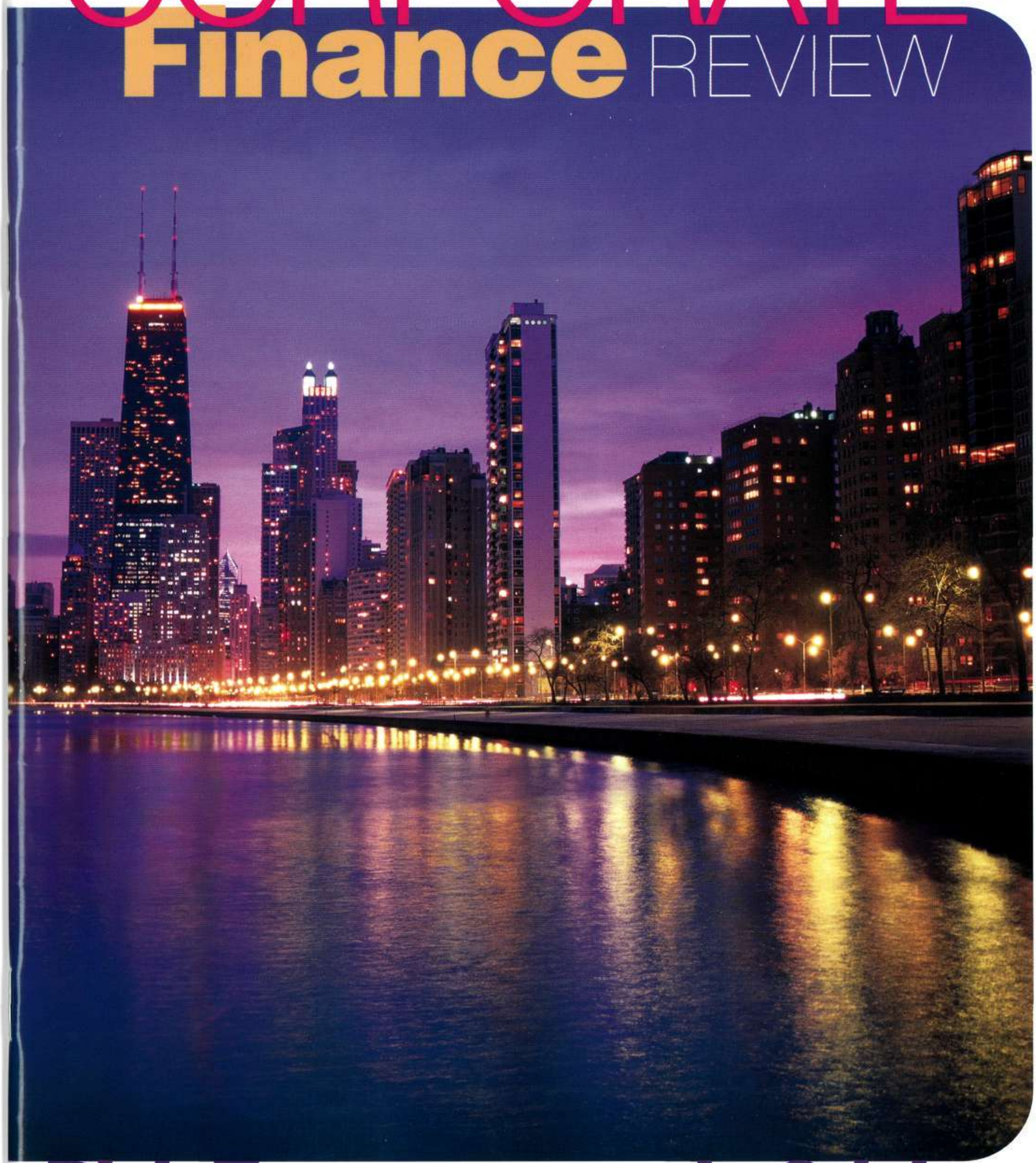
January
February
2008

CORPORATE Finance REVIEW



Risk Transparency in Crisis

Design Issues in Bonus Contracts

A Look at the Subprime Saga

Financial Statement Fraud and the Mistakes of the US

2008: ANOTHER YEAR OF TREMORS AND SEISMIC SHIFTS FOR FINANCE PROFESSIONALS?

Those who live in earthquake fault zones, such as the Pacific Rim, know all about earthquakes and the sudden shaking of buildings and highways. The frightening shifts of the earth's crust occur as tremendous pressure is released by the grinding of massive tectonic plates far beneath the ground. Unseen, these events often occur without advance warning; at other times, warning signs will be there, and you ignore them at your peril. Earthquakes can create wide swaths of damage on land; if they occur in the seabed, deadly tsunamis may strike distant shorelines. Some earthquake zones are highly visible—like the San Andreas fault line undulating for miles through California—and others are not. Metaphorical earthquakes occurring in the capital markets behave similarly.

New York's tiny island of Manhattan really does sit on a fault line deep beneath the bedrock on which modern skyscrapers have been built—the fault line slices diagonally across midtown but no one here worries much about earthquakes because none of any magnitude has happened in New York City in four centuries. But New York the capital-market center has seen its share of other types of earthquakes, with devastating aftershocks rippling from the tiny downtown epicenter to distant financial capitals — as occurred in October 1929, October 1987, and most recently during the tech-stock meltdown in spring 2000.

Recently, tremors have been rippling out from Wall Street as fears about the subprime lending earthquake escalate. Of course, we're talking now about sudden capital-market shake-ups, investment bubble bursts, broad stock-market meltdowns, and various tremors and Shockwaves that can pound the financial system. The ongoing subprime mortgage bubble bust is sure to roil the earth beneath Wall Street in 2008, as well as London, Singapore, Tokyo, Frankfurt, et al. (Two million consumer US mortgages are scheduled to reset to higher rates early in 2008.)

There are other issues that could send Shockwaves to public companies and capital market interests, and 2008 has the potential to be a year filled with many metaphorical earth tremors and perhaps a few major earthquakes that will shake up Corporate America and Wall Street. Here are a few warning signs we're picking up on our editorial seismometer.

Excessive CEO compensation

Stay tuned to the still-intensifying focus in the United States on excessive CEO compensation on the part of a growing number of institutional investors and others zeroing in on the sometimes astronomical numbers of executive compensation—including finance and

HENRY (HANK) BOERNER is chairman of the Governance & Accountability Institute, Inc. (and editor and publisher of the institute's www.accountability-central.com publishing site). He retired in summer 2007 from the global management consulting practice of Rowan & Blewitt after a long career counseling boards and management of public companies. Mr. Boerner can be reached at hboerner@accountability-central.com.

business journalists, members of congress, shareholder advocates and their powerful coalitions, social critics, and academics. The debate centers on compliant boards "overpaying" executives for their "underperformance" or "unresponsiveness" in company-shareholder relations.

Given the complexity of corporate-compensation programs, board members are often unaware of the "total" compensation until the tape is run. Everyone got a better look at total compensation early in 2007 as new Securities and Exchange Commission (SEC)-mandated "Compensation Discussion & Analysis" (CD&A) narratives were published by company management. The SEC late in 2007 indicated it was unhappy with a large number of the initial CD&A disclosures. All this disclosure and increased transparency is sure to create a continuing flow of media headlines and further reveal the growing gap between CEOs and bottom-pay workers. (Journalists trumpet CEO-to-workforce ratios anywhere from 400-to-l to 1,000-to-l in their expanding coverage of CEO compensation.) As a result of all this, issues surrounding executive compensation have the potential to deliver real shockwaves to the reputations and share prices of some public companies. And perhaps topple more than a handful of underperforming CEOs—not to mention significant votes against candidates standing for reelection to their boards.

Disclosure and response: the expanding debate

The spring 2007 proxy-season maneuvering was already underway in late fall of 2006 when the first round of expanded disclosure rules for executive compensation became effective at year-end 2006; this proved too late for concerted action by shareholders in the January-June 2007 peak proxy season. But like the warning tremors occurring before the earthquake, there has been much behind-the-scenes activity throughout 2007 as both activist and more mainstream investors prepare for the 2008 proxy contests. It may be that the 2007 voting campaigns were just the warm-up for 2008 and 2009 proxy contests that will pit shareowners against executives and boards. Fidelity, Vanguard, and other major investment company advisory firms are developing new voting policies for the 2008 elections—surely something for managements and boards to be attuned to now. No "friendly votes" can be counted on as in past elections.

Keep in mind that it's not just about the cash that is paid out but all elements of escalating and "out-of-control" executive-compensation packages that are the focus of critics. Here's an early warning: Senator Carl Levin (D-Michigan) put stock options on the congressional agenda for discussion; the long-serving senator sees options accounting and its negative impact on the tax code as loopholes costing average taxpayers billions of dollars and fueling the growing pay gap between executives and average workers.

Senator Levin's Permanent Subcommittee on Investigations held hearings in 2007 and found that nine companies claimed $1 billion in stock-option tax deductions they were not entitled to. The IRS found in 2004 that US companies claimed a total of $43 billion more in stock-option tax deductions than they showed as expenses, meaning they could avoid paying billions of dollars in taxes on that year alone.

Is this a warning tremor to tune in to? Senator Levin has a bill in process, the "Ending Corporate Tax Favors for Stock Options Act" (S-2116), which could gain traction in 2008, especially if any of the major presidential candidates latch on to the "wealth-gap" issue. If enacted, the law would treat stock options as other forms of compensation and require that the corporate tax deduction match and not exceed the booked expense.

2008 proxy season

And stay tuned to the 2008 proxy season, the very public arena in which your company's individual and institutional shareholders make a lot of noise about what they would like to be changed at your company. This could include your prod-

BUT LIKE THE WARNING TREMORS OCCURRING BEFORE THE EARTHQUAKE, THERE HAS BEEN MUCH BEHIND-THE-SCENES ACTIVITY THROUGHOUT 2007 AS INVESTORS PREPARE FOR THE 2008 PROXY CONTESTS.

OFTEN, PROXY CONTESTS MOUNTED BY INSTITUTIONAL INVESTORS ARE A CLEAR SIGNAL OF A BREAKDOWN IN COMMUNICATION BETWEEN COMPANY AND OWNER.

uct marketing (think of the issues surrounding poisonous ingredients in imported toys and harmful ingredients in imported food); the debate about human rights policies in distant lands; your potential or real supply-chain vulnerabilities; the company's commitments and disclosures on climate change and global warming (we think this will be a huge issue for some companies); sales of military hardware to foreign countries; and pricing and distribution practices of pharmaceutical companies.

"Say on pay" will be an issue for many companies—it was a big issue at Verizon and Citi proxy votes in 2007. Institutional investors are discussing with issuers the more than 100 shareholder resolutions that got a majority vote in 2007—especially at public companies that didn't respond to or deal with the issues, and whose executives and board members will be seeing the crowd at the gates of the castle again in 2008.

Some companies have been voluntarily adopting shareowner-friendly policies on proxy voting: If directors do not enjoy a majority of cast votes, they may not assume their position at the boardroom table. Policies that draw fire from a majority of voters maybe negotiated to everyone's satisfaction between proxy-voting seasons. Institutions and institutional investor coalitions are becoming much more savvy at leveraging public opinion to bring about these types of changes.

Thanks to the massive adoption of index investing, institutions can't walk away from holdings in companies whose policies, practices, and behaviors they disagree with—they now prefer to see the CEO and even board members walk the plank. One major investor and consumer irritant occurred in December in Manhattan, sending tremors across the capital markets: bonus time! Even though shareholders with portfolio positions in the financial industry may end 2007 on a dismaying, losing note, the people who work with other people's money will receive an average of $200,000 each at the five biggest securities firms, according to Bloomberg News. Notwithstanding *$75* billion of equity "gone," by Thanksgiving Day Wall Street's largest houses paid record-level bonuses shortly thereafter (about $38 billion). The subprime mess helped to create what will be tremors and Shockwaves from the investment community on this issue.

As Bloomberg's Christine Harper noted in a wire story, in spite of the fact that big name, financial-investment powerhouses lost 20% or more of their market cap, this will not prevent Wall Street from paying out a total of $38 billion in bonuses; if companies didn't, they'd "lose all their good people."[1] And the impact on their investors as they hear about these bonuses? That's a story for another day—and the journalists will be playing this issue for months to come if the stock market tanks in 2008 and if financial stocks remain below 2007 levels. The optics of financial companies' traditional year-end bonus programs won't endear either Wall Street or Corporate America to voters, consumers, and investors. After all, these investment-banking firms are publicly held companies.

Also in 2008, stay tuned to your shareholders speaking—loudly! No matter what directions the contentious debate on changing federal proxy *access* rules may take, the message should now be clear to all boards and corporate executives: Your shareowners want to have effective discussion and communication with the enterprise. In response to the draft proxy access resolutions floated by the SEC in fall 2007, a record of well over 30,000 public comments were entered, most of which opposed the changes the SEC proposed for limiting shareholder access to the proxy-nominations process. No matter where the issue goes in the short term, the important takeaway for financial professionals is this: In 2008, investors want dialogue, input to the board room, more effective communication, and improved relationships with the company. Often, as our monitoring of proxy seasons over the long term demonstrates, proxy contests mounted by institutional investors are a clear signal of a breakdown in communication between company and owner.

You should stay tuned as well to important proxy season 2008 developments quietly underway as the year begins. The tremors are becoming more pronounced here—shareholder coalitions have been very busy building momentum for spring 2008 contests. Significant announcements will be coming shortly with a wide range of issues on the agenda, some attempting to link CEO pay to demonstrable improvement in corporate governance, shareowner-corporate communications, and a range of corporate social responsibility issues; there is a continuing collaboration between traditional corporate governance and socially-responsible-investor interests applying pressure on issuers. In addition, the 100+ activist hedge-fund managements are launching their own proxy challenges or supporting those of governance activists.

There are more "earthquake moments" that could occur in 2008, but let's stop here and consider that the strengths of real earthquakes are categorized and rated on the Richter magnitude scale. Though in these pages we can set out for you the tremors we now are sensing, we can't reliably rate the potential of damage to your company. What can *you* do? The key to surviving crises is usually preparing in advance, arming yourself with knowledge, and maintaining a cool head.

Conclusion

Keep in mind that most earthquake damage occurs *after* you have felt the advance tremors. You can monitor and closely track the warning signs so that you are prepared to deal with tremors and aftershocks of tectonic plates crashing if the markets experience a major quake in 2008 that affects your company. This is especially important if your company is or continues to be a proxy-season target for activists. The Year 2008 could be quite a year of upheaval for the financial profession. •

NOTE

1 C. Harper, "Wall Street Plans $38 Billion of Bonuses as Shareholders Lose," Bloomberg News, available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ahE8xVisWsbE.