WMRC Article

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United States: SEC Poised to Issue New Governance Standards for US Corporations

The US Securities and Exchange Commission (SEC) has taken a significant step towards approving a comprehensive set of corporate governance reforms that will be applied to firms listed with both the New York and NASDAQ stock exchanges. The new regulations are in response to the number of high-profile corporate corruption scandals that have plagued the US over the last two years.

WMRC Perspective	
Significance	The US Securities and Exchange Commission is close to final approval of a comprehensive set of corporate governance reforms in response to the number and extent of a litany of corporate scandals.
Implications	The new regulations have been a long time coming and many corporations in the US have taken steps to voluntarily implement governance reforms in anticipation of stricter regulations from the government, but the SEC rules will set a common standard by which all companies will have to live.
Outlook	The corporate governance scandals that plagued the US created a crisis of confidence in financial markets, which sent investors and consumers running for cover, contributing to the economic downturn in the US and beyond. After an initial, brief period of consternation, corporate leaders will accept the moderate SEC reforms and investors will slowly but surely begin to trust in their stewardship once again.

How Could Something so Right, Go so Wrong?

The good news...: During the 1990s, the US stock market was advancing by 300%, and corporations were innovative, efficient and profitable. Their financial statements were above reproach and their veracity was unquestioned by investors and regulators alike. As CEOs hit their targets and earned celebrity status for doing so, they were the heroes of the American economic juggernaut. Wall Street analysts and mutual fund managers also grew popular and powerful as they gained recognition and importance.

The bad news...: In the late 1990s, corporate America increasingly emphasised a short-term focus, fuelled by an obsession with quarter-to-quarter earnings, and in some cases this focus was sharpened by massive amounts of stock options granted to corporate executives. Analysts, some tainted by conflicts of interest, became cheerleaders for companies attempting to achieve their projected earnings, rather than creating the conditions for sound, long-term strength and performance. The perception that continuous earnings growth was the standard for corporate success caused managers to manipulate financial results in order to meet projected results.

CEO Smackdown

One after the other, beginning with Enron in late 2001, corporate giants began to fall after it was revealed that they hid massive losses, personal loans from the company they never intended to pay back, under-funded pension plans, and shell game financial schemes to hide expenses. Dozens of the most respected corporate leaders and bellwether stocks on the New York and NASDAQ stock exchanges began to tumble, some as far as bankruptcy and criminal prosecution. US regulators and elected officials declared war on corporate America, vowing to root out corruption and malfeasance and bring those responsible to justice. A chill was sent down the spine of every Chief Executive Officer (CEO) and Chief Financial Officer (CFO) who wasn't 100% confident of the veracity or accuracy of their financial statements - which was most of them. In the first six months of 2003 alone, the SEC filed 258 enforcement actions, 72 of which involve financial fraud or reporting. During this period, the commission has also sought to permanently bar 95 offending corporate executives and directors from holding such positions with publicly traded companies.

Politics Beats Out Corporate Reform...Initially

Despite the public outcry, the market crash, and the machinations of politicians from coast to coast, fundamental reform of corporate America was not to be. The economic slowdown and cooling of financial markets after the dotcom bubble burst, coupled with the terrorist attacks of 11 September 2001, and then revelations of widespread corporate corruption, sent the economy towards recession. This created a bigger political problem for the powers-that-be than the corporate scandals in themselves, and dramatically slowed the progress of the Corporate Governance Reform Express barrelling down the tracks. The politically expedient option was to impose some changes at the edges of the problem, rather than address the root problems for fear of queering the economic recovery that most politicians - including US President George W Bush - were counting on to solidify their re-election hopes.

...And the Floodgates Are Opened

In the wake of corporate scandal, the US Congress did pass the Sarbanes-Oxley Act (SOA), but it focused primarily on the rules governing public accounting firms, some of which had become complicit in financial schemes used by the companies they were supposed to be auditing. The SOA stipulates that CEOs and CFOs are now personally responsible for ensuring the accuracy of processes such as financial reporting, and defines a set of standards for tracking and reporting requirements intended to hold top executives' feet to the fire on corporate financial statements. However, these new regulations did not address some of the core problems underlying the governance of US corporations such as compensation schemes, conflicts of interest, and lack of transparency and accountability.

Since SOA was passed, a number of other scandals have erupted. It was revealed that stock analysts for Wall Street investment banks were inflating estimates of the value of stocks of companies with whom the banks were doing business, so as not to upset the client, or to inflate the value of the preferred stock given to the investment bank as part of the financing deal. Earlier this year, the corruption epidemic reached the indefatigable, government-banked mortgage giant Freddie Mac, which was engaging in a shady accounting scheme that led to the largest restatement of earnings in US history. The mutual and hedge fund industries were next on the list for indictment, as the Attorney-General of New York Eliot Spitzer zeroed in on a number of the largest fund managers' penchants for late trading and market timing that used international banks in places with loose laws to buy and sell securities based on outdated prices. Most recently, the New York Stock Exchange itself was the subject of a bitter controversy as it was revealed that Chairman Richard Grasso was drawing an exorbitant salary that was approved by a small and insular group of board members, with some of whom Grasso has financial ties.

Corporate Governance Reform, Take Two

Two years after Enron, the SEC is set to issue a new set of governance standards for corporations listed with either the New York Stock Exchange (NYSE) or the NASDAQ stock market. As the federal agency responsible for overseeing the equity industries in the US, the SEC's approval of the proposals offered by the NYSE and NASDAQ was required before they could be implemented. The two exchanges developed the stricter governance standards following the spate of high-profile and expensive corporate scandals, but since the exchanges offered competing proposals, the SEC has developed a common set of rules that strikes a balance between the two as well as taking into account the concerns expressed during the public comment period. The new rules stipulate that a majority of company directors are independent, this being defined as someone who is neither an employee, nor has been an employee of the company for three years prior, nor is related to anyone who received US$100,000 or more in direct compensation from the company. The rules also require that all companies have independent audit, compensation and nominating committees.

Outlook and Implications

The SEC's new rules are an important step in bringing the level of direct corporate malfeasance and conflicts of interests under control, which will send a strong message to investors that corporate leaders are serious about reform. However, it remains to be seen if the new rules will go far enough to restore the confidence of investors that they are adequately protected from corruption and collusion at the hands of corporate leaders and Wall Street analysts. Given the level and type of malfeasance that seems to be pervasive throughout the financial system - whether true or not, perception is reality - regulators are not finished with Wall Street. More regulations will follow, but not without a longer-term impact.

According to the Securities Industry Association, during the first two quarters of 2003 there has been a 25% increase in the number of publicly traded companies that have reverted to private status, compared to the same period in 2002, and a 51% increase over the number of companies that went public to private in the same period in 2001. A number of companies have done so in response to a market that has seen venture and traditional investment capital dry up, but a number of others are choosing private financing so as to avoid the rules passed in the last two years and, moreover, out of fear about what is yet to come.

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