Implications of Corporate Governance in the New Millennium

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What is Corporate Governance?

A framework that includes:

- rules and regulations

- corporate charters and bylaws

- formal policies

- customs and other processes that determine the leadership, organization, and direction of a company

What is Corporate Governance?

Can also be described in terms of several inter-related elements:

- activist institutional shareholders

-open market for corporate control (high risk of takeover for poorly performing companies)

- independent outside directors on the board

-committees to improve board processes

- long-term equity-based compensation for executives (linked to shareholder returns)

- gatekeepers who monitor the process of market disclosure (audit firms)

What is Corporate Governance?

- Good corporate governance plays a vital role in the integrity and efficiency of financial markets.
- Poor corporate governance weakens a company's potential and at worst can pave the way for financial difficulties and even fraud.
- If companies are well governed, they will usually outperform other companies and will be able to attract investors whose support can help to finance further growth.

Evolution of Corporate Governance:

- Pre-1980s

  - Strong management and weak owners (individual share ownership was dominant into the 1980s)
  - Boards largely made up of “inner circle” of current and former executives with “advisory role” and would rarely challenge management decisions
  - Outside directors made up less that 25% of all directors through 1980
  - Shareholders had little say

Evolution of Corporate Governance:

- 1980s – The Deal Decade
  - Power shifted toward investors with rise of activist institutional investors; by 1985, pension funds owned 28% of corporate equity
  - Start of enlightened shareholder approach
  - Management power challenged by wave of hostile takeovers (spurred by changes in anti-trust law and creation of junk bonds – non-investment grade debt used to finance leveraged buyouts)
  - Increased lobbying for anti-takeover legislation
  - Executive pay became scrutinized, shifting attention to linking pay and performance
  - Rise of “golden parachutes,” “poison pills” and other rewards to strengthen resistance to corporate takeovers
  - Opened door to the explosion of executive compensation in the 1990s

Evolution of Corporate Governance:

- 1990s – Shareholder Value
  - Managements' acceptance of "shareholder value" as a new ideology for corporate America
  - Institutional investors began voting more actively against anti-takeover defenses proposed by management
  - Decline in hostile takeovers due to anti-takeover legislation
  - More outside directors due to legal decisions focusing on their importance in monitoring take-over bids
  - Executive compensation shifted from being primarily cash-based to primarily stock-based giving management a greater stake in orienting their activities toward increasing share price in the stock market

Financial Scandals and Crisis in the First Decade of the 21st Century Led to New Regulation on Corporate Governance:

The Sarbanes-Oxley Act of 2002 (SOX)

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)

Enron - The Early 2000s

- Through the use of accounting loopholes, special purpose entities and poor financial reporting, the company and its management were able to hide billions of dollars in debt from failed deals and projects.

- CFO Andrew Fastow and other executives misled Enron's BOD and audit committee on high-risk accounting practices, and pressured accounting firm of Arthur Andersen to ignore the issues.

- From 1997 until its demise, "the primary motivations for Enron's accounting and financial transactions seem to have been to keep reported income and reported cash flow up, asset values inflated, and liabilities off the books."
  -James Bodurtha, Jr., Ph.D. and Professor of Finance and International Business at Georgetown University.

Enron - The Early 2000s

Results:

- Shareholders lost nearly $11 billion when Enron's stock price, which reached a high of $90 per share in mid-2000, and plummeted to less than $1 by the end of November 2001
- Numerous executives were indicted and sent to prison;
- Arthur Anderson dissolved
- Enron filed for bankruptcy in December 2001, with its $63.4 billion in assets, making it the largest corporate bankruptcy in U.S. history until WorldCom's bankruptcy the next year

Enron - The Early 2000s

Corporate Governance Failures:

- Shareholders failed to rationally value the Company
- Board failed to protect integrity of financial disclosure
- Management incentivized to adopt high-risk strategies to prop up earnings and an overvalued stock price to maintain the value of their stock options
- Gatekeepers (Arthur Anderson) failed to effectively interface between management and investors

WorldCom - The Early 2000s

- From 1999 through May 2002, WorldCom (under the direction of its top executives) used fraudulent accounting methods to disguise its decreasing earnings to maintain the price of its stock.

- To mask its declining financial condition, WorldCom's accounting department underreported costs by capitalizing these costs on the balance sheet rather than properly expensing them.

- The company inflated revenues with bogus accounting entries.

WorldCom - The Early 2000s

Results:

- Company's assets were inflated by approximately $12 billion
- Company made $75 billion restatement due to accounting fraud
- Numerous executives were indicted and sent to prison
- WorldCom filed for bankruptcy in July 2002, at the time, the largest bankruptcy in U.S. history

Sarbanes-Oxley Act of 2002 (SOX):

Enacted in response to Enron and the other corporate and accounting scandals of the early 2000s, which cost investors billions of dollars.

Purpose:

- Enhance and set new standards for all U.S. public company boards, management and public accounting firms
- Improve the accuracy and reliability of corporate disclosures made pursuant to the securities laws

Corporate Governance Provisions of Sarbanes-Oxley (SOX):

Auditor Related Changes:

§201 - Limits on multiple roles and services by auditors (restricting outside auditor from non-audit services to same company to reduce conflicts of interest)

§301 - Increased roles for audit committees of public companies (it has power to hire, fire and compensate external auditors)

Corporate Governance Provisions of SOX:

§404 - Management Assessment of Internal Accounting Controls

- Top management required to publish information in their annual reports concerning the scope and adequacy of the internal control structure and procedures for financial reporting.
- Auditor must attest to and report on the effectiveness of the internal control structure and procedures for financial reporting.

Corporate Governance Provisions of SOX:

§302 - Corporate Responsibility for Financial Reports

- Requires executive and financial officer to certify and approve the integrity of the company's quarterly and annual reports.
- Criminal penalties for certifying a misleading or fraudulent financial report (Section 906).

Corporate Governance Provisions of SOX:

§101 - Public Company Accounting Oversight Board (PCAOB)

Creation of board to independently oversee outside auditing firms

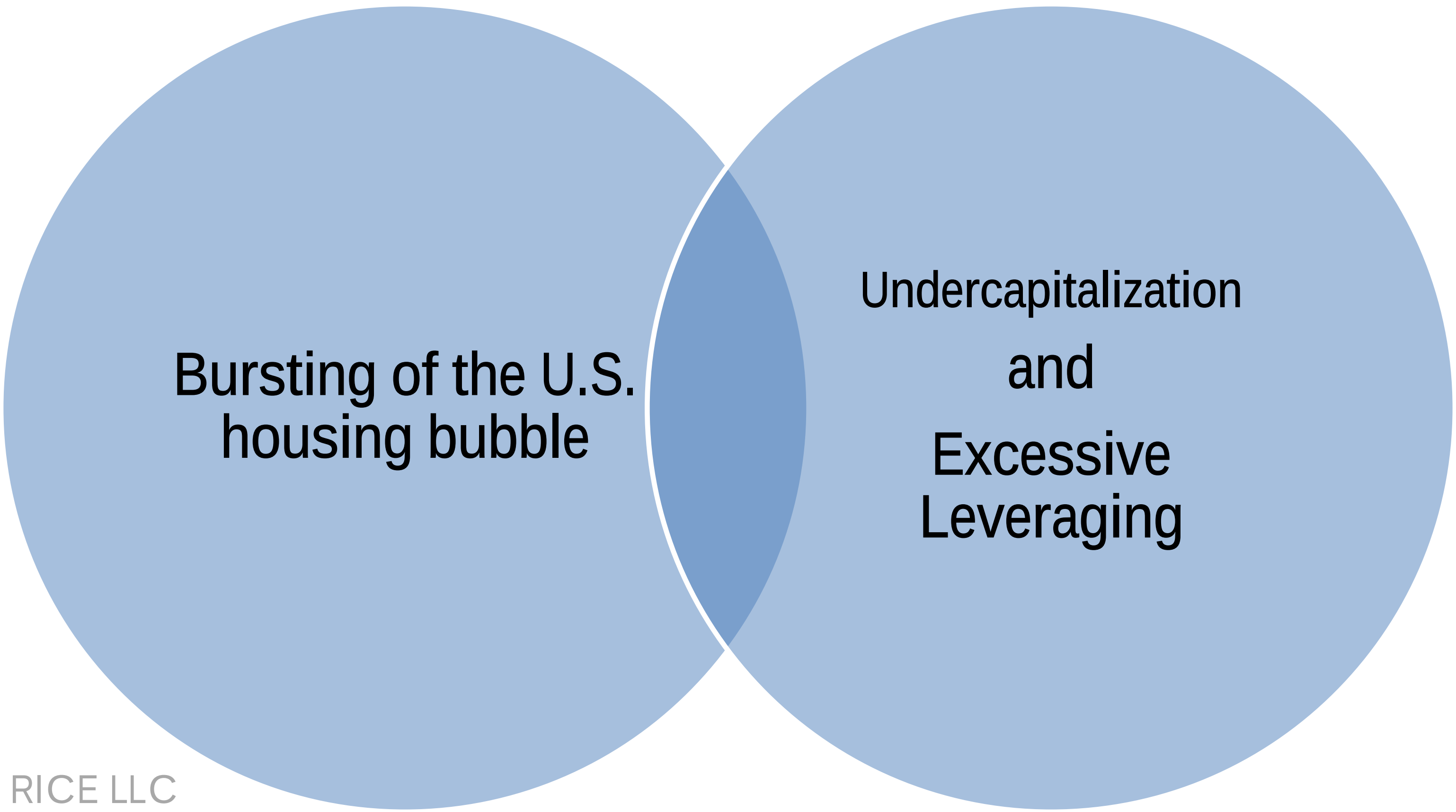
Corporate Governance Provisions of SOX:

§304 - Clawback Provisions

- To recoup compensation from executives in circumstances where it is later determined that there were financial accounting issues requiring restatements of the company’s financial statements.
- Requires CFOs and CEOs to disgorge any bonus, other equity or incentive-based compensation and any profits from sales of company stock received during the 12-month period following public issuance or filing with the SEC of an accounting restatement due to material non-compliance resulting from misconduct.
- Can only be enforced by the SEC; the company and shareholders possess no private right of action to bring a clawback claim.

The Financial Collapse of 2007 – 2008

Many opinions and theories of what caused the financial collapse – among them are:



Bursting of the U.S. Housing Bubble:

Shoddy Mortgage Lending – a poorly regulated primary mortgage market led to an increase in non-traditional mortgages that resulted in a large number of foreclosures in 2007 and 2008

Adjustable (interest) Rate Mortgages - had rising interest rates which homeowners could not pay and, ultimately, the values of the mortgages were higher than the values of the residential properties

Subprime Mortgages - homeowners were given mortgages without adequate income, credit or assets

Securitization of these mortgage loans - excessive packaging and sale of loans to investors and risky bets on securities backed by the loans

Failures in credit ratings agencies - credit rating agencies erroneously rated these mortgage backed securities as safe investments and buyers did not do their own due diligence

Undercapitalization and Excessive Leveraging:

- For about every $40 in assets, the top 5 largest U.S. investment banks had only $1 in capital to cover losses (3% drop in asset values could wipe out entire firm).
- These banks hid excessive leveraging using derivatives, off-balance sheet entities and other devices.

The Financial Collapse of 2007 - 2008

Conclusion:

When housing and mortgage markets cratered, the lack of transparency, extraordinary debt loads, short-term loans and risky assets all came together to cause a financial panic, causing:

- Mortgage backed securities failure
- Declines in credit availability
- Bank solvency questions
- A global economic decline
- Damaged investor confidence

The crisis was the result of "high risk, complex financial products, undisclosed conflicts of interest, and failure of regulators, credit rating agencies and the market itself to rein in the excesses of Wall Street."

- U.S. Senate's Levin-Coburn Report released April 13, 2011

Dodd-Frank Act Enacted in 2010:

Enacted in response to the fallout from the financial crisis.

Purpose:

- Make changes to all federal regulatory agencies and almost every part of the financial services industry
- Improve accountability and transparency in the financial system
- End “too big to fail” and bailouts
- Protect against abusive financial services practices

Principal Corporate Governance Provisions of Dodd-Frank

- **§**951 - Say on pay
- **§**952 - Compensation committees must be fully independent and be given certain specified oversight responsibilities
- **§**953 - SEC must require companies to provide additional disclosures with respect to executive compensation
- **§**954 - Expand SOX rules re: clawbacks of executive compensation
- **§**971 - Affirms SEC authority to issue a proxy access rule allowing shareholders to use the company proxy statement to nominate candidates to the board of directors
- **§**972 - Requires companies to disclose whether the same person holds both the CEO and chairman of the board position and why they either do or do not do so

§951 - Say-on-pay

3 separate, non-binding shareholder votes

- **Say on pay votes** - requires public companies to hold a shareholder advisory vote on the compensation of the most highly compensated executives.
- **Frequency votes** – requires public companies every 6 years to provide their shareholders with an advisory vote on how often they would like to be presented with say-on-pay votes – 1, 2 or 3 years.
- **Golden parachute disclosures and votes** – requires public companies to disclose arrangements and understandings with its executive officers in connection with an acquisition or merger. In certain circumstances, companies are required to conduct a shareholder advisory vote to approve the golden parachute compensation arrangements.

§951 - Say-on-pay

Results:

- A non-binding, but crucial vote
- Companies ignoring the vote results are subject to reputational risk, alienating shareholders and damaging its value
- More engagement between institutional investors and companies over pay issues
- Companies are much more likely to reach out to institutional investors to listen to their concerns about executive compensation

In 2012, only about 3% of executive compensation packages failed to be approved.

§954 - Clawback Provisions

Expands SOX clawback provisions:

- Requiring companies to adopt and disclose clawback policies, recover all incentive based compensation paid to current or former executives during the three years preceding the date on which the restatement is required.
- No requirement that the restatement be triggered by misconduct of the company or any employee.
- Requires the policy to cover the executive officers of the company.

Example:

- On May 2, 2013, giant hedge fund SAC Capital Advisors announced that the fund would start using a clawback policy to reclaim compensation from employees who are found to engage in insider trading.
- While this act to strengthen compliance should be commended, industry professionals say it may be too late as the fund has been under fire by regulators for employees' insider trading since at least 2007.
- It will, however, change the direction of the fund after it has had time to implement the policy.

§971 - Proxy Access under Dodd-Frank:

Provided the SEC with authority to issue proxy access rules.

Corporate Proxy - the principal means by which shareholders exercise their voting rights. Because most shareholders don’t attend shareholder meetings, voting of shares to elect directors and approve or reject major transactions occurs via solicited proxies.

S.E.C. RULE 14a-11 – Final proxy access rule issued by the SEC on August 25, 2010

- If shareholders want to nominate outside directors to board seats, companies would be required to give investors a right to place their nominees to the board of directors on the company's proxy ballots.
- This would make it easier for shareholders to trigger contested elections and shift much of the cost of the election process to the company.
- Previously, investors who wanted to replace directors had to mail separate ballots to all shareholders and wage a costly campaign.

Proxy Access Rule Struck Down by Court:

Business Roundtable v. SEC, No. 10-1305
(D.C. Cir. July 22, 2011)

The U.S. Court of Appeals for the D.C. Circuit vacated the proxy access rule, holding that the SEC failed to consider the economic consequences of the rule and its effect on efficiency, competition and capital formation.

Consequences:

- Bad for shareholders as electing or removing directors is a critical shareholder right.
- Entrenches existing directors and executive management.
- Prohibitively costly and time consuming for most shareholders to mount a proxy contest.
- SEC estimates that a proxy contest would cost shareholders $368,000 on average.
- Delaware corporate law permits shareholders to vote on whether some form of proxy access should be adopted.

Corporate Voting (State law controlled)

Plurality Voting - an electoral process for the nominees of available directorships whereby the nominee who receives the highest number of affirmative votes cast is elected, irrespective of how small the number of affirmative votes is.

Shareholders can either vote ‘For’ a director or ‘Withhold’ their support from a nominee.

- **‘For’ vote** - If one share is voted for the election of a nominee, then that individual will gain or retain the board position irrespective of a lack of support from the remaining shareholders.
- **‘Withhold’ vote -** where the shareholder votes against a director These votes are not counted; a single “For” vote ensures an incumbent’s election.

Example where corporate governance changes were still effectuated:

The Walt Disney Company

- In a 2004 proxy vote, Walt Disney Company CEO Michael Eisner was a candidate for reelection as chairman and CEO.
- 43% of shareholders withheld their votes for Eisner.
- Although reelected, the 43% withheld vote was viewed as a powerful protest and Eisner initiated a succession process shortly thereafter.
- More and more companies are voluntarily adopting rules to require that directors get more “For” votes than withhold votes, making a withhold vote a “no” vote.

Majority Voting

Requires greater than 50% ‘For’ votes for the candidate to be elected to the Board.

- Supported by the Council of Institutional Investors (CII).
- 2011 – Shareholders submitted 80 resolutions for majority voting - more than any other topic for the year.

Example:

- In February 2011, CalPERS called for a non-binding shareholder proposal that Apple, Inc. amend the Company's articles of incorporation and/or bylaws to provide that director nominees shall be elected by the affirmative vote of the majority votes cast at an annual meeting of shareholders, with a plurality vote standard retained for contested director elections.
- The non-binding vote passed in favor of the proposal.
- In advance of the 2012 annual meeting, the Apple board of directors approved a majority-rule measure that would force directors to resign their positions if they do not receive a majority vote.

Plurality Voting is Still the Norm:

- Earlier versions of Dodd-Frank included majority vote provisions, however, final version did not have these provisions.
- Delaware corporate law imposes rules that are generally more favorable to management than to shareholders and has long tolerated plurality voting.
- According to the FactSet research study noted by CalSTRS in summer 2012, more than 73.5% of companies in the Russell 2000 index still utilize pure plurality voting.

You Can Change the Policies of Public Corporations:

- Communicate with directors regarding key issues.
- Introduce shareholder resolutions for a proxy vote.
- If you don’t introduce resolutions, pay attention to those that are on annual proxy statements and cast your ballot.
- Exercise your fiduciary duties and scrutinize the pay practices of companies and bring to their attention any issues regarding executive compensation.
- Continue pressuring companies to be better corporate citizens.

You Can Change the Policies of Public Corporations:

- For smaller funds:
  - Use Proxy Advisory Firms to recommend and assist in proxy voting (i.e. ISS (Institutional Shareholder Services) serves 69% of public pension funds as clients).
  - Rely on money managers to inform your corporate governance policies and make voting recommendations.
  - Join organizations such as NCPERS and CII (Council for Institutional Investors) to educate yourselves on the issues.
  - Portfolio monitoring to identify poor corporate governance and targeted litigation to compel reforms.

Takeaways:

This year, so far, shareholders filed the following proposals during proxy season:

- 76 calling for annual election of directors
- 40 on executive compensation
- 39 calling for disclosure of corporate political spending
- 28 calling for an independent chair of the board of directors
- 3 calling for proxy access

Institutional shareholders should make their voices heard – Use Your Voting Rights!

You own part of the company in which you own stock as you have provided capital for the company to run its business.

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