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The Millennium Bubble And Its Aftermath: Reforming Corporate America And Getting Back To Business

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Bubbles are recurring and inexplicable phenomena. Periodically, the seemingly irrational conduct of investors results in a speculative "mania" evidenced by skyrocketing stock prices and exaggerated investor enthusiasm. Virtually all market participants become absorbed in this mania, encouraging investor bravado and thereby contributing to the growth of the bubble until it bursts. The burst of the bubble causes widespread losses and often reveals mismanagement, misfeasance and malfeasance that contributed to the bubble. The losses and the scandals erode public confidence and contribute to a serious downturn in economic activity.

The burst of the "Millennium Bubble" of the late 1990s and early 2000s and the ensuing collapse of corporate giants such as Enron have, as in past collapses, resulted in a crisis in investor confidence and an economic downturn of such magnitude as to threaten deflation. The response has been congressional hearings, investigations, prosecutions and sweeping new regulation — to express our condemnation of the conduct that created the crisis, to punish corporate wrongdoers and to impose structural, procedural and behavioral requirements to reduce the likelihood of the crisis's recurrence.

This paper, which is an update of a speech I gave to the Commercial Club of Chicago in November 2002, discusses the evolution and collapse of the Millennium Bubble and the regulatory regime that has emerged as a result of the post-Enron crisis. It then highlights two essential themes for long-term reform of corporate America: First, post-Enron regulations will be effective only if accompanied by fundamental changes in corporate culture. To bring about true reform, those who are regulated must share the goals embodied in the rules that they are obligated to follow. Second, in our efforts to restore confidence in our markets, we must guard against overregulation and overzealous prosecutions, as these may stifle the recovery of our economy.

I. The Burst of the Millennium Bubble: What Went Wrong?

America glorified the apparent prosperity of the late 1990s and 2000. Stocks were yielding extraordinary returns, the IPO market was booming, and merger deal volume was extraordinarily high. Moreover, the advent of the Internet introduced a type of company with apparently limitless possibilities — the "dot-com." The media and the business community extolled this new era: CNBC became a hot channel and a cheerleader for the bull market, it was impossible to rent office space on Sand Hill Road at any price, and investment bankers abandoned suits and ties to better resemble "dot-comers." An unprecedented number of American households began investing in the stock market, lured in large part by the exponential returns on investments and the fantasy of early retirement based on the value of investors' stock portfolios. Day-trading was touted as a profession. Enron was the darling of the media, extolled

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as a model for dynamic forward-looking energy companies. Its reported earnings were growing steadily, its price-to-earnings ratio was extraordinary, its stock was continuously reaching new highs and the best names on Wall Street were competing to provide it with funding. In short, this was an era of overwhelming optimism, and perhaps even blind faith, in the U.S. markets. This fearlessness permeated key aspects of our economy, from the first-time investor to the Wall Street analyst to the top tiers of corporate management.

Then the bubble burst. Stock prices began to plummet. High-flying Internet companies began to lose the confidence of investors and many were eventually driven to bankruptcy. Enron collapsed, and several hundred others of the 1997-2001 peak performers, new and established companies alike, followed; these included former heavyweights such as WorldCom, Adelphia, Global Crossing and Health South. These collapses exposed a massive amount of fraud, misleading accounting, market manipulation and misfeasance and malfeasance of a scope and dimension not previously experienced in the United States. One of the most respected accounting firms in the country, Arthur Andersen, was convicted of obstruction of justice and was forced to dissolve. In the end, more than $7 trillion of market value was wiped out. The media flooded the air waves with human interest stories of retirees losing their life savings, being forced back into the work force and feeling betrayed by a system that lulled them into a false sense of confidence in what they viewed as their stock portfolio safety nets. Our markets, our corporations and our regulatory system suffered a severe crisis in public confidence.

The regulatory and public response was immediate, far-reaching and still continues. Congress passed the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), a sweeping set of reforms aimed at, among other things, curbing accounting fraud, regulating the accounting profession and increasing corporate accountability and transparency. The two major stock markets, NYSE and Nasdaq, proposed rules to strengthen corporate governance. Academics, institutional investors, labor unions, activist shareholders and advisory organizations also presented proposals and recommendations in various areas, from corporate governance to risk assessment to insurance to fundamental ethics. Meanwhile, we are continuing to experience congressional inquiries, investigations by federal and state authorities, grand jury investigations, "perp walks," criminal prosecutions and proposals for even more new regulation.

To properly understand and evaluate the regulatory regime that is emerging from this crisis, it is useful to explore the confluence of forces that contributed to it.

A. What Went Wrong: Wall Street

In the 1970s and 1980s, the poor performance of U.S. companies led many on Wall Street to believe that our companies were on a downward spiral — that we had lost our competitive edge against countries such as Japan and Germany. This created a marked rise in shareholder activism, which in turn forced companies to focus on creating "shareholder value," *i.e.*, short-term increases in stock price. Indeed, shareholder value quickly became the mantra. In the 1990s and 2000, companies new and old faced this same pressure and thus, in an environment of inflated stock prices and "irrational exuberance," raced to create the appearance of shareholder value at all costs. Transparency gave way to opaqueness, and the focus shifted from long-term growth to quarterly results.

Dot-coms and other Internet-related companies were at the heart of the stock market bubble. Their sudden and extraordinary price increases largely reflected the market's enthusiasm regarding the seemingly endless possibilities for growth that the Internet represented. In the eyes of many, traditional valuation methods based on revenues and cash flows did not accurately capture the future potential of these Internet-related companies. As a result, these companies turned to alternative valuation methods and used highly optimistic assumptions regarding the growth of the Internet. The number of "hits" on a website, for example, was considered indicative of a dot-com's future revenue. Research analysts fueled this speculation by endorsing — and often creating — these misleading valuation methods. Investment bankers, in turn, had a strong incentive to bring these Internet-related companies public. The virtually guaranteed profits that "hot" IPOs represented — particularly if the recipients of the IPO shares sold these shares in the immediate aftermarket — created an incentive for underwriters to use IPO shares as a currency for currying favor with venture capitalists, institutional investors, hedge funds and corporate officers. Some underwriters manipulated the IPO process through "laddering" and other activities that artificially inflated the prices of these IPO shares.

Internet companies were not the only ones that felt the pressure to increase (or fabricate) shareholder value. Indeed, the pressure was on all of corporate America, new and established companies alike, to keep pace with the perceived "growth" of the dot-com era. Companies thus began looking for ways to improve the appearance of their financial statements. If companies had weak earnings, they would look to alternative valuation methods. If the existing earnings were not sufficient to satisfy analysts, companies turned to pro forma earnings to satisfy the market's thirst for optimism. If organic earnings growth was not satisfactory, companies turned to acquisitions to augment future projections. "Structured finance" became a popular tool to achieve some of these objectives, using special purpose entities and similar tools for the purpose of creating fictitious revenues, keeping debt off the balance sheet, postponing or not recognizing losses and creating earnings where none existed. Companies also made other accounting decisions that, though permissible, conveyed a misleading portrait of true earnings, such as choosing not to expense the large amounts of stock options that they used as compensation for employees. And some companies, as we have learned, went as far as engaging in outright accounting fraud to achieve these objectives.

Research analysts in many cases became anything but arbiters of value. Although traditional valuation methods and an analysis of fundamentals may have indicated that stocks were overvalued, analysts exacerbated the craze by accepting companies' misleading valuations and pro forma earnings, overvaluing steady earnings growth no matter how achieved and issuing overzealous forecasts and projections. This message from Wall Street led to a perceived need for companies to meet these expectations. Companies would strain (if not break) the rules in order to achieve the expected growth rate, in many cases by reporting an extra penny or two per share in order to hit the "whisper number," which was usually pennies or a nickel more than the analysts' consensus number. Some analysts failed to focus on the most fundamental issues that would have indicated that this overzealous optimism was misdirected. And some analysts had a separate agenda, maintaining strong recommendations on stocks so that the investment banking arm of their institutions could obtain or retain investment banking business.

The aggregate impact of this environment was cogently summarized by Daniel Vasella, Chairman and CEO of Novartis, in the November 18, 2002, issue of *Fortune*:

> The practice by which CEOs offer guidance about their expected quarterly earnings performance, analysts set "targets" based on that guidance, and then companies try to meet those targets within the penny is an old one. But in recent years the practice has become so enshrined in the culture of Wall Street that the men and women running public companies often think of little else. They become preoccupied with short-term "success," a mindset that can hamper or even destroy long-term performance for shareholders. I call this the tyranny of quarterly earnings.

It is noteworthy that, although all of these problems were open and notorious during the bubble, the SEC, which is charged with protecting the investor, did little to protect the public from the bubble or even warn the public of its dangers. Congress and the White House were similarly silent and did not provide the SEC with sufficient resources to intervene in these abuses. The Federal Reserve issued a few warnings, including questioning how one is to know "when irrational exuberance has unduly escalated asset values," and acknowledging the possibility of a "bursting bubble." The Fed, however, did little to temper the financial markets and instead continued to pump air into the bubble. In fact, there was reluctance at the Fed to intervene in the market despite awareness of pervasive symptoms of a bubble. In short, regulators and legislators allowed investors to place an irrational faith in the stock markets, and they stood idly by as the bubble grew.

B. What Went Wrong: Corporate Governance

Given the overwhelming emphasis on immediate shareholder value, coupled with unrealistic expectations from both Wall Street and investors, it is of little surprise that public companies sought the appearance of short-term prosperity at all costs. As the post-Enron debacle has demonstrated, however, in seeking this prosperity, too many companies engaged in conduct that was improper and at times illegal. Two key facets of corporate governance structures encouraged, or at the very least facilitated, this conduct – excessively deferential boards and short-sighted compensation structures for senior management.

The distinct roles of management as running the day-to-day aspects of the company and the board of directors as the body charged with overseeing management on behalf of the shareholders were blurred in the era of the "imperial" CEO. In the latter half of the twentieth century, major companies gradually moved away from predominantly local boards (with few outside directors) and toward national boards consisting of a large majority of outside directors, most of whom were themselves CEOs of comparable major companies. In too many cases, the CEO would oversee the selection process for these director candidates, recommending acquaintances or former colleagues whom he believed would be loyal to him. Thus, "independent" directors often were independent in name but not in spirit.

The changing nature of the board's composition, and the necessity for many of the directors to travel by plane to the meeting, coupled with the increased influence of the CEO, in too many cases fostered a passivity and deference to management that was reflected in the boardroom. Board and board committee meetings frequently involved a working breakfast for committee meetings followed by a board meeting that ended at noon, with a buffet lunch

attended by only a few directors because most left for the airport immediately after the meetings. With this type of schedule, committee meetings, including the audit committee, were usually limited to one to two hours, and the board meeting itself often lasted not more than three hours. These meeting schedules did not provide board committees with the opportunity to explore adequately the issues faced by the corporation or to provide effective oversight of management. Audit committees, for example, often failed to understand the accounting issues that the company faced and had relatively limited contact with the company's independent auditors. Meetings of the entire board were similarly plagued by brevity and passivity. Directors often did not fully understand the transactions that they were approving or for which they were granting waivers of ethics codes. Boards would rely on the CEO's account of developments in the company and sought no independent source of information regarding management's performance. Additionally, there was no formal process for the non-executive directors to discuss the performance of the CEO.

Moreover, the compensation structures for senior management created an incentive for these individuals to inflate (or indeed fabricate) shareholder value. The perceived "boom" of the bubble period revolutionized companies' perceptions of competitive compensation. A large part of the compensation packages for the CEO and senior management took the form of equity (as opposed to cash) and stock options that were tied to short-term performance. This motivated management to focus on short-term stock appreciation rather than adopting a broader, long-term perspective. Some executives would exercise their stock options as soon as they became exercisable and immediately sell the shares. Thus, companies created an environment where rewards for corporate performance were measured vis-à-vis short-term goals.

In sum, the fever that accompanied the "boom" also infected the corporate governance structures of too many companies. Senior management, especially the CEO, had disproportionate power; senior officers shrugged off whistleblowers; boards deferred to management as long as they continued to see "prosperity"; and lax oversight was generally condoned because shareholders believed they were receiving value.

C. What Went Wrong: The Gatekeepers

Investors rely, directly and indirectly, on various participants in the market to affirm the veracity of the information reported by companies, including earnings and assets and liabilities, and to give them comfort that public companies are not engaging in fraud or other illegal activities. The crisis of recent years has led many to comment on the perceived failure of the "gatekeepers" — accountants and lawyers.

At its most basic level, the role of the independent auditor is to evaluate whether the judgments made by the company's management in its financial statements were reasonable. Financial statements include many judgment calls, and the independent auditor's key role is to lend legitimacy to these often-difficult decisions. But as the nature of the auditor-client relationship evolved and became more complex, auditors transformed from watchdogs to salesmen. They abandoned their objectivity and began to participate in, rather than police, the malfeasance that caused the crisis. Their client was management, not an independent oversight body such as the audit committee; in fact, many companies had a revolving door between

company financial staff and auditor staff. This made auditors even less likely to resist pressure from management.

During this period, auditing firms also discovered the lucrative business opportunities of consulting. To help companies meet the pressure for earning's growth, accountants began to market creative tax planning and financing structures to their audit clients, in addition to a range of other non-audit services for which they were often paid amounts greater than their auditing fees. An example of these devices is the various "swap" or "wash" transactions, or "round-trip trades," employed by telecommunications, technology and energy companies. Companies would swap power, capacity and even advertising to companies engaged in similar businesses. Each of the participating companies booked the transaction as revenue, thereby inflating its figures even though no value was created and allowing the company to present a picture of prosperity. An article in the June 10, 2002, issue of *Fortune*, entitled "Is Energy Trading a Big Scam?," states that these trades had an enormous impact on the results of large energy companies; for example, such transactions amounted to 72% of the total megawatts that CMS Energy traded in 2001 and one-fourth of the company's original reported revenues. Not only did these structures undermine accounting firms' objectivity, but they presented what became an insurmountable conflict of interest: These firms were creating the transactions that they were later (or simultaneously) hired to audit.

Although some of these questionable (or at least misleading) transactions infringed upon established rules, in many cases these "creative structures" in fact adhered to the letter of the accounting standards established by the profession. In this regard, the SEC and the accounting profession erred in allowing a hyper-textual adherence to rules-based GAAP, even when doing so presented a false or misleading picture of the finances of the corporation. Moreover, regulators failed to insist on clarity in financial statements, which became riddled with footnotes and at times were virtually incomprehensible.

Both in-house and outside lawyers also failed to be effective gatekeepers. A lawyer-client relationship — whether the client is the company, the board or an individual within the corporate structure — is markedly different than the auditor-company relationship. Lawyers act as advisers to management and/or the board and must, among other things, address concerns of attorney-client privilege and confidentiality. Nevertheless, at the very least the burst of the bubble has highlighted the fact that at times lawyers approved questionable transactions and did not force recognition of accounting or disclosure violations by reporting such practices to the audit committee or the full board.

Finally, to the extent that all key actors within the company should act as gatekeepers, their failure to do so has led to a perennial shift of blame: Boards of directors and audit committees blamed management and the independent accountants. CEOs and CFOs of failed companies that used "creative accounting" denied knowledge and blamed subordinates and the independent accountants. The independent accountants, in turn, blamed management for not being forthcoming with all necessary information.

II. The Aftermath of The Bubble: A New Regime

The burst of the bubble and the scandals that followed have produced extensive reforms designed to right these wrongs and restore credibility. The Sarbanes-Oxley Act introduced a broad spectrum of regulations to promote corporate responsibility, enhance disclosure, improve the quality and transparency of financial reporting and auditing, strengthen oversight of public company auditors and strengthen penalties for securities law violations. Several states enacted legislation that applies in addition to the Sarbanes-Oxley requirements. In addition, the stock markets, including the NYSE and Nasdaq, have proposed changes to their listing standards to implement key reforms in the area of corporate governance. The SEC, in turn, has enacted rules to implement the provisions of Sarbanes-Oxley and has been pursuing an extensive enforcement effort. Accompanying these regulatory efforts is a plethora of proposals (and, in some cases, demands for radical changes) from a spectrum of organizations, including institutional investors, activist shareholder organizations, labor unions, the Business Roundtable, the Conference Board and the American Bar Association, on various aspects of corporate governance.

This cornucopia of structural reforms and best practices recommendations has permanently changed the corporate landscape and has set a higher bar for directors and officers in terms of governance, internal controls, accountability, ethics and best practices. I discuss below some key trends and developments that have emerged as a result of our regulatory reconstruction efforts in the post-Enron era.

A. A Shift in Power to Independent Directors

1. *Director Independence and Heightened Standards for Board Conduct*

One of the most critical changes in the corporate governance landscape will be a tectonic shift in power away from senior management (particularly the CEO) and toward a majority-independent board, independent board committees and shareholders. In terms of compensation, boards will reduce significantly the size of management stock incentives and the extravagant perquisites that have received so much public attention. We should also expect shorter tenures for CEOs, as well as increased tension between the CEO and the board when performance falls below peer companies or when a very significant non-ordinary course transaction is presented to the board for approval. In other words, boards will be markedly less passive and will not show the deference to CEOs that often characterized board oversight during the bubble period.

This lack of deference is the direct product of Sarbanes-Oxley, SEC rules and proposed stock exchange regulations that will force the board, and especially independent directors, to engage in more active oversight of management. Proposed NYSE and Nasdaq rules will require a majority of the board to be independent, defined generally by the absence of family or material relationships to the company. Audit committee members must satisfy additional independence criteria. To further the goal of independent board oversight, some commentators, including the Conference Board, advocate separating the roles of chairman and CEO. Although this is not currently required by stock exchanges or legislation, we are experiencing attempts by certain activist shareholders and other groups that have their own agendas, but no real corporate

experience, to seek to take advantage of the current crisis to promote such separation, or alternatively a mandated lead director.

Sarbanes-Oxley and proposed stock exchange regulations will also create a new paradigm for board oversight. The key committees – the audit, compensation and nominating/corporate governance committees – will consist entirely of independent directors. The audit committee will include a “financial expert” (as defined by the SEC) and will hire and supervise the independent auditor, oversee compliance programs and establish whistleblower procedures. Due to the more active oversight role of the board and its committees, we should expect improved information flow between management and the board. Finally, boards and board committees will engage in self-evaluation consistent with proposed stock exchange regulations.

We should also expect more frequent, longer and more meaningful meetings, more extensive meeting agendas and a greater focus on director education. Directors will no longer be able to discharge their obligations properly in the four-to-five hour time frame that had become customary at many companies. Boards should consider the desirability of an annual two-to-three-day board retreat with the senior executives at which there is a full review of the company’s financial statements and disclosure policies, strategy and long-range plans, and current developments in corporate governance. This retreat could be held at a location close to one of the company’s operations to give the directors an opportunity to become acquainted with a number of the company’s operations as the annual retreats are rotated among the company’s various locations. Companies should also provide comprehensive orientation for new directors to acquaint them with the company’s strategy, long-range plans, financial statements, properties and operations, corporate governance guidelines and senior executives. Given the increased focus on director independence and the heightened oversight role of independent directors, we should also expect to see both smaller boards and a marked decrease in board interlocks.

As a result of this new paradigm, boards will be more likely to resemble Professor Jeffrey Sonnenfeld’s description of “What Makes Boards Great” in the September 2002 issue of *The Harvard Business Review*:

> What distinguishes exemplary boards is that they are robust, effective social systems . ... The highest performing companies have extremely contentious boards that regard dissent as an obligation and that treat no subject as undiscussable.

2. *Director Liability*

The current regulatory environment unquestionably has raised expectations for the performance of directors. It is important to note, however, that these changes generally will not translate into increased liability exposure for directors who act in good faith. The basic responsibility of directors remains to exercise their business judgment to act in a manner they reasonably believe to be in the best interests of the company, the shareholders and the other constituencies they serve. Moreover, the substance of the business judgment rule, which protects directors who act with due care and reasonably rely on management and advisors in making business decisions, remains applicable even in today’s environment. In light of the current

regulatory regime, however, directors should take special care in establishing a reasonable basis for such reliance. At an October 2002 roundtable discussion sponsored by the Harvard Business Review and the University of Delaware's Center for Corporate Governance, Chief Justice Norman Veasey of the Delaware Supreme Court advised:

> I would urge boards of directors to demonstrate their independence, hold executive sessions, and follow governance procedures sincerely and effectively, not only as a guard against the intrusion of the federal government but as a guard against anything that might happen to them in court from a properly presented complaint . . . Directors who are supposed to be independent should have the guts to be a pain in the neck and act independently.

Directors who follow these recommendations will continue to be protected by the business judgment rule, and there is no reason why they should restrain or restrict management initiatives, even very risky or untried initiatives, in the interest of avoiding litigation.

B. Transparency

Current and proposed rules and recommendations will lead to greater transparency and a clearer articulation of companies' notions of best practices and ethical behavior. We will see increased clarity in the information presented to shareholders, and increased disclosure regarding the governance methods that companies have implemented to ensure that they are acting in shareholders' best interests.

Sarbanes-Oxley and implementing SEC rules contain numerous provisions aimed at increasing transparency in the financial information provided to shareholders by means of SEC filings and/or other communications. The new rules have enhanced and expanded MD&A disclosure and require detailed discussion of critical accounting policies, off-balance sheet transactions and certain contingent obligations; the rules further require that financial statements reflect all "material correcting adjustments." In addition, companies are no longer permitted to use the tool of "pro formas" to paint an optimistic picture of their financials; there is now a clear recognition of the potentially misleading nature of pro forma information. Some pro forma measures (termed "non-GAAP financial measures" in Sarbanes-Oxley and implementing SEC rules), such as certain liquidity measures, are prohibited altogether, and the pro forma information that remains permissible must now be reconciled to GAAP. Moreover, Sarbanes-Oxley provides for enhanced disclosure in press releases, SEC filings and other public disclosures where non-GAAP financial measures are used. These rules will result in a marked reduction in the use of pro forma earnings.

New and proposed rules will also increase the amount and nature of information regarding the company that is available to shareholders. Sarbanes-Oxley and/or proposed stock exchange rules would require companies to adopt and disclose to shareholders corporate governance guidelines, codes of ethics (including a code of ethics for senior financial officers) and key committee charters that set forth, among other things, the committees' duties and obligations. Companies' websites and/or public filings will also include disclosures of items that

were previously not readily made available to shareholders, such as standards for determining director independence, fees paid to auditors, audit committee preapproval policies and Section 16(a) reports. Finally, the rules also require prompt disclosure of certain events that may be of particular interest to shareholders, including earnings releases, code of ethics waivers or amendments and insider transactions.

New and proposed rules will also lead to heightened attention to, and greater disclosure regarding, a company's internal controls and general compliance with new regulations. Under proposed NYSE rules, each listed company CEO must certify that he or she is not aware of any violations by the company of NYSE corporate governance listing standards and must promptly notify the NYSE after any executive officer of the listed company becomes aware of any material non-compliance with applicable provisions of the corporate governance standards. In addition, Sarbanes-Oxley requires the CEO and CFO to provide certifications as to the accuracy of the company's financial statements and the effectiveness of internal controls. Sarbanes-Oxley further requires that a CEO and CFO forfeit any bonus and equity compensation if the company is required to restate its financials due to material noncompliance, or as a result of misconduct regarding financial reporting requirements. In connection with the required certifications, CEOs and CFOs will expect internal certifications by subordinates and will demand comfort from the independent auditor and legal counsel. As a result, management, under the board's supervision, will establish and maintain an internal control structure and procedures for financial reporting and compliance with law. This will likely include, as advised by the SEC, a disclosure committee charged with reviewing disclosures and controls and should include careful oversight by a company's audit committee. Companies will develop checklists and review procedures to assist in performing the due diligence and to keep a record of the matters that have been reviewed. These internal controls will also be discussed in the newly required internal control report in a company's Form 10-K. The new obligations and procedures regarding internal controls will increase both the effectiveness of internal controls and the quality of corporate responsibility at every level.

The new disclosure regime is a giant leap toward transparency of the type described in *Fortune* by Daniel Vasella:

> To me transparency means that I will communicate truthfully what I do and don't know about my company's performance and prospects, the doubts that I have, and the things that I don't doubt. The goal of transparency is to give the shareholder an opportunity to form an opinion about you, to make a judgment. That's not to say one has to be naïve and publicly share information that will harm your company from a competitive standpoint. But in general one has to be transparent to a degree that allows fair judgment of both the company and the strength of the underlying business.

C. Transparency in Accounting and Truly Independent Auditors

The scandals of the bubble period have eliminated the public's tolerance for auditor conflicts of interest and aggressive accounting methods that are misleading and often illegal. An independent audit committee will closely monitor the auditor/company relationship.

It will hire and oversee the auditor and will review carefully the auditors' and audit firm partners' qualifications, independence, quality controls and history of problems and restatements. The audit committee must pre-approve all audit and non-audit services provided by the independent auditor and will exercise a heightened level of care in monitoring the company's financial statements. Sarbanes-Oxley and proposed NYSE rules also require the auditor to provide more extensive reports to the audit committee, including reports of all critical accounting policies and alternative GAAP treatments discussed with management. Finally, audit committees will insist on the auditors taking more responsibility for the financial disclosures, and the audit committee will more frequently engage outside counsel or experts to advise them on these matters.

In addition to oversight by a company's audit committee, Sarbanes-Oxley has imposed concrete provisions to ensure that independent auditors remain genuinely independent. First, Sarbanes-Oxley imposes heightened standards for auditor independence, including conflict of interest provisions and mandatory rotation of certain audit partners. Second, the Public Company Accounting Oversight Board, as well as the independent audit committees, will closely monitor auditing firms. Third, auditing firms will no longer provide the consulting services that created some of the perceived conflicts of interest, as Sarbanes-Oxley prohibits independent auditors from performing a number of non-audit services.

Finally, we have begun to see a regulatory shift away from detailed rules and toward general principles of compliance and transparency. The FASB has begun to recognize that adherence to technical aspects of accounting rules may yield misleading results. Thus, we should expect increased discussion regarding a convergence of rules-based accounting and principles-based accounting. The shift to principles-based accounting is evident in a number of Sarbanes-Oxley provisions and implementing rules. This includes requirements that financial statements "fairly present" the financial condition and results of operations independent of GAAP as well as the significantly enhanced SEC rules broadening MD&A disclosure.

D. Shareholder Activism

The burst of the bubble, the public outcry against corporate abuses and the resulting plethora of enacted or proposed rules and recommendations have increased the potential oversight role of the shareholder. We should expect shareholders to be (or attempt to be) more actively involved in matters that were heretofore reserved for the board and management. They will approve equity compensation plans pursuant to NYSE and Nasdaq rules. They will have a means of communicating confidentially with non-management directors. They will review more closely the voting history and voting procedures employed by registered investment companies through which they own shares. And they have begun to fight for access to their companies' proxy statement for board nominations. Shareholder proposals were presented to a number of corporations for the 2003 proxy season seeking shareholder adoption of bylaws requiring inclusion in company proxy materials of director candidates nominated by holders of a threshold percentage of the company's outstanding shares. The SEC has indicated that it may consider amending the proxy rules to mandate such shareholder access. Some commentators have echoed this initiative, recommending that shareholders be responsible for nominating a certain number of independent directors on a company's board. We should expect this issue to yield extensive debate in the near future.

These initiatives, coupled with the momentum and general sentiment that shareholders were wronged by those within the company whom they trusted, have created a much more activist shareholder. We should expect more proxy fights for full control of corporations, exertion of shareholder influence through withhold-the-vote campaigns and greater use of proxy resolutions to bring matters to a shareholder vote at annual meetings.

While some proxy solicitations by shareholders and some shareholder initiatives may lead to improved company performance, it is of critical importance that irresponsible and narrowly self-seeking shareholders and shareholder advisory organizations not be allowed to take advantage of reaction to the scandals to impose new requirements on corporations and their directors and officers that decrease rather than increase their effectiveness.

E. Clearer Channels for Communicating Concerns Regarding Company Compliance

The new regulatory landscape encourages, and in some cases obligates, those who see evidence of or strongly suspect violations of the securities laws to report such violations to decisionmakers at the company. Sarbanes-Oxley and implementing rules require "up the ladder" reporting of material violations of securities laws and material breaches of fiduciary duties or similar violations by attorneys. An attorney who has credible evidence of a material violation or breach must report it to the company's chief legal officer (CLO) or to the CLO and CEO, who must then conduct an inquiry. Alternatively, the attorney may report the violation to a company's Qualified Legal Compliance Committee, if the company has chosen to create one. The SEC is also considering additional provisions that would require the attorney to make a "noisy withdrawal" of his representation upon specified circumstances of suspected violations. As a result of these requirements, lawyers will actively report such matters to the appropriate parties within the corporation. Recommendations by the American Bar Association encourage boards to emphasize the role of a company's general counsel in compliance and whistleblowing efforts. The ABA recommends, among other things, that boards establish a practice of regular executive session meetings between the company's general counsel and the company's independent directors. Moreover, the ABA recommends that corporations strengthen the channels of communication and reporting obligations between outside counsel and the company's general counsel.

In addition to lawyers, company employees will also be encouraged to report securities law violations to the proper officials within the company. The code of business conduct and ethics that proposed NYSE rules require should encourage employees to report any violations of laws, rules, regulations or the code of business conduct to appropriate company personnel. Moreover, Sarbanes-Oxley and implementing SEC rules, as well as proposed NYSE rules, facilitate and mandate audit committee procedures for receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters. Finally, Sarbanes-Oxley provides specific protections against retaliation for public company employees who provide or facilitate providing information regarding violations of SEC rules.

III. Long-Term Reform: Measured Responses and Changes in Corporate Culture

Like the collapses of bubbles before it, the post-Enron debacle engendered public outrage, disappointment and resentment toward both the malefactors and the regulators who

either were not attuned to the illegal practices that were occurring or who chose to turn a blind eye to these events. Regulators have presented a cohesive, immediate and far-reaching response to the crisis. Sarbanes-Oxley, new SEC rules and proposed stock exchange regulations have defined parameters for conduct by all key actors in corporate America, including directors, senior management, auditors, legal counsel and Wall Street.

But regulations alone will not immunize us against "Enronitis." We must have introspection by directors and senior managers and a fundamental adherence to the principles that underlie the recent regulatory reforms. As SEC Chairman William Donaldson aptly noted in a May 8, 2003, speech to the Economic Club of New York:

> [T]he most important thing that a Board of Directors should do is determine the elements that must be embedded in the company's moral DNA . . . .
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> It should be the foundation on which the Board builds a corporate culture based on a philosophy of high ethical standards and accountability. This culture should penetrate every level of the organization and influence all of the board's decisions including the selection of a CEO and the senior management team who will ultimately ensure that the company's operations reflect its philosophy.
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> As we move past Sarbanes-Oxley and the requirements, rules and regulations that have come in its wake, it's essential that corporate boards look beyond the letter of the law and be ever mindful of the spirit of the reforms. By determining what makes up the moral DNA of the company and establishing a culture that puts ethics and accountability first, a company and its Board are less likely to fall into the common trap of mere compliance – where simply identifying a new line of legally acceptable behavior and how to maneuver the loopholes that accompany it passes for a commitment to reform.

Directors and senior management must consider this culture of transparency, accountability and fairness to be in the best interests of shareholders and the other constituencies to which they owe fiduciary duties.

To reap the long-term benefits of recent reforms, however, we must guard against excesses. We must ensure that our outrage at the abuses committed by some will not result in overregulation, "witch hunts" or media frenzies that demoralize business and retard the revival of our economy. As Chairman Donaldson also stated:

> The power of the American economy is tremendous, and the American spirit of entrepreneurship is an inspiration to the entire world. In our enthusiasm to correct and redress the problems of the past, we must take care that the solutions we propose are calculated and well thought out. We must make sure that we do not throw the baby out with the bathwater, so to speak. To

> ultimately stifle and inhibit the innovation and entrepreneurial zeal on which the American economy is built, would be just as tragic as the losses that investors suffered in the past several years, and ultimately, investors would be on the losing end again.

Malefactors of the bubble period should be punished. But it is time for us to cease investigations that are not of known violations, but designed to dredge up any lurking remaining violations. And it is time to stop the counterproductive competition between prosecutors and regulators that leads to criminalizing violations that are most properly addressed in civil proceedings.

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We have responded to the public outcry for reform. We have created a measured, long-term regulatory regime. We have made great progress in transforming the corporate psyche. Business leaders, gatekeepers and Wall Street understand that honesty, transparency and compliance with the spirit of the regulations is both mandated by government and expected by the public. The business world does “get it.” Now it is time to let corporate America get back to work — to revive our economy and restore investor confidence with the help of improved regulations and without the fear of overregulation, “witch hunts” and media frenzies.