Testimony of Keith D. Grinstein

Implementation of the Sarbanes-Oxley Act of 2002 and Restoring Investor Confidence
Before the Senate Committee on Banking, Housing, and Urban Affairs
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Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee:

Thank you for the privilege of appearing before you today to discuss the implementation of the Sarbanes-Oxley Act of 2002.

Background

I am currently a member of the boards of directors of three small to mid-sized public companies traded on NASDAQ: Coinstar Inc., F5 Networks, and Nextera Enterprises, Inc. Although a member of the boards of these companies, I appear here today solely on my own personal behalf, and not as a representative of those companies. I am not authorized to comment on our own board deliberations.

Coinstar is a Bellevue, Washington-based company which develops, owns, and operates a network of automated, self-service, coin-counting and processing machines that provide consumers with a convenient means to convert loose coins into cash. Coinstar's market capitalization is roughly $280 million and is listed under the symbol CSTR. I am an independent/ non-employee director and serve as Chairman of the Board of Directors and serve on three board committees: the audit committee, the compensation committee, and the nominations/ corporate governance committee. Consistent with proposed NASD rules, Coinstar has a majority of independent board members.

F5 Networks Inc. is a Seattle company that provides integrated products and services to manage, control, and optimize Internet traffic. F5 Networks would be considered a mid-cap company with a market capitalization of roughly $500 million and trades under the symbol FFIV. I am an independent, non-employee director of F5 Networks and serve on the audit committee and compensation committees of the board. F5 Networks does not have a nominations committee. F5 Networks also has a majority of independent board members.

Nextera, is headquartered in Cambridge, Massachusetts. Nextera's primary asset is Lexecon, an economics consulting firm whose clients include major law firms and the corporations that they represent, government and regulatory agencies, public and private utilities, and national and multinational corporations. Nextera trades under the symbol NXRA, and has a market capitalization of roughly $17 million. I am one of three independent, non-employee directors of Nextera, and I serve on two board committees, the audit committee and compensation committee of the board. Nextera does not have a nominations committee. As a closely held company, Nextera is exempt from the board independence requirements of NASD rules.

In addition to my affiliation with publicly traded companies, I am an attorney and sit on the boards of three privately held companies and am a founding partner of Second Avenue Partners, a private venture capital firm in Seattle that provides funding and support to Pacific Northwest early-stage companies.

Significant Tangible Benefits of Sarbanes-Oxley

My connection with public companies pre-dates passage of the Act, and thus my perspective on the significance of the changes brought about by the Act comes from the perspective of one who has lived intimately with the pre-existing obligations imposed on those responsible for governing publicly-traded companies. Further, my perspective also comes from involvement in companies that have sought scrupulously to comply with their federal disclosure obligations, have not been the subject of investigations by federal or state authorities, and where I have been privileged to serve with a group of outstanding fellow directors, who have genuinely sought to do the right thing.

As an initial matter, it is important to recall that prior to the date of the Act, while the NASDAQ had certain requirements for listed companies such as requiring audit committees, corporations are creatures of state law and state law does not dictate how a company is to be governed. State law does however spell out the duties of directors such as the duty of care and loyalty. Nonetheless there was a growing understanding among public companies that certain corporate governance practices were better than others. Except as a matter of disclosure, there was no federal law concerning corporate governance and the federal law simply required disclosure of the company's practices, most notably in connection with its proxy statements and its annual and periodic reports.

Further, prior to passage of the Act the existing federal and state proscriptions against fraud and the federal disclosure obligations were taken seriously and the existing criminal sanctions were a significant deterrent to wrongdoing. There was, however, a mood of complacency that had crept into the board rooms, especially in the heady days of the bull market. This complacency led to excessive latitude being given to management in the conduct of corporate affairs and less attention given to the independent oversight function of board members.

This manifested itself in several ways: boards gave undue deference to management in matters such as (1) compensation packages, (2) recommendations of management about corporate decisions, (3) accounting policy and disclosure matters, and (4) nominations for future directors. This also meant that directors would frequently not voice issues that could be viewed as questioning the judgment of management.

Directors serve for many reasons but often for the money and prestige associated with board membership. Because management often controls the director selection process, board members could be held hostage to that management Although I have not directly experienced this in my tenure, it seems that there are few directors that may place undue importance on the money and prestige of board membership. This may have caused some board members to acquiesce in management demands for larger and larger compensation packages and to condone the reporting of the financial consequences of poor management decisions through issuing management-friendly audit reports.

The notorious and well-known corporate scandals that prompted passage of the Act have brought about a marked change in attitude in the board room. There has been less deference being given to management initiatives. Questions that went unasked before are being asked now. Board meetings are more frequent and board members are better prepared at meetings. Management has provided us with more information, we see more attorneys at board meetings, board committee charters are being written or reviewed by outside counsel, and more attention is being paid to corporate governance and structure. Boards are adopting written compensation policies, and tend to be more “hands on” with respect to pay-package decisions. Issues that before would not have even been discussed, are being presented to the board for discussion and advice.

It is difficult to isolate specifically those provisions of the Act that have had this effect. I will point to just a few of the most important changes.

<u>Audit Committees</u>

I sit on three audit committees. The requirement for independent audit committees and the specification of their powers have been markedly strengthened by the Act. Even on the boards where I sit that had adopted the best practices guidance for performance of their duties even before the passage of the Act, the audit committee members have undertaken to take their duties even more seriously and their powers have been strengthened. The auditors also appreciate more clearly than before that they work for the audit committees, not management. We see two important changes: auditors are more responsive to our requests, and auditors are giving more attention to their audits.

<u>Consulting services by auditors</u>

The audit committees on which I sit do not authorize our auditors to engage in consulting services. Auditors do not invite the potential for conflict. This has been a marked change wrought by both the SEC's 2001 independence rules and the changes adopted by the Act.

Internal control audits

Companies are now required to have quarterly internal control audits. Where before these internal audits may have been performed by our auditors as part of non-audit services, the auditor independence reforms have required us to look elsewhere for those services. There is increased competition for these services, increased information to audit committees and a renewed focus on responsibility -- we are getting a good work product.

CEO/CFO certifications

The certification process has been a disciplining process for executives and financial officers, and that disciplining process has filtered down to others within the company who report to them. From the board's perspective, it has provided us with additional comfort as to our ability to rely on management's representations concerning internal controls and the financial condition of the company.

Costs of Implementation

There can be no question that the Act has increased the cost to companies of compliance. For small and mid-cap companies these increased costs are a significant drain on the bottom line. Such companies have fewer assets and less revenue over which to amortize implementation and continuing compliance liabilities and expenses. In my personal view, the benefit in investor confidence and the improved corporate governance that is taking place, is worth the cost. It is hard to put a short-term price tag on the lack of investor confidence that was mushrooming out of control at the time of passage of the Act.

In general, I estimate that compliance with the Act imposes a direct cost on a small cap company of about $250,000 per year, and a larger mid-cap company of closer to $1 million. Some of these costs are likely to be recurring costs, and some of these costs are likely to be one time costs and could level off as we gain more experience in administering the changes brought by the Act.

Let me summarize the components of those costs:

<u>More board of director time</u>

Directors are compensated by a per-meeting fee and by the amount of time spent on matters. Since enactment of the Act, we have had more frequent board meetings and more frequent meetings of board committees. This is especially true in the case on the audit committees. This translates into a direct increase in board fees.

<u>Increased auditor fees.</u>

As I have noted, auditors are spending more time on engagements, and the direct interaction between audit committees and the auditor has increased. Further, another direct increased cost is caused by the new requirement that annual and quarterly reports be issued more quickly. There is an increased demand on auditors to conduct their review more rapidly before the quarterly and annual reports are filed. This translates into a direct total increase in auditor fees.

<u>Increased insurance costs</u>

Companies have seen the cost of Director & Officer insurance increase by between 15% and 30%. In my experience this is an increase of about $100,000 in premiums for each $10 million in insurance coverage. As I understand it, insurance companies have not yet begun to see a substantial increase in actual outlays, but the premiums have increased because of a perceived increase in risk; premiums may level off in time as we have more experience under the Act.

<u>Legal Fees</u>

We see more attorneys at every phase of our work on boards. This includes work on drafting or redrafting board or committee charters, attendance at board and committee meetings and on consultations with management.

<u>Looking forward</u>

The Act was landmark legislation that was needed at the time and has had a profound impact on corporate America and the accounting and brokerage industry. There has not been sufficient time to assess the impact of the changes brought about by the Act, including the indirect benefit of increased investor confidence, and the intangible benefit of better corporate governance. The direct federal oversight over the accounting profession was long overdue and I have already seen a marked improvement in accountant responsiveness. I am optimistic that the Act strikes the appropriate balance between federalization of certain aspects of corporate governance and increased federal disclosure obligations.

There are some areas on which the committee should pay particular attention. The cost of initial compliance for small and mid-cap companies is significant for those companies. If those costs increase and do not level off or decrease over time, then these companies are faced with a long-term compliance cost drain. In particular we have little experience with increased costs of litigation spawned by the new duties imposed by the Act. If we see a significant increase in litigation costs, then the committee may want to consider enacting some safe-harbors to curb abusive and unwarranted litigation in the future.

As a venture capitalist I am well aware that there are alternative sources of capital than the public markets and that at some point companies could be driven to those alternative sources if the costs of being public financing keep escalating. However, I have seen no evidence that the Act has had that effect, i.e. that the Act has driven companies that otherwise would have become public to those alternative capital sources.

Conclusion

Enactment of the Act was the right thing to do at the right time – a time of a severe crisis in investor confidence in publicly traded companies. From my vantage point, I have seen a subtle shift in the balance of power away from corporate management and towards independent members of boards of directors and ultimately shareholders. There are a number of procedural and substantive rules adopted by the SEC in implementing the Act and some of those rules have only recently been implemented and there has not been sufficient time yet to assess their merit or to evaluate their true costs. And I remain optimistic that as we gain more experience administering the Act, the initial costs of implementation may be reduced substantially. But the increased costs of implementation and compliance of the provisions of the Act are in my judgment a necessary price of restoring investor confidence in publicly traded companies.

Thank you. I look forward to your questions.