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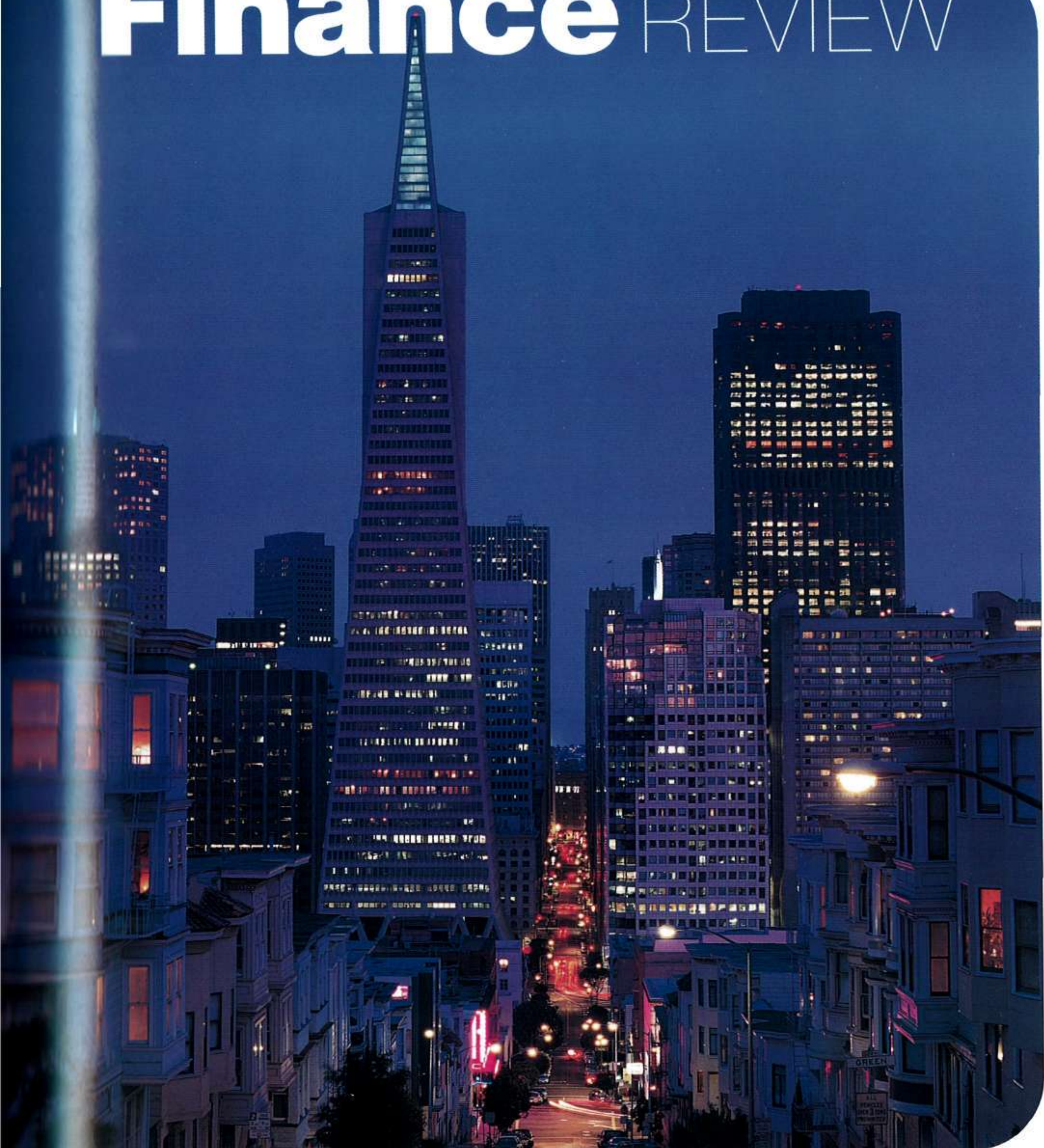

Our Perception of Risk

Predicting Distress for New Public Companies

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Research on Financing Efficiency: Evidence From China

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HANK BOERNER

CORPORATE GOVERNANCE

SHAPE-SHIFTING: DRAMATIC CHANGES IN THE CAPITAL MARKETS

In popular folklore and mythology in almost every culture we find tales of mysterious creatures capable of changing physical form or shape — "shape shifters," the ancients dubbed them. Such legends live on today. Shape shifters are capable of making major alterations to their general appearance.

Sometimes it seems as though shape-shifting is becoming a dominant theme in today's capital market trends—with some of these metamorphoses, it's hard to know if we are looking at something real and substantive or something metaphorical or hypothetical. It could just be a theory floated about, the beginning of a trend, or the end of an era.

During the last months of 2007 and first months of 2008 there were a number of potential shape-shifts, and you can figure out for yourself if these were fantasies, the beginnings of myths, or reality. Perhaps only time will tell. Some say the most important thing about shape-shifting is whether it is voluntary or imposed.

The Federal Reserve: shape-shifting in earnest

The big news in commercial and mortgage banking, capital markets, and regulatory news is the subprime credit crisis, or "mortgage meltdown," that began in the United States and soon swept through capital markets around the globe. Commercial banks and investment banks for months have been announcing billions-upon-billons of dollars in nonperforming or underperforming assets, reserve set-asides for bad loans, write-offs and write-downs, and more. The total tab could exceed $500 billion or more before we are out of the crisis.

The shape-shift here was originally triggered, we submit, by the 1999 demolishment by the federal government of the seven-decades-old protective barriers that existed between depository institutions (banks and thrifts) and the investment banking and brokerage organizations. The Glass-Steagall Act, a Depression-era law, eventually became an anachronism according to market players because in the global marketplace "financial supermarkets" would rule the roost. Thus large banks — Citibank, Bank of America, Chase — could combine with major Wall Street houses to create the holding company supermarkets of the future, such as JPMorgan Chase. The numerous bank/bank holding company consolidations that took place from 1995 through 2002 were important shape-shifts that set the stage for the credit crisis of 2007-2008 (and beyond?).

The Federal Reserve System was established in 1912 and structured over the years, among other things, to assure safety and soundness in commercial banking. And its shape-shift: The Fed stepped in to ensure the soundness of the entire capital market by setting up conditions for a supermarket (i.e., JPMorgan Chase) to acquire the damaged assets of one of the market's largest brokerage players, Bear Stearns. "Fed Rescues Wall Street," the newspaper headlines read. In essence, the central banker assured the capital markets that it would step in to support the mortgage investment pools (mortgage-backed obligations) that Bear Stearns had packaged and peddled to investors in the US and abroad to pre-

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vent a domino-effect of defaults. (The Fed's commitment was up to $30 billion in this transaction. Soon after, $100 billion was made available in loans to cash-strapped banks via auctions.)

Bear Stearns would be shotgun-wed to JPMorgan Chase at a fraction of the company's share value just days earlier, although that transaction is still not completed. Did the Federal Reserve intervention in investment banking and brokerage represent a shape-shift for the central bank? Did the Fed decide to bail out risky players? If the mortgage crisis deepens, if more depository institutions get in trouble, if more investment pools fail—if, if, if—the Fed may very well have shape-shifted into an entirely new kind of surety agency for the capital markets. For better (saving the markets from themselves) or for worse (assuming the risk for nondepository institutions).

Reregulating the US capital markets

Secretary of the Treasury Henry M. Paulson is a Wall Street man — he was a former partner and leader of the powerful Goldman Sachs organization before he went to Washington to assume one of the most important cabinet posts. There's an old tale the tour guides tell as you circle the sixteen-acre compound that is the White House grounds: The President's House (the name of the White House for many years) is right next door to the Treasury building so that the head of state can keep an eye on the money and the Treasury people. But since most of the Treasury leaders come from Wall Street, perhaps there is in reality an interesting form of public policy shape-shift here as well: The Treasury secretary is leading the Bush administration parade and keeping an eye on the head of state for the capital markets! It seems this may be the case, anyway, given the bold pronouncements by Secretary Paulson regarding the future state of regulation of banking, capital markets organization, and other matters.

The US Treasury's "Blueprint for a Modernized Financial Regulatory Structure" spells out recommended short- and long-term restructuring of capital markets and banking systems. "Our challenge," Secretary Paulson commented, "is to thoughtfully evolve to a more flexible, efficient and effective safety and soundness regulatory framework."[1] Would this be akin to hanging out a window to change a flat tire on a speeding car, given the ever-changing crisis conditions and the "financial meltdown" we are experiencing in spring 2008?

This really would be a major shape-shift if all or major parts of the framework were enacted. Among other things, there would be a new federal commission for mortgage origination to protect consumers; the President's Working Group on Financial Markets would be upgraded; and the Federal Reserve's "liquidity provisioning" (read: market bailout) would be "clarified." A "top cop" might oversee all financial regulations (vs. the patchwork of today's various "cops" overseeing different parts of the financial system).

A whole new regulatory structure could emerge if Secretary Paulson and others drive the reform process to success. This is a continuation of the initiative begun in 2007 and outlined in a prior issue[2] to roll back Sarbanes-Oxley and other reforms launched at the Conference on US Capital Markets Competitiveness convened by the secretary. The kinds of reforms considered were published in the Federal Register in October 2007, prompting hundreds of letters to flow in, noted the Treasury.

While many details are still forming, if adopted these types of reforms would be a major shift in the shape of securities and banking regulations, the most important in seventy years.

ISS says no to AT&T management

The corporate proxy voting season of 2008 — peak vote-casting season is April-June, but proxy voting continues to year-end—was being shaped by shareholder activists and other events as early as the end of peak season 2007, as voting outcomes from last year's contests were being examined. A number of observers have been saying for months now that the 2008 votes, while as numerous in number as in 2007 and prior years,

THE CORPORATE PROXY VOTING SEASON OF 2008 WAS BEING SHAPED BY SHAREHOLDER ACTIVISTS AND OTHER EVENTS AS EARLY AS THE END OF PEAK SEASON 2007.

were best seen as a preview of what is to come in 2009. The proxy battles of 2009 could be the most dramatic in years, as shareholders and their advocates and coalitions square off against corporate executives and boards.

SHAPE-SHIFTING IS BOTH REAL AND METAPHORICAL IN THE U.S. CAPITAL MARKETS.

In terms of shape-shifting, for three decades the increasing focus by activists and advocates on the corporate ballot box to effect change in the boardroom and corporate suites were found in two main streams of thought: (1) the focus on corporate governance issues and (2) the focus on social and environmental issues. There were usually separate and distinct players for each set of issues and different tactics employed, with not too much crossover or cooperation.

Over the past five years, however, there was an important shape-shift: these two streams came together to form a mighty river of change, speaking metaphorically, with a focus on a more common approach: analyzing the company's record on environmental, social, and governance (ESG) issues. Based on numerous conversations this writer has had with US corporate managers and board members, there is still a lagging awareness and acceptance (or at the least, acceptance) of the importance of this merging of shareholder interests, and the power of forces for change behind the owners' focus on ESG. This is not true for European Union managers we speak with; they are more familiar with and more comfortable with shareholder focus on ESG. But ESG is going to loom large in 2009 proxy contests in the US, we predict.

Sometimes a powerful shift in attitude triggers massive change. RiskMetrics—owners of Institutional Shareholders Services (ISS), which typically focuses on traditional corporate governance issues (board composition, election, etc.)—embraced the philosophical importance of the board of directors' oversight of political contributions made by the company and the disclosure of such contributions. Here is a critical shape-shift: For the previous three voting seasons, ISS opposed shareholder-sponsored resolutions that called on AT&T to disclose contributions to political parties and individuals running for office and to have the board oversee this activity. ISS reversed this position in 2008.

Now ISS, the largest of the corporate governance rating entities and a major player in proxy voting, Domini Social Investments, and the Center for Political Accountability, a nonprofit and nonpartisan advocacy group that works to bring transparency and accountability to corporate political spending, are calling on AT&T to disclose its political contributions.

Whereas in the past ISS had resisted being involved in such social issues, now it is effectively saying, "Shareholders have a right to know how the companies they own are exerting political influence. This information has been kept from investors—and the broader public—for far too long. If Verizon can disclose this information, why can't AT&T?"[3] (Verizon agreed in 2007 to report annually on political contributions after Domini filed shareholder resolutions for three consecutive years on the issue.)

And we see ISS/RiskMetrics repeatedly using the terms "accountability" and "greater transparency" in its discussions of corporations: these are important "shift" terms, linking governance and social issue advocates in the public dialogue on proxy issues. Corporate executives and boards should not underestimate the important shape-shift that occurred here.

This shift takes place as the tally for socially responsible investment (SRI) in equities continues to rise: From 2005 to 2007, says the Social Investment Forum, professionally managed SRI funds rose 17% in assets to $2.71 trillion total, in one or more core strategies: screening (negative and positive), shareholder advocacy, and community-based investment. These findings clearly define one of the two "streams of thought" above (social and environmental concerns).

Public pension funds and divestment

The public employee pension fund managers in the US oversee $3 trillion plus in assets, and a good number of these funds have been active players in both corporate governance (CalPERS) and social investment (New York City funds).

More than twenty states have passed laws compelling public employee pension funds to divest from companies doing business in or with, say, Iran or Sudan.

Now, an important shape-shift may be taking place: While a number of state legislatures have considered draft bills that would force the funds to divest from companies doing business with certain states, most fund trustees oppose the handcuffs that would be put on them. With markets in turmoil over the credit crisis, there is shape-shifting in state capitals. Some legislators, governors, and fund leaders are maintaining that while well-intentioned, such bills could add even more costs to pension fund overhead and reduce flexibility for investing even as market returns have gone negative. Beneficiaries won't like that! And focusing on social issues could violate in some way the fund managers' fiduciary responsibilities to generate the best return on investment. This bears watching as the shape-shifting is still going on—violence against the US originating in a target country will create broad public support for this type of divestment.

Summing up, shape-shifting is both real and metaphorical or allegorical in the US capital markets. Sometimes major events, positioned as important changes in investor attitudes, fizzle out. Other times a real shifting in actual shape takes place — as might happen if the secretary of the treasury and other market players can bring about "modernization" of the financial regulatory framework. Watch the events outlined here, along with others, and decide: Did the mythical and mysterious "shape-shift" take place? ■

NOTES

[1] US Department of Treasury, "Remarks by Secretary Henry M. Paulson, Jr. on Blueprint for Regulatory Reform," March 31, 2008.

[2] H. Boerner, "The Anti-Sarbanes-Oxley Movement: Have Corporate Governance Reforms Gone Too Far?" *Corporate Finance Review* (Vol. 11, No. 6, May/June 2007): 39-43.

[3] Center for Political Accountability, "Key Proxy Advisor Recommends Vote Against AT&T Management on Political Contributions Disclosure," April 21, available at Accountability-Central.com.