SF bulletin

By Stephen Barlas, Michael Castelluccio, Lance A. Thompson

GOVERNMENT

House Bill Exempts Nonfinancial Companies from Derivative "Margin" Requirements

By Stephen Barlas

The Business Risk Mitigation and Price Stabilization Act (H.R. 2682) was passed in late November by the House Financial Services Committee and is likely to clear the full House. The bill, which ditches margin requirements for business "end users" of derivatives, was approved by a voice vote, including the voice of Rep. Barney Frank (D.-Mass.), who recently announced his retirement. Specifically, the bill eliminates a provision in Dodd-Frank that says nonfinancial companies buying derivatives to hedge business risks must pay collateral to their bank to establish a margin. But a final rule implementing that requirement has yet to be published by the federal bank regulators, the Commodity Futures Trading Commission, or the U.S. Securities & Exchange Commission (SEC). The Coalition of Derivatives End-Users has complained about the proposed rule, which would allow margins to be different from bank to bank and be based on the creditworthiness of the company purchasing the derivative.

The House bill cancels the margin requirement for transactions executed by nonfinancial end users, but financial end users (including community and regional banks; pension funds of industrial companies; and companies with central treasury centers, microfinance funds, real estate funds, etc.) remain adversely impacted by the margin rules. "But in lieu of waiting on bipartisan agreement on financial end users, we are pleased that the committee has found common ground on a critical aspect of the debate," says Luke Zubrod, director of Chatham Financial, who also leads lobbying for the Coalition of Derivatives End-Users. "We think this bill will be especially helpful to nonfinancial end users who are accustomed to pledging physical assets to secure their derivatives trades, as such assets are not among those that can be used to satisfy margin requirements imposed by prudential regulators in their proposed rule."

Sen. Mike Crapo (R.-Idaho) has the Senate companion (S. 1650) to H.R. 2682, although Crapo's bill has some differences. He tried to attach his bill as an amendment to a House appropriations bill that landed on the Senate floor on November 1. The Crapo amendment would have prohibited any funds from being used by the CFTC to promulgate any Dodd-Frank derivatives rules until the agency substantiates that those rules are economically beneficial, adhere to Congressional intent, provide end users with a clear exemption from margin requirements, and set clear bounds on the overseas application of derivatives requirements.

Crapo had to withdraw that amendment for lack of support, but he did get some support for the concepts behind his bill from Sen. Debbie Stabenow (D.-Mich.), chair of the Senate Agriculture Committee, which has jurisdiction over the CFTC. After Crapo agreed to withdraw his amendment, Stabenow said that she and Crapo have "a number of areas of shared concern, and I have committed to work with him on these issues."

SEC's Khuzami Predicts More "Clawback" Cases

Look for an emboldened Securities & Exchange Commission to file new "clawback" civil suits against CEOs and CFOs who were on board during a period in which their companies engaged in financial reporting shenanigans—even if they themselves knew nothing about the misdeeds. At a Senate Banking Committee hearing in mid-November, SEC Director of Enforcement Robert Khuzami said that there are likely to be other cases similar to the recently completed case where Maynard Jenkins, former

SF bulletin

CEO of CSK Auto Corporation, returned $2.8 million in stock profits as part of a clawback settlement. Jenkins had been resisting a settlement. At the hearings, Khuzami told Sen. Jack Reed (D.-R.I.), chair of the Subcommittee on Securities, Insurance, and Investment, that Section 304 of the Sarbanes-Oxley Act is "a strong tool" but "not without some issues." He went on to explain that some CEOs and CFOs are "completely absentee" when the reporting fraud takes place—the implication being that clawback prosecution is much more viable in those cases. In other cases, according to Khuzami, the CEO or CFO "may be very active, even following best practices," which is why the SEC must "exercise a range of discretion." That discretion apparently includes reducing initial demands. The lawsuit the SEC filed against Jenkins in 2009 sought a $4 million clawback.

COSO Releases Framework for Public Comment

By Michael Castelluccio

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) has released its updated *Internal Control—Integrated Framework* and is seeking comment for the exposure draft. To participate, download a copy of the document at www.ic.coso.org and answer a series of questions. The comment period will end March 31, 2012, and the Framework will be revised and released in the fall of 2012.

COSO originally engaged PricewaterhouseCoopers (PwC) to develop a framework for internal control in response to a recommendation from the Treadway Commission. Following the success of the original Framework, COSO has worked with PwC on updates to adapt to changes and increasing complexity and to provide reliable information to support sound decision making.

To ensure a broad representation of perspectives, COSO formed an Advisory Council composed of representatives from industry, academia, government agencies, and not-for-profit organizations to provide input as the project progresses. The Framework retains the core definition of internal control and the five components of a system of internal control. One of the most significant enhancements is the codification of internal control concepts introduced in the original framework into 17 principles and supporting attributes that further support organizations as they develop decisions to manage risk and improve performance in a rapidly changing environment.

COSO Chairman David L. Landsittel characterizes the *Internal Control—Integrated Framework* this way: "Issued in 1992, [it] has become the most widely used internal control framework in the world. The key concepts proposed in our original framework are timeless, yet the changes we have seen in the business and operating environments have driven the need for this update. The update should allow organizations to more effectively utilize the framework to develop and maintain systems of internal control."

COSO is a joint initiative of the Institute of Management Accountants (IMA®), the Institute of Internal Auditors (IIA), the American Accounting Association (AAA), the American Institute of Certified Public Accountants (AICPA), and Financial Executives International (FEI).

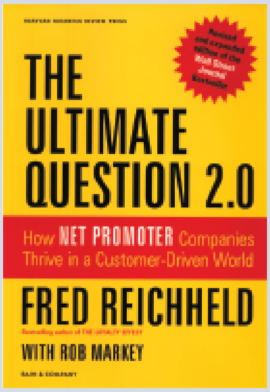
Notice of Termination

The IMA® Committee on Ethics voted to terminate the membership of the following individual for an ethics violation, as provided in Article II, Sections 5 and 6 of the IMA Bylaws: Kai Zhao, member #7118833.

BOOKS

Promoters vs. Detractors

The balance of power in the business world is shifting away from the corporations to those who buy from them and to those who work for them. Business leaders must find ways to enable frontline teams to delight customers by knowing what customers are expecting and how to establish accountability for the customer experience. *The Ultimate Question 2.0*, by Fred Reichheld, shows how companies can put themselves on the path to true growth by ensuring that the business goal isn't merely to delight customers but, rather, to turn them into customers who buy more and who actively refer friends and colleagues.



The "Ultimate Question" is typically phrased "Would you recommend us (or this product/service/brand) to a friend?" The responses to this question help a company put its customers into three groups: promoters, passives, and detractors. Promoters represent successes, passives are just satisfied, and detractors represent serious failures. From this data, a company can calculate its Net Promoter Score (NPS): percentage of promoters minus the percentage of detractors. NPS stars such as Amazon, Costco, and United Services Automobile Association (USAA) operate at NPS ratings of 60% to more than 80%.

Over the years, the Net Promoter Score has evolved from a basic metric to measure loyalty into the Net Promoter System, a comprehensive business philosophy, system of operational practices, and leadership commitment. The System includes these fundamental elements:

1. Companies systematically categorize promoters and detractors in a timely, transparent fashion.

2. Companies create closed-loop learning and improvement processes and build them into their daily operations and key decision processes.

3. CEOs and the entire senior leadership team embrace the improvement of customer loyalty through the NPS as a mission-critical priority.

4. Companies organize the Net Promoter initiative as a long journey of business transformation and cultural change.

More than 10 years of research confirm that companies with the highest NPS ratings in their sector typically enjoy both strong profits and healthy growth, and the leading companies tend to grow at more than twice the rate of their competitors. In the book, Reichheld discusses the best practices of these leaders and the key lessons learned. Though most of the examples are from the business world, both nonprofit and government organizations can benefit from the application of these ideas.

Some key learning nuggets are:

1. Experienced practitioners rely on relative NPS or competitive benchmark NPS as the basis for setting corporate priorities and goals.

2. If true customer centricity is a top priority, resources need to be allocated similar to the resources allocated to generating reliable financial information.

3. Be careful about linking NPS to compensation. Don't rush the process of developing a mature, trustworthy measurement system.

4. Over time, companies have expanded NPS to help build employee engagement and commitment.

Peter Drucker believed that: (1) the purpose of a business is to create a customer, and (2) marketing is providing value for your customers. *The Ultimate Question 2.0* provides a framework that enables a company to become truly focused on the customer and to evolve beyond the traditional approaches to customer satisfaction, loyalty, and value. This is an excellent book that helps companies increase their growth and profitability. I recommend it for all business leaders, especially for the executive team and the marketing and financial functions.—Lance A. Thompson, Thompson Management Consulting Services, LLC, lancephx@aol.com