant industry, company, functional area, and governance expertise. The directors should reflect a mix of backgrounds and perspectives. All directors should receive detailed orientation and continuing education to assure they achieve and maintain the necessary level of expertise.

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[1] National Association of Corporate Directors, *Recommendations from the National Association of Corporate Directors to the House Committee on Energy and Commerce,* 2002

[2] The Institute of Chartered Accountants in England & Wales, *Internal Control – Guidance for Directors on the Combined Code,* 1999

[3] Joint Committee on Corporate Governance, *Beyond Compliance: Building a Governance Culture,* 2001

[4] The Institute of Directors in Southern Africa, *The King Report on Corporate Governance,* 1994

[5] Corporate Governance Center, Kennesaw State University, *21st Century Governance and Financial Reporting Principles for U.S. Public Companies,* 2002

6. Meetings and Information – The board should meet frequently for extended periods of time and should have access to the information and personnel it needs to perform its duties.

7. Leadership – The roles of board chair and CEO should be separate.

8. Disclosure – Proxy statements and other board communications should reflect board activities and transactions (e.g., insider trades) in a transparent and timely manner.

9. Committees – The nominating, compensation, and audit committees of the board should be composed only of independent directors.

10. Internal Audit – All public companies should maintain an effective, full-time internal audit function that reports directly to the audit committee.

The Institute believes these 10 principles provide a sound model for effective governance because, like the Corporate Governance Center, the IIA believes that sound governance is dependent on the synergy generated among the four components of the governance system: the board, management, internal auditors, and external auditors. In order to achieve consistent and effective governance processes, all four groups must be in place and working cohesively. These four groups provide an effective system of checks and balances that melds internal understanding of the business with independent external assessments.

Within the broad Corporate Governance Center framework, the Institute believes that the disclosures described in Principles 8 and 10 have particular relevance to internal auditing. Following are recommendations that expand upon these principles and associated disclosures.

Internal Controls Reporting

The boards of directors of all publicly held companies should be required to publicly disclose an assessment of the effectiveness of internal controls within their organizations. Such disclosures should address internal controls broadly, rather than being limited to accounting controls over the recording and reporting of financial information.

The Institute believes that mandatory reporting on the system of internal control would be a potent weapon in the ongoing fight to protect shareholders and the investing public. To ensure effective reporting, internal auditing should report to the audit committee on the adequacy and effectiveness of internal controls. The report should be coordinated and draw on representations from management about the sufficiency of internal controls, the result of control system tests performed by internal auditors and others on the management team, and the work of the external auditor. The audit committee should then evaluate the adequacy of the report and make appropriate recommendations to the board for public reporting.

The IIA believes that the most effective internal control framework available today is *Internal Control – Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).[6] The COSO report defines internal control broadly and does not limit internal controls to account-

[6] Committee of Sponsoring Organizations of the Treadway Commission (COSO), *Internal Control – Integrated Framework,* 1992

ing controls concerning financial reporting. While financial reporting is an important responsibility of the audit committee, other aspects of the business relating to resource protection, operational efficiency and economy, and compliance with rules, regulations, and policies also are exceedingly important. Further, COSO drives home the point that effective internal controls are management's responsibility and require the participation of all persons within an organization to be effective.

The organization's report on internal controls should be sufficiently comprehensive to provide the audit committee with a reasonable basis for drawing conclusions about the adequacy and effectiveness of internal controls. In order to provide this comprehensive information and to ensure that multiple viewpoints are considered, the report on controls should be based on information from a variety of sources including:

- Independent evaluations of risk and control systems performed by internal auditors;
- Reviews of internal controls performed during the external audit;
- Management opinions on significant risks and the sufficiency of controls and associated reports provided to the board of directors; and
- The results of special investigations or other activities that could have a material impact on the board's consideration of risk management and the sufficiency of internal controls.

The Federal Deposit Insurance Corporation Improvement Act of 1991 requires large banks to maintain an adequate system of internal control and to issue a management report on the effectiveness of this system over financial reporting. Berlin-based Transparency International and Financial Executives International[7], in Morristown, N.J., also called for public reporting on internal controls in the annual report, as did the Combined Code[8], the Treadway Commission[9], and the King Report on Corporate Governance[10]. Despite these initiatives, disclosures on internal controls have not yet become a standard part of annual financial reporting. The Institute believes that a written disclosure on internal control sufficiency must be an essential component of any initiative to improve the quality of the financial reporting and governance processes.

The evaluation of the system of internal control should be based on the identification of significant financial and non-financial risk. The Combined Code specifically calls for a public report covering all controls, including financial, operational, and compliance controls as well as risk management.

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[7] Financial Executives International, *Proposed Action Steps for Enhancing the Effectiveness of the Implementing of the Accounting, Auditing and Internal Control Provisions of the Convention and the 1997 Revised Recommendations – United States,* OECD Convention on Combating Bribery – Accounting, Auditing and Internal Control Provisions, Washington, D.C., 2002

[8] The Institute of Chartered Accountants in England & Wales, *Internal Control – Guidance for Directors on the Combined Code* (Turnbull Report), 1999

[9] National Commission on Fraudulent Financial Reporting, *Report of the National Commission on Fraudulent Financial Reporting,* 1987

[10] The Institute of Directors in Southern Africa, *The King Report on Corporate Governance,* 1994

In a recent survey of 178 corporate directors, 45 percent of respondents indicated that their organization did not have in place a formal enterprise risk management process – or any other formal method of identifying risk. An additional 19 percent of directors indicated that they were not sure whether their organization had a formal method of identifying risks.[11] The Institute believes that disclosures related to risks and controls would serve the public interest not only by providing transparency for investors and other stakeholders but also by helping ensure that corporate directors are aware of the risk and control issues for which they have oversight responsibility.

Internal Auditing

All publicly held companies should establish and maintain an independent, adequately resourced, and competently staffed internal auditing function to provide management and the audit committee with ongoing assessments of the organization's risk management processes and the accompanying system of internal control. If an internal auditing function is not present, the board of directors should be required to disclose in the company's annual report why the function is not in place.

Internal auditors and audit committees are mutually supportive. Consideration of the work of internal auditors is essential for the audit committee to gain a complete understanding of an organization's operations. Contemporary internal auditing is based on the identification of strategic, operational, and financial risks facing the enterprise and the assessment of controls put in place by management to mitigate those risks within dynamically changing contexts. Included in the identification of these risks are issues such as:

- Related-party transactions, joint ventures, and partnerships;
- Restructurings, including mergers and acquisitions;
- New businesses, products and systems;
- Vulnerability to interest rate changes or changes in cash flows;
- Information systems risks; and
- Reputation risks.

A process that includes the identification, understanding, and control of such risks and an assessment of the effectiveness of controls should help ensure consideration of the very items underlying recent governance and quality of earnings problems.

As noted in the *Competency Framework for Internal Auditing*[12], internal auditors monitor and report on the processes that are established within organizations to ensure that significant risk exposures are understood and managed appropriately within a context of continuous change. In many organizations, internal auditors uniquely perform ongoing, systematic evaluations and assessments of risk management and internal controls. Therefore, the Institute supports the existence of an effective, comprehensive auditing approach that includes both internal and external auditing at all publicly held corporations.

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[11] The Institute of Internal Auditors and The National Association of Corporate Directors, *After Enron: A Survey for Corporate Directors,* 2002

[12] The Institute of Internal Auditors Research Foundation, *Competency Framework for Internal Auditing,* 1999

a. <u>Internal Audit Independence</u>

In establishing and providing oversight for an internal audit function, audit committees should ensure that the function is structured in a manner that achieves organizational independence and permits full and unrestricted access to top management, the audit committee, and the board.

The IIA's *Standards for the Professional Practice of Internal Auditing (Standards)* require that the chief audit executive (CAE) report to a level within the organization that allows the internal audit activity to fulfill its responsibilities. The Institute believes that to achieve necessary independence, the CAE should report functionally to the audit committee. For administrative purposes, in most circumstances, the CAE should report directly to the chief executive officer of the company. The final point of the *21st Century Governance Principles for U.S. Public Companies* [13] is that public companies should maintain an effective, full-time internal audit function that reports directly to the audit committee.

To enhance independence, the Institute recommends that the following provisions be included in the audit committee charter:

- The audit committee should ensure that the internal audit function is structured in a manner that achieves organizational independence and permits full and unrestricted access to top management, the audit committee, and the board.
- The audit committee should review the internal auditing function's charter and ensure unrestricted access by internal auditors to records, personnel, and physical properties relevant to the performance of engagements.
- The audit committee should review and approve the annual internal auditing budget and assess the appropriateness of the resources allocated to internal auditing.
- Decisions regarding hiring or termination of the CAE should require endorsement by the chairman of the audit committee.
- The chairman of the audit committee should also be appropriately involved in performance evaluation and compensation decisions related to the CAE.
- The audit committee should regularly provide the CAE and the external auditor with the opportunity to confer privately with the committee, without the presence of management.

b. <u>Internal Audit Professionalism</u>

In establishing and providing oversight for the internal auditing function, audit committees should charge CAEs with the responsibility of ensuring that internal auditing work is performed in accordance with the IIA's *Standards*. Internal auditors – and especially CAEs – should demonstrate their professional competency by attaining appropriate professional certifications.

The professional practice of internal auditing is governed through a system of self-regulation based on widely accepted standards, ethical principles, and other guidance indicative of best practices. The IIA believes internal auditing best addresses management's strategic objectives when internal audits are performed by competent

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[13] Corporate Governance Center, *21st Century Governance and Financial Reporting Principles for U.S. Public Companies*, 2002

professionals in accordance with professional standards and rules of conduct requiring independence, due professional care, and effective quality assurance mechanisms.

The most widely recognized standards for this purpose are the IIA's globally recognized *Standards*, which provide the basis for the guidance and measurement of internal auditing performance. Adherence with the *Standards* and the Institute's *Code of Ethics* is mandatory for members of the Institute and for all Certified Internal Auditors. By requiring that internal audit work be performed in accordance with the *Standards*, audit committees and boards gain additional assurance that their organization's internal controls are adequate to protect the public trust in the financial reporting system.

The Institute recommends that internal auditors should demonstrate professional competency. The IIA believes that the preferred internal auditing credential to meet this requirement is the Institute's Certified Internal Auditor (CIA) designation. The CIA designation is the only globally recognized professional credential for internal auditing. CIAs have been required to meet rigorous education and experience requirements and to pass a comprehensive certification examination. They are bound by a professional code of ethics and by the IIA's *Standards* – and they are subject to due process and disciplinary actions for violations of the *Standards* and the *Code of Ethics*. Once certified, CIAs are required to obtain continuing education to maintain professional certification.

Conclusion

In conclusion, the Institute of Internal Auditors believes that internal auditors, the board, senior management, and external auditors are the cornerstones of the foundation on which effective corporate governance must be built. All publicly traded companies should have a fully resourced, independent internal auditing function that is professionally staffed and chartered to evaluate the risk management, control, and governance processes. The Institute strongly endorses adoption of a uniform set of corporate governance principles for publicly held companies. The IIA further supports initiatives requiring public disclosures related to compliance with endorsed principles, the effectiveness of internal controls, and internal auditing.

The Institute of Internal Auditors is an international professional association with world headquarters in Altamonte Springs, Florida. Established in 1941, the IIA has over 75,000 members working in the fields of internal auditing, governance, internal control, IT audit, education, and security. With representation from more than 100 countries, the Institute is the acknowledged leader in standards, certification, education, research and technological guidance for the internal auditing profession.

NACD
NATIONAL ASSOCIATION OF CORPORATE DIRECTORS

March 4, 2002

Mr. Richard Grasso
Chairman and CEO
New York Stock Exchange
18 Broad Street
New York, NY 10005-1904

Dear Mr. Grasso:

I testified before the House Committee on Energy and Commerce on February 6, 2002, on Corporate Governance and the Impact of the Collapse of Enron. At the end of six hours of testimony and discussions, Chairman Billy Tauzin asked me to provide written recommendations to the Committee on what boards should do to fulfill their fiduciary responsibilities. In response, the Board of the National Association of Corporate Directors (NACD) has sent the Committee its recommendations, which are attached for your review.

You will note in our recommendations that NACD strongly encourages the New York Stock Exchange to take this opportunity to require their listed companies to disclose their conformity to certain recommended board practices.

At this critical time, the NACD and entire governance community have a unique opportunity to raise the visibility and value of good corporate governance to shareholders, as well as to the general public. We encourage your support in our effort to enhance board performance, accountability, and integrity.

Sincerely yours,

/s/ Roger W. Raber

President and CEO

National Association of Corporate Directors 1128 L Street NW Suite 801 Washington DC 20036

NACD®
NATIONAL ASSOCIATION — OF — CORPORATE DIRECTORS

RECOMMENDATIONS FROM THE NATIONAL ASSOCIATION OF CORPORATE DIRECTORS

Concerning Reforms in the Aftermath of the Enron Bankruptcy
Submitted March 1, 2002. Updated May 1, 2002.

We believe that the New York Stock Exchange, the American Stock Exchange, and the Nasdaq (self-regulatory organizations, or SROs) should endorse a set of general standards for board practices. We therefore recommend that the House Committee on Energy and Commerce ask the Securities and Exchange Commission (SEC) to urge the SROs to develop such standards or adopt an existing set of standards. Furthermore, we believe that the SEC should require public companies to disclose the extent to which they meet these endorsed standards. Public companies not following these practices would be required to describe to their shareholders any plans they have to adopt the practices, or explain why they do not find it necessary to do so. We believe that the SEC has the power to make this requirement without any special action by Congress.

This system would be similar to the ones established in 1993 in the United Kingdom (Cadbury Committee report, now the Combined Code) and subsequently in other countries inspired by the U.K. system, such as Canada (Dey Report). In these countries, stock exchanges require disclosure of conformity to certain recommended practices.

Experience and research have shown that disclosure requirements make a difference. Boards that do not initially conform to recommended practices tend to adopt them eventually, thereby strengthening their governance and, ultimately, the likelihood of improving long-term corporate performance.

U.S. SROs have been reluctant to endorse any particular set of governance policies and practices in part because of the state-based nature of governance in this country. In the U.S., expectations for director performance are set in part by state corporation laws, which vary somewhat from state to state. Although directors have affirmative duties of care and loyalty in every state, these duties differ slightly in their statutory expression and judicial interpretation. In contrast, the countries mentioned above have unitary federal legal systems. Furthermore, U.S. companies tend to have a strong culture of voluntary governance, creating and following their own codes based on those of other companies, or from the codes of business, legal, and investor groups.

The time has come, however, to consider SRO endorsement of a set of general governance practices. Although our state-based, voluntary system has worked well for the companies it has touched, too many companies remain on the fringes of good governance practice. Mandating public company disclosure of certain core governance practices would require companies to pay more attention to board governance, yet would still preserve flexibility and diversity in their application to individual boards' needs.

The challenge, therefore, is to select the source and number of practices that should be endorsed for disclosure purposes. There are many valid sets of recommended governance practices. It will be very important to select the right set.

The SROs may wish to use their recently formed governance panels to determine which practices should be endorsed. The panels could examine the many codes that already exist from other nations' stock exchanges, and from the various kinds of groups listed above. The NACD would be honored to participate in such an effort.

Alternatively, and preferably, the SROs may wish to consider and endorse the following set of practices, which are based on the Blue Ribbon Commissions the NACD has hosted on a variety of governance topics since 1993. These Commissions have considered a broad range of issues, including executive compensation, CEO evaluation, director compensation, director professionalism, CEO succession, audit committees, the role of the board in corporate strategy, and board evaluation. Although NACD periodically updates these reports, their fundamental recommendations have endured.

Our Blue Ribbon Commissions have involved a full range of constituencies, including corporate directors, corporate officers (including CEOs and senior officers), institutional shareholders, accountants, attorneys, retired government officials, and corporate governance scholars. In total, more than 200 individuals have been involved in these Commissions, with between 25 and 40 individuals serving on each Commission. Furthermore, in every instance, the recommendations made by these Commissions have taken into account other existing governance codes.

These Commissions' recommendations, with dozens in each report, number in the hundreds--far too many to be practical for disclosure purposes. However, the Commissions have yielded a core set of recommendations the NACD board considers crucial to good governance. Furthermore, these recommendations are consistent with those endorsed by other prominent organizations in the governance field. These core recommendations follow.

Core Recommendations

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, at a minimum, should include two key elements: a) oversight of the quality and integrity of financial reports and the process that produces them; b) oversight of the management 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 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 that management pays strict attention to ethical behavior and compliance with laws and regulations, approved auditing and accounting principles, and with 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 governance practices. Boards should also ensure that directors are continually updated on these matters.

We consider the final recommendation to be particularly important. The SROs should be encouraged to consider making director orientation and continuing education mandatory. This would place the U.S. ahead of other countries, where continuing education for corporate directors is not yet mandated. Mandating director education would not be difficult, and the benefits would be great. Many organizations offer industry education, and a small but growing number of organizations, including several leading universities and the NACD, provide education in governance. This type of education seems particularly critical today, when there is a heightened need for directors to maintain a current knowledge of governance issues and practices.

We believe that the SEC has the authority to take action on our recommendations, with the encouragement of your committee, without the need for further action by Congress.

Our proposal would not require any new financial reporting standards. In our view, the current system of a standards-setting body overseen by a public oversight body remains the best approach to financial disclosure standards-setting for public company reporting. True, some have criticized the Financial Accounting Standards Board, as well as the recently disbanded Public Oversight Board, for having overly close ties to business and accounting groups, so there may be a need to ensure greater independence of these groups. The greatest need for stronger independence and oversight, however, may lie in the boardroom itself.

The current system does not need more financial disclosure rules. Rather, it needs stronger oversight of those rules. We believe that the recommendations we have made in this statement can help boards of public companies ensure that their members are informed and independent, and can fulfill their oversight duties with integrity.

Commonwealth of Pennsylvania

Testimony of The Honorable Barbara Hafer
Treasurer, Commonwealth of Pennsylvania &
President, National Association of State Auditors, Comptrollers, and Treasurers

Before the NYSE Corporate Accountability and Listing Standards Committee

April 4, 2002

Chairman H. Carl McCall, Chairman Gerald M. Levin, Chairman Leon E. Panetta, Members of the Committee:

I am pleased to appear today before the NYSE Corporate Accountability and Listing Standards Committee to discuss corporate governance matters that will be used to provide guidance to the NYSE and industry governing bodies on measures to bolster public confidence.

Introduction

As the Treasurer of the Commonwealth of Pennsylvania and as President of the National Association of State Auditors, Comptrollers, and Treasurers, I have been following the recently renewed interest in corporate governance matters and have held and participated in similar hearings.

On February 19th, as Treasurer of the Commonwealth of Pennsylvania, I held a hearing to gather information in preparation for my participation in a forum sponsored by the U. S. General Accounting Office in Washington D. C. related to the Enron collapse. The issues discussed at the Pennsylvania hearing were: How did all the safeguards fail; how extensive was the impact on workers and retirees in Pennsylvania; and, how can we make sure this does not happen again? The general consensus of the participants was that the Securities and Exchange Commission needs to better exercise their authority including ensuring fuller and clearer accounting disclosures and separating the research analyst side from the Investment banking side.

On February 25th, I participated in a GAO sponsored forum entitled Corporate Governance, Transparency and Accountability. The GAO organized the forum in response to a Congressional request to examine the issues that caused the Enron collapse and determine what could be done to reduce the possibility of a similar situation occurring in the future.

On March 5th, David Walker, Comptroller General of the U.S., issued the GAO Report on the Highlights of the February 25th forum, and testified before the U. S. Senate on the same topic (a copy of the GAO report has been submitted with my written testimony).

Observations

Many of the statements I made at the GAO forum addressed many of the same issues you are dealing with today, and I will therefore share three of those observations with you.

First — Deliberate Effort Not to Disclose

There was a deliberate effort to avoid transparency by failing to fully and clearly disclose the "off balance sheet" partnerships. As the GAO reported to the Senate on March 5th, "In the end, no matter what system exists, bad actors will do bad things with bad results." Although I agree with this statement, I would like to add that in the case of Enron, the extent of the bad acting was such that their licenses to ever act again should be taken away. Every actor that was supposed to be a check and balance in the system failed, which leads me to my second point.

Second — Professional Advisors and Conflicts of Interest

There was a failure by the professional advisors involved to avoid "conflicts of interest."

If you look at the actions of the Accounting firm, you see clearly that they were wearing two hats: one, as supposedly an independent audit function, and two, as conducting a consulting business. For the sake of profits to the consulting function, the independence of the auditors was compromised.

Proposal for improvement

Going forward, we should demand that corporations select audit firms with no other material ties to them, never again allowing both functions as was done with Enron.

Similarly, the other professionals, the lawyers, whether internal counsel or outside counsel, how could any of them have signed off on the questionable partnership deals?

Likewise, an examination of the actions of various financial firms' research analysts touting the stock as a "buy" even after the stock dropped dramatically in price leads one to question whether the firms' investment banking divisions caused the analysts to be pressured to compromise their independence similar to the accounting firms scenario.

Proposal for Improvement

Again, there should be a mechanism in place to ensure there is a firewall between the research analysts and the investment banking divisions to ensure public confidence.

I am also in full agreement with Federal Reserve Chairman Alan Greenspan's comment that publication of past recommendations made by securities analysts would be welcome. The Federal Reserve Chairman has been quoted as saying ... "that with such transparency, the current upward bias of analysts' earnings projections would diminish rather rapidly, because investment firms are well aware that security analysis without credibility has no market," and I totally agree.

One other issue, that I am also in agreement with Chairman Greenspan, deals more with accounting treatment than conflicts of interest, but is important to mention. I totally support Chairman Greenspan's recommendation to Congress that stock options be treated as company expenses rather than requiring companies report the cost of providing options as a footnote in their annual report, which is the current rule and leads to many corporations inflating reported earnings. Counting options as expenses would not bar companies from offering them as incentives but would mean only that their cost would be reflected on the books.

Third — Board of Directors

The conduct of the members of the Board of Directors of Enron and its executive officers is reprehensible; taking a once highly regarded component of the S&P 500 and allowing or executing its demise into bankruptcy to the detriment of the portfolios of every State Treasury, every large public or private pension fund, professional as well as individual investors, and most significantly those loyal Enron employees who were forbidden from selling their Enron stock.

The March 5th GAO Report that resulted from the forum I participated in and the GAO's subsequent testimony to the Senate, in particular, spoke to this issue as follows:

> Serving on the Board of Directors is at times a difficult and challenging responsibility, especially with increased globalization and rapidly evolving technologies having to be addressed while at the same time meeting quarterly earnings projections. These pressures, and related executive compensation arrangements, can create perverse incentives, such as managing earnings to inappropriately report favorable financial results, and/or failing to provide adequate transparency in financial reporting that disguises risks, uncertainties, and/or commitments of the reporting entity.
>
> However, the difficulty of serving on a public corporation's board of directors is not a valid reason for not doing the job right, which means being knowledgeable of the corporation's business, asking the right questions, and doing the right thing to protect the shareholders and the public interest. A board member needs to have a clear understanding that the client being served is the shareholder. Audit committees have an important role to play in assuring fair presentation and appropriate accountability in connection with financial reporting, internal control, compliance, and related matters. A weak board of directors will also likely translate into an ineffective audit committee.

Proposal for Improvement

> The GAO also provided the Senate with a list of 20 basic factors to consider in reviewing the requirements that govern membership and responsibility of boards of directors of public companies. Although I believe all 20 factors are important and have included them in my written testimony as an attachment, the one that needs to be highlighted is: "Do requirements provide for the board of directors to establish a formal code of conduct to set the tone for expected personal and business ethical behavior within the corporation?"

I am also aware that one of the areas your committee will be examining as part of corporate governance is the possibility of requiring continuing education programs for officers and directors. I would like to be on the record as strongly supporting such a requirement. As the former Pennsylvania Auditor General for eight years and as the current President of the National Association of State Auditors, Comptrollers, and Treasurers, I know firsthand the benefits and rewards of requiring continuing professional education. Because of the ever changing environments, continuing education is a must for most professionals and should be so for corporate officers and directors.

Conclusion

Finally, I would also like to add that I am here today to ask that we demand of our corporations and the professionals that serve them, that they conduct their affairs not only in compliance with the "Letter of the Law" but in compliance with the "Spirit of the Law."

Thank you for the opportunity to testify today. I am pleased to respond to any questions the Committee may have.

Factors for Board of Directors

Basic factors to consider in reviewing the various requirements that govern membership and responsibilities of boards of directors of public companies include the following:

- Is there a clear understanding of whom the board is serving and its fiduciary responsibility to shareholders and related impact on the capital markets?
- What type of relationship should the board have with management (for example, constructive engagement)?
- What, if any, selection process changes are necessary in order to assure the proper identification of qualified and independent board members?
- Is the nominating process for board membership designed to ensure that the board is getting the right mix of talent to do the job?
- Do board membership rules address who other than management would nominate Board members?
- Are the independence rules for outside directors and audit committee members sufficient to ensure the objectivity of the members?
- Do board membership rules address whether the corporation's CEO should be allowed to be the board chairman?
- Do board membership rules address whether independent board members should nominate the chairman of the board?
- Do board membership rules address whether members of corporation management, including the CEO, should be allowed to be board members, and if so, what percentage of total board membership?
- Do board membership rules address whether corporation service providers, such as major customers or other related parties, should be allowed to be board members?
- Do requirements ensure that the board will have access to the resources and staff necessary to do the job, including its own staff and access to independent legal counsel and other experts?
- Do requirements ensure that the responsibilities of board members, including the members who serve on audit committees and other committees, such as the nominating, finance, and compensation committees, are required to be committed to a charter that governs their operation?
- Do requirements address the appropriate working relationship between the audit committee and the internal and external auditors?
- Do requirements provide for the board of directors to establish a formal code of conduct to set the tone for expected personal and business ethical behavior within the corporation?
- Do requirements provide that waivers of the code of conduct are not expected and should such circumstances arise, which should be extremely rare, that any exceptions must be approved by the board of directors and publicly reported?
- Do requirements provide for public reporting on the effectiveness of internal control by management and independent assurances on the effectiveness of internal control by the corporation's independent auditors?

Factors for Board of Directors (Continued)

- Do requirements provide for public reporting by the board of directors, the audit committee, and other committees of the board on their membership, responsibilities, and activities to fulfill those responsibilities?
- Do the stock exchanges and the SEC have sufficient authority to enforce requirements governing boards of directors and audit committees and to take meaningful enforcement actions, including imposing effective sanctions when requirements are violated?
- Does the SEC have sufficient resources and authority to fulfill its responsibilities under the federal securities laws and regulations to operate proactively in monitoring SEC registrants for compliance and to take timely and effective actions when noncompliance may exist?
- Is the SEC efficiently and effectively using technology to manage its regulatory responsibilities under the federal securities laws by assessing risks, screening financial reports and other required filings, and accordingly prioritizing the use of its available resources?[1]

[1] See page 7 and 8 of Protecting The Public Interest, Selected Governance, Regulatory Oversight, Auditing, Accounting, and Financial Reporting Issues, Statement of David M. Walker, Comptroller General of the United States, Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, March 5, 2002 (GAO-02-483T).

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April 11, 2002

Co-Chairs, H. Carl McCall, Gerald M. Levin, Leon E. Panetta and
Members of the Corporate Accountability and Listing Standards Committee
c/o The New York Stock Exchange
11 Wall Street
New York, NY 10005

Dear Co-Chairs and Members of the Committee:

I am pleased to submit these written comments to the Committee. The New York Stock Exchange (NYSE) has both the opportunity and the obligation to consider the corporate governance standards of listed companies. The goal must be to raise standards in order to meet the expectations of investors and the public, particularly in light of recent events. My recommendations are presented for your consideration in achieving this goal.

In large measure the NYSE is in a unique position to fulfill these expectations. As an exchange with a deserved reputation for understanding its responsibilities, the NYSE can and should evaluate its standards in relation to new developments and newly exposed problems. Clearly, the public now expects that the NYSE will evaluate not only specific listing rules but also other ways in which the exchange can elevate corporate governance standards. The Committee brings together excellent experience and judgment from the issuer community and professional representatives who have served that community at the highest quality level. I suggest as the Committee moves forward towards its final report that it consult with representatives from other constituencies -- primarily the investors -- to the greatest degree possible in a candid exchange of views so that when its report is made public the NYSE has the fullest support for its recommendations.

I will now turn to certain of our recommendations for consideration in two general areas: (1) improving the quality of board performance, and (2) assuring that the relationships among the management, the board, and the shareholders best align their appropriate roles.

TIAA-CREF has long been a leader in articulating its views on these subjects and I refer therefore to our Policy Statement on Corporate Governance, last revised in year 2000. Although this Policy Statement fairly states our current views on the various topics, it is also true to say that we shortly will be in the process of our next revision, and trends and developments since year 2000 no doubt will affect the focus and emphasis of our views.

(1) Improving Quality of Board Performance

A concerned shareholder, TIAA-CREF has long appreciated that we must rely critically on the performance of boards of directors of our portfolio companies. We do not sit in at board meetings and, therefore, must try to assess board performance as best we can from observations of the company and certain indicia, which over the years we have come to believe will make a difference.

We start with board independence -- true board independence. Here we observe that NYSE definitions of independence no longer work satisfactorily. The remedy for this problem fortunately is relatively easy to identify. When the NYSE looked at the appropriate definition of independence for audit committee members, it adopted standards that are more sensitive to the various ways independence can be compromised, though the definition was not all that was called for by the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees. Thus:

RECOMMENDATION 1: Apply the audit committee definition of independence to all directors, and consider strengthening that definition to provide (a) that a director employed by the corporation or its affiliates is not considered independent until five years after termination of employment (as called for in the Blue Ribbon Committee report); and (b) that financial relationships between the director and any executive disqualify that director from being considered "independent" (an area not addressed by the BRC).

The next area of concern is board composition as a whole. What is the minimum number of independent directors appropriate for a NYSE listed company? In our view, the Policy Statements of the Business Roundtable as well as TIAA-CREF have it right by stating that a substantial majority of the directors should be independent. Thus:

RECOMMENDATION 2: Provide that a substantial majority of directors should be independent.

Board independence, however, cannot be divorced from independence of key board committees, since so much critical board activity takes place in that context. The key committees are widely acknowledged to be the Audit, Nominating (or Governance), and Compensation committees. It is important that each of these committees function as best they can without an overly pervasive influence of the senior management. It may be particularly helpful for the NYSE to address the existence of an independent nominating committee. Many companies continue to lack such a committee, and many such committees in existence are not sufficiently independent, often including the CEO or other non-independent directors. Thus:

RECOMMENDATION 3: The NYSE should mandate the existence of each of these key committees, and should require they each consist entirely of independent directors.

There are particular issues relating to the compensation committee and serious questions about this committee's effectiveness such as:

- Has the committee obtained the services of an independent consultant? Was that consultant the same organization used by the Human Resources department of the company? (Executive compensation is now taking on extraordinary significance as reflecting a problem with U.S. corporate governance, and special rules as to that function are appropriate.) Thus,

RECOMMENDATION 4: The NYSE should study the special importance of the role of executive compensation and recommend appropriate standards and practices of the compensation committee.

The above recommendations can very well be implemented as listing requirements. They are all capable of reasonable interpretation and clear in intent. Certain other corporate governance improvements could perhaps equally be implemented as "Best Practices" recommendations, but with the NYSE listing requirement that each listed company disclose in its proxy statement whether it conforms to these Best Practices and, if not, explains why the company believes this is an appropriate response. I would note that the London Stock Exchange and the Toronto Stock Exchange have taken this approach, with rather detailed Best Practices guidelines for governance.

Issues that could be dealt with as Best Practices are numerous, and would require considerable attention and thought. Suggestions could range from straightforward recommendations that clearly should be followed by all boards – such as that there be periodic meetings of independent directors in executive session – to more complicated subjects that may suggest a diversity of approaches, such as appropriate remuneration structures for outside board members. Some of the additional issues that I believe should be handled in Best Practices guidelines might include:

Director and Board evaluations:

- Does the company, either at the board level or individual director level, conduct evaluations to assess the quality of its own processes?

Director education:

- Does the company have an on-going program to assure that directors avail themselves of any of the myriad of outstanding programs offered by Business Schools, NACD, and other organizations? This concern is particularly addressed to what we perceive as a lack of understanding on the part of many Compensation Committee members as to that committee's role and responsibilities, and the information and understanding required to be an effective compensation committee member.

Thus:

RECOMMENDATION 5: Provide that the NYSE will set up a committee or task force with appropriate representation from affected constituencies to study and recommend "Best Practices" with disclosure requirements along the lines of British and Canadian practice.

(2) Relationship Among the Management, the Board, and Shareholders -- Shareholder Voting Rights

The next area of corporate governance needing improvement relates to when shareholders have the right to participate in decisions that vitally affect their interests. Some are so critical that they should be implemented by listing standards.

First and foremost on the agenda now is the right of shareholders to approve dilutive stock option plans. Since this is a subject upon which the NYSE has much knowledge and experience I need not go on at great length.

Thus:

RECOMMENDATION 6: Require shareholder approval for all materially dilutive option plans, with a requirement along the lines of the NYSE Task Force recommendation back in 1999. Indeed, the NYSE should restate its willingness to adopt those standards.

Other issues

There are other issues which are appropriate for the NYSE to take up which might not directly relate to its direct regulatory responsibilities. These might include the governance of the regulatory structure for the accounting field. The NYSE would be a respected voice in recommending appropriate regulatory oversight of the accounting profession.

Conclusion

I have identified a number of areas for corporate governance improvements that are both possible and realistic for implementation by the NYSE. The exchange could also be pro-active and identify other issues worthy of addressing. It is important that the Committee not view its mandate in a narrow sense and appreciate the broader public interest we all have in the credibility of our securities markets. Above all, the Committee should assure that by the time it issues its report publicly it has shared its findings and approaches with other affected constituencies so that when later debated all such constituencies have a sense that they were appropriately engaged and that their views were fully taken into account.

I would be glad to discuss these issues with you at greater length and continue to participate with the NYSE in achieving these important goals and purposes.

Sincerely,

/s/ Peter C. Clapman

Peter C. Clapman

Cc: Richard Grasso, Chairman, New York Stock Exchange
Catherine Kinney, Group Executive Vice President, Office of Chief Executive, New York Stock Exchange
James L. Cochrane, Senior Vice President, Strategy and Planning, New York Stock Exchange

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April 18, 2002

Co-Chairs, H. Carl McCall, Gerald M. Levin, Leon E. Panetta and
Members of the Corporate Accountability and Listing Standards Committee
c/o The New York Stock Exchange
11 Wall Street
New York, NY 10005

Dear Co-Chairs and Members of the Committee:

I appreciated the opportunity to share my views with the Committee and am following up on a request by Peter Larson for additional material supporting the conclusion that increasingly non-approved stock option plans are being implemented. Attached are the relevant pages of the final rule "Disclosure of Equity Compensation Plan Information" as promulgated by the SEC earlier this year.

In the release, accompanying the final rule, the SEC writes: "We also estimate that approximately 20% of these registrants [those with equity compensation plans] maintain non-security holder-approved equity compensation plans and, thus will be required to describe the material features of these plans and file copies with us unless immaterial in amount or significance." The SEC references footnote 89 citing the report of iQuantic, which mentions that 27.3% of its survey respondents in 1999 maintain non-security approved stock option plans compared to 3.2% before 1996.

Additionally, the SEC release states, "Until recently, security holder approval was required for most equity compensation plans. However, as approval requirements have been relaxed and as opposition to these plans has grown, an increasing number of registrants have adopted stock option plans without the approval of security holders, thus potentially obscuring investors' ability to assess the dilutive effect of a registrant's equity compensation program."

I also enclose Page 15 of the iQuantic report that includes Chart 17, a graph showing companies with non-shareholder-approved plans indicating a rise at an accelerating rate, each year between 1996 through 1999, 15% - 18% - 21% - 35%.

I hope this information is helpful to the Committee.

Sincerely,

/s/ Peter C. Clapman

Peter C. Clapman

U.S. Securities and Exchange Commission

Final Rule:

Disclosure of Equity Compensation Plan Information

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 228, 229, 240 and 249

[Release Nos. 33-8048, 34-45189; File No. S7-04-01]

RIN: 3235-AI01

DISCLOSURE OF EQUITY COMPENSATION PLAN INFORMATION

Agency: Securities and Exchange Commission.

Action: Final rules.

Summary: We are adopting amendments to the Securities Exchange Act of 1934 disclosure requirements applicable to annual reports filed on Forms 10-K and 10-KSB and to proxy and information statements. The amendments will enhance disclosure of the number of outstanding options, warrants and rights granted by registrants to participants in equity compensation plans, as well as the number of securities remaining available for future issuance under these plans. The amendments require registrants to provide this information separately for equity compensation plans that have not been approved by their security holders, and to file with us copies of these plans unless immaterial in amount of significance.

Dates: *Effective Date*: 30 days after publication in the *Federal Register*.
Compliance Dates: Registrants must comply with the new disclosure requirements for their annual reports on Forms 10-K or 10-KSB to be filed for fiscal years ending on or after March 15, 2002 and for proxy and information statements for meetings of, or action by, security holders occurring on or after June 15, 2002. Registrants voluntarily may comply with the new disclosure requirements before the compliance dates.

Comments: Comments on the "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 should be received 30 days after publication in the *Federal Register*.

For Further Information Contact: Mark A. Borges, Special Counsel, Office of Rulemaking, Division of Corporation Finance, by telephone at (202) 942-2910, or in writing at the Securities and Exchange Commission, 450 Fifth Street NW, Washington, DC 20549.

. . . .

C. Revisions to Reporting and Cost Burden Estimates

As a result of the changes described above and a change in one of our underlying assumptions,[86] the reporting and cost burden estimates for the collections of information have changed. Accordingly, we have revised the estimated information collection requirements that were originally submitted to the OMB. With respect to Forms 10-K and 10-KSB, we have increased our estimate by 1,174 hours in the case of Form 10-K and increased our estimate by 707 hours in the case of Form 10-KSB. With respect to Schedules 14A and 14C, we have decreased our estimate by 13,139 hours in the case of Schedule 14A and decreased our estimate by 139 hours in the case of Schedule 14C.

Our estimates are based on several assumptions. First, we estimate that approximately 60%[87] of the registrants that file an annual report on either Form 10-K or 10-KSB maintain equity compensation plans and will be required to provide the new disclosure table.[88] We also estimate that approximately 20%[89] of these registrants maintain non-security holder-approved equity compensation plans and, thus will be required to describe the material features of these plans and file copies with us unless immaterial in amount or significance.[90] We further estimate that, in any year, 30%[91] of the registrants with equity compensation plans will either adopt a new plan or amend an existing plan to increase the number of securities authorized for issuance under the plan, thereby triggering proxy or information statement disclosure.[92] In this situation, we have assumed that a registrant will include the required disclosure in its proxy or information statement and incorporate that disclosure by reference into its annual report on Form 10-K or 10-KSB. We estimate that approximately 28%[93] of the registrants filing annual reports on Form 10-K or 10-KSB are subject to Section 13 of the Exchange Act by virtue of Section 15(d) of the Exchange Act and, thus, do not file proxy or information statements,[94] and that approximately 98%[95] of the registrants file proxy, rather than information, statements in connection with their annual meeting of security holders at which directors are to be elected.[96] Finally, we estimate that preparation of the required tabular disclosure will take two burden hours and, where required, preparation of the description of the material features of a non-security holder-approved equity compensation plan will take two burden hours.[97]

. . . .

IV. Costs and Benefits of Final Rules

A. Background

The use of equity compensation, particularly stock options, has grown significantly during the last decade.[112] Consequently, existing security holders may face higher levels of dilution of their ownership interests as some companies issue more shares of their stock to employees.[113] Since the distribution of equity may result in a significant reallocation of ownership in an enterprise between existing security holders and management and employees, investors have a strong interest in understanding a registrant's equity compensation program.[114]

Until recently, security holder approval was required for most equity compensation plans. However, as approval requirements have been relaxed[115] and as opposition to these plans has grown,[116] an increasing number of registrants have adopted stock option plans without the approval of security holders,[117] thus potentially obscuring investors' ability to assess the dilutive effect of a registrant's equity compensation program. Our current rules do not require that a registrant disclose specific information about its non-security holder-approved equity compensation plans.[118] Nor do current financial reporting disclosure rules require that non-security holder-approved plans be identified.[119]

Consequently, it is often difficult for investors to determine whether they have adequate information about a registrant's equity compensation program. In response to ongoing investor concerns,[120] in January 2001 we proposed amendments to our rules to enhance the quality of information available to investors about equity compensation plans.[121]

. . . .

[89] *In the Proposing Release, we estimated that this figure was 25%. The available survey data does not appear to be representative of the general registrant population. See William M. Mercer, Inc., Equity Compensation Survey (2001) (48% of survey respondents (83 participants) maintained non-security holder-approved stock option plans for employees below management level; 60% of such plans most prevalent in large companies (more than 5,000 employees)); iQuantic, Inc., Trends in Equity Compensation 1996-2000 (2000) (27.3% of survey respondents in 1999 (161 participants) maintained non-security holder-approved stock option plans, compared to 3.2% before 1996). After discussions with several compensation professionals, we reduced our estimate to 20%.*

TRENDS in EQUITY COMPENSATION 1996-2000

An Executive Summary of iQuantic's High-Tech Equity Practices Survey

. . . .

The hunger for shares has also led to an increase in the number of non-shareholder approved plans (See percentages below), a trend that requires careful attention. These plans are aimed at providing options to non-executives.

If a plan is not approved by shareholders, it functions under several statutory limits. First, if a company is listed on the NYSE, at least half the shares must be granted to non-officers, and at least half of employees in the company must be eligible to participate in the plan. Second, no incentive stock options can be issued under the plan. Finally, if the stock options are not part of a shareholder-approved plan, they will not be considered as "performance-based pay" for purposes of the "million dollar cap" on deductible compensation. iQ

Chart 17: Companies with non-shareholder-approved plans, year in which instituted[1]
1996: 15%
1997: 18%
1998: 21%
1999: 35%

[1]Located in "TRENDS in EQUITY COMPENSATION 1996-2000 - An Executive Summary of iQuantic's High-Tech Equity Practices Survey," Ted Buyniski and Daniel Silver, ©2000 iQuantic, Inc. (Chart 17)

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3/27/02

From: **James B. Cloonan, Chairman**
American Association of Individual Investors

To: **NYSE Corporate Accountability and Listings Standards Committee**

Re: **Investor concern in matters of corporate governance and reporting**

I thank you for the opportunity to provide input into your deliberations on steps that should be taken to insure corporate and accounting firm integrity in their relationships with stockholders and other stakeholders. In my opinion, there are a number of areas that are of concern to serious individual investors and should be of concern to the more lethargic investors who depend on regulation to protect them.

The main areas of concern from the perspective of the individual investor, I feel, are:

Reliability of the financial statements. Under this I would emphasize the abuse of *pro forma* to provide creative accounting scenarios. This term should be saved for cases where there is a merger or other activity that requires a combination or separation of different entities. The concept of "unusual or onetime" versus "ongoing" expenses seems to be abused and needs some testable definition.

I believe it is essential that stock options be expensed at market value and that any reset of exercise prices be reflected as additional expense when it occurs.

In addition, the responsibility of outside auditors to the Board of Directors through the Audit Committee rather than to management needs reaffirmation.

Corporate Governance Issues. The overall balance of inside versus outside directors may or may not be a critical factor. Clearly, unless outside directors are truly independent, percentages of inside/outside don't matter. A standard for defining independence is necessary. I don't know if the CALPERS approach is the best but some standard is very desirable.

I believe the Chairman of the Audit Committee must be independent and assume major responsibility for checking the work of the auditors. Companies must provide whatever support the Audit Committee requires and this support should be from outside services or from a company unit that is controlled by the audit committee. For a major public corporation service on the audit committee is, or should be, a major undertaking and I don't believe that any individual should be performing this function for more than one company. I also feel that no individual can perform on more than 2-3 boards of major corporations.

I feel the mechanisms of reporting insider transactions need to be tightened. There seems little reason that reporting can't be computerized and that it can't be accomplished within 5-7 days from the transaction. Transactions with the company or any adjustment of exposure through derivatives, public or private, should also be reported on an expedited basis.

Hopefully, the kind of problem that appeared with Enron is unusual. The next problem with such wide impact will likely be different but the whole concept of hiding activities to make performance look better is anathema to good corporate management and should be aggressively discouraged by auditors.

As to what steps need to be taken by governmental and regulatory agencies, I believe that the reporting rules for insider transactions should be changed to cover all transactions public and corporate and to insure fast reporting. I also believe that stock options and any adjustments to options issued by a corporation need to be expensed and the necessary legislation and regulation be enacted.

Beyond that, I am not sure that additional regulation is desirable or necessary. The case of Enron, which has spurred increased interest in these areas, must be a strong warning to companies and auditors alike that such behavior will not be tolerated. While all the details will be coming out in civil and criminal trials in the future, it seems fairly clear that laws were broken so it wasn't the absence of laws that let the disaster occur. In addition, the market seems to be, through stock price changes, forcing desired changes in company behavior.

On the other hand, the setting of standards for Corporate Governance by self-regulating agencies and the publishing of the extent to which companies comply could prove useful. If investors are aware of how company management lives up to standards of behavior they will use the marketplace to force compliance.

The comments here have been limited to concerns of investors. Obviously, other problems of company management, such as pension and credit reporting, have been exposed by the Enron disaster. Some of these may require changes in laws and regulations.

Thank you for your attention. I feel sure your deliberations will lead to valuable insights into problems with current procedures. If I can answer any questions, or if you would like me to poll our members on any issue, please let me know.

/s/ James B. Cloonan

May 2, 2002

James L. Cochrane
Senior Vice President
Division of Strategy & Planning
New York Stock Exchange
11 Wall Street, 6th Floor
New York, NY 10005

Dear Mr. Cochrane,

The Ethics Officer Association (EOA) appreciates the opportunity to respond to your invitation to provide input to the Special Committee of the New York Stock Exchange Board of Directors currently reviewing listing requirements and matters involving corporate governance. Attached please find the EOA's comments and recommendations pertaining to this matter.

The EOA is the professional, non-profit, non-consulting association for executives who manage their organizations' ethics and compliance programs. Founded in 1992, it currently has over 800 members. A complete list of member organizations is [not] attached.

The EOA's comments and recommendations are based on discussions with many of our members but do not necessarily represent the views of all of our member organizations.

Thank you for asking the EOA to provide its thoughts on this important matter. If you have any questions or require additional information, we would be happy to discuss these issues with you.

Sincerely,

/s/ Francis J. Daly

Francis J. Daly
Chair, Board of Directors
Ethics Officer Association

/s/ Edward Petry

Edward Petry, Ph.D.
Executive Director
Ethics Officer Association

30 Church Street • Suite 331 • Belmont • Massachusetts • 02478 • *phone:* (617) 484-9400 • *fax:* (617) 484-8330 • *website:* www.eoa.org

Comments and Recommendations of the Ethics Officer Association

Overview

The Ethics Officer Association (EOA) is pleased to have the opportunity to present comments and recommendations in response to an invitation by the New York Stock Exchange (NYSE) to provide input to the Special Committee of the NYSE Board of Directors currently reviewing listing requirements and matters involving corporate governance.

The EOA is the professional, non-profit, non-consulting association for executives who manage their organizations' ethics and compliance programs[1]. Founded in 1992, it currently has over 800 members. A complete list of member organizations is [not] attached.[2]

As recent events have illustrated, an ethics and compliance breakdown can have widespread and unanticipated consequences that can extend beyond the immediately affected companies. Beyond the devastating impact of shareholder losses, these events can also contribute to an erosion of investor confidence. There is ample evidence, accumulated over more than a decade, that effective corporate ethics and compliance programs can help reduce these risks. The effectiveness of a program, however, requires adequate oversight by a board of directors. Only the board can ensure that the corporate ethics and compliance program is institutionalized, sustained over time and fully supported by senior management.

Over the last decade there has been increasing recognition by U.S. corporations and others of the importance of creating and maintaining ethics and compliance programs. Today such programs are widespread, and hundreds of corporations regularly participate in associations and conferences that are devoted to exchanging information and strategies for implementing such programs.[3]

Since 1991, the accepted model for ethics and compliance programs has been the description of "an effective program to prevent and detect violations of law" contained in Chapter Eight of the United States Sentencing Guidelines for Organizations.[4]

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[1] There is considerable variation in terminology that is used to describe this function and the individuals with management responsibility. The EOA defines an ethics officer as an individual who has responsibilities for devising, implementing, monitoring and/or administering their organization's ethics/compliance, or business conduct program.

[2] The EOA's comments and recommendations are based on discussions with many of our members but do not necessarily represent the views of all of our member organizations.

[3] In addition to the EOA (www.eoa.org), other organizations that facilitate the exchange of information and strategies for implementing "effective programs" include: The Conference Board, The Defense Industry Initiative, the Health Care Compliance Association, the Practicing Law Institute, and The Ombudsman Association.

[4] An excerpt is attached as Appendix[1]. The complete guidelines may be found in Chapter Eight – Sentencing of Organizations, U.S. Sentencing Commission, *Guidelines Manual* (2001) (available through West Group Publishing or on the Commission's website at www.ussc.gov).

Not only has the U.S. Sentencing Guidelines' description of an "effective program" served as the model for hundreds of companies, it also has been adopted, in whole or in part, by other governmental bodies, including the U.S. Departments of Justice[5] and Health and Human Services,[6] and the Environmental Protection Agency.[7] The U.S. Supreme Court, in a series of cases, limited liability for companies that develop effective anti-harassment compliance efforts.[8]

Perhaps most significantly because of its impact on boards of directors, in 1996 the influential Delaware Chancery Court issued an opinion stating that directors who fail to ensure that their companies have effective compliance programs could be subject to personal civil liability to shareholders for breach of the fiduciary duty of care.[9] The court noted that, "any rational person attempting in good faith to meet an organizational governance responsibility would be bound to take into account [the U.S. Sentencing Guidelines] and the enhanced penalties and the opportunities for reduced sanctions that [they] offer."

We believe that these developments reflect the acceptance of this approach as good, sound business practice. We further believe that these developments underscore the need for specific steps to be taken at this time to strengthen corporate governance and board of directors' oversight in the areas of ethics and compliance.

The overall goals of the EOA's recommendations are to:

- Clarify the responsibilities of an appropriate committee of a company's Board of Directors to oversee the creation and maintenance of a company's ethics and compliance program and to ensure that the program is in accordance with widely accepted guidelines and practice in this field, and

- Improve the effectiveness of the Board of Directors' oversight through orientation and updates on a regular basis regarding ethics and compliance issues including conflicts of interest.

Recommendation #1

There should be a formal resolution, or other similar action, taken by the Board of Directors to create within the company an ethics and compliance program that is consistent with the description of "an effective program" contained in Chapter Eight of the U.S. Sentencing Guidelines for Organizations.

As noted above (see "Overview"):

- The U.S. Sentencing Commission's "effective program" model for ethics and compliance programs has been in place for over a decade;

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[5] *Federal Prosecution of Corporations,* Memorandum from Deputy Attorney General Eric Holder to Heads of DOJ Department Components and All United States Attorneys, U.S. Department of Justice (June 16, 1999).

[6] See, e.g., U.S. Health and Human Services (HHS) Compliance Program Guidance for Individuals and Small Group Physician Practices, Federal Register, Vol. 65, No. 194, October 5, 2000. See also http://oig.hhs.gov/fraud/complianceguidance.html for other HHS compliance program guidance.

[7] See Incentives for Self-Policing: Discovery, Disclosure, Correction and Prevention of Violations, 60 Fed Reg 66, 706 (1995).

[8] See, e.g., Burlington Industries, Inc. v. Ellerth, 524 US 742, 141 L Ed 2d 633, 118 S Ct 2257 (1998).

[9] *In re: Caremark International Inc. Derivative Litigation,* Civil Action No. 13670, Delaware Chancery Court (New Castle), September 25, 1996.

- The model has been implemented by hundreds of corporations and has been the subject of extensive review and discussion by these organizations through associations, conferences and publications, and

- Numerous governmental bodies have adopted the model.

In light of these developments, we strongly believe that it is now appropriate for corporate Boards of Directors to have a clear and established responsibility for overseeing ethics and compliance as they relate to board members and all employees. At a minimum, the board should ensure that the company has in place an ethics and compliance program that is consistent with the description of "an effective program" contained in the U.S. Sentencing Guidelines.

In sum, this would require that a company have an "effective program" which would include taking the following seven steps:

1. Establish ethics and compliance standards and procedures,

2. Assign specific, high-level person(s) to oversee ethics and compliance,

3. Take due care in delegation of substantial discretionary authority to individuals,

4. Effectively communicate standards and procedures to all employees and agents through training and also through printed and electronic materials,

5. Monitor and audit the operation of the ethics and compliance program and establish a retribution-free means (e.g., a helpline or guideline) for employees to obtain information about standards and procedures and to report possible wrongdoing,

6. Consistently enforce discipline of employee violations, and

7. Respond promptly and appropriately to any wrongdoing and remedy any program deficiencies.

Recommendation #2

A committee of the board should have designated oversight responsibilities for the company's ethics and compliance program. These responsibilities should be included in a description of the scope of responsibilities of the committee contained in a formal charter or other similar board document.

The committee's responsibilities should be set forth in the formal charter of the committee. One of its responsibilities should be to receive a report on at least an annual basis from the company's ethics officer or other person within the company who has the designated responsibility for the company's ethics and compliance program. The report would include, but not be limited to:

- A review of the existing ethics and compliance program;

- A summary of the results of any relevant audits of the program and a summary of recommended changes;

- A statement of adequacy of resources for the ethics and compliance program and adequacy of cooperation between the ethics officer and all relevant functions;

- Substantiation that the organizational environment in its customs, structures and rewards encourages and promotes the highest standards of ethics and conduct;

- A report on high-risk ethics and compliance areas; and

- A report of significant government inquiries, significant violations of legal or regulatory requirements or of company policies, events with the potential for significant reputation risk, and associated corrective actions.

In addition, the scope of responsibilities of the responsible board committee should include providing the ethics officer with unfettered access to the committee as a whole or the chair of the committee, independent of reporting lines.

Recommendation #3

All board members should receive periodic orientation regarding ethics and compliance matters including conflicts of interest and company risk areas. The orientation may be provided by the company or by a third party.

As a general matter, the fiduciary duty of care requires a director to make informed decisions. To meet this duty in the area of ethics and compliance, the EOA recommends that all company Board members attend periodic, general orientation sessions on ethics and compliance matters pertaining to their board responsibilities, including conflicts of interest and company risk areas.

Excerpt from - 2001 Federal Sentencing Guidelines Manual

§8A1.2. Application Instructions - Organizations

(k) An "effective program to prevent and detect violations of law" means a program that has been reasonably designed, implemented, and enforced so that it generally will be effective in preventing and detecting criminal conduct. Failure to prevent or detect the instant offense, by itself, does not mean that the program was not effective. The hallmark of an effective program to prevent and detect violations of law is that the organization exercised due diligence in seeking to prevent and detect criminal conduct by its employees and other agents. Due diligence requires at a minimum that the organization must have taken the following types of steps:

(1) The organization must have established compliance standards and procedures to be followed by its employees and other agents that are reasonably capable of reducing the prospect of criminal conduct.

(2) Specific individual(s) within high-level personnel of the organization must have been assigned overall responsibility to oversee compliance with such standards and procedures.

(3) The organization must have used due care not to delegate substantial discretionary authority to individuals whom the organization knew, or should have known through the exercise of due diligence, had a propensity to engage in illegal activities.

(4) The organization must have taken steps to communicate effectively its standards and procedures to all employees and other agents, e.g., by requiring participation in training programs or by disseminating publications that explain in a practical manner what is required.

(5) The organization must have taken reasonable steps to achieve compliance with its standards, e.g., by utilizing monitoring and auditing systems reasonably designed to detect criminal conduct by its employees and other agents and by having in place and publicizing a reporting system whereby employees and other agents could report criminal conduct by others within the organization without fear of retribution.

(6) The standards must have been consistently enforced through appropriate disciplinary mechanisms, including, as appropriate, discipline of individuals responsible for the failure to detect an offense. Adequate discipline of individuals responsible for an offense is a necessary component of enforcement; however, the form of discipline that will be appropriate will be case specific.

(7) After an offense has been detected, the organization must have taken all reasonable steps to respond appropriately to the offense and to prevent further similar offenses – including any necessary modifications to its program to prevent and detect violations of law.

<u>The FASB's Role in Serving the Public</u>

A Response to the Enron Collapse

By Edmund L. Jenkins, Chairman, Financial Accounting Standards Board

The Enron collapse has caused the American public to raise questions about United States accounting standards, why Enron restated its financial statements to comply with those standards and the role of the Financial Accounting Standards Board (FASB). As the public learns more about the Enron story, the FASB's role as a financial reporting standard setter, with authority to develop new and ever-evolving standards, has recently received attention.

While the FASB is an independent, private, not-for-profit organization, some observers believe it is not independent enough from the Big-Five accounting firms. In fact, the Board comprises a broad range of constituencies representing accounting firms, academia, corporations and the investor community. Board members serve the FASB on a full-time basis and are required to sever all connections with their prior employers.

For nearly 30 years the FASB has had the responsibility of establishing standards governing accounting and financial reporting in the United States. The FASB's responsibility as standard setter is carried out in a fully open due process. Our focus is on the investor and other users - the "customers" of financial information.

The FASB has no authority to enforce its standards. Responsibility for ensuring that financial statements comply with accounting requirements rests with the officers and directors of the reporting entity, the auditor of the reporting entity's financial statements, and for public companies, the SEC. It is also important to understand that the FASB has no authority or responsibility with respect to auditing, independence, or scope of services matters. Rather, our responsibility relates solely to establishing financial accounting and reporting standards.

The FASB's vision and mission summarize our responsibilities in serving the public:

> Our vision is "to serve the public through transparent information resulting from high-quality financial reporting standards, developed in an independent, private-sector, open due process."
>
> Our mission is "to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors and users of financial information."

High-quality financial reporting is essential to maintaining a robust and efficient capital market system. A highly liquid capital market requires the availability of transparent and complete information so that all investors and potential investors can make informed decisions as they allocate their capital among competing alternatives. While not all information needed by investors is available from high-quality financial reporting, financial reporting is essential to the process.

While many have commented on the importance of financial reporting, Lawrence Summers, former Secretary of the Treasury, said it perhaps best:

> The single most important innovation shaping [the American capital] market was the idea of generally accepted accounting principles.
>
> The importance of an independent, private-sector, open due process system to establish financial reporting standards cannot be over-emphasized.

An independent standard setter is necessary so that standards can be set in an objective manner and without bias. Information provided from applying the standard must be neutral so that it faithfully reflects the underlying transaction or event of the reporting entity.

A private-sector standard setter is important because it avoids politicizing the setting of standards. A government standard setter, like the SEC, would be subject to significantly greater political pressures to reflect public policy goals into financial reporting. This would reduce the transparency of information to investors.

An open due process is essential to the credibility of financial reporting standards. It is important that standards be debated and set in public forums. Preliminary ideas and proposed standards need to be commented on by all constituents so that the best answers are achieved in the end. The FASB's open due process is extensive. Board meetings are open to the public, constituent comments are sought at several stages during the course of developing a new standard, and public hearings and open meetings of constituent task forces often are held. The FASB listens carefully to what it hears and learns from that process.

The FASB does not know many of the facts relating to Enron's financial accounting and reporting. Enron, however, publicly acknowledged in its filings with the SEC that its financial statements did not comply with existing accounting requirements in at least two areas. The Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron suggests that Enron's financial statements included other violations of existing accounting requirements. One such reference in the report states:

> Enron's original accounting treatment of the Chewco and LJM1 transactions that led to Enron's November 2001 restatement was clearly wrong, apparently the result of mistakes either in structuring the transactions or in basic accounting. In other cases, the accounting treatment was likely wrong, notwithstanding creative efforts to circumvent accounting principles through the complex structuring of transactions that lacked fundamental substance.

Over the years the FASB has issued many financial reporting standards to continuously improve the transparency of information available to investors. Several examples are:

- Requiring that reporting entities recognize liabilities for retirement benefits when those entities promise them to employees rather than when they later pay them.
- Requiring significant disclosures about the separate operating segments of an entity's business so that investors can evaluate the differing risks in the diverse operations.
- Requiring that derivative instruments and hedging transactions be reflected in financial statements, which, previously, were not reflected.
- Requiring that the acquisition of one company by another be accounted for in the same way for all entities and that the total amount paid for the acquisition be reflected in the financial statements. In the past, that was not often the case.

The Board has active projects under way in over a half-dozen areas that will propose significant improvements to existing requirements, including a project to improve the accounting for consolidations, and a project to improve the guidance for determining the fair values of financial instruments. With respect to the project on consolidations, which the FASB has struggled with for far too long, the Board plans to issue a proposal on an expedited basis in the second quarter of this year that will resolve some of the more common issues encountered by some entities in present practice, including issues relating to consolidation of SPEs.

The Board also understands the concerns that some, including SEC Chairman Harvey L. Pitt, have raised about the speed of our standard-setting activities. The Board has begun pursuing a number of projects and activities focusing on improving the Board's efficiency and effectiveness without jeopardizing the openness and thoroughness of our due process.

High-quality financial reporting is essential to an efficient capital market, and establishing and maintaining comprehensive standards is the key. But the FASB and its standards cannot alone achieve high-quality financial reporting. Others must be involved, and they too must carry out their responsibilities in the public interest. Reporting entities, auditors and regulators all have important roles.

Reporting entities seeking to access the capital markets for financing prepare the financial reports and present those reports to investors. Those entities must apply the standards developed by the FASB in a way that is faithful to the intent of the standards. Seeking loopholes to find ways around the standards obfuscates reporting and does not result in a transparent and true reflection of the economics of the underlying transactions.

Auditors examine the application of standards established by the FASB by entities to determine that those standards have been fairly applied. They also must assure that the intent of the standards are followed and not accept an argument that the reporting is acceptable just because the standards do not say an entity cannot report in a certain obfuscating way. Auditors have a primary responsibility to the public, since investors and other users do not have access to the underlying facts about an entity's operations and transactions.

Regulators, principally the SEC, also have an important role to play. Their responsibility is investor protection. Through their oversight and enforcement activities they assure that entities report based on following financial reporting standards and that auditors are independent and examine financial statements using accepted auditing standards.

With respect to the FASB, the SEC has oversight responsibilities. The SEC assures that the FASB agenda is addressing issues where improved reporting is desirable. Generally, the SEC does not influence the resulting standards, but it could. The Securities Acts of the 1930s gave the SEC the power to set financial reporting standards, but early on the SEC said it believed the accounting profession was best equipped to set standards and it would look to that profession to do so.

So, we can see the importance of the FASB to our efficient United States capital markets. The high-quality standards established by the FASB are the cornerstones to providing investors with the financial information they require. Standards provide all parties with the same benchmarks. Investors can know what reporting should result from applying a standard to a particular transaction. Entities preparing financial statements can look to the standards for a consistent and transparent application to underlying transactions. Auditors can audit an entity's reporting against the standards, and regulators can use the standards to test that entities and auditors are providing and examining financial statements that reflect those standards.

Without the high-quality financial reporting standards established by the FASB, each party to our capital market system would need to determine for itself how to present, read and examine financial information. There would be no consistency, no comparability, little transparency and a lack of trust in the information, which would lead to higher costs for capital and increased risks for investors.

If anything positive results from the Enron Bankruptcy, it may be that this highly publicized investor and employee tragedy serves as an indelible reminder to all of us that transparent financial accounting and reporting do matter and that the lack of transparency imposes significant costs on all who participate in the US capital markets.

The FASB is prepared and committed to proceed expeditiously to resolve any financial accounting and reporting issues that may arise as a result of Enron's bankruptcy so that the transparency of information available to participants in our capital markets is maintained and enhanced.

Corporate Accountability and Listing Standards Committee of the New York Stock Exchange

Statement of James E. Heard
Chief Executive Officer
Institutional Shareholder Services, Inc.
May 8, 2002

I appreciate the New York Stock Exchange's invitation to submit this statement to the Corporate Accountability and Listing Standards Committee. The statement represents my own views on how the Exchange could improve its corporate governance listing standards, and not necessarily the views of our clients.

In the post-Enron environment, the Exchange, and the Committee, bear a special responsibility to ensure that listed companies live up to high standards of ethics and accountability. NYSE Chairman and CEO Richard Grasso put it well when the Exchange appointed the Committee in February: "It is imperative that we reinforce trust and confidence in our publicly traded companies and in our markets.... Investors demand and deserve nothing less than timely and accurate disclosure, sound corporate governance, and an established set of practices that ensure transparency and integrity."

Director Independence

The New York Stock Exchange's listing standards, and the Exchange's rules and regulations, are a critically important part of our nation's corporate governance system. Much attention has rightly been focused on these corporate governance listing standards, especially standards for directors, which are a major focus of the current review.

The Committee has been urged by others to set higher standards of independence for individual directors, key board committees and boards as a whole. I would urge the Committee to consider carefully standards suggested by groups such as the Council of Institutional Investors, TIAA-CREF, California Public Employees' Retirement System and the National Association of Corporate Directors. I believe that the Exchange's standards can and should be raised.

In particular, the Exchange's listing standards should ensure that independent directors meet a strict standard of independence. At a minimum, directors who have business relationships with a company, and directors who work for firms that have non-trivial business relationships with a company, should not be considered independent directors. And only directors who meet a very strict test of independence should be permitted to serve on a company's audit committee. There should be no exceptions to this rule.

Many observers have pointed out that Enron's board met many if not most nominal tests of independence. Yet the board as a whole, and the audit and compensation committees in particular, failed to do their jobs. From this some draw the conclusion that stricter standards of board independence will have little or no impact on corporate governance. A better assumption, I think, is that higher standards will set higher expectations, which in turn will encourage directors to discharge their responsibilities.

In addition to higher standards of director independence, I believe the Exchange should carefully consider support of a voluntary code of corporate governance, as recently suggested by John Whitehead and Ira Millstein. Listing standards are an effective way to set minimum requirements. A voluntary code, coupled with mandatory disclosure requirements regarding code compliance, is now being used in Canada and the United Kingdom. Voluntary codes provide a flexible, dynamic framework to encourage best practices on a range of issues for which a singular regulatory standard may be difficult to fashion.

In addition to board independence, there are other areas in which the Exchange could act to strengthen our system of corporate governance. Let me mention two, both of which would promote greater accountability by giving shareholders a stronger voice in corporate governance.

<u>Shareholder Approval of Stock Option Plans</u>

Many institutional investors view shareholder ratification of stock option plans as an important shareholder right. Yet growing numbers of NYSE listed companies are adopting option plans that significantly dilute shareholders, often transferring huge sums of wealth to a select few, without submitting these plans for shareholder approval.

The Exchange's current rules not only permit, but actually encourage, such behavior by listed companies: lax standards are seen by many as a green light to circumvent shareholder approval, something that is happening at an increasingly rapid and alarming rate.

The Exchange has studied the issue for years. It has sought and received recommendations from a special advisory committee, which recommended higher standards. Yet the Exchange has failed to act. There is no justification for further delay.

The Exchange's failure to act highlights a major weakness in our federal securities laws. The Securities and Exchange Commission may recommend changes in NYSE listing standards, and it has authority to approve or disapprove changes that the NYSE itself proposes, but as a result of the *Business Roundtable v. SEC* court decision a decade ago, the SEC cannot promulgate rules that require changes in listing standards. Congress can, and perhaps soon will, grant the Commission greater rulemaking authority over listing standards of the NYSE and other self-regulatory organizations.

<u>Broker Votes</u>

The Exchange should also revise its rules to prohibit brokers from voting on any substantive issue unless they are instructed to vote by their clients. Current rules permit brokers to cast uninstructed votes on behalf of beneficial owners if the latter fail to vote within 10 days of a meeting on issues that the Exchange considers routine.

Incredibly, the Exchange considers the election of directors and votes on many compensation plans to be routine. The result is that brokers routinely deliver votes, overwhelmingly in favor of management, on issues that are increasingly important to shareholders without ever consulting their clients.

Our experience today is that there are few votes that can be classified as routine. The uncontested election of directors — especially organized "Vote No" campaigns — often serve as a referendum on board performance and the fitness of individual directors to hold office. Even ratification of auditors is now a nonroutine vote for many shareholders.

In the past, permitting brokers to cast uninstructed votes has been justified by the need to assure annual meeting quorums. Recent research suggests that it is open to question whether broker votes are needed for quorums. But if broker votes are needed to meet quorum requirements, then brokers should be allowed to cast uninstructed votes only for quorum purposes but not otherwise.

Conclusion

The Enron debacle has revealed many weaknesses in our corporate governance system. It has also created an environment that offers an opportunity to strengthen the system. Actions of self-regulatory organizations such as the New York Stock Exchange are critically important to such efforts. The Exchange's decision to undertake the current review clearly indicates it understands its responsibilities. Your recommendations, and the Exchange's response, will speak loudly to the question of whether the Exchange is willing to live up to the high expectations that now await its actions.

INVESTMENT COMPANY INSTITUTE

STATEMENT OF THE
INVESTMENT COMPANY INSTITUTE
TO THE
NYSE CORPORATE ACCOUNTABILITY AND LISTING STANDARDS COMMITTEE
MATTHEW P. FINK, PRESIDENT

May 17, 2002

The Investment Company Institute[1] appreciates the opportunity to provide its views on corporate governance and shareholder accountability issues. These issues are of significant interest to our members, as investors in equity securities worth more than 3.5 trillion dollars on behalf of millions of middle-income Americans.

The Institute commends the Exchange for appointing this special Committee to review corporate governance matters and listing requirements, and develop recommendations designed to bolster shareholder confidence. These matters are especially important in the wake of the Enron scandal. We would like to focus our comments on one issue in particular – the role of shareholders in the authorization of stock option plans. We believe that stricter standards in this area are needed in order to ensure that the interests of shareholders are protected in compensation matters.

The Institute previously has recommended that the Exchange amend its listing standards to require shareholder approval of certain stock option plans.[2] The Institute recognizes that stock option plans can be beneficial by aligning shareholder and corporate management interests and in furthering corporate stability. Indeed, if properly designed, such plans can enable a company to attract and retain key personnel, and provide incentives for employees to work hard to increase a company's value, thereby increasing the potential for maximizing shareholder return. On the other hand, stock option plans that are improperly designed can cause the interests of management and shareholders to conflict and, consequently, have a deleterious effect on shareholder value.

Many stock option plans have the potential of transferring wealth or voting power from shareholders to corporate management. Plans that are not tied to company or stock performance can have a dilutive effect on existing shareholders. Some stock option plans, for example, provide for the issuance of shares at no cost or at a significant discount to the then-current fair market value. Other plans permit the repricing of so-

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[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 9,064 open-end investment companies ("mutual funds"), 485 closed-end investment companies and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about $7.050 trillion, accounting for approximately 95% of total industry assets, and over 88.6 million individual shareholders.

[2] *See* Letter from Amy B.R. Lancellotta, Senior Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated December 10, 1998; letter from Amy B.R. Lancellotta, Senior Counsel, Investment Company Institute, to Stephen Walsh, Vice President and Managing Director, New York Stock Exchange, Inc., dated July 9, 1998.

called "underwater" options to current market value without prior shareholder approval. Still other plans, such as "evergreen" or reload option plans, have similar dilutive effects on shareholders' equity.[3]

The increasing popularity of stock option plans and the potentially dilutive effect they can have on shareholder value highlights the need to ensure that they receive appropriate shareholder scrutiny. This is particularly compelling given the unavoidable conflict of interest faced by management as they design such plans. Denying shareholders the right to review, evaluate and vote on these plans allows corporate management to act in a manner that is patently inconsistent with shareholders' best interests.

For the reasons discussed above, the Institute urges the Exchange to require shareholder approval for stock option plans. There are different approaches that the Exchange could take to implement our recommendation. One approach would be to require that shareholders have an opportunity to vote on *all* plans (and plan amendments). This approach has some merit, as it would be the most comprehensive way to protect shareholder value. Another approach would be to limit the requirement to those instances where the plan is most likely to have a significant adverse effect upon shareholders' interests. If the Exchange were to take this approach, we would recommend that, at a minimum, shareholder approval be required in two cases: first, in any situation where the plan would grant options to officers and directors; and second, in any situation where the options granted would exceed a specified dilution threshold. Under the latter, it is important that the threshold be applied on a *cumulative* basis so that an issuer could not avoid a shareholder approval requirement by granting options on an annual basis in an amount under the threshold (but where the cumulative effect would be over the threshold). In addition, the requirement for shareholder approval should also apply to the repricing of outstanding options (including the cancellation of options and issuance of new options at lower exercise prices six months and one day later). Otherwise, the requirement could be circumvented by issuers unilaterally changing the exercise prices of options after issuing them.

Ideally, any changes to the Exchange's listing standards to require shareholder approval of stock option plans should be done in coordination with Nasdaq. Harmonization of these requirements would ensure that the leading securities markets do not compete on the basis of disparities in their rules, leading to a "race to the bottom" to attract new listings, to the ultimate detriment of investors. Nevertheless, in view of the increasingly high levels of dilution embedded in corporate stock option plans, we urge the Exchange to proceed on its own to address this problem rather than wait to act in tandem with Nasdaq.

We appreciate your consideration of our views.

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[3] Evergreen option plans, in which a nominal percentage of shares outstanding (*e.g.*, one percent) are reserved for award each year, can be dilutive because (a) there is no termination date for the plan and (b) the number of shares issued potentially can increase yearly depending on the number of shares outstanding. Reload options, which are options that are used to replace shares of stock that executives use to exercise current options, can be dilutive depending on the date that is used for determining the market value of the option. In many cases, the date used for valuing a reloaded option is not the date on which the current option is exercised (*i.e.*, the then-current market price), but rather the date on which the current option was originally granted – often years earlier.

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April 5, 2002

Mr. James Cochrane
Senior Vice President
New York Stock Exchange
11 Wall Street
New York, NY 10005

Dear Jim:

I am prompted to write by the article on page C5 of today's New York Times about the consideration of new listing rules relating to corporate governance. I am enclosing herewith a Summary of the testimony I gave to the Senate Banking Committee on February 27th which relates to the issues reportedly under consideration. (If you are interested, I could send you the entire testimony and its attachments -- but it is probably far too much for anyone to read.)

After the testimony, the staff asked me and John Whitehead (who co-chaired with me the NYSE/NASDAQ/SEC sponsored Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees) to make suggestions on specific legislation to improve corporate governance. I am attaching the document we provided to Steve Harris of the Committee staff. In it, we suggest that a corporate governance code of conduct be established against which the SEC would require disclosure on a comply or explain basis. A special study group of the American Bar Association chaired by my partner, Todd Lang, has recommended something along the same lines.

I would hope that the concept which John and I have espoused will get some traction. Steve Harris thinks it will, if others get behind it. I think it's an idea whose time has come if we really mean to solidly implant the board reforms, which have been occurring incrementally during the past 10 years.

Sorry for the length of all this but I wanted you to have a complete story as you are someone who thinks about these things.

My best regards.

Sincerely,

/s/ Ira

Ira M. Millstein

SUMMARY OF TESTIMONY

Ira M. Millstein
Co-chairman of the Blue Ribbon Committee
on Improving the Effectiveness of Corporate Audit Committees

Recent financial reporting and governance failures implicate the incentives that drive managers, boards and those who advise them to push to the limit and beyond the numbers that are meant to accurately reflect the company's financial performance and health. In the last decade, management has faced increased market pressures for short-term stock price performance and corresponding pressures to satisfy market expectations on a quarterly basis. This, coupled with increased reliance on forms of compensation that focus on short-term stock appreciation, may have created incentives that tipped the balance toward the promotion of self-interest rather than the protection and promotion of long-term shareholder value. We need to seek incentives and disincentives that are more carefully attuned to pressures in the current environment. Incentives and disincentives are needed to deal with the "given" that directors, managers, auditors, analysts and lawyers are fallible human beings (like all of us). They may not always subordinate their self interests to those on whose behalf they are acting.

Board Independence

- Boards of publicly traded corporations should be required (through listing standards) to include a substantial majority of "independent" directors under a strict definition of independence (ideally the same definition that applies to audit committees, but with some refinement).

- The definition of director independence now provided in listing rules for audit committee purposes should be reviewed to determine whether it adequately addresses all the relationships that may reasonably be expected to reduce independence.

- Boards should be required (through listing standards) to constitute a compensation committee with entirely independent directors.

- Boards should be encouraged or required (through SEC disclosure requirements based on either listing requirements or a code of best practice) to separate the position of CEO from that of board leader. Board leadership should be provided by an independent director.

- The boards of listed companies should be encouraged or required (through SEC disclosure and listing requirements) to adopt, regularly review and disclose a corporate code of conduct that addresses conflicts of interest and management and director stockholding and trading policies.

Compensation

- Performance compensation based on a snapshot of stock market performance at a single point in time chosen by the manager may not provide incentives for the kind of management activity that is "good" for the company and shareholders as a whole in the long run.

- Pay-for-performance programs should be linked to measures of profitability or economic value added rather than short-term changes in stock market valuation. They should be designed to consider company performance relative to peer group performance. Consideration should be given to creating a stricter definition of what constitutes "performance based" compensation under I.R.C. § 162(m).

- Mechanisms should be developed to encourage executives and directors to hold stock they receive, whether in the form of stock grants or stock options, for a significant period of time. Ideally, companies should restrict or discourage sale of company stock during a director's tenure and require or encourage significant holding periods for executives. Consideration could be given to creating tax incentives designed to encourage executives to hold stock.

- Prompt disclosure of *all* transactions in the company's stock by corporate executives and directors should be required by SEC rules.

- Directors should be compensated fairly for the time necessary to fulfill their responsibilities, but grants of stock options to directors should be avoided.

Conflicts of Interest

- The boards of publicly-traded companies should be required or encouraged through listing standards and SEC disclosure requirements to adopt, regularly review and disclose a corporate code of conduct that addresses conflicts of interest, and management and director stockholding and trading policies. The actions taken by boards in implementing these policies should also be reported on, including disclosure of any exceptions granted under these policies and the reasons for the exceptions.

- SEC rules should be amended to mandate prompt disclosure of transactions between the corporation (or its affiliates) and members of senior management, directors or controlling shareholders.

Professional Advisors

- The presumption should be that audit and consulting don't mix. However, the audit committee should have authority to decide if and when an exception to this presumption is necessary and desirable for the company and its shareholders. (This could be encouraged through an additional SEC requirement that audit committees disclose the reason why they believed it necessary and desirable to allow an exception to the general presumption that the outside auditor should not provide consulting services.)

- The ABA should consider whether ethical conduct rules give lawyers sufficient guidance in balancing these roles; and

- The ABA should consider encouraging a set line of reporting for in-house counsel to bring to the board concerns not otherwise acted on by management.

* * *

Diligent independent directors, when properly led, informed and assisted, can circumscribe the agency (self interest) problems. If managers are not overly motivated by options to seek short-term market price appreciation, they should be less likely to push the limits. And if auditors, analysts and lawyers remove the conflicts that stand in the way of the true professionalism the public expects, they are more likely to resist.

TESTIMONY OF JOHN C. WHITEHEAD BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

I am honored to appear before you this morning as I have done a number of times in the past: first back in the early 1970's as Chairman of an SEC landmark study of the effect of institutional investors on securities markets, later as Chairman of the Securities Industry Association and also as Co-Chairman of Goldman Sachs on various matters, still later as Deputy Secretary of State and again on one occasion as Chairman of the Federal Reserve Bank of New York. I appear today, however, as a former non-management director and audit committee chairman of more than a dozen public companies, not all of them, I assure you, at the same time.

I have always championed the importance of our securities markets and the competitive structure of the institutions that serve them. They are a national asset and an important part of our leadership position in the world economy. The confidence that investors have in the system must be protected at all costs. I have also championed the importance of diligent independent non-management directors who represent the stockholders effectively and the public interest.

The Enron disaster is a severe blot on the generally good record that the system has had over the years. Indeed, it is an embarrassment to those of us who have been involved in that system. It is still hard for me to believe that what was coming to be considered one of America's great companies could collapse so rapidly in such an ignominious way, with such huge losses to employees, to lenders, to stockholders, and to the reputations of everyone involved: the management, the board, the audit committee, the auditors, the bankers, the security analysts and the customers. It would seem to me that grounds for criticism exist in many places and that a thorough public review and investigation, including these hearings, is absolutely desirable and necessary. I am knowledgeable enough about the system, however, to be quite confident that most companies act responsibly and that there are not a lot of Enrons out there.

The only good result of the collapse is that it is causing companies now to look closely at their practices and at their disclosure policies, causing boards to review their attitudes, causing auditors to be more independent and more thorough, lenders to be more careful, security analysts to be more thorough, etc. I can assure the Committee that there is now a self-cleansing process going on out there which is very healthy. It might be fruitful for the hearings to begin to focus not only on what actually happened to Enron but on what the various institutions are doing now to keep it from happening again somewhere else. It may be wise to let this self-cleansing process go on for a while without being too precipitate with legislative action.

It is clear to me that there were many signs that a more alert or even a more curious board might have recognized as fair grounds for questioning. Certainly any request to the Board to waive the Board's ethics rules to exempt a transaction that otherwise would have violated them should have been enough to bring a lot of questions. However, the Committee should realize that it is very difficult these days to find and successfully recruit good board members. Many top experienced executives who would make excellent non-management directors feel that their hands are full handling their present job, that their lives are already too full of other responsibilities and that the doubtful prestige and unimportant extra compensation from taking on one or two outside directorships is not worth the increasing legal risks and the necessary time commitments. It would be a very unfortunate result of the Enron disaster if it became impossible now to recruit to board membership the kind of experienced, capable people that the system increasingly requires. The Committee should be careful about unnecessarily increasing the financial risks and the time commitments of non-management corporate directors.

Having said that, I do believe some things can and should be done now.

1. Having given the matter a lot of thought in recent years, particularly when I was Co-Chairman with Ira Millstein (who testified before you a few weeks ago) of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, I have reached the conclusion that the accounting firm that does the audit should not do other advisory work for the company. Without that, the independence of the auditor's work will always be suspect. I reach that decision reluctantly but I don't see that it is possible now to restore public confidence in the independence of the auditors without it. The auditing firms should understand that this certainly does not require them to spin off or close down their advisory services. They would still be free to do advisory business with any company, excepting those they audit. Thus for any one firm what business they lose to others could be offset by business that others would lose to them, with no loss to the industry as a whole. As an alternative way of accomplishing the same purpose, it might be worth considering whether the restriction might be placed on the company rather than on the auditors by requiring that a public company should not employ their auditing firms for services other than the audit. It would be preferable if this all could be accomplished by SEC action or action of the exchanges rather than by legislation. Of course, it might be appropriate to except from the rule fees for minimal advisory business and in any case a reasonable phase-out period should be allowed.

2. An unfortunate practice has developed in the relationships between management, auditors, and board audit committees on the setting of auditor's fees. Fees are set annually by negotiation between management and the auditor and then approved by the audit committee. Management's objective, as it is with all expenses, is to keep the fees as low as possible. The auditor, at that stage, has no idea of how much time it will take, or how much extra work might be required to complete the audit and is often pressured to accept a lower fee and agree to a shorter time schedule than might be necessary in case questions arose. Audit committees often agree to the fee and the time schedule, unwilling to question what seems reasonable in relation to last year. If the auditor later does find questionable practices, he may have neither time nor money to pursue them under the terms of his agreement. A better practice would be to allow the auditor, at his option, to do work and charge fees up to a limit of, say, twice the original fee. This would tend to make management more aware of the authority of an independent auditor.

3. Over the years accounting rules, something like the income tax code, have become increasingly complex and arcane with the result that in combination they can often obfuscate the simple facts and obscure full disclosure. Rules that permit these results, such as hiding off-balance sheet debt, transactions with related parties, alternative accounting for acquisitions, etc., evade the principle of full disclosure and undermine the foundation stone of our free market system. The Financial Accounting Standards Board should be asked to review these matters promptly and recommend appropriate changes in the interest of full disclosure.

4. Rules now require that the chairman of a public company's audit committee have considerable financial background and experience. Those rules should be amended to require all members of the audit committee to have such backgrounds. This will encourage the recruitment to the board of more experienced and qualified people and recruitment to the audit committee those with the most financial experience.

5. Since the principal purpose of audits is to provide public information to investors and the financial community, I believe the self-regulating authority of the SEC over the securities industry and the stock exchanges should be extended to the auditing firms. This would be an important addition to the present self-inspection system of the auditing companies. The authority of the SEC should also be extended to create a new self-regulatory entity charged with drafting a voluntary code of best corporate governance practices linked to an SEC disclosure requirement. Companies would then disclose whether they comply with the voluntary code, and explain areas of non-compliance.

April 2, 2002

TO: Steven B. Harris
Senate Committee on Banking, Housing and Urban Affairs

FROM: John C. Whitehead
Ira M. Millstein

RE: Proposal for Legislation relating to Voluntary Corporate Governance Standards and Disclosure on a "Comply or Explain" Basis

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As the Committee requested, we have given additional thought to a potential legislative response to concerns about corporate governance that have been raised by the recent spate of asserted corporate governance failures. We propose herein that legislation be enacted to create a representative body charged with developing and issuing a voluntary corporate governance "code of conduct." We further propose that the SEC require reporting companies to disclose the degree to which they comply with the voluntary code of conduct and explain areas of noncompliance. We are not legislative draftsmen, and hence will herein outline only the substance of the legislation we propose.

As emphasized in our testimony, we believe that any legislative or regulatory response needs to be carefully tailored to provide appropriate incentives in a rapidly changing business environment. We would have serious concerns about any federal effort to mandate significant aspects of how boards are structured and how they govern. This is best left to state corporate law, supplemented by listing rules and SEC disclosure requirements. However, the SEC could make greater use of disclosure requirements to create incentives for conduct consistent with continually evolving notions of board governance best practices. Specifically, the SEC could require companies to disclose whether they follow certain governance best practices developed by a standard setting-like body.

To this end, we propose that Congress enact legislation to:

(1) create and federally fund a Corporate Governance Conduct Board (or some such denominated entity):

(a) with a chairman selected by the SEC, with the consent of the Senate, who is charged with selecting eight other members in consultation with the SEC;

(b) members of which would be representative of the corporate governance constituency: shareholders, corporate directors, corporate management, investment banks and institutions, the New York Stock Exchange and NASDAQ;

(c) charged with developing, through outreach and discussion, issuing and updating, as appropriate, a voluntary corporate governance code of conduct ("the Code");

(2) direct (and, if necessary, empower) the SEC to require that reporting companies disclose on an annual basis whether they comply with each element of the voluntary Code and explain any areas of non-compliance ("comply or explain"); and

(3) direct the Corporate Governance Conduct Board and the SEC to regularly survey and report to Congress and the public on the degree of compliance.

The proposal outlined above would provide a light-handed and flexible mechanism to encourage boards to undertake a number of the best practice recommendations relating to board governance that have been suggested in testimony. It would not involve the federal government in mandating specific aspects of board governance -- which would likely meet stiff resistance akin to the debate after calls for federal chartering, which occupied significant attention from the mid 1970's to mid 1980's.[1] Rather, it would use the SEC's disclosure powers to encourage the adoption of recommended practices set by a group representing key private sector actors, while providing far greater transparency as to board practice.[2]

Recommended practices could cover aspects such as:

- the composition/independence of the board;
- a strict definition of director independence;
- the composition/independence of audit, compensation and nomination/governance committees;
- independent board leadership;
- regular sessions of non-executive directors;
- the role of independent directors and committees in setting the "tone at the top";
- director participation in setting the board and committee agendas;
- director participation in information flow;

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[1] See, A. Cary, Federalism and Corporate Law: Reflections Upon Delaware, 1974 Yale L. J. 663 (1974); A. Cary, Proposed Federal Corporate Minimum Standards Act, 29 Bus. Law. 1101, 1115 (1974); D. E. Schwartz, Constitutionalizing the Corporation: A Case for Federal Chartering of Corporations, 31 Bus. Law. 1125 (1976); Nader, Green & Seligman, Taming the Giant Corporation (1976); A. Boxer, Federalism and Corporation Law: Drawing the Line in State Takeover Regulation, 47 Ohio St. L.J. 1037, 1041-56 (1986) (overview of debate).

[2] Although I believe that this proposal is consistent with the SEC's current regulatory authority, before legislation is drafted for this proposal, further study needs to be given to this issue and to any implications the proposal may have concerning federal encroachment on state authority for corporate law. See e.g., The Business Roundtable v. SEC, 905 F.2d 406, 406 & 408 (1990) (SEC exceeded authority granted in Exchange Act of 1934 in promulgating rule that would prohibit national security exchanges and associations from listing stock of issuers that restrict or disparately reduce per share voting rights of common shareholders; "the Exchange Act cannot be understood to include regulation of an issue that is so far beyond matters of disclosure, . . . and of the management and practices of self regulatory organizations, and that is concededly a part of corporate governance traditionally left to the states.")

- use of staff and outside advisors to support board and committee efforts;
- evaluation practices for assessing the CEO, the board as a whole and individual directors;
- compensation practices (for directors and senior executives);
- audit committee practices;
- retention of, and relationship with, the outside auditors; and
- practices relating to conflicts of interest and ethics.

Others who have called for a similar disclosure-based "comply or explain" approach to promoting improved governance practices include a special task force of the American Bar Association Section of Business Law's Committee on Federal Regulation of Securities [not attached], and the National Association of Corporate Directors [not attached]. In addition, we note that, at the request of SEC Chairman Harvey Pitt, both the NASD and the NYSE are currently studying their role in promoting effective corporate governance practices and it is expected that they may consider -- and eventually recommend -- a comply or explain approach.

The "soft regulation" provided by a voluntary code of conduct is in keeping with the regulatory philosophy that one size does not fit all when it comes to board practices. By definition, a code of conduct establishes standards for improved corporate governance primarily through entreaty; its prescriptions are non-imperative. Such codes are common throughout the world, and a number already exist in the U.S. They lack compliance authority as to their substantive prescriptions about governance structures and practices. This does not mean, however, that these codes lack force and effect. Even though compliance with substantive code provisions is wholly voluntary, reputational and market forces help focus the attention of companies and investors on governance issues and provide some compliance pressures.

In several markets outside the U.S., voluntary codes of conduct rely on a mandatory disclosure requirement to encourage compliance. For example, in the United Kingdom and Canada, domestic companies listed on the London Stock Exchange and the Toronto Stock Exchange, respectively, are required to disclose whether they comply with the specified code (the Combined Code in the U.K.; the Dey Report in Canada). They are also required to explain any deviations. Germany is about to adopt a similar system.

Although none of the U.S. listing bodies has yet adopted a code of conduct (or best practice guidelines), nor has any U.S. code yet been linked to a disclosure requirement on a "comply or explain" basis, as mentioned above, a number of practice recommendations have been issued by business and director associations -- including by The Business Roundtable and the National Association of Corporate Directors, as well as by institutional investors and investor groups, including CalPERS, TIAA-CREF, the AFL-CIO and the Council on Institutional Investors. Although these best practice recommendations express some differences, they contain a number of significant common features.

Should the Committee request, we would be happy to provide a comprehensive set of these existing recommendations for your records.

Report to the Special Committee of the Board of Directors of the New York Stock Exchange

Kenneth S. Janke
Chairman & CEO
National Association of Investors Corporation

American companies have long led the world in the area of corporate governance and transparency. The investment community in the United States, professional and individual, receive financial and corporate information that is the envy of all other nations. It is my opinion that alleged misconduct by one or two companies should not change the view that the vast majority of American corporations report honestly and in a timely fashion.

Corporations have adopted policies of having independent directors who have brought expertise to the CEO and management team. Those board members are selected and elected to be the policy-making body of the corporation. They wish to be a part of and identified with a successful organization. Since the measurement of success is profitability, I feel that is one of the driving factors for any board of directors. They want to feel they are contributing to the return to shareowners and to the stability of the company for employees.

My observation is that more and more, companies seek independent directors who can bring expertise in one or more areas. They represent different constituencies and are no longer the insider dominated boards. The selection of board members is a difficult task and not something that can be mandated as to who will be named. A director needs a long-term view, does not manage, but serves as an advisor for management's plans and actions.

With that in mind, it does not appear to me that sweeping changes are necessary as they were following the market crash of 1929. That, of course, led to the establishment of the SEC and major changes were required at that time. Those changes have served investors well, with minor adjustments following.

In the area of corporate governance, it may be advantageous to consider how the board of directors deals with the auditor. While the audit committee by definition has the most direct contact with the auditor, it seems to me that a requirement that the auditor might be required to make at least an annual presentation to the full board. That would give the directors an opportunity to ask specific questions in addition to hearing a formal report. That may be the practice at the present time for some corporations, but I do not feel it occurs at all companies.

The length of time an auditor serves a specific corporation has been the subject of some discussion in Congress. I have seen suggestions that the auditor should be changed every three, five or seven years. I am not sure that a restriction such as that should be placed on a board, or the financial staff. For complex companies, it takes time for an auditor to become familiar with all of the intricacies of an operation. Mandated changing of auditors might not be in the best interest of either the corporations or shareowners.

However, a self-regulating approach of interviewing potential auditing firms from time to time could be enlightening to a board of directors. If they were to hear from the current auditor as well as potential new auditing firms, a decision could be made as to a possible change, or retention of the present firm. Something like that could be scheduled once every five years, or more often if the board felt it was necessary. Such a practice might have the result of helping directors determine if they are satisfied with the current situation, or if a change is needed. It would not require the board to change auditors. As a further comment, I feel it is necessary for the entire board to vote on any change of auditors, not just the audit committee.

With the evolution of independent boards, a practice of having committees such as audit and compensation made up entirely of outside directors might be a step in the right direction. As is the current practice with the audit committee, I would suggest that members of the compensation committee not include any independent directors who are related to executive officers of the corporation.

I feel it would also be informative to have the Investor Relations Officer (IRO) make at least one presentation to the entire board. That may also be the practice of some corporations, but is not widespread. I'm not sure I would make that a requirement, but a suggestion to listed companies.

A requirement to have the nominating committee consist of all independent directors would be a mistake, in my opinion. The CEO is in a position to know potential independent directors with skills that will benefit the corporation. I see no reason to disqualify an inside director from this committee, although a rule requiring the majority of the committee be independent is advisable.

It would also be advantageous to have a regulation for streamlining the reporting of sales and purchases by insiders. Quicker reporting of all transactions would be helpful information. While investors should not make investment decisions solely on such transactions, it would add to the transparency of reporting and full disclosure.

That issue also deals with stock options. Opinions have been voiced by Chairman Pitt without any specific recommendations. I would like to offer one and that is for stock options to senior officers and directors not be allowed to be re-priced. When options are granted, those senior officials should have to live with the original option price, one that reflects the price of the stock on the date of the grant. All too often, I have seen them repriced for the convenience of a few members of management.

When it comes to listing requirements by the New York Stock Exchange, I feel they should continue to be strict and higher than for any other market. In an era of global investing and the desire by foreign corporations to be listed in the United States, the requirements should be the same as for American-based companies. The New York Stock Exchange has always had a reputation of being a leader and that should not change in any way.

In the information that I received, I am not sure if the committee of the board of the New York Stock Exchange is addressing some recommendations regarding analysts reports, or not. If it is, I would like to offer some comments. It deals with the tie-in of research and investment banking. It has been my experience that the current reports usually conclude with a boiler room statement if the firm has a position in the stock. Unfortunately, it is in a type size that is difficult to read and much smaller than the body of the report. Typically, I have observed that the first thing an investor looks at in a research report is the summary, trying to determine if the stock is a buy, hold or sell. If the summary is of interest, the investor then goes on to read the remainder of the report, seldom looking to see if the firm has a position in the stock. I feel the type should be of sufficient size and have the same readability as the rest of the research report.

I believe the New York Stock Exchange is already on record as to limitations for security analysts trading in stocks they cover. That probably needs no additional comment and is something in which I fully agree.

There has been talk about a public scorecard listing analysts' recommendations and earnings estimates. Being able to judge analysts' research in such a manner could be extremely helpful to individual investors.

When events such as the collapse of Enron occur, it is only natural that Congress immediately wants to implement new laws and rules. In my opinion, self-regulation is still the key. I prefer to see self-regulation rather than Congress get involved. As I mentioned at the beginning, we do have a wonderful system at the present time that has worked well. Minor changes may be necessary, but not a complete revamping of the entire system.

Investing has always involved risk taking. Self-regulation should provide investors with full disclosure. That mistakes will be made in the future is inevitable. That's part of the investment world. Providing full disclosure so that investors can make informed decisions is the job of management, boards of directors and analysts.

Thank you for the opportunity to express my views. It is greatly appreciated.

The National Association of Investors Corporation (NAIC) is a non-profit organization of individual investors and investment clubs. Founded in 1951, NAIC has a current membership of more than 400,000 individuals. The organization is an educational association dedicated to creating new investors and providing them with tools to help in building a successful program of regular investing in equities.

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To: Special Corporate Accountability and Listing Standards Committee

I am submitting these comments in an effort to be helpful to your Committee in its deliberations. Before making specific comments, I have a few preliminary observations.

Your Committee has a rare opportunity through NYSE listing standards to improve corporate accountability. Recent events have provided a major impetus for reasonable reform measures to improve corporate governance for the benefit of the investing public. The President's program to make corporate America more accountable to employees and shareholders, Chairman Pitt's recommendations to improve corporate disclosure and financial reporting and, most important, investor expectations that corporate conduct must improve – all provide a favorable climate for your Committee to recommend major improvement in corporate governance standards.

Second, I think your Committee's recommendations, wherever possible, should complement or reinforce those of the SEC, consistent with the kind of cooperative regulation that has worked effectively in the past. There is no need for a new self-regulatory entity to draft a code of best corporate governance practices when both the NYSE and NASDAQ have used their listing standards over the years for that purpose. However, your committee is being asked to extend self regulation beyond where the Exchange and the NASD have traditionally operated and into areas where some listed companies would want you to keep out.

Finally, by getting more deeply involved in corporate conduct, the NYSE will raise public expectations – perhaps lulling investors into thinking that the NYSE affords more in the way of protection than can be achieved in the real world. But this is a risk worth assuming. In a free market system, codes of conduct cannot guarantee good corporate governance; they cannot deter those determined to defraud, deceive, or cheat public investors. They can, however, set a standard by which officers and directors and the investing public can judge their behavior.

Here are some specific steps that your Committee might consider recommending to the Board:

- Endorse the SEC's program to improve the quality and timeliness of corporate disclosures, particularly, the requirement that CEO's certify to shareholders that any significant information of which the CEO is aware has been disclosed and that the disclosures are not misleading, inaccurate or false.

- Back the SEC's request to the Congress for administrative authority to bar future service by officers and directors of public companies, subject to judicial review.

- Amend the Exchange's corporate governance standards on audit committees by requiring that all non-audit services from auditing firms above a threshold amount require audit committee approval and enumerate the factors to be considered before granting such approval. Because so much attention has been devoted to the role of audit committees over the past several years, I would not recommend any major changes in the Exchange's standards, in order to give the current standards a reasonable time to work. Moreover, the Enron affair has energized corporate audit committees to focus on their critical role.

- Adopt corporate governance standards for board compensation committees. In my view, this area will be the most challenging for your committee. These standards should focus on two matters: first, the kinds of information needed for these committees to make informed recommendations about executive compensation, e.g., a financial analysis of the costs of option grants and second, requiring contractual provisions in option grants to the effect that option gains will be forfeited in the event of a restatement of results (as defined) within a period of time after exercise of an option. Such a provision would complement the SEC's enforcement policy requiring the disgorgement of unearned compensation based on corporate performance that turns out to be fraudulent. The history of the SEC's attempts to insure improved disclosure of compensation in proxy statements demonstrates that disclosure alone has not worked. These improved disclosures have not discouraged some corporate boards from awarding excessive – even unconscionable compensation – to management. Your committee could make a major contribution to corporate governance standards by requiring compensation committees to consider more carefully the impact of what they are doing upon public shareholders.

- Establish a voluntary code of best practices on corporate governance and require listed companies to disclose the reasons for non-compliance. Listed companies also might be required to disclose in their annual proxy statements compliance or non-compliance with the voluntary code of the Exchange.

- Consider expanding the number of independent directors from two to a number which makes your proposals on corporate governance standards workable.

Your Committee's recommendations can go a long way towards restoring public trust and confidence in the effectiveness of corporate governance.

R. S. S.

cc: Richard Grasso
Catherine R. Kinney

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