SEE-SAW OR SEA CHANGE:
CORPORATE GOVERNANCE AND
ETHICS IN THE BALANCE

Dov Seidman
Chairman & CEO
LRN, The Legal Knowledge Company
The Three Pillars Of Stability

All three pillars that give us a foundation for a life worth living – physical security, financial prosperity, and spiritual or ethical sustenance – have been shaken.
SEE-SAW OR SEA CHANGE: Corporate Governance and Ethics In The Balance

Business Community Shaken

108,000 Jobs Lost In March, 2003 - unemployment rate rose to 6.2%

Financial Scandals Taking Toll on Rebound
Every Corner of Financial Field Feeling Impact of Disclosures...

Scandal Takes Center Stage in 2002
- SEC / Sarbanes Oxley
- NYSE / Nasdaq
- Wall Street Research
- Moody’s / S&P
- Institutional Investors
- Stakeholder groups

STOCK MARKET STINKER
"Stock markets just finished their worst first half in three decades."
Bush pledges no tolerance of wrongdoing in boardrooms

WASHINGTON (CNN) -- Released a report Sunday holding the board of directors directly accountable for...

WALL STREET FLEES ACCOUNTING-CHALLENGED COMPANIES
Companies involved in reporting or management controversies get pounded by investors....

$1.4 Billion Wall Street Settlement Announced (April 2003) (AP) – Federal and State regulators...
### Reader Survey

#### A Crisis of Trust

<table>
<thead>
<tr>
<th></th>
<th>Equity Markets</th>
<th>Government</th>
<th>Corporations</th>
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<tbody>
<tr>
<td><strong>How much confidence do you have that the stock market treats individual investors fairly?</strong></td>
<td>![Bar Chart]</td>
<td>![Bar Chart]</td>
<td>![Bar Chart]</td>
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<tr>
<td>A great deal</td>
<td>5.89%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Only some</td>
<td>30.84%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hardly any</td>
<td>61.1%</td>
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#### How much confidence do you have in Congress to write effective rules governing corporate financial practices? |

<table>
<thead>
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<th>Government</th>
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<tbody>
<tr>
<td>A great deal</td>
<td>3.33%</td>
<td></td>
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<tr>
<td>Only some</td>
<td>28.43%</td>
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<tr>
<td>Hardly any</td>
<td>65.88%</td>
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#### Do you agree or disagree that corporations can reform themselves without new laws and regulations? |

<table>
<thead>
<tr>
<th></th>
<th>Equity Markets</th>
<th>Government</th>
<th>Corporations</th>
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<tbody>
<tr>
<td>Strongly agree</td>
<td>19.84%</td>
<td></td>
<td></td>
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<tr>
<td>Somewhat agree</td>
<td>5.30%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Somewhat disagree</td>
<td>14.93%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Strongly disagree</td>
<td>59.92%</td>
<td></td>
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</tbody>
</table>
Opportunity: Community Leadership Sets Standards

In The Room Today:

- Over sixty leading architects of corporate legal, governance and business strategy
- Oversight of operations spanning hundreds of countries with over 5 Million employees
- Responsibility for thousands of the most essential global products and services
- Used by hundreds of millions of consumers and businesses and generating:
  - Over $1.7 Trillion in Revenues
  - Over $2 Trillion in Market Capitalization
Crisis Driving New Risk Management Environment

Examples of recent increases:

- D&O Premiums: up 75% in 12 months.
- Director compensation: up 70% since 1998
- Legal governance services: up 35% from 1999
- Forensic audit services: up 25% in 12 months.

Level/cost of risk mitigation

- New reporting demanded
- Beyond 2003??
- 2002: Sarbanes-Oxley, NYSE / Nasdaq
- 2001: REG FD*

*Regulation Fair Disclosure

Time

Time required to report reduced

LRN AGC Presentation: Dov Seidman May 2, 2003
Risks Increasing Across Key Areas

**Description**

- **Legal Risk**
  - Exposure to increased fines (Sentencing Guidelines)
  - Individual criminal culpability

- **Regulatory Risk**
  - Unmet requirements from Sarbanes-Oxley, NYSE can result in increased investigation, embarrassing warnings, de-listing
  - Increasing coordination of enforcement activities.

- **Governance Risk**
  - Board compelled to adopt more independent aggressive auditing role
  - Growth of “commercial regulators” such as Moody’s and ISS which grade governance and influence institutional investment policy

- **Reputation Risk**
  - Public Relations and Media-based exposure
  - Suppliers, investors and customers opting out of business relationships
Legal Risks Rising for Corporations & Employees

- 163 SEC actions for financial reporting and issuer disclosure violations in FY 2002, ~46% higher than FY 2001 and 58% higher than in FY 2000
- A record 598 SEC enforcement actions, ~24% more than in FY 2001, and 19% more than in FY 2000
- 126 officer/director bars. 147% more than in FY 2001 and 232% more than in FY 2000
- 48 TROs, seeking immediate relief to prevent irreparable harm to investors – up 55% from FY2001 and 45% from FY 2000
- By end of FY 2002, 259 criminal actions by 30 different U.S. Attorney's Offices and DoJ were taken for securities-related offenses or obstruction of justice in SEC investigations
- 157 of 227 enforcement matters (1997-2002) involved charges against at least one senior manager:
  - 75 Chairmen of the Board
  - 111 CEOs
  - 111 Presidents
  - 105 CFOs
  - 21 COOs
  - 16 Chief Accounting Officers
  - 27 VP Finance
Regulation Scrutiny Rising

“Analysts also have acquired an increased appreciation for the correlation between governance and returns, as an increasing number of reports have explicitly altered investment recommendations based on the strength or weakness of a company's corporate governance infrastructure.”

– SEC Commissioner Glassman

“The future is about coordinated enforcement;”

▶ Financial Fraud Task Force
▶ State Attorneys General (Spitzer, et al.)
▶ U.S. Attorneys
▶ District Attorneys
▶ State Securities Regulators
▶ NYSE/Nasdaq/Other SROs
 Governance Risks on the Rise

Board Governance Risk

Investor concerns have direct costs:
- 75% of institutional investors are willing to pay a ‘substantial premium’ for shares of companies with good governance practices
- 60% might avoid investing in individual companies based on governance concerns – McKinsey & Co.

Altered board composition and decision-making:
- “We’ve had our third meeting without executive management in the second half.” - Fortune 500 Director, 2002
- “Going with separate outside counsel is being considered.” - Fortune 500 Director, 2002

And based on the Caremark decision:
- Directors have a duty generally to ensure that a company has effective compliance and control systems
- Failure to fulfill that duty can “render a director liable for losses caused by non-compliance with applicable legal standards.”
Reputational Value Increasingly Critical

- Change in index of Fortune’s “most admired companies” survey between 1983 and 1997 associated with an average of $500 million in market value. (Kansas Study)

- 96% of CEOs believe reputation is “very important” / 65% dedicate more time to reputation than 5 years ago. (CEO Magazine)

- 60% difference in reputation score was associated with a 7% difference in market capitalization = $53M. (Texas Study)

- Improving employee attitudes by 5% improved customer satisfaction by 1.3% which led to a 0.5% increase in revenues. At Sears that meant $65m a year, increasing its market capitalization by $80m. (Harvard Study)
Crisis Have Historically Resulted in New Regulation

History of Concern Regarding Corporate Financial Reporting & Behavior

1970s

Watergate (1973 - 1976)
Illegal payments (political contributions & bribes) to foreign governments

SEC (1979)
Proposed requirement for management reporting with attestation by independent auditors
Subsequently withdrawn

AICPA recommended management reporting
Attestation by independent auditor

Foreign Corrupt Practices Act (1977)
Effective internal controls prevent illegal payments
Extensive documentation of internal accounting controls

1980s

Congress (1985)
Legislation requiring management reporting on internal control, attested by independent auditors (not enacted)
Not enacted

Treadway Commission (1987)
Recommended management reporting

SEC (1988)
Proposed requirement for management reporting with limited independent auditor involvement

1990s

FDICIA (1991):
First Legal Requirement
Large banks (assets in excess of $500 million) to assess and report on the effectiveness of internal controls over financial reporting
Evaluation must be based on internal control criteria

An effective internal control or compliance program will be considered in determining penalties

Sarbanes-Oxley Act (2002)
Enhanced role of the Board Audit Committee
CEO/CFO Certification of the Financial Statements
Certain limitations on types of compensation for executive management
Code of Ethics for senior financial executives
Current Response to Crisis: New Regulations & Historic Reexamination of Governance & Ethics

Important New Regulation

- Comprehensive SEC Rulemaking
  - New Attorney Responsibilities
  - Certification
  - Audit Committee Responsibilities
  - Material Event Reporting
  - Executive Compensation
  - Document Retention for auditors

- NYSE & NASDAQ Listing Requirements
  - Codes of Conduct
  - Director Training?

Creating Heightened Awareness

- Increased compliance spending
- Revision of corporate structures
- New and improved processes
- Re-focused communications efforts

Sarbanes-Oxley
Corporate Governance
Will Traditional Responses Satisfy New Regulations?

Traditional compliance approaches:
- Hire outside counsel to ensure procedural ‘best practices’
- Achieve compliance – assurance provided by elite firms and consultant specialists
- Ensure appropriate legal and compliance communication with regulatory agencies

Impact to date:
- 85% of multinationals have new compliance controls and procedures
- But only 4% claim significant changes...
- Early responses are reactive: solely based on compliance with regulation

SOURCE: PricewaterhouseCoopers
SEE-SAW OR SEA CHANGE?

Has The World of Business Been So Altered That Companies Must Respond More Fundamentally?

- Is it risky to treat current market dynamics as just another “corporate compliance event”?
- Does evidence suggest “it’s different this time”?
- Will 21st century corporate leadership go beyond mere compliance with recent legislation?
Technology’s Disruptive Pace Has Driven an Explosion in Information Transparency
SEE-SAW OR SEA CHANGE:
Corporate Governance and Ethics In The Balance

Average hours online per month: 20.2
Source: Jupiter Media Metrix

Floodgates of Communication

1.38 billion chat messages a day on AOL!

Forms of monitoring:
- Data - email traffic: 46%
- Overt (visible) video: 32%
- Audio: 16%
- Covert video: 11%

Trillions of E-mails Sent:
- 2000: 2.6
- 2005: 9.2

Source: IDC

78% of businesses state that employees are formally made aware that monitoring is taking place

Is monitoring the floodgates futile?
SEE-SAW OR SEA CHANGE:
Corporate Governance and Ethics In The Balance

Changed Nature of Communications

• **Can't hide truth from customers**
  “Through the Internet, people are discovering and inventing new ways to share relevant knowledge with blinding speed. As a direct result, markets are getting smarter – and getting smarter faster than most companies.”

• **Can’t hide truth from employees**
  “…employees are getting hyperlinked even as markets are.”

• **Can’t hide truth from investors**
  “…Alert Stream displays REAL-TIME corporate alerts as they are filed.”

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**All Customer Reviews**

Avg. Customer Review:

*Write an online review* and share your thoughts with other customers.

2 of 2 people found the following review helpful:

***** Amazingly simple!, April 21, 2003
Reviewer: elohehis1 (see more about me) from Ringgold, VA USA

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**INTERNAL MEMOS**

THE INTERNET'S LARGEST COLLECTION OF CORPORATE MEMOS AND INTERNAL COMMUNICATION

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**10k Wizard: SEC Filings: Alert Scroll - Microsoft Internet Explorer**

<table>
<thead>
<tr>
<th>Date</th>
<th>Form</th>
<th>Headline</th>
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<tbody>
<tr>
<td>6/30/2002</td>
<td>10-K</td>
<td>Smith Barney Managed Municipal Funds Fund Inc.</td>
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<td>6/30/2002</td>
<td>10-K</td>
<td>Zodiax Trust</td>
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<td>10-K</td>
<td>Managed High Income Portfolio Fund Inc.</td>
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<tr>
<td>6/30/2002</td>
<td>10-K</td>
<td>Victory Corp (VCNT)</td>
</tr>
<tr>
<td>6/30/2002</td>
<td>10-K</td>
<td>Forum Funds (FOFT)</td>
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</table>
Wall Street & Main Street Converge

- Propelled over 50% of US households to invest in equity markets
- Channeled billions to institutional funds
- Expanded stakeholder awareness
  - Employees, Stockholders, Retirees

### Figure 1
Equity Ownership in the U.S., 1983–2002, Selected Years
(number and percent of U.S. households, and number of individuals)

<table>
<thead>
<tr>
<th>Year</th>
<th>U.S. Households (millions)</th>
<th>Individuals (millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1983</td>
<td>15.9</td>
<td>42.4</td>
</tr>
<tr>
<td>1989</td>
<td>30.2</td>
<td>52.3</td>
</tr>
<tr>
<td>1992</td>
<td>34.6</td>
<td>61.4</td>
</tr>
<tr>
<td>1995</td>
<td>40.6</td>
<td>69.3</td>
</tr>
<tr>
<td>1999</td>
<td>48.2</td>
<td>78.7</td>
</tr>
<tr>
<td>2002</td>
<td>52.7</td>
<td>84.3</td>
</tr>
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</table>

Percentages:
- 1983: 19.0%
- 1989: 32.5%
- 1992: 36.6%
- 1995: 41.0%
- 1999: 48.7%
- 2002: 49.5%
In An Era of Individual Responsibility

Reputation of individuals and businesses mix
- Media has helped individuals increasingly personify a corporate image
- Individual actions now perceived correlated to corporate action (with $ billions at stake)

Individuals held accountable for business actions
- Previous business scandals led to prosecutions of corporations.
- Current prosecutions lean towards the individuals:
  – In 227 SEC investigations of improper financial reporting and disclosure between 1997-2002, CEOs and Presidents were charged 111 times (SEC Report, 1/27/03)

THE BOTTOM LINE:
One person 10,000 miles away can bring down a company.
## From Asset Value To Reputational Value…

### Reputational Value Increasingly Critical

<table>
<thead>
<tr>
<th>Company</th>
<th>Market Value (12/31/02)</th>
<th>Stockholder Equity (12/31/02)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Procter &amp; Gamble</td>
<td>$111.1 billion</td>
<td>$14.8 billion</td>
</tr>
<tr>
<td>Johnson &amp; Johnson</td>
<td>$156 billion</td>
<td>$22.7 billion</td>
</tr>
<tr>
<td>IBM</td>
<td>$134.6 billion</td>
<td>$22.8 billion</td>
</tr>
<tr>
<td>Pfizer</td>
<td>$202.1 billion</td>
<td>$20.0 billion</td>
</tr>
<tr>
<td>GE</td>
<td>$277.4 billion</td>
<td>$63.7 billion</td>
</tr>
</tbody>
</table>
...Or From Reputational Value to Asset Value!

<table>
<thead>
<tr>
<th>Company</th>
<th>Market Value – THEN (Peak)</th>
<th>Market Value - NOW</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enron</td>
<td>$100+ billion</td>
<td>Bankrupt</td>
</tr>
<tr>
<td>WorldCom</td>
<td>$175+ billion</td>
<td>Bankrupt</td>
</tr>
<tr>
<td>Global Crossing</td>
<td>$75+ billion</td>
<td>Bankrupt</td>
</tr>
</tbody>
</table>

Over $600 Billion Market Value Estimated Lost From Scandals in 2002
CEOs, Boards: Actively Concerned

“The rapidity of Enron's decline is an effective illustration of the vulnerability of a firm whose market value largely rests on capitalized reputation.”

- Alan Greenspan

“One concern that keeps me up at night is that among the 300,000-plus GE employees worldwide, there are a handful who choose to ignore our code of ethics…We spend billions each year on improving our training, enforcing our compliance with ethical norms and reinforcing our values, all to preserve our culture and protect one of our most valuable assets-our reputation.”

- Jeffrey Immelt, Chairman & CEO of GE

(2002 Annual Report)
"There is a difference between what you have a right to do and what is right to do."

Potter Stewart
United States Supreme Court
SEE-SAW OR SEA CHANGE: Corporate Governance and Ethics In The Balance

SEE-SAW

- Compliance driven: characterized by reactive response to regulation
- Internally-oriented: activities geared to employees alone
- Financial visibility: concerned with financial operating metrics only

VS

SEA-CHANGE

- Ethics-driven: Sustained culture of ethics, proactive communications
- Stakeholder-oriented: embracing of investors, customers, suppliers, etc.
- Corporate visibility: tracking and reporting on non-financial metrics, triple-bottom-line value
Requirements to Comply, Opportunities to Lead

What you have a right to do
Law & Compliance

Narrow Approaches
Law & Compliance
- Compliance with today’s regulations
- Deal with the law minimums
- US Sentencing Guidelines 7-step program

Broad Approaches
Ethics & Business leadership
- Ethical leadership at the top
- Enterprise-wide programs
- Constant investment in innovation
- Accountability and rewards
- Systematic and rigorous risk management
- Transparency and disclosure leadership
- Anticipate legal requirements beyond minimums

What is right to do
Ethics & Business leadership

Law
Ethics
What you have a right to do
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What is right to do
Ethics & Business leadership
In Addition To Virtue Being Its Own Reward, Ethics Pays!

- Return on investment for “do-it-right” culture
- Reputation for integrity drives consumers
- Ethical companies are more successful
  - High Trust = High Performance
- Better employee retention and morale
- Strong ethical culture promotes innovation
- “Ironically”: Get ahead faster!
The World of Business has Changed

And the Role of General Counsel is Changing with It…
The Evolution of the Role of General Counsel: First Waves

From better law practice management…
Steady expansion of role and influence of Office of General Counsel over time:
• Efficient management techniques, partnering with outside counsel
• Increasingly seen as strategic advisor on key initiatives, business functions
• Employment of tools such as Six-Sigma to increase discipline

To proactive, workplace-wide influencers:
Strategic transition to broad-based, proactive approaches:
• From firefighters to builders of fireproof enterprises
• Democratize law and ethics for the entire organization
• Enterprise-wide preventative legal and compliance training programs
• Office of General Counsel increasingly implementing efficient re-usable technology systems – raising the bar of practicing corporate law
General Counsel Embracing Technology to Deliver More Than Advice...
Innovative Approaches From Office of General Counsel Evidencing Positive Results

• Very substantial increase in multi-year, enterprise-wide commitments and actively managed mandatory compliance training programs across all industries
• Setting communal standards and sharing best-practices that raise the bar
• Improved focus on targeting multiple preventative risk areas (legal and ethical)
• Select examples of prosecutorial discretion in sentencing and insurance premium reductions
• Positive feedback from large workforces (CEOs to frontline-workers)

“On average, an extra dollar invested in compliance reduces damages, settlements, and fines by $1.37.”
The General Counsel Roundtable of the Corporate Executive Board

Over 1,000% increase in Compliance training and certification usage: 2000-2003
The Evolution of the Role of General Counsel: Next Waves

From expanded role of importance to CEO/Board…
Management now looking to GC for guidance on new tools and approaches
- Visibility based on robust compliance management and quantitative reporting
- Tracking of initiatives such as preventative training against actual outcomes
- Certification and Pre-Certification to prevent future litigation costs

To champion of systemic enterprise risk management:
Strategic transition to integrated systems that improve transparency, ethics
- Deliver empirical insights into “world beyond the balance sheet”
- Integrate and manage key business processes and practices to ensure governance and ethics are part of corporate fabric
- Efficiently monitor and report select information to key stakeholders

Similar to how Safety and Quality approaches have become standardized, the Office of General Counsel will embed new practices as part of core enterprise management systems—raising the bar of practicing corporate law--and facilitating leadership capabilities in business strategy
Charter Subscriber Group Developing Visionary Governance & Ethics System

- A unique and distinctive group of world-class businesses collaborating in development, sharing best-practices, leadership approaches
- Program targets involvement of key stakeholders in a cross-functional effort led by the Office of General Counsel with input from:
  - Finance, HR, Ethics Office, Corporate Secretary, MIS/IT, Audit
- Members currently include:
A Systemic Approach to Governance & Ethics:

Creates Example For Capital Markets Worldwide

Protects Financial Strength, Reputation, People

Is Executed By Leading Multinationals Setting A Collective Global Standard
THE ASSOCIATION OF GENERAL COUNSEL
Spring Meeting
May 2, 2003

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