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How Long is Long Enough for SOX Reforms?

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HOW *LONG* IS *LONG ENOUGH* FOR SOX REFORMS?

Both Sides Mount the Barricades in Debate

BY HANK BOERNER

You'll be hearing the questions debated in coming months: How *much is too much*…how *long* is *long enough?* These are not trick questions if the subject is U.S. government regulation of securities and capital markets and the state of regulatory oversight in Corporate America. As you read this we'll be passing the five-year mark since passage in July 2002 of the comprehensive Sarbanes-Oxley package of legislation (SOX has 11 separate titles and several separate laws). The anti-reform debate is beginning around these central questions: Is five years *long enough* (now) for the cycle of capital markets and corporate reforms to have effectively run their course? Should we (now) weaken, repeal or begin to ignore the various reforms of 2001-2007? The debate has powerful advocates on either side of these questions — and the answers (and outcomes) will directly affect IROs in the coming months.

The 21st Century Era of Corporate Governance Reform

As the spectacular corporate financial debacles rolled on — those that we now familiarly quote as a sort of litany — *"Enron, WorldCom, Adelphia, Computer Associates, Fannie Mae, Freddie Mac, et al…"* — a wide range of corporate governance reforms were instituted:

✦ The Sarbanes-Oxley (SOX) package of federal statutes was passed by Congress and immediately signed into law by President George W. Bush (July 2002); many of the 11 major titles (subsections) were updates of the 1930s securities protection legislation.

✦ SOX legislation created the Public Company Accounting Oversight Board (PCAOB) to license and supervise the public company audit profession. PCAOB is empowered to issue rules to govern the audit process.

✦ The U.S. Sentencing Commission was directed by SOX to significantly increase criminal and civil penalties for corporate accounting fraud. Tough fines and jail sentences followed for fallen leaders; some anti-reform forces now want to de-criminalize SOX-related reforms.

✦ The Financial Accounting Standards Board (FASB) and the Securities & Exchange Commission were the only organizations left standing by Congress as accounting rules standard-setters. (Formerly a hodge-podge of bodies set accounting rules and interpretations in place, helping to create a cumbersome U.S. "rules-based" GAAP.)

✦ Months before passage of SOX, President Bush marshaled the resources of his cabinet-level departments, independent regulatory agencies and other arms of the federal government to form a "Corporate Fraud Task Force" to address corporate fraud (January 2002); some task force recommendations were embodied in Presidential Executive Orders and in SOX; the task force efforts continue in 2007 and prosecutions roll on. Although corporate executives blame SOX for the Section 404 obligation to sign off personally on financial reports, it was actu-

ally put in place by President George W. Bush as an Executive Order before SOX was law.

Stay Tuned to…*Yes/No/Maybe* positions in the reforms debate; many advocates are bringing passion and conviction to their public positions. Some leaders in the capital markets and in Corporate America say the answer is already settled: *Yes, it is time to begin to roll back SOX*. For others with a stake in the capital markets, the answer is…*"not yet, not enough time..."* And for some investor and advocates for reform the future is clear: "*SOX reforms must stay in place to continue to build investor trust in the markets."* We even see some advocates calling for *more* and not less regulation.

Also, separate from federal statutes and regulatory rules, a growing number of institutional shareholders are now shaping reforms through their public and private demands on boards and the "C suite," and plaintiff lawyers are in the debate, effecting changes through class action and other litigation. Proxy voting campaigns are acting in some ways as regulators of corporate behavior as institutional shareholders demand reform and change in companies they own. Consider that more than 1,000 shareowner-drafted resolutions were presented to companies for 2007 proxy votes; not all made it to the ballot.

The Impact of Globalization on Reforms

Stay Tuned to…the continuing impact of U.S. reforms affecting foreign capital markets and investors. Post-Enron, the U.S. capital markets and Corporate America are much more "globalized" and the U.S. interests much more integrated with capital markets in many other nations. Institutions from the U.S. invest in European companies and vice versa; investors' respective points-of-view — cultural, political, social, financial, and economic — now get embedded in their expectations and potential activism on more than one continent.

The U.S. capital market entities are directly competing with foreign markets for investor and corporate dollars — think of the choice of issuer listings on the New York Stock Exchange or NASDAQ vs. the London Stock Exchange as one critical example of growing tension over the extent of U.S. reforms and the impact on U.S. and foreign exchange listings and trading platforms.

IN MID-2006 THE ANTI-REFORM MOVEMENT BEGAN IN EARNEST, WITH MAJOR PLAYERS BASING THEIR ARGUMENTS FOR WEAKENING SOX *ET AL* ON THE GROWING COMPETITIVE DISADVANTAGES THAT THE U.S. CAPITAL MARKETS AND THE CORPORATE SECTOR OF THE UNITED STATES WERE EXPERIENCING

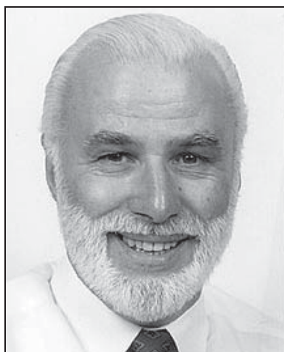
In mid-2006 the anti-reform movement began in earnest, with major players basing their arguments for weakening SOX *et al* on the growing competitive disadvantages that the U.S. capital markets and the corporate sector of the United States were experiencing — thanks the corporate governance reform movement that began with the 21st Century.

For a certain group of U.S. corporate and capital markets thought-leaders, some of the Sarbanes-Oxley era reforms have run their course and just 1,500 weeks or so into the reform era. Anti-SOX forces are mounting a vigorous assault on the numerous statutes, rules and regulations adopted since 2002.

Stayed Tuned to…The powerful voices and thought-leaders involved in the anti-SOX reform parade: There are three separate efforts involved in what we'll call the "roll back SOX" effort.

First, there is the group including U.S. Secretary of the Treasury Henry Paulson (a former managing partner of New York-based investment bankers Goldman Sachs); NYSE Euronext CEO and director John Thain (also a former Goldman Sachs banker); and John Thornton, Chairman, The Brookings Institution think tank and head of the "Committee on Capital Markets Regulation," which argues that U.S. capital markets are suffering because of overzealous prosecution and unwieldy governance rules. These interests are focused on U.S. capital market competitiveness. The Committee on Capital Markets Regulation began its campaign with announcement of its formation in December 2006 and issuance of a report outlining 32 specific recommendations in four key areas: shareholder rights; the regulatory process; public and private enforcement (including litigation); and Sarbanes-Oxley, especially Section 404, certification of financial controls, etc.

New York City capital markets interests are joining in the reduce-reforms chorus; leaders include (surprisingly) the champion corporate and capital markets reformer, the Hon. Eliot Spitzer, once New York State Attorney General, who wrung huge fines and reforms out of Wall Street and the mutual fund industry. Also, U.S. Senator Charles Schumer (D-NY), and NYC Mayor Michael Bloomberg, the billionaire former Wall Streeter. The trio joined with Wall Street forces to lash out at year-end 2006 at corporate governance reforms…as now *gone too far.* The New York City interests began their efforts in March 2007



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with issuance of a report sponsored by Mayor Michael Bloomberg and U.S. Senator Charles Schumer: "Sustaining New York's and the U.S.' Global Financial Leadership" (prepared by McKinsey & Company). The report asserts that "New York financial markets, stifled by stringent regulation and high litigation risks, are in danger of losing business and highly-skilled workers to overseas competitors, relegating New York to regional market status and adversely impacting the U.S. economy."

Joining its voice with the other two "reduce reforms" groups, the powerful United States Chamber of Commerce, which created the "Commission on the Regulation of U.S. Capital Markets in the 21st Century," and issued a report in March 2007 on the increasing lack of competitiveness of America — "Report on the Regulation of U.S. Capital Markets in the 21st Century."

The key argument for Wall Street interests: because, in large part, of recent corporate governance reforms, the United States is fast eroding from its vaunted position atop the global capital markets heap. As just one proof, just look at the number of Initial Public Offerings emanating from London-town in recent months, vs. the IPO's issued in our own Gotham. Some dramatic arguments state that, notwithstanding the US$24 billion paid in bonuses by Wall Street houses for 2006, Wall Street is heading for ruin because U.S. and foreign issuers don't like Sarbanes-Oxley *et al.*

The recommendations of the 22-member Committee on Capital Markets Regulation in December 2006 included making changes in capital markets regulation based on the goals of (1) enhancing shareholder rights and (2) reducing excessive and overly burdensome regulation and litigation.

The background of all this pro- and con-reform debate is very complex and interwoven — and with both real and potential conflicts of interest…and conflicts of duty of care…or societal responsibilities…for key players.

THE BACKGROUND OF ALL THIS PRO- AND CON-REFORM DEBATE IS VERY COMPLEX AND INTERWOVEN — AND WITH BOTH REAL AND POTENTIAL CONFLICTS OF INTEREST…AND CONFLICTS OF DUTY OF CARE…OR SOCIETAL RESPONSIBILITIES… FOR KEY PLAYERS.

The report followed a year's schedule of meetings in New York, Washington, Chicago, and other cities. The Commission looked at 70 years of federal regulation of securities and intends to act "before a crisis arises" in the capital markets.

Here is the common central argument shared by the three groups against the *status quo:* "Maximizing the competitiveness of U.S. capital markets is critical to ensuring economic growth, job creation, low cost of capital, innovation, entrepreneurship, and a strong tax base in key areas of the country (and especially New York)," according to Dean Glenn Hubbard of the Columbia Business School, the U.S. Chamber's Commission Co-chair. "While U.S. capital markets historically have been the deepest, most liquid and lowest cost markets anywhere, the world is vastly different today. There are several viable markets for raising capital and many companies are now using cost-benefit analysis…including the potential cost of litigation and the complexity of regulation…to focus on the competitive differences among the markets…"

Stay Tuned to…continuing efforts by the three main interests described here to continue to position their arguments to shape public opinion and affect the regulatory environment. Pro-reform and anti-reform advocates will continue to advance their arguments to either stay the course or begin to reduce the effects of reform on the markets and companies. SEC will be in the middle, as always. Journalists will lean toward keeping the status quo — consider what even mainstream *Fortune* magazine said: *"Stop Whining About SarbOx! Critics want to repeal the law, but it's been a boon to the market…"* (December 2006.) Some CEOs and directors may begin to speak out on either side of the issue. We'll present updates on the struggle for investor hearts and minds in issues to come. IRU

Hank Boerner is Editor, NIRI Publications. You can reach him at: ***hank@hankboerner.com***