FORCES SHAPING THE FINANCIAL PROFESSIONAL'S WORLD

Corporate and capital markets finance professionals correctly sense that their professional lives are often buffeted and their practices shaped by larger, outside forces. Financial executives quickly feel the effects of social trends and public policy-making emanating from the intersection of politics, government, media coverage, and institutional investor activism. These forces are the most impactful outside "issue shapers and movers," and their influence on financial reporting and accounting practices today is considerable.

In the United States, over the past four years — coinciding, with unfortunate timing, with the administration of President George W. Bush, which began in January 2001—financial professionals have been directly affected by such events as:

- The collapse of once-mighty publicly owned corporations (Enron, WorldCom), and the instant decline in investors' trust and confidence in many other public companies;
- The prosecution of prominent chief executive officer (CEOs) of public companies (Tyco, Adelphia);
- The passage of sweeping federal legislation in summer 2002 (Sarbanes-Oxley or SOX) expanding and updating the securities and investor protection framework;
- Increased criminal prosecution of and penalties for corporate officers;
- The adoption of implementation rules for SOX;
- The collapse of the bull market of 1994-2000, particularly the "Tech Wreck" for many high-technology and Internet stocks;
- Thousands of shareholder lawsuits filed against corporations and investment banking firms by plaintiff bar;
- Increased activism by the institutional shareowner community, especially public employee and labor union pension funds;
- Increased focus on disclosure and transparency (complicated by advances in technology that strip away barriers to once-confidential corporate information);
- The consolidation of the banking and financial services industries (with repeal of the Glass-Steagall Act of the 1930s separating the two);
- Increased demand for fully independent boards of directors;
- The demand for separation of chair and CEO posts;
- New accounting industry oversight through the SOX-mandated Public Company Accounting Oversight Board (PCAOB);
- More independent board audit committees, which are directly hiring outside auditors, and to whom chief financial officers (CFOs) are now often reporting; and
- The aftermath of the September 11, 2001, terror attacks.

Red vs. blue nation

During this presidential election year in the United States, some issues will inevitably serve as campaign fodder. But how many of the reforms ultimately adopted, or the changes and practices imposed or voluntarily adopted, are really politically driven? Just how much public sector response to contemporary events, such as those described above, is appropriate? Most importantly: how long-lasting will the reforms be?

The answers are not readily available for the financial professional. So, one must add greater understanding of political and social

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sciences to the corporate professionals' portfolio, it would appear, to divine where the winds of public opinion may take financial reporting next! In this context we offer the views of two thought-leaders who have recently shaped aspects of the daily work of financial professionals. There views may help as you contemplate what changes may be ahead in your daily lives in finance.

SEC: top cop for finance... challenged

The U.S. Securities and Exchange Commission (SEC), the regulatory "cop on the beat" for public corporations and capital market organizations, has had three chairs during the critical 2001 to 2004 period: Democrat Arthur Levitt, a former investment banker, later chair of the American Stock Exchange, turned populist reformer at SEC after appointment by President Bill Clinton; Harvey Pitt, a moderate Republican lawyer for public corporations and Wall Street firms who succeeded Levitt (he was appointed by President George W. Bush); and present chair William Donaldson, former chairman of the New York Stock Exchange (NYSE) and a leading Wall Street presence for most of his career.

Each of these individuals has been buffeted by the same forces indicated above. Each has reacted differently in policy making and enforcement policies. All argue that they have been proactive and aggressive on the issues and that there are limitations to their power.

A fourth player, some would argue, has had an even more long-lasting influence on the capital markets and financial services industries: Democrat Eliot Spitzer, the elected New York State Attorney General. Wielding the power of media exposure and state laws that often precede 1930s federal securities legislation, Mr. Spitzer has wrought massive change—at least for now—in investment banking, financial analysis and research, mutual fund management, and, more recently, the insurance industry.

It is certain that the actions of these four powerful players have been directly shaping the world of corporate finance in recent years, and the aftereffects could be long-lasting.

State-level crusader Spitzer. Everyone in finance knows of the highly publicized prosecutions by New York Attorney General Eliot Spitzer, first elected in 1998, of investment banking organizations that resulted in a landmark $1.4 billion settlement with the top ten Wall Street firms. Then, when an investment management insider brought Mr. Spitzer information on certain mutual fund trading practices (such as condoned late trading), prosecutions began and the repercussions were far-reaching (and continue at this writing). The mutual fund industry will pay millions to investors in fee reductions and other measures. Some of the prosecutions were criticized as "headline-hunting" forays by an elected official. Despite the "protections" offered by the investigations, they were not without criticism.

In spring 2004, Mr. Spitzer began consciously setting out an intellectual framework for his prosecutorial crusades. This may have been in reaction to criticism that he was headline-hunting in his ambitious prosecution of investment banking and mutual fund industry practices, but also because "the work is far from done," as he explained in a university lecture, "and it is important that the role and actions of government be fully understood to ensure a truly free and efficient capital marketplace." That is especially true for finance executives.

Explained Mr. Spitzer: "I am focusing on making the marketplace more efficient, recognizing there must be a balance between free markets and free enterprise and government intervention, and what some might say is meddling. I am striving for the middle ground, with some government involvement but with events more driven by marketplace forces creating reform. But, when the marketplace fails to police itself, then government must intervene."

Intellectual framework—important to understand. The framework: first, he argued, government must help enforce the rules, especially those intended to create more transparency in capital markets. Only government can ensure evenhanded enforcement of the securities rules. Mr. Spitzer made it clear that this is not an issue he will step back from, despite any criticism.

Second, government must look at the externalities, the plusses and minuses that are or are not captured in the price of a transaction, and make sure there is fairness and equity. (This rationale is the underpinning of a separate litigation involving utility companies in midwest states for polluting New York state in the form of acid rain carried on the winds eastward from 1,000-foot tall stacks in Ohio and other states.)

Third, where there are important societal values at stake, government must step in. Think of child labor; the understood societal value here is that young children should not work in factories, and so government creates the rule and then enforces it because society has deemed such a rule to be an embodiment of its values. The same could be said for civil rights laws. Even if conditions such as blatant racial discrimination exist, usually markets left to themselves do not focus on these types of values. So government must.

But, Mr. Spitzer insisted, "Above all, we in the public sector must be careful not to over-regulate and re-regulate those industries that public policy shaped by consumer demand for change has moved out of tight regulation, such as airlines, financial services, the energy markets, and others."

"We are experiencing a *crisis of accountability*, among all institutions in our time, including financial services organizations, not-for-profits, religion, media and even the public sector," he explained. "Think back to the brilliant deduction of [the late] New York Senator Patrick Moynihan, who described 'defining deviancy down,' and the broken window theory. Small offenses build over time. We grow lethargic, lazy, and fail to enforce boundaries, or right and wrong. We don't enforce regulations. Broken windows not attended to will invite larger crimes."

That theory could be applied to the 1990s, he stresses, when the stock market was booming. Superficially, we all had it very good. Special purpose entities (SPEs)? Maybe one here or there on the books, and so what, people asked. Soon we were on a slippery slope—dozens, and then hundreds were created, then came Enron's implosion with many SPEs containing off-the-books debt. "Now," said Mr. Spitzer, "we must re-establish rules . . . and deal with individual broken windows as well."

A wake-up call to corporate America. Eliot Spitzer sees the events of 2000 through 2004 as a clear wake-up call to corporate America."What we experienced was a 'perfect storm' of corporate governance failure," he said, referring to the events of the summer of 1991 when three powerful storms converged in a "perfect" meteorological event in the North Atlantic, wreaking unprecedented havoc on fishing and shipping vessels.

There is progress being made, in Mr. Spitzer's view: "Now, institutional shareowners recognize their fiduciary responsibilities and are engaging corporations in dialogue and getting involved in public policy debates, such as the many reform measures adopted."

"But, not all are hearing the wake-up call; in March, 43 former CEOs signed an ad sponsored by the Business Roundtable challenging the SEC's proposed rules on shareowner nominations for boards. They apparently don't get it; shareowners own the company!"

Mr. Spitzer is also focused on executive compensation, the major issue of the 2004 proxy season, noting that in the 1980s, the ratio of CEO pay to that of the lowest paid workers in the same organizations was 43-to-l. By 2002, the gap had soared to 531-to-l, with options included. CEOs must recognize their own fiduciary responsibilities to owners and employees. Mr. Spitzer is bringing action against former NYSE chairman Dick Grasso to attempt to recover some of the compensation granted by the board of the NYSE (New York's Attorney General has oversight of New York's nonprofits, which, after an early 1970s reorganization, include the NYSE).

Mr. Spitzer conducts his public crusades against investment bankers, federal bank regulators (on "preemption" issues), the insurance industry, and mutual fund advisors in the context of two major forces that are converging and often create conflict:

1. Increased concentration in the financial services industry, including ever-larger combinations of banks and brokerages (Mr. Spitzer cites the Citigroup model—*large and getting larger*—and sees continuing consolidation and concentration of power on a global basis, one reason for Con-

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gress's repeal of the Glass-Steagall Act); and

2. Continuing democratization of the markets, creating a clash between the 100 million Americans now participating in the equities markets through direct investment and mutual funds, IRAs, 401(k) plans, annuities, and other vehicles, and the universe of ever-larger financial services organizations.

How to reconcile the conflict? "We need to reinstill a sense of duty to investors or the big and bigger model will not work. I think we have lost the understanding of fiduciary responsibility to the investor. It is much easier to think in terms of fee generation."

The question is not whether there is a permanent "fix" from the attention, statutes passed, regulatory oversight, and more zealous prosecutions, but, says Mr. Spitzer, "for how long?" New types of punishment will be sending shock waves through the corporate community. New sentencing guidelines will mean longer and harsher imprisonment for corporate criminals.

NEW TYPES OF PUNISHMENT WILL BE SENDING SHOCK WAVES THROUGH THE CORPORATE COMMUNITY.

The $1.4 billion settlement with Wall Street's top ten investment bankers did not "hurt," in the financial sense, but it did send a strong signal that change is needed. The mutual fund industry settlements had much more financial impact on advisor companies. .. and for a much longer time, looking ahead to the future costs to advisors of settlements and new regulations coming from the SEC.

Can these types of reforms — and prosecutions—go too far? Mr. Spitzer said the answer would be known at trial, where today about 85 percent of charges result in convictions. But the response to wrongdoing can indeed swing the pendulum too far. "If you ask around," he said, "you will find that smaller cap companies are facing higher costs and higher thresholds under SOX and may find themselves shut out of the capital markets. Even some federal lawmakers would rewrite some portions of SOX, which after all sped through the system to enactment in two months."

But as for mutual funds, Mr. Spitzer's message to advisor CEOs and boards is this: You could have prevented all of this. For too long, as issues were raised about fund practices, or the need for greater oversight, the industry trade associations were strong voices of opposition to virtually any new measure.

Setting out the framework for debate. In an article he recently coauthored for the *New Republic,*[1] Mr. Spitzer wrote: "Two essentially opposite viewpoints dominate today's debate: Those who see market capitalism, loosely regulated and unencumbered by the artificial interventions of government, as perfection. And those who argue that, as miraculous as the capital experiment has proved to be, free markets cannot be left unchecked."

Markets must be protected from their natural tendencies toward excesses that lead to monopolies and unfairness, and government must put the brakes on capitalism to protect the public from market forces through the power to tax and regulate. Most important: the proper role of government is to be market facilitator, to ensure that markets run clean and smooth.

In some parts of the article, the reader sees the *blue and red nation* arguments, "blue and red" being the states that voted Democrat and Republican, respectively, in 2000. Mr. Spitzer, a Democrat believed to be a candidate for New York governor in 2005, criticizes the inaction of the Bush administration to protect the markets.

Mr. Spitzer also advances the very important issue of transparency and its impact on investor choice. More transparency is being achieved through disclosure requirements, such as the SEC's Regulation FD; removing institutional barriers and abuse; and widely accepted rules of conduct. These he sees as longer-term impacts of reform.

The views of former SEC chair Harvey Pitt

During his time as SEC chair, Harvey Pitt was often at odds with Eliot Spitzer. When the Bush administration gained control of most senior federal government posts, Arthur Levitt departed and Harvey Pitt assumed the SEC chair. He had been a staff lawyer in the SEC early in his career, had a distinguished career with the Fried Frank law firm (mostly defending corporations and

Wall Street firms), and brought to the SEC a significant level of experience, expertise, and knowledge about the capital markets and securities regulatory framework.

During his tenure as the 26th chairman of the SEC, Harvey Pitt found himself criticized by members of Congress, various media outlets, shareowner activists, and others for a perceived lack of aggressiveness in addressing the "perfect storm" of events occurring on Wall Street and in corporate suites. As public criticism reached a fever pitch, Chairman Pitt resigned his post. He now notes: "On my watch, we passed more new rules in a month than many other chairmen passed in their entire tenure. But it was increasingly difficult to get the message out and the political backbiting did not stop. I thought it best for the agency that I step down."

Today, Harvey Pitt heads the corporate governance consulting organization Kalorama Partners in Washington, D.C. Not long ago, he set out his views on recent events in a college distinguished lecture setting.

"Three years of reporting on the scandalous behavior of companies, institutions and individuals has created a feeding frenzy for business bashers," he observed. "And that created a significant loss of confidence by investors. It also brought pressure on government to overregulate, legislate and prosecute. Time will tell what the lasting results will be."

Pitt offered five cautionary tales for the financial professional to monitor for long-lasting effects:

1. Boeing, where the CEO resigned and SEC investigations of government contracting activities are underway;
2. Royal Dutch Shell, whose previously reported reserves of oil are now in question;
3. Walt Disney Company, where 43 percent of shareowners withheld votes for former Chairman Michael Eisner in spring 2004;
4. The NYSE, standard-setter and self-regulating organization (SRO) for listed companies and member firms, which is having serious problems with its own governance (all but two former directors have been forced out, and the board apparently did not know how much the former chairman was being compensated); and
5. Putnam Funds, which, though asserting to investors that certain trading practices were not allowed, came under federal and state prosecution for those same practices and was found to treat large and small investors very differently.

"In these and other examples, we see CEOs being removed from office, and the emerging pattern of companies being fined, new rules being enacted, and executives eventually being prosecuted. There have always been corporate scandals," Mr. Pitt observed. "What made the 1990s excesses different is this: there was a false illusion of value [underpinning share prices] that made the investor losses stunning; some executive conduct was shockingly evil; and this is not just about behavior in the United States, but is now affecting global companies as well."

Speaking from his own experience at the SEC, Mr. Pitt observed that being a gatekeeper or regulator in this environment is "as uncomfortable as being an executive in an investment banking organization, or in a large corporation." What's ahead? The issues will be swirling well beyond the November 2004 elections, he believes. The financial press, for example, is primed now to report bad behavior in "nanoseconds," and Congress reacts to bad news just as quickly. The story line too often has been: *Business is run by insensitive, unthinking, selfish men and women.*

HONEST BUSINESS LEADERS MUST STEP UP AND BE COUNTED.

Honest business leaders must step up and be counted, Harvey Pitt suggested. "If we let government set the standards, God help us all," he stated. "The pendulum is swinging too far [toward reform] and the danger is that we could have useless, counterproductive financial reporting measures adopted."

The problems of the 2000-2004 era were not about compliance: "Much of the misconduct was illegal before Sarbanes-Oxley (SOX) was adopted." Why do the majority of people (then) do the right thing? Mr. Pitt offers these explanations:

- Most people were raised with ethical standards and know the right thing to do, which is also true for the majority of executives;

- Most people have a fear of getting caught and punished; and
- Most important, it is in [the executive's] own self-interest to obey regulations (for example, if an auditor's client is in trouble, the auditor will suffer as well).

Harvey Pitt's rules to stay on the right path. Finally, Mr. Pitt offered this checklist for corporate leaders who wish to avoid being featured in the wrong type of story on page one of the *Wall Street Journal:*

- **Rule 1:** It is not just happening to *them;* it is also happening to *us.* ... we are all affected by tales of corporate wrongdoing. You are not isolated from the problems.
- **Rule 2:** Lawyers used to say, "Don't go looking for problems." No more. Executives, go and look! Know for yourself.
- **Rule 3:** The skills a director needs are not innate or inherited; learn, educate yourself, and educate your board.
- **Rule 4:** Don't treat your shareowners as the enemy; maintain contact and conduct dialogue.
- **Rule 5:** Have a sound system of internal controls, especially a strong internal audit to catch problems before a crisis.
- **Rule 6:** Seize the moment. Use SOX to create state-of-the-art systems for catching complaints (beyond internal controls). Know that your employees must have an outlet for lodging complaints, probably an outside mechanism, or they will take problems outside in a public way (a real challenge: in 35 years, Pitt said he never saw an internal system he would want to take a problem to, primarily because of lack of confidentiality).
- **Rule** 7: Appearances matter. Ask yourself: *Are we doing better? What are our competitors doing?* Know what the outside perceptions are.
- **Rule 8:** Transparency is critical. Outsiders want to know about problems early. Don't wait for the crisis moment to determine what to tell them. Companies that do this usually don't survive.
- **Rule 9:** Reward senior managers for doing the right thing. Align their interests with shareowner interests. Base compensation on instilling the right values.
- **Rule 10:** If you were a shareowner, *what would you want to know?* Give your owners this kind of information.
- **Rule 11:** During a crisis, it is too late to prepare. You only have the time before the crisis to prepare. And regulatory response today is more rapid than in the past.
- **Rule 12:** In a crisis, you will have a short window during which to disclose. Your rule should be disclose, disclose, disclose . . . before the window snaps shut.

Finally, *always do the right thing. . .* and be able to prove that you did. You know what the right thing is.

Summer politics, November elections

As we enter the summer months, the U.S. presidential race will heat up. Both major political parties will have their platforms before the American public. Implementation of SOX-mandated rules will continue. Eliot Spitzer will continue his investigations and prosecutions. The news media will remain focused on corporate and Wall Street behavior. "Red and blue" arguments and agendas (partisan views) will be brought to bear on any suggested reforms for corporate America or Wall Street . . . and a fair number of contemplated reforms are on the table.

In May, SEC Chairman William H. Donaldson sent this writer a fulsome package regarding sweeping reforms he has proposed to "help us regulate and enforce the laws that assure fair and orderly markets." He called our attention to proxy voting reforms, discussions on security holder director nominations, and various corporate governance best practices being encouraged or mandated.

As reforms are debated, all of the issues touched on in the foregoing will be of greater importance to corporate financial leaders in their daily professional lives.

NOTES

[1] E. Spitzer and A. G. Celli, Jr., "Bull Run," *New Republic* (March 22, 2004): 18-21.