



NEW YORK STOCK EXCHANGE
COMMITTEE ON ACCOUNTABILITY AND LISTING STANDARDS

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I appreciate the opportunity to present to this Committee Fidelity's views on corporate governance. In the wake of Enron, as lawmakers and regulators consider ways to strengthen the roles and responsibilities of corporate boards, outside auditors, governmental overseers and self-regulatory bodies such as the New York Stock Exchange, Fidelity Investments has an important stake in the debate. Fidelity manages the savings of over 17 million customers invested in over 260 mutual funds. As of April 30, 2002, our mutual funds held aggregate assets of over \$794 million.

Despite the collapse of Enron, we should remind ourselves that this nation's capital markets remain strong, vibrant and resilient. Through the interplay of governmental regulation, industry self-regulation, and the forces of free and open competition, our capital markets are among this nation's most important assets. However, the Enron debacle and other highly publicized cases involving irregularities in financial reporting and corporate governance are calling into question the basic integrity of our capital markets and the efficacy of our regulatory system. Improvements to that system, including changes to the rules of corporate governance, must be made to maintain the confidence and trust placed in our markets by the millions of investors who supply the capital that is the lifeblood of our nation's economic growth.

The NYSE plays an important role in fashioning the corporate governance standards of its listed companies. Historically, the NYSE, through its listing standards,

has sought to elevate the corporate governance practices of companies above the bare minimum requirements dictated by state corporate and federal securities law. A listing on the NYSE has been seen to signify an acceptance by a listed company of the high standards of fairness and fiduciary responsibility that the NYSE has sought to further through its marketplace. The NYSE, along with NASDAQ, must play a part in improving corporate governance practices of its listed companies and should take the initiative in implementing change, rather than wait for others to act.

My remarks today are divided into three parts. I will first offer some general views on the objectives of corporate governance from the perspective of an institutional shareholder. I will then speak to the institutional shareholder role played by Fidelity and other mutual fund managers engaged in the active management of customers' assets. Finally, I will address three categories of current proposals that are important to Fidelity and relevant to the NYSE's corporate governance standards-setting: (1) improving corporate disclosure, (2) expanding shareholder voting on stock option plans and repricing of options, and (3) strengthening the role of a company's compensation and nominating committees.

Corporate Governance Objectives

As lawmakers attempt to identify the corporate governance fault lines that contributed to Enron's collapse, a wide range of measures are being proposed to prevent the next Enron from happening. With so much in flux, it may be useful to identify the key objectives which corporate governance ought to advance. In Fidelity's view, there are three.

Accountability The first objective of corporate governance is accountability. Given the division of ownership and control in our nation's publicly-held companies, effective means must be in place to hold accountable those entrusted with running a company's business. Management of a company must be accountable to its board of

directors and the board, in turn, must be accountable to shareholders. Promoting accountability can take many forms, including enforcing rules and laws imposing duties on officers and directors, protecting shareholder voting rights, ensuring rigorous scrutiny of a company's financial statements by independent, outside auditors, and maintaining free and open markets to allow for the re-allocation of capital and transfers of corporate control.

Alignment of Management and Shareholder Interests A second objective of corporate governance should be to align the interests of a company's management and board, on one hand, and the company's shareholders, on the other. While accountability may be viewed as the "stick" of corporate governance, proper alignment of management and shareholder interests often involves the "carrot." In this regard, issues surround the forms of compensation paid to management, the fairness and effectiveness of stock option grants and other equity-based compensation, and the repricing of out-of-the-money stock options.

Effective Disclosure The third objective is to promote timely disclosure of important information about a company's business operations and financial performance to allow diligent investors, individual and institutional alike, to reach informed decisions on when to buy, sell or hold a company's securities. Certainly, the proposals recently announced by the SEC to shorten the lag time between the end of a fiscal period and the subsequent filing of annual or quarterly financial reports hold out the prospect for improving the current state of disclosure. Given the complexities and accounting judgments underlying the financial statements of many companies, a focused effort to enhance informed investor decision-making should also take into account the role played by buy side institutions, including mutual fund managers such as Fidelity, on behalf of their retail investors, to ferret out information and fill out the interstices of mandated corporate disclosure.

Fidelity as an Institutional Shareholder

How does corporate governance fit within the broader focus that we bring to bear in managing our mutual funds? At Fidelity, we start with the overriding importance of fundamental research in arriving at investment decisions from the “bottom up,” on a company-by-company basis. We seek to understand what drives a company’s business. A key element of our work is to assess the quality of a company’s management. Is management fully engaged, deeply committed to leading the company in the face of stiff competition? Do a company’s leaders demonstrate far-sightedness, integrity, sound judgment, and receptivity to new ideas?

We often find a correlation between the quality of a company’s management and sound corporate governance. Recent studies indicate that investors will pay a premium for the stocks of companies with strong corporate governance practices. Many examples can be drawn from the NYSE’s listed companies list. A company’s corporate governance practices, however, are not ends in themselves. They reveal management’s responsiveness to shareholders and commitment to serving the interests of shareholders. For at the end of the day, the overarching duty of management is to maximize shareholder value and to place shareholders’ interests first.

It is our strong view, as a shareholder, that improvements in corporate governance can be made without impeding the ability of a company’s senior officers to manage the business of the company. Fidelity recognizes that management must retain sufficient latitude to run the day-to-day operations of the company as well as engage in longer term strategic planning that is subject to the active and informed oversight of the company’s board of directors. Shareholders, however, must retain the ultimate power to judge how well management and boards of directors are performing their duties, and actions that implicate shareholders’ rights and ownership interests should not be taken without obtaining the consent of shareholders.

Sound corporate governance principles should reflect this allocation of roles and responsibilities among a company's officers, board of directors and shareholders. Fidelity, as an institutional shareholder investing in several thousand companies on behalf of its mutual funds, does not seek to manage or control any of them. Indeed, given practical and regulatory constraints under the Investment Company Act of 1940, mutual fund managers cannot do so.

The proxy voting guidelines that we follow in voting shares in portfolio companies held in our mutual funds – guidelines approved by the funds' Board of Trustees – are designed to promote the accountability of management and the board. The Fidelity funds' guidelines generally call for the funds to vote in support of management's proposals. The guidelines, however, recognize that certain matters touch directly upon the interests of shareholders or raise potential conflicts of interest for management and, accordingly, prescribe standards for how we are to vote. The guidelines, in this regard, deal with three types of proposals presented to shareholders raising corporate governance concerns. These deal with: (1) anti-takeover measures (such as poison pill plans, staggered boards, super-majority votes for mergers, and golden parachutes), (2) shareholder rights (such as the right to call special meetings, initiate changes in corporate bylaws or act by written consent) and (3) executive compensation (most notably, stock option and restricted share award plans).

As a shareholder, Fidelity, of course, retains the ability to invoke the "Wall Street rule" -- selling shares of a company -- when in disagreement with the policies or directions being taken by a company's management. On a daily basis, the marketplace offers an immediate "ballot" for shareholders to signal their confidence, or lack of confidence, in a company's stewards. For this reason, no system for corporate governance can be complete or effective without liquid and transparent markets to sustain active trading in a company's outstanding securities. This is a point that bears directly on the importance that the NYSE plays as a marketplace for transfer of share ownership in our country's major corporations.

Improving Financial Disclosure

The SEC's proposal to shorten the deadlines for the filing of annual reports (from 90 to 60 days) and quarterly reports (from 45 to 30 days) are eminently sensible and ought to be promptly adopted. The SEC would exclude from this requirement companies that have been publicly-held for less than one year and have a float of less than \$75 million. It is not clear that this exclusion is necessary. Indeed, the shortened reporting deadlines in some cases are apt to prove at least as important for shareholders of these smaller companies as for their counterparts of larger companies.

The SEC stopped short of requiring that companies post periodic reports on their websites concurrent with filing at the SEC. If the SEC declines to require this, the NYSE should do so for its listed members for all periodic reports (including current reports on Form 8-K) as well as insider trading reports.

The SEC has also proposed to close the reporting time gap for securities sales by corporate insiders by imposing a disclosure obligation upon the companies themselves. Companies must make 8-K filings within two business days if aggregate transactions by executive officers and directors equal or surpass \$100,000. Transactions under this threshold (but over \$10,000) must be reported within no later than six business days. The SEC proposal would pick up derivative transactions by insiders that are not necessarily covered by current reporting rules and would also cover loans made or guaranteed to insiders by their companies. These are salutary proposals that would promote transparency and also should be promptly adopted.

While the SEC disclosure proposals would bring some improvement, more needs to be done. SEC Chairman Pitt has made known the SEC's plans to expand the types of events that trigger an obligation upon companies to make prompt disclosures on Form 8-K. The SEC proposes to add 12 items, including changes in credit ratings, private securities offerings, waivers of corporate ethics and conduct rules for officers and directors, withholding of an auditor's consent to the use of an audit opinion in an SEC

filing and the start of any lock-out period under a company's employee benefit plans. These also will be useful changes to the disclosure system.

The SEC also plans to require companies to explain in the MD&A section of their annual reports and elsewhere the critical accounting policies that underlie their financial statements. While the SEC has not yet published its proposal, we endorse the call already made by others to require companies who release pro forma earnings numbers to reconcile those numbers with financial results contained in GAAP financial statements. Such reconciliation should be contemporaneous, so that companies choosing to release pro forma numbers can do so only if accompanied by GAAP financials.

Another step the SEC plans to take is to require a company's CEO personally to certify to shareholders, when the company files a disclosure document (including any financial statement) with the SEC, that all significant information of which he or she is aware has been disclosed and that the disclosures made are not misleading, inaccurate or false. We support this approach, which will enhance a CEO's accountability to shareholders. We would add a requirement that the CEO represent that he or she has undertaken reasonable efforts to remain informed of all significant information, including information contained in the company's financial statements.

How can the NYSE supplement the efforts being undertaken by the SEC? We suggest that the NYSE require that all of its listed companies maintain websites and post all SEC filings (other than filings for which confidential treatment is sought) as soon as they are filed with the SEC. The NYSE should require its listed companies to reconcile to GAAP any pro forma results released to the public and to do so at the time pro forma numbers are released to the public. Any changes that the NYSE adopts should be mandatory for its listed companies and should take the form of revisions to its listing standards submitted to the SEC for approval after opportunity for comment by the public. As a body entrusted with self-regulatory powers under the federal securities laws, the NYSE should not seek to effect change through voluntary "best practices" guidelines.

Shareholder Voting on Stock Option Plans and Repricing of Options

Having served on the NYSE's Task Force on Stock Option Plans and Shareholder Voting Rights, I endorsed two years ago the recommendation of the Task Force that the NYSE amend its listing standards to require that shareholders be afforded the opportunity to vote on most stock option plans, whether limited to officers or directors or broadened to include non-officer employees. Given the developments of the last two years, and the increasingly higher levels of dilution embedded in the stock option plans of publicly-traded companies, the NYSE should now require its listed companies to put all stock option plans, without exception, before shareholders for approval. There should be no distinction between plans that include officers or directors and those that do not. Nor should a requirement for approval by shareholders turn on the amount of dilution that a stock option plan (alone or together with other plans) would produce.

One is hard pressed to identify any other aspect of corporate governance which raises more immediate, and serious, issues of accountability and proper alignment of interests between management and employees, on one hand, and shareholders, on the other, than do stock option plans. When a company sells shares to its officers exercising their stock options, it is reallocating corporate ownership between existing shareholders and management. The ownership interests of shareholders are necessarily diluted because those exercising company stock options are not paying a price proportionate to the corporate ownership rights they acquire. The company, in a very real economic sense, is paying its officers out of the share ownership of other shareholders, rather than solely out of corporate coffers.

Aligning the interests of management and shareholders should also lead the NYSE to amend its listing standards to require shareholder approval of any proposal to reprice outstanding options (including the cancellation of options and issuance of new options at lower exercise prices six months and one day later). The requirement that option plans must gain shareholder approval would be circumvented if companies after

issuing options can unilaterally change their exercise prices. Unless option repricings are based upon some notion of a value-for-value exchange and are circumscribed in other respects, the underlying purpose of stock option plans – to link compensation to performance – is compromised.

Although the NYSE has been prepared over the last two years to expand shareholder voting rights over stock option plans of its listed companies, the NYSE has not acted for fear of suffering a competitive disadvantage in attracting new listings in competition with NASDAQ, which did not evidence a willingness to adopt similar changes to its listing standards. Today, this country's securities markets should not be caught up in the trap of self-regulatory arbitrage, which impedes initiatives to strengthen corporate governance among the country's leading companies.

The stalemate between the NYSE and NASDAQ on shareholder voting rights over stock option plans points to a structural defect that should be remedied in the laws governing the SEC's oversight of securities market self-regulators. The NYSE, given its leadership role in corporate governance matters, should advocate a solution. In the *Business Roundtable* case in 1988, the federal appeals court in Washington, D.C. interpreted the federal securities laws to withhold from the SEC authority to require changes in exchange listing standards to promote corporate governance ends, such as restricting the listing of classes of common stock with inferior voting rights. Although the NYSE and other exchanges must still submit any changes to their listing standards to the SEC for approval, the SEC, in light of the *Business Roundtable* decision, cannot initiate changes or require the exchanges to do so. It also is not clear, after *Business Roundtable*, what standards the SEC may properly apply under the Securities Exchange Act of 1934 in passing upon proposed changes to an exchange's listing standards.

If the SEC had the power to require the exchanges to amend their listing rules, the agency could have stepped in through rulemaking to break the self-regulatory deadlock between the NYSE and NASDAQ that has stalled for over two years any enhancement of shareholder voting rights over stock option plans. The NYSE should advocate a change

to the securities laws to restore this authority to the SEC and to specify the corporate governance standards that the SEC may apply in approving or disapproving exchange listing standards.

Composition of Board Committees

Three years ago, the NYSE implemented most of the recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees. Importantly, the NYSE amended its rules to require that its listed companies, subject to a narrow exception, establish audit committees consisting entirely of independent directors. The NYSE also strengthened the test of independence by taking into account prior business relationships, interlocking board and management positions between companies and sources of compensation of independent directors. The NYSE should now amend its listing standards that apply to the composition of compensation and nominating committees to require, in each case, at least a majority of independent directors. A compensation committee having a majority of independent directors is in a position to represent solely the interests of the company and its shareholders in structuring the compensation – including equity-based compensation – of management. The NYSE’s listing rules should also specify that the compensation committee should have authority to retain its own outside experts in the field of executive compensation.

For similar reasons, the nomination of persons to serve as independent directors should be left to a nominating committee consisting of at least a majority of independent directors. This would enhance the likelihood that persons selected to serve as independent directors will not only meet the black letter test of “independence” under the NYSE’s listing rules, but also will serve with an independence of mind. Independent directors elected to the board through this process are unlikely to be beholden to management for their positions, and are more likely to maintain their independent-mindedness throughout their tenure on the board, guided by the interests of shareholders.

Conclusion

The NYSE should play a leadership role to improve the corporate governance practices of our nation's leading companies. The strategy underlying the regulatory framework that Congress settled upon nearly 70 years ago depends upon the ability and willingness of the NYSE and other self-regulatory bodies to act with vision, judgment and far-sightedness to promote the interests of investors and safeguard the integrity of this nation's securities markets. Self-regulation can produce improvements in corporate governance that cannot be as readily achieved directly by legislation or administrative rules. By amending its listing rules to promote accountability, alignment of management and shareholder interests, and greater levels of disclosure, the NYSE will help restore confidence in our markets.