THE CORPORATE GOVERNANCE ALLIANCE DIGEST

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As a service of Eleanor Bloxham and John M. Nash, below are complimentary summaries of up to date news, information and perspectives on issues in value and corporate governance. We hope you find this service useful. If you don't want us to send you this information in the future, please just notify Eleanor Bloxham (ebloxham@thevaluealliance.com).

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A listing of abbreviations is available at the end of the digest.

This edition of the DIGEST has 5 major sections:

I. BOARDS: NOMINATIONS, SUCCESSION, COMPOSITION, CONFLICTS

The SEC has adopted disclosure requirements that include: 1) whether a company has a separate nominating committee and, if not, the reasons why it does not and who determines nominees for director; 2) whether members of the nominating committee satisfy independence requirements; 3) a company's process for identifying and evaluating candidates to be nominated as directors; 4) whether a company pays any third party a fee to assist in the process or identifying and evaluating candidates; 5) minimum qualifications and standards that a company seeks for director nominees; 6) whether a company considers candidates for director nominees put forward by shareholders and, if so, its process for considering such candidates; 7) whether a company has rejected candidates put forward by large, long-term security holders or groups of security holders; 8) whether a company has a process for communications by shareholders to directors and, if not, the reasons why it does not; 9) the procedures for communications by shareholders with directors; 10) whether such communications are screened and, if so, by what process; 11) and the company's policy regarding director attendance at annual meetings and the number of directors that attended the prior year's annual meeting..
(SEC.gov 11/19; WashPost 11/20)

Two reports outline the issues of increasingly powerful VCs, last to invest in Silicon Valley companies who have been able to wrest board control at the expense of early investors, company founders, employees and directors. When they sit on boards of companies in which their firms have investments, VCs have a fiduciary duty to both the company and to the limited partners who invest in their funds. The issues are causing fiduciary breech lawsuits between founders and the VCs that serve on the board. (WSJ 12/2)

Roy Disney and Stanley Gold resigned from Disney's board criticizing Eisner and other directors. They were being asked to leave under guidelines that call for all directors to retire at age 72. Andrea Van de Kamp, a former board member who also criticized Eisner resigned from the board last year. Sybase CEO, John Chen, is to take on a director's role at Disney starting in January. (FT, NYTimes, WashPost, WSJ 12/01; CFO, Forbes, FT, NYTimes, USAToday, WashPost, 12/2; NYTimes 12/3; FT 12/4)

HealthSouth announced that 5 directors who sat on the board while the fraud was taking place will step down by 8/30/04 (as part of a settlement of a lawsuit by the Louisiana Teachers' Retirement System). During this transition period, significant action by the board will require an 80% supermajority vote, ensuring that all such actions will have the support of a majority of new directors. (CFO, FT, USAToday 12/3)

SEPARATE CHAIR AND CEO

Recent new appointments with older executives in separate CEO and Chair positions: Delta, Boeing. Separation was agreed to by Freddie under OFHEO consent order. (WashPost, WSJ 11/24; NYTimes, CFO 11/25; CFO, FT, NYTimes, USAToday, WSJ 12/2; USAToday, WashPost, WSJ 12/3; FT, NYTimes, USAToday, WashPost, WSJ 12/8; BW 12/15)

CEO SUCCESSION

According to a survey by Burson-Marsteller: when asked if they'd like to be CEO today, 35% of senior executives said they would turn down the offer vs 54% in 2002 and 27% in 2001. (CFO 12/4)

The number of CEOs replaced for poor performance has more than doubled since 1995. (USAToday 12/1)

FEMALE DIRECTORS

The 100 largest companies now all have at least one female director. Female directors hold 13.6% of board seats at Fortune 500 companies, up from 12.4% in 2001, and 9.5% in 1995 according to a Catalyst survey. The number of seats held by women of color is 3% up from 2.6% in 2001. Avon and SBC have the most, with 6. Golden West has 5 and the highest percentage, 55.6%. 54 Fortune 500 companies have no women on their boards, down from 96 in 1995. 208 have only 1 female director. Steve Sanger, CEO of General Mills, one of 19 companies with 4 or more female directors says 40% of the company's workforce is female, and it's important that they have "visible leadership." (USAToday, WashPost 12/4)

Tom Peters, author of Re-imagine: Business Excellence in a Disruptive Age
"I really believe that hierarchies were invented by men for men, and essentially hierarchies by definition are slow moving because they aren't parallel processors of information. And if there is a fundamental change in organization structure coming…the skills that women inherently bring to the table are particularly well suited for a different organizations shape...Women do the multitasking thing, the relationship thing." (USAToday 12/7)

II. COMPENSATION TRENDS & ISSUES

John Plender, author of Going off the Rails: Global Capital and the Crisis of Legitimacy
"Good corporate governance comes down to carrots and sticks...The regulatory effort since Enron has been devoted to increasing the weight and number of the sticks without looking much at the carrots…The move from a patchwork regulatory response to a broader approach that more closely embraces behavioural incentives and ownership structures may soon be in the cards." (FT 11/21)

REPORT ON COMPENSATION

The NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee, says that a consultant retained and reporting directly to a board pay committee "should not be retained by the company in any other capacity"; that exit packages should be examined, that performance measures should not be changed "after the fact", that incentive overpayments should be recaptured, and alternatives to contracts at the CEO level should be considered.
(WSJ 12/11)

PAY FOR PERFORMANCE

You can expect higher performance from "falling knives" - stocks that fall by 60% or more in a 12-month period. They generally go on to outperform their peers over the following two years in almost every world market, according to a study by the Brandes Institute of 1,142 falling knives. Knives outside the US gained an average of 19% in the year after their fall, compared with a 9.6% rise in their benchmark. In the second year, they gained 22.2%, compared with a 14.8% rise in the benchmark. However, in the third year they dropped by 6.6%, compared with a 2.7% drop in the benchmark. The results mirror a similar recent study of falling knives in the US market. (FT 11/24)

The compensation committee of Union Pacific has decided to add to earnings an estimated $1.45 a share related to proceeds from an IPO offering of its Overnite Corporation unit thereby raising cumulative income so executives can earn long-term payouts in stock and cash. A portfolio manager whose funds own 1m shares says that a one-time nonrecurring gain from an equity deal should not be used to reach the targets. (NYTimes 11/23)

A board committee, formed at the request of shareholders, said Lord Black and other top officials received unauthorized payments totaling $32.2m, in addition to $180m in various kinds of management and other fees the company paid to Lord Black and other executives/directors. Hollinger is eliminating payments for a variety of items that supported Black's lifestyle and is considering selling papers that belonged to President Roosevelt, an $8m purchase made with unanimous board approval, for which Lord Black "was not prepared [personally] to spend." KPMG is facing scrutiny in approving SEC filings and not checking whether the audit committee had approved the payments. The SEC has issued subpoenas to Hollinger and KPMG. Four independent directors that made up the audit committee resigned after the board rejected their recommendations for changes in senior management and the board itself. (FT, WashPost, WSJ 11/17; FT, NYTimes, USAToday, WashPost, WSJ 11/18; FT, WashPost, 11/19; FT, NYTimes, WSJ 11/20; USAToday 11/21; FT 11/29; FT 12/1)

III. AUDIT COMMITTEE ALERTS

POLICY AND PRACTICES

A KPMG survey of executives at over 450 medium- and large-sized organizations found 75% had reported at least one instance of fraud this year, up from 62% in 1998. Financial reporting fraud more than doubled, to 7% in 2003, up from 3% in 1998, with the average cost more than $250m per episode. Internal audits are on the rise, with 65% of companies conducting them, up from 43% in 1998. Most organizations identify collusion between employees and third parties as the most significant factor contributing to fraud. (WashPost 12/1, CFO 12/2)

According to a Glass Lewis review of 509 companies in the Russell 3000 index with market values of $500m or more shows some companies are continuing to use off-balance-sheet accounting that keeps debt off their books and some may have structured arrangements to sidestep the rules, by arguing they don't technically control the entity (citing SBC, Liberty Media) or shrinking their size (citing Citigroup). The new rules go into effect December 15 and are intended to eliminate off-balance sheet entities – SPVs and VIEs. (USAToday 11/28)

RESTATEMENTS AND INVESTIGATIONS

As Parmalat moves to avoid default on its debt, questions are being raised about a 117m euro Citigroup financing arrangement that went undisclosed to investors until last month, called Bucanero LLC (Italian for "black hole"), that has been consistently recorded on Parmalat's books as a form of investment. Accounting Firm Grant Thornton, which audited that part of Parmalat's books, said the arrangement was somewhere between equity and debt: "It's half-man, half woman." Investors also questioned S&P which had maintained Parmalat's status as investment-grade until just last week. Earlier, investors questioned why D&T had not raised questions about a 500m euro investment Parmalat made in a

Cayman Islands vehicle where Parmalat has acknowledged difficulties in recovering the investment. (WSJ 12/12)

Freddie Mac estimated it will owe as much as $30m in back taxes. In addition, the IRS is reviewing Freddie Mac's tax treatment of certain transactions related to the restatement which could result in a tax bill of as much as $750m. Freddie Mac has spent nearly $100m, to date, on its reaudit and reported it understated earnings by a combined $5bn in 2000, 2001 and 2002 and some periods before 2000. Offsetting the cumulative understatement, for 2001 it inflated earnings by nearly $1bn. Under review: Bonuses for the CEO, COO and CIO during 2001. (Compensation was based in-part on earnings). Freddie expects net income for periods following the restatement to reflect greater volatility and expects to release quarterly and full-year 2003 results by 6/3/04. The company still lacks effective internal controls, the current CFO said. OFHEO is investigating the role of Morgan Stanley and Citigroup, among others, in arranging transactions that helped them hide big gains and smooth earnings. In a settlement with OFHEO, in addition to a $125m fine, Freddie Mac's board is required to review and, as necessary, revise its bylaws, the frequency of its meetings, the company's codes of conduct, determine whether to impose term limits, and put in place a plan to base compensation on long-term goals rather than short-term earnings. The company is required to report on its internal controls and on plans for strengthening its internal audit and accounting functions. (WSJ 11/18; WSJ 11/20; WashPost, WSJ 11/21; FT, NYTimes, USAToday, WashPost, WSJ 11/22; WSJ 11/23; FT, USAToday, WashPost, WSJ 11/24; NYTimes, USAToday, WashPost, WSJ 12/11)

The SEC launched an informal inquiry into Goodyear's $84.7m restatement of earnings for the last 5½ years due to internal billing errors. Goodyear will postpone filing an amended annual report because of newly discovered "possible improper accounting issues in Europe". (WSJ 11/20; WSJ 12/11; FT, USAToday 12/12)

Enron's bankruptcy examiner's report says: Ken Lay and Jeff Skilling were "hands on managers" who, along with directors, "breached their fiduciary duties" in approving transactions with no business purpose and that inhouse and outside counsel committed malpractice. The report said Mr. Lay could owe the company $94m and Mr. Skilling could owe $2m related to the loans which were not approved by the full board. 3 new banks - Credit Suisse First Boston, RBS and Toronto Dominion were cited for aiding and abetting Enron's fraud. (FT, NYTimes, USAToday, WashPost, WSJ 11/25; WSJ 11/28)

Cablevision uncovered another $400k in improperly booked expenses as part of its ongoing accounting investigation. Its accounting is being investigated by the SEC. (NYTimes, USAToday, WashPost, WSJ, 11/12; CFO 12/3)

The SEC instituted cease-and-desist proceedings against two former CFOs of Akorn for making false statements concerning Akorn's financial condition and causing Akorn to carry on its books at least $7m in accounts receivable that were significantly impaired, if not completely uncollectable. Had Akorn appropriately recorded a reserve it would have posted a $2m loss for its fiscal year ended 12/31/00, rather than the $2m profit it reported in its 2000 annual report, the SEC asserts. (CFO 12/3)

Friedman's is restating its results back to at least fiscal 2000 due to concerns over its accounting of bad debt and losses. The company's auditor, E&Y, withdrew its audit opinions on previously filed annual financial statements. (CFO 12/2)

California notified 7,500 corporations and wealthy individuals that they are suspected of investing in illegal tax shelters, a crackdown that could become a model for other states with falling corporate tax revenue. A multi-state Tax Commission estimated that state governments are losing as much as $12.4bn a year -- or 35% of total corporate tax takes -- to tax sheltering. The IRS deems a shelter illegal if its only economic purpose is tax avoidance. (WashPost 12/4)

AUDIT FIRMS

Wachovia disclosed that the SEC has launched a formal inquiry into its relationship with KPMG under which the banking concern earned fees for referring wealthy clients to KPMG. (USAToday 11/13; FT, USAToday, WashPost, WSJ 11/17; NYTimes, WashPost, WSJ 11/19/03)

KPMG, in 1998, decided not to register a new tax-sheltering strategy for wealthy individuals after a tax partner determined the potential penalties were vastly lower than the potential fees. Deutsche Bank and Hypo-und Vereinsbank made more than $10bn worth of loans essential to one of the KPMG tax shelters. (WSJ 11/17; NYTimes, 11/21;USAToday 11/24)

The UK's APB plans to ban firms from doing certain tax and corporate finance work for audit clients, and ban the use of "success fees" in any audit or tax work by firms for audit clients, and for some corporate finance services.
All main audit partners who work with audit clients are to be replaced after seven years and lead partners would be replaced after five years. (FT 11/22)

The SEC has begun an inquiry into E&Y's independence related to 3 audit clients with whom E&Y had "strategic partnering" relationships: American Express, AMR and Continental Airlines. The SEC is considering suspending E&Y from accepting new publicly registered audit clients for 6 months over auditor-independence violations involving PeopleSoft. (WSJ 12/8)

IV. SHAREHOLDER, EMPLOYEE AND CUSTOMER RELATIONS

TRENDS (BUSINESS PRACTICE, THE ENVIRONMENT, AND M&A

Two pension funds are suing Safeway's management and board alleging they misled investors about serious problems that were alienating shoppers and employees. (WashPost 11/22)

Kodak Chair Danial Carp has agreed to a second meeting with Herbert Denton, a shareholder who recently held a meeting of investors, is pressing Kodak to set up a shareholders committee, and wants that committee to name his firm, Providence Capital, as a financial adviser. (WSJ 12/3)

According to a recent Mori survey, 17% of adults have boycotted a product on ethical grounds in the past year and 14% have bought a product from a company because of its ethical reputation. 38% of the public say they regard corporate social responsibility as very important when making purchases, yet far fewer act on this. Communication makes the difference. Case Example: Although within legal limits, 2 years ago Marks & Spencer (M&S) was impacted when Friends of the Earth (FOE) revealed that there were more pesticide residues on fruit and vegetables sold by M&S than by any other supermarket. M&S decided to turn the issue to commercial advantage by working with FOE. "We came up with a list of 79 chemicals that are going to be banned at some point, and we decided we'd stop them being used in our production and publish all test results on our website." In a year their pesticide strategy moved them to #1 good performer in the FOE league table. They still occupy that position. M&S describes groups such as FOE as "brand editors". Others are the media and socially responsible investors, who comment regularly on companies' ethical or environmental performance. They take large quantities of information on complicated issues and boil them down into simple messages or league tables about brands to which customers respond. Positive media coverage can be significant. M&S gained the equivalent of $2.9m in “free” advertising through widespread coverage of its 1997 decision to be the first retailer to stock only free-range eggs. (FT 12/4)

Sir Philip Watts, Chair of Shell, confers with Amnesty International, the WWF and Human Rights Watch and attends UN development conferences. Shell has become the first oil and gas company to declare that it will not explore or develop oil and gas resources in the natural areas designated by Unesco as "World Heritage" sites. It will disclose the royalties it pays to foreign countries, so long as the governments approve. And it sets aside $140m a year for social programs. Other oil companies, most notably BP, have taken similar approaches to reviewing their operations. The annual Shell Report discloses Shell's successes and failures in human rights and environmentalism, including oil spills and community protests. When Corporate Watch gave Shell a "Greenwash" award for failing to keep its promises, the Shell Report duly noted the distinction. "We take the criticism seriously, but disagree with Corporate Watch's conclusions," it said. (NYTimes 12/1)

California's state treasurer, Phil Angelides, who helps oversee CalPERS and CalSTRS, says the funds should start considering companies' environmental actions when making investment decisions, finding that funds that focus on environmentally oriented companies "are beginning to see good returns in the marketplace." State treasurers are meeting to discuss ways to pressure U.S. companies (perhaps via SEC regulation) to disclose more information about how environmental issues such as global warming could affect their bottom lines. (WSJ 11/21; NYTimes 11/22)

M & A

MONY, responding to criticism from shareholders that it rushed into a proposed acquisition by AXA, filed a draft proxy with additional details about unsuccessful discussions with other companies and the nature of those discussions. (WSJ 12/2)

Following their acquisition of Wella, P&G, reversing an earlier position, has agreed to call an extraordinary shareholder meeting. Wella's preference shareholders say they received poorer terms than ordinary shareholders. (FT 11/24)

After Morrison launched its bid, Safeway's HR team faced the challenge of trying to maintain morale among a workforce worried about the fate of their company. The response has involved training, information and incentives. To underline the importance, a director has attended every workshop which has been held for employees (in new skills) and management (in handling the changes). As a result, staff turnover is in line with last year's and has even fallen by 8% in the stores division since January, while customer service, as measured by an independent market research firm, has improved. (FT 11/27)

V. OTHER REGULATORY AND LEGAL UPDATES

MUTUAL FUNDS

Mutual fund boards have come under fire as the issues and number of companies involved in the mutual fund scandals have ballooned. An SEC survey found at least ½ of the nation's 88 largest fund companies allowed select customers to time the market. Many fund companies shared fund holdings information with important clients, prospective investors, brokers and clients, but not others. 1/3 of large mutual fund companies gave portfolio information to consultants and others in ways that raise concerns about whether some investors were able to benefit improperly. SEC Chair, William Donaldson, acknowledged his agency was slow to spot and react to mutual-fund problems and the SEC has approved new rules that, if made final, require fund companies to: 1) Receive orders by 4 pm EST to eliminate the potential for late trading; 2) Disclose market-timing policies and practices for determining the fair value of securities — especially stocks on international markets — in their portfolios; 3) Appoint a chief compliance officer responsible for making sure rules are followed, reporting directly to the fund's board of directors. Proposed rules coming later may include requirements that:
1) Advisers have rules governing how insiders can invest in fund shares; 2) Fund companies and brokerages disclose any payments to brokers to push particular funds; 3) Funds charge a 2% redemption fee when investors redeem within 5 days of purchase, making market timing less profitable; 4) 75% of mutual fund boards be independent. Pension fund managers, the SIA, and the American Benefits Council, a group that represents corporations and retirement plans covering more than 100 million Americans, are against the 4 pm trading cutoff because of the time it takes to complete the administrative work to transmit orders for buying and selling mutual fund shares. As a result of the Mutual Fund scandals, CalPERS is drawing up a code of ethics that its fund managers must adopt. (WSJ 11/12; FT, NYTimes, USAToday, WashPost, WSJ 11/19; FT 12/1; WashPost, WSJ 12/3;

FT, USAToday, NYTimes, WashPost, WSJ, 12/4; NYTimes 12/12)

A survey of institutional investors by Greenwich Associates found that 70% of the 131 public and private pension managers and endowment managers believed that improper practices were pervasive across the mutual fund industry and that the responses by mutual fund companies to the scandal were inadequate. Roughly 30% said they would fire a fund company that engaged in improprieties, and 18% said they would terminate their relationship with a 401(k) provider. 60% said that improper trading was systemic to the US mutual fund industry. (FT, NYTimes, USAToday, WashPost, 11/21; FT 11/24)

Callum McCarthy, chair of the FSA, has warned CEOs of UK fund managers they will be held personally responsible for investigating whether abuses in the US mutual fund industry have spread to the UK. (FT 12/11)

NYSE

The ICI asked the SEC to refuse approval of the proposed NYSE reforms unless the exchange grants board seats to institutional investor representatives. Previously the heads of public pension funds had asked for similar changes to Mr Reed's reform proposals. The ICI also asked for greater representation on the Board of Executives, where the proposals call for 4 institutional investor representatives, 4 traders from the NYSE floor, 4 executives from NYSE-listed companies, 2 NYSE members who lease their trading rights and at least 6 Wall Street executives. NC State Treasurer, Richard Moore, will join the NYSE advisory board of executives. He plans to seek the separation of the exchange's regulatory and market operations. The Senate Banking Committee said investors had been hurt by ineffective regulation of the NYSE's specialist trading firms and asked Donaldson to consider suggestions to redirect oversight of NYSE floor trading to the SEC. (NYTimes, WSJ 11/21; WSJ 11/22; FT 12/8; FT 12/23)

SEC BUDGET

Next year, $1.6bn is expected to be raised in "SEC" fees, paid by investment firms. Yet only $842m is expected to be passed on to the SEC, the rest siphoned off by the US Treasury. The ICAA is calling for a greater percentage to go to the SEC. (FT 12/1)

Despite calls for greater funding, $30 million has been taken out of the SEC's budget in the large budget measure that went through Congress recently. (WashPost 12/1; FT 12/2)

ABBREVIATIONS:

AIMR – Association for Investment Management and Research
APB - Auditing Practices Board
BofA – Bank of America
CalPERS - California Public Employee's Retirement System
CalSTRS - California State Teachers' Retirement System
CGS – Cost of Goods Sold
CFTC - Commodity Futures Trading Commission
CIBC - Canadian Imperial Bank of Commerce
CSFB - Credit Suisse First Boston
DOL – Department of Labor
E&Y – Ernst & Young
FASB – Financial Accounting Standards Board
FSA – Financial Services Authority
GAO - General Accounting Office
ICAA – Investment Counsel Association of America
ICI - Investment Company Institute
IFAC - International Federation of Accountants
IRS – Internal Revenue Service
KKR - Kohlberg Kravis Roberts & Co.
NACD – National Association of Corporate Directors
NASD - National Association of Securities Dealers
OFHEO - Office of Federal Housing Enterprise Oversight
PIS – Postal Inspection Service
PwC – PricewaterhouseCoopers
SPV – Special Purpose Vehicle
VC – Venture Capitalist
VIE – Variable interest Entity
WWF – World Wildlife Fund
WTO – World Trade Organization