WORLDWIDE PCE LLC

"Meeting the Challenge of Corporate Change"

8 August 2005

VIA EMAIL (e.normanveasey@weil.com)
AND FIRST CLASS MAIL

E Norman Veasey
Chair, Committee on Corporate Laws
1201 North Market Street
Suite 102
Wilmington, Delaware 19801

Re: Request for Comments on Discussion Paper on Voting by Shareholders for the Election of Directors[1]

Dear Chairman Veasey:

Bertrand Russell observed laconically that "the greatest challenge to any thinker is stating the problem in a way that will allow a solution." Since the fall of Enron and WorldCom, much has been written about and many changes have been advanced to remedy, those startling failures of corporate governance. Yet there is nonetheless a persistent, unidentifiable hollowness to the entire dialogue, reflecting an unspoken yet intuitive doubt that, perhaps like Dorothy in *The Wizard of Oz*, we are focusing our efforts on an apparition before us, failing to turn our attention to the "man behind the curtain." Clearly, there is a general recognition now that the remarkable haste with which the Sarbanes-Oxley Act was adopted was more the result of the President's and Congress's need to look responsive to the millions of registered voters who had lost their pension savings than it was an acknowledgement of the methodological soundness of that law's prescriptions. That something needed to be done, and

[1] As the majority of the text of this letter is taken verbatim from a soon-to-be published article entitled *Beyond Berle and Means*, the text herein is subject to a copywrite in favor of the author, Richard L Wise 2005. Permission is hereby granted, however, for any and all non-commercial reproduction and publishing of this work, provided appropriate attribution is given to the author.

Northeast office: Fifty-One Washington Square North • Salem, Massachusetts 01970 • Tel/Fax: 978.594.5310
Direct Tel: 978.594.0678 • Cell: 617.308.0100 • Email: **richard.wise@comcast.net**

still needs to be done, however, cannot justify the result; for furious activity can never be a substitute for understanding.

The purpose of this intervention, therefore, is to step back for a moment and to analyze with precision some of the underlying assumptions and principles that have lead your Committee to look into the desirability of enhanced accountability to shareholders by public company boards as a way of improving corporate governance. It is my goal, frankly, to state the problem of corporate governance in a remarkably different fashion, and thereby allow for better minds than mine to fashion proper solutions. As fair warning, I shall state up front that this analysis challenges two, heretofore unquestioned truths: the first being that enhanced accountability to "shareholders" (and I put this word in quotes as its imprecision has clouded much of the argument relative to corporate governance) of public corporations is a desired goal at all, and the second being the relevance of the 1932 analysis of distinguished Professors Berle and Means to the modern, public corporation. I do this in the spirit of Jeffersonian intellectual honesty which admonishes us to "Question with boldness even the existence of a God; because, if there be one, he must more approve of the homage of reason, then that of blindfolded fear."

This discussion will have three parts. First, I shall engage in a qualitative, definitional analysis of the term "shareholder" to establish how the full spectrum of dramatically differing relationships that this word encompasses is too broad to allow for one set of rules to govern all of those relationships. Second, I shall analyze the critical differences, from an organizational perspective, between the two corporate models that are on the opposite polar ends of the shareholder spectrum; namely the entrepreneurial model and the public enterprise model. Third, I shall define the "shareholder" relationships in terms of the essential goals and objectives of these two corporate structural models, and show how as one progresses away from the entrepreneurial model towards the enterprise organizational model, less accountability to the shareholders is both a deductively inescapable and a desired end. In concluding, I discuss the insightful analysis of Professors Berle and Means and show how their analysis, while an accurate approximation of reality in 1932, has little relevance to the modern, publicly-trade corporation.

1. <u>What is a Shareholder?</u>

At its inception, the term "shareholder" had a narrow and clear meaning. However as will soon be seen, the same term and attendant hypothetical legal rights is still used today to cover an entirely different and greatly expanded set of circumstances. In this sense, the term "shareholder" is akin to the term "ownership." Laypersons use this latter term assuming its meaning is clear. Thus, if I "own" a painting, presumably I may do what I want with it, including destroying it, or even taking pictures of it and selling those pictures to others. Yet if I "own" a book, I cannot take pictures of its pages and sell them freely in the marketplace. In the Commonwealth of Massachusetts, if I "own" a piece of land I likely also own any mineral rights under my property. Yet the same result does not automatically obtain in Texas. Thus it makes sense to look with great specificity at the details of underlying cultural assumptions as well as what is intended, both so that we shall have our words be precise as to what it is that we intend and wish to accomplish and because the law itself, at least in the United States, evolves after the fact to honor the intent of our people and the changes in our culture.

Just for the moment then, let us begin by focusing on the intent of the parties in forming and transferring corporate shares rather than legal constructs. This is particularly appropriate because since we are, in the final analysis, examining what changes should be made to the existing law, we ought to look first at what it is that we are trying to achieve.

The origins of the modern American corporation have their roots in what may have been the first common law corporation; namely the East India Tea Company. Formed pursuant to a special charter from the king, the rights to receive a share of the entity's profits as well as to vote on management decisions was, for mathematical convenience, divided into separate shares, giving the holder or owner of such shares his pro rata interest in both ownership and management. These ownership interests were held by an intimate group of "clubby" elites who had close business and, often, social relations with each other. While business judgment might vary widely among them, their underlying interests and cultural views were likely the same. In this entity, ownership and management roles and interests were clearly intertwined and united.

These concepts have changed little in the closely held corporation of today. Take, for example, the hypothetical case of Mr Operator, the 100% owner of XYZ Widget Manufacturing Inc. Mr Operator may believe that he has a

wonderful product, but that he does not have the necessary marketing skills, contacts or both to expand his revenues. He knows Ms Marketer, an individual with whom he has had a long and cordial relationship. From her years of experience in the widget industry, she has close business relations with retail sellers of widgets across the country, and also has advanced degrees from the Harvard Business School and two decades of industry experience in sales and marketing. Mr Operator proposes that he and Ms Marketer join forces to combine their talents to expand his business and enhance its income for the benefit of both of them. She agrees and he sells her fifty percent of his stock, with her coming aboard as a director and chief sales and marketing officer. In this instance, both are expected to have an intimate interest in the ownership and operation of the day-to-day affairs of the corporation, and likely have aligned interests on most management decisions.

Contrast the foregoing simple case with the following scenario that I assume did occur, although I of course have no evidence to that effect: Mr Henry Ford is sitting in the smoking room of his all-men's club talking to his neighbor about the success of his company and his intent to take it public. In the course of that discussion, Mr Ford suggests that his neighbor should buy some of the shares to be offered as it "would be good" for him. Would anyone suggest that, as is the case in my first example, Mr Ford is actually thinking that he is "selling" a portion of his company to his neighbor or, even more preposterously, that Mr Ford expects his neighbor to have a say in managing his company or in telling him what to do? More likely, both Mr Ford and his neighbor believe that Mr Ford is merely offering the neighbor the opportunity to obtain the benefits of capital appreciation and dividends by investing funds in the products, business acumen, and organization that Mr Ford had created. Similarly, while the neighbor likely expects Mr Ford to apprise him from time to time of the progress of the company and give him a fair accounting of its operational results, it is doubtful that he has any illusions about second guessing Mr Ford's operational decisions or expecting that he should have the right to impose new and differing corporate goals on the Ford Motor Company. Indeed, to the extent that he has any such major differences, he would merely express his disapproval by "voting with his feet;" that is, selling his shares.

Of the above three examples of corporate structures, the case of XYZ Widget Manufacturing Inc is the far more numerous type of corporate organization. Yet we use the same term "shareholder" to describe the ownership rights and

interests in all three. The logical absurdity of using this term to refer to the same types of relationships becomes even more extreme if we apply were to try to apply shareholder actions commonplace for publicly traded companies to closely held corporations. I shall name just three:

- Short Term Investments—In the example of XYZ Widget Manufacturing Inc ("Widget"), imagine if Ms Marketer were to agree to come aboard but wanted the right to sell her interest and move on to another business, even one directly competitive with the business of Widget, after three months. Would Mr Operator have agreed and sold her a half interest in his company?
- Short Positions—Ms Marketer agrees to buying a fifty percent interest in Widget but discloses that her principal motivation is that a third party is paying for her shares and she has to repay this party in one year in an amount proportional to Widgets increase or decrease in profit during such year, and she believes that such profit will drop markedly, thereby enabling her to obtain a bargain purchase price. Would Mr Operator agree to this combination?
- Share Lending—For investment purposes, Ms Marketer wants the right, from time to time, to lend her shares to an unrelated third party, who, of course, will have the right to vote her shares in Widget as they deem fit, including voting for changes in major operational decisions. Would Mr Operator likely agree to such a right?

Shareholders in public corporations may have long-term goals, short-term goals, and even may desire that the stock value deteriorate, but the interest of a stockholder in a closely held corporation may only appropriately be long-term. Thus should we automatically require that the same bundle of rights be accorded all such parties in all such situations merely because we have, for historical reasons, called them by the same name? As the status quo relative to sales of corporate shares has evolved, might it not be appropriate for the rights relative to them to change as well? I am told that in one of the native Eskimo languages there are around twenty-eight different words for what we call "snow." Certainly our failure to differentiate among these types of snow does not change their differing natures or characteristics. Analogously, if form is to follow function, this should lead us to begin to question whether we ought to adopt differing terms, with attendant differing rights, for the different relationships by which individuals or corporations hold shares of stock. In the

next section, I examine the two basic types of corporate organizational models and the evolutionary differences between them.

2. The Entrepreneurial and Enterprise Organizational Models.

Having looked briefly at the interests of the parties who may hold stock interests in a corporation, let us now look at the two basic types of corporate organizations that exist, and the differing benefits and deficiencies that they offer to their owners. Much of this analysis is a distillation of my twenty-eight years of having observed the growth of corporations from startup to publicly traded entities, and the painful, and often fatal, changes that they must go through in attempting such growth. Once we do this, we shall, in the third section of this analysis to follow, endeavour to match the interests of those wishing to hold stock in a corporate entity with the attendant benefits and rights that relate to those interests.

The vast majority of United States corporations begin their existence as the reflection of the vision of one main individual, or small, close-knit group of individuals. Even in close-knit groups, one primary leader usually emerges, driving the company forward. The organization takes on the personality, values, and culture of this person, and most all decisions, even the most trivial, are subject to his or her determination and review. This "prime mover" is involved in all aspects of the business, and in successful companies this person is looked up to much as a father figure or feared general. Death or disability of this individual is likely fatal to the enterprise. Similarly, growth of the enterprise cannot exceed the prime mover's ability to deal with it. Usually, too, this individual is jealous of all control, since he or she created the entity's success, and has an intuitive feel for the entity's potential limits, strengths, and weaknesses that no one else can have, simply because it is a reflection of his or her own very nature.

At some point—in today's environment usually when gross turnover starts edging over fifteen to twenty million dollars—these prime movers sense a dramatic change that they can neither understand nor deal with. Most simply, there is just too much to do. They feel a loss of control as their enterprise's scope begins to grow beyond them, and if decisions need to wait for their attention, opportunities will be lost or production will halt. In organizational terms, the corporate culture is one of the individual, but the enterprise now needs a cohesive team; an organization shared responsibilities and authorities

that can function independently of the owner, but that carries out his vision, goals, and objectives. The entrepreneurial model of operation must change into that of an organizational enterprise. Yet if this change is to occur, the prime mover must also cease to be a boss, and become a leader. Bosses can only control that which is before them, but leaders can induce results without their very presence. This is because the essence of leadership and teamwork is the establishment of independent, yet interrelated provinces of authority and responsibility in others, whereas all responsibility and authority in the entrepreneurial corporate environment reposes only in the prime mover.

This newly expanded capability of the enterprise necessarily will permit and stimulate growth; and growth, in turn, expands the need further for enhanced stability: for growth cannot be achieved if the death or departure of key executives halts normal action. Hence, protocols for succession planning, manuals governing corporate procedure, and the like must be developed. Further, with enhanced growth, there arises the opportunity for the enterprise's wealth to be shared with those in management, and often even with lower level employees, while raising the overall return to the prime mover as well.

Only a very few entrepreneurs can make this change from boss to leader. Indeed, to do so takes great emotional security and courage as the prime mover begins more and more to lose control of more and more decision making, and, perhaps worse, a corporate culture necessarily begins to evolve that is reflective of the experience and personality of those who have authority over their areas of responsibility; a culture that will of necessity be independent of, and different from those of, the prime mover and the way things have been done in the past.

This is a good thing for our economy. Increased productivity and stability is, clearly, a primary goal for businesses. Yet if a corporation is anchored in one person and his or her motivational force, surely that entity must cease to exist upon the death or retirement of that individual. A good example of this that lawyers will recognize is the firm of Testa, Hurwitz & Thibeault LLP which quickly grew from a startup law firm to one of the largest firms in Boston and eventually with offices across the country—primarily based on the magnetism and personal capabilities of founding partner Richard Testa—and which collapsed quickly following his untimely death.

Lawyers colloquially say that one of the fundamental and unique aspects of corporations is their feature of "unlimited life;" but the truth is corporations have no life at all. They only have the *potential* for unlimited *existence*. Only humans have life and the capability for imbuing an organization with life through their establishment of an organizational culture. Thus if an organization's existence can be imbued with a culture that is independent of one person and reflective of a self perpetuating value system with which succeeding generations may identify and within which they may feel nourished, then that enterprise will have a "life" of its own that, by definition, will not be delimited by the lifespan of one or more human beings. And "unlimited life" inescapably results in two, new attributes: stability for the entity's investors, and separateness from them. Furthermore, this enterprise will be capable of continued growth and continued existence only so long as its culture is responsive to the nurturance of creative individuals who feel rewarded in working for this enterprise, and its products or services are increasingly desired by the economy. Indeed, it is the very development of a new, enterprise organizational culture that permits longevity and expansion.

This new "stability" and lack of necessary ties to the "owner" creates then a fertile new opportunity for those who may, nonetheless, desire to invest in such an enterprise. To put this opportunity another way, such an investor may acquire the right to participate economically in the profits and capital appreciation of the enterprise without ever having to work for it or participate in its management. From the enterprise's perspective, this is also a perfect result: growth requires increasingly larger levels of capital to fuel the realization of corporate goals, and regularly these needs exceed the ability of the founder and its banks to provide. Yet if infusions of capital meant also that new positions needed to be created within the organization for such investors to work, and that such investors input would have to be considered in all business decisions (as would be the case in the Widget company), growth would become markedly complicated and would likely grind to a halt. The elegant simplicity of this new structure, on the other hand, is what makes it so appealing both to an investor and to the company. The company receives need capital without extraneous entanglements and the investor receives his or her share of increased value without necessary personal involvement.

3. Matching Shareholder Interests and Corporate Models.

In the previous section, I discussed briefly the two models of corporate organizational structure and the evolutionary process of change from entrepreneurial to enterprise models of organization. The key element of this process from the standpoint of the shareowner, is the *uncoupling* of the concept of his ownership of the company from the company itself. From the standpoint of the investors in the East India Tea Company or the owners of the Widget company, such uncoupling was neither necessary nor desirable. A further corollary of this evolutionary process from entrepreneurial to enterprise model is that the issuance of certificates to represent share interests is likely more of a formality than a necessity in the entrepreneurial model, as their property rights in and to their respective companies was neither negotiable nor freely alienable. On the other hand, pure investors desire attributes of free alienability and ready marketability in their investments, thus to the extent that their investment can be certificated, those attributes will be enhanced. In this way we begin to recognize that the interests and attendant rights in those holding "shares" in public companies, bears little resemblance to the interests and rights desired by those involved in closely held companies. Why this is so requires a brief additional explanation.

As economist Hernando de Soto describes in his book *The Mystery of Capital* [2] "Capital is born by representing in writing...the most economically and socially useful qualities *about* the asset as opposed to the visually and more striking aspects *of* the asset.[3] Thus, to paraphrase de Soto, a formal property representation such as a stock certificate is not a reproduction of the corporation itself, but rather merely a representation of those concepts or qualities about the corporation that are relevant to a specific purpose. In this way, our legal property system becomes "a staircase that...[takes] the universe of assets in their natural state to the conceptual universe of capital where assets can be viewed in their full productive potential."[4] A consequence of this change is that assets become transformed from a less accessible state to a more accessible state. "Unlike physical assets, [their legal] representations are easily combined, divided, mobilized, and used to stimulate business deals. By

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[2] Hernando de Soto, *The Mystery of Capital* [2] (Basic Books 2000; (herein, "de Soto")

[3] de Soto at pp 49-50

[4] de Soto at 51

uncoupling the economic features of an asset from their rigid, physical state, a representation *makes the asset 'fungible... .'* "[5]

Fungibility is a *sina qua non* for shares to be freely and frictionlessly traded on public exchanges. Uniqueness in ownership attributes is therefore a factor that will impair free transferability and diminish marketability. Definitionally, it seems clear that the more that one desires free alienability and marketability of the instruments representing the shares, the fewer must be the unique and personal rights and responsibilities between the shareholder and the issuer. Conversely, the more important the relationship between the holder of an instrument and the issuer, the less alienable and marketable will be the shares. Thus, in the initial public offerings of stock, managements' shares are universally restricted from transfer for long periods of time. Putting this issue another way, as the granting of rights generally carry with such grant the imposition of responsibilities, the more rights a share of stock carries with it, the greater will be the responsibilities of its holder; and this complication will materially and adversely affect both marketability and alienability of the instrument.

Let us now look at the matching of interests with organizational models from an economic cost perspective. All desired growth or expansion of an organization's business must generate sufficient additional economic returns so as to enhance (or, at the least, not diminish) the profitability of the enterprise, and to provide a sufficient return to those advancing the capital as will induce them to make such an investment. This, of course, is merely another way of saying that an enterprise's profitability must at least equal its cost of capital. Thus to make any expansion work, management must do what it can both to enhance profitability and to lower its cost of capital.

In the case of the example given in the previous section of the Widget company, there is a very limited pool of investors who would be willing to risk their capital in the venture. Other than those who might be willing to do it for social reasons (such as family), the primary investor would likely be someone who was looking at the company to work within it and to "make it his" to a greater or lesser extent. Such an investor will likely want such additional assurances such as an employment agreement, a board seat, restrictive and preemptive rights with respect to all stock, stock redemption agreements,

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[5] Emphasis supplied; de Soto at 56

shareholder agreements, and the like. The relationship will be further complicated by that fact that courts have held that shareholders in closely held corporation have "fiduciary" obligations to each other.

Larger enterprises, of course, can neither accommodate nor afford the complications, entanglements, and costs that would be normal for Widget. Similarly, as discussed above investors that are looking merely to put their capital to work for a fair return do not wish to be bothered with either the personal time commitments nor the unmarketability of the shares that an investment in Widget would require. The enterprise model of corporate organization, as it expands in size and seeks to bring in additional investment, offers the stability and permanence that a pure investor requires, while also freeing the transfer of such shares from restrictions on transfer, alienation, and repurchase, as well as from fiduciary rights and obligations attendant to closely held corporations; thereby greatly enhancing marketability and greatly lowering the risks (the "beta" factor) associated with investing in such a company. This, in turn, enables the company to achieve a lower cost of capital. For these reasons, corporate enterprise organizations routinely seek to uncouple their shares' ownership rights from management rights so that these shares will then be fungible with all other shares of all other corporations, except, of course, as to value.

In summary, then, the key attributes of the two models of corporate organization and the shareholder interests that they serve form a continuum with its two ends being reflected in the following table:

ENTREPRENEURIAL MODEL	**PUBLIC ENTERPRISE MODEL**
Center is the Entrepreneur Culture: Cult of Personality Life: Limited to existing persons Stock Alienability: Highly restricted Stock Marketability: Unclear value; limited market; very large transaction cost Management Control: Full/Coupled to Ownership	Center is the Organization/Team Culture: Bureaucratic, Team Derived Life: Unlimited except by failure Stock Alienability: Unrestricted Stock Marketability: Precise value; wide market; de minimus transaction cost Management Control: None/Uncoupled from ownership

Conclusions—Berle & Means Revisited.

In light of the preceding analysis, let us now ask again that question with which modern legislators have been struggling and which distinguished professors Berle and Means asked so long ago in their seminal work, *The Modern Corporation and Private Property*: namely, for whom should the corporation be run? Since as a purely legal matter a corporation's shareholders are its owners and under the common law, owners generally have the general right to control their property, there is a seductive simplicity to jumping to the conclusion that shareholders should have greater rights to keep wayward management in line. Ultimately, those advocating greater shareholder rights come back to the distinguished analysis of Berle and Means to justify their thinking. Professor Jeswald Salacuse in his article *Corporate Governance in the New Century* [6] summarizes this work succinctly:

> Berle and Means examined the growing concentration of economic power in the modern corporation and noted the rise of professional managers having operational control of large corporations but little or no ownership of the enterprise. ...This divorce of ownership from control in the modern American corporation posed a challenge to the interests of shareholders. Berle and Means viewed corporate governance (a term that appears nowhere in their book) as a classical agency problem: how could corporate managers, as agents of the shareholder, be induced to manage corporate assets in the pest interests of their principals?

However as can be seen from the above analysis, the intent of both the investor and the organization in enterprise-model corporations is not one of "principal-agent." One might then ask why the good Professors began with this approach.

Berle and Means had three crippling disadvantages that effected the formulation of their theory. First, their work was formulated between the beginning and the depth of the Great Depression—it was first published in 1932—when largely unregulated markets, no formal accountability to shareholders, and wild, rumor-fed speculation in stock was the norm. Second, they had not conceived of the pure disclosure-based approach that became to be embodied in the 1933 and 1934 Securities Acts and the strong regulations

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[6] Jeswald Salacuse, *Corporate Governance in the New Century* (25 The Company Lawyer No 3, 69 at p.71 2004)

promulgated by the then yet-to-be-formed Securities Exchange Commission. Third, they could not foresee what became the meteoric growth of public companies—I believe, primarily as a consequence of these Exchange Acts and regulations—into the multinational behemoths that they have now become.

Referring back to the chart set forth above, one realizes that, yes indeed, as management becomes separated from ownership, the interest of ownership and management do not automatically fall into alignment as they did in the closely held corporation. However where I differ from Berle and Means is that not only is this a good thing, but that it is a necessary, logical consequence of the growth of a company into a large, public corporation: for close management control on the one hand and free, unrestricted alienability and marketability of fungible shares on the other hand are necessary opposites. As investors desire more and more the ability instantly to buy and sell shares, such a result can be achieved only by uncoupling these "shareholders" and their peculiar interests from any critical nexus with the enterprise. One can thus have control or free marketability; but not both. And corporations that are hungry for growth capital want to attract investors interested only in the ability knowledgably to buy and sell shares and to do so instantaneously and with little transaction cost or delays; not investors who are looking for a job or to have input into company policy or direction.

It is my belief, too, that this was the choice that Congress made in its enactment of the 1933 and 1934 Securities Acts. Rather than enhance accountability to individual shareholders, as your committee is considering, Congress mandated greater ***accountability to the market***. This, then should be your standard. It demanded an end to insider information, secret transactions, and the like, believing that if all had access to all relevant information equally, normal market forces, and the laws of economics would by and large reward good companies and eliminate the bad. It chose daylight as the great panacea.

These changes, by imbuing the public markets with greater stability and fairness, enabled greater alienability and free marketability of publicly traded shares, thereby increasing the willingness of the public to provide more capital to enterprises now hungry for growth.

There is still one other way to look at the issue. Berle and Means could not envision the magnitude of the modern corporation. A study in 2001 revealed

that if one called the "gross turnover" of Fortune Magazine's 100 largest global companies "gross domestic product," then these companies would all fall between the thirty-third and the ninety-six largest countries in the world in term of their gross domestic product. Should enterprises of such power and affecting so many lives and economies, be solely, or even primarily, accountable to transitory investors whose primary motivation is only maximizing returns?

The Committee began its discussion paper stating that it felt that it was seeking "to make directors more accountable to shareholders." This paper asks a more preliminary question; namely, why would one want to do this in the first place? More precisely, the concept of making directors more accountable to shareholders is not a goal in itself, but rather a possible solution to a particular problem. What then is the precise problem that we are trying to address? If we fail to answer this question in sharp relief, the blunt tools that we fashion will, even if they do address what is really at issue, will also have unintended spillover effects; effects that could prove quite material and adverse to the continued growth and health of publicly traded companies. As this comment endeavours to show, our American system has, since the adoption of the Securities Acts, been based upon the concept of accountability to the market, not individual shareholders, and the judgment that the markets will more than adequately reward the better run companies, and punish the bad.

The failures of Enron and WorldCom were failures in boards fulfilling their oversight functionalities. (For a fulsome discussion of this conclusion, see Wise, R L, *"The Current Crisis of investor Confidence: Corporate Governance and the Imbalance of Power"* published on the Securities Exchange Commission Official website at http://www.sec.gov/rules/proposed/s71903/rwisethesis.pdf) In doing so, they failed in their obligations to the public markets. Had they done their jobs, is there little doubt that the market would have responded appropriately?

Yours very truly,

Richard L Wise

Richard L. Wise
Senior Director and General Counsel