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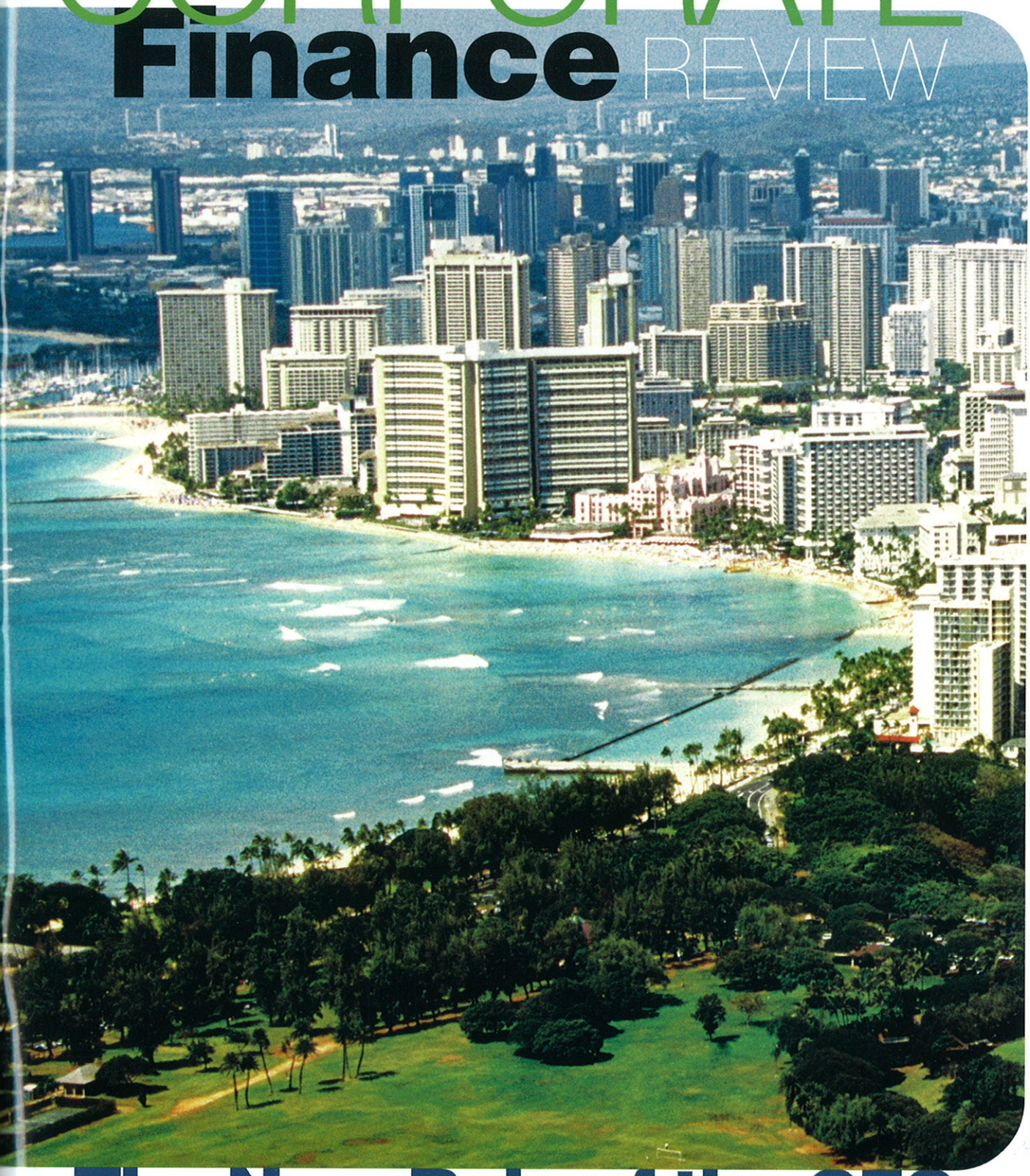

The New Role of the CFO

A Framework for Setting Financial Objectives

The Future of Capitalism

Globalization Enters a New Era

WILL PUBLIC OUTRAGE DRIVE REGULATORY REFORM?

Capitalism is all about evaluating and balancing risk and opportunity to seek maximum return on investment. The process is straightforward, or should be: The issuer's shareholders elect members of company boards to oversee management—and presumably oversee strategies and risk-taking—and to represent their interests as the board carries out its duties. Boards appoint the "chiefs" (chief executive officer, chief financial officer, et al.) to manage but not micromanage the enterprise day-to-day, and to be ready to step in to protect the owners. Things don't always work out quite that way.

In the wake of the turmoil in the US and global capital markets, public outrage at the failures of both managements and boards of large enterprises (including those "too big to fail") to manage risk is understandably rising and elected officials and investors—and voters—are demanding reform of the vast investor protection and financial and banking oversight frameworks and machinery in the USA and in other developed economies. Was there not enough financial services regulation in place? Were the federal regulators charged with maintaining order and assuring compliance in financial services and banking asleep at the switch? Were regulators pulled back from enforcement by political forces? What do we do about this? Such are the questions as the public sector debate continues and suggestions for new or enhanced financial and banking regulations are aired.

In the United States, this is serious business: Some $7 trillion or more in investor wealth went missing following the recent collapse of the markets due to the following: investors' and traders' appetites for the auction rate securities market disappeared; credit default swaps that were cleverly positioned as a type of "insurance" on highly-leverage investments by marketers AIG and others; mortgage-backed securities obligations; collateralized debt obligations; and several other exotic and risk-prone financial instruments.

Investor and voter reaction—the phases of reaction to loss

The long slide of the equity market into negative territory after years of positive results for many investors steadily brought on the emotional roller coast ride of the five stages of grief and loss as set out by author Dr. Elisabeth Kubler-Ross.[1]

These are *denial, anger, bargaining* (or *reality adjustments), depression,* and finally, *acceptance*—not always occurring in that order, but experienced for the most part by many humans after a great loss. Judging from the news media coverage of 2009 and early 2010, the *anger* phase is reaching its peak for many individual and institutional investors (and voters who sent members of congress to Washington), even as the equity markets are recovering much of the portfolio losses of late 2007 and early 2008.

How would you describe the public reaction to a market in which the largest bank in the United States, Bank of America, becomes a small-cap stock? Bank of America shares plummeted to $2.53 from a high of $55.00 in the five years from 2005–2009, a 70% loss from mid-year 2007 to early 2009. Most likely, the first reaction would be denial, and then *anger*

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AS EIGHT MILLION JOBS HAVE DISAPPEARED IN THE MARKET COLLAPSE ON MAIN STREET, ELECTED OFFICIALS AND VOTERS VOICED THEIR ANGER AT WALL STREET.

as the investment statements arrived showing month-after-month declines in net worth.

Disbelief might apply in an environment where the largest American automaker, General Motors, files for bankruptcy protection, wiping out shareowners' interest, and where venerable Wall Street "names" such as Bear Stearns and Lehman Brothers disappeared literally overnight. And where the largest and presumably well-financed names lined up to receive hastily conceived federal bailout funds.

There are many ways investors have characterized the crisis and its effects on their assets—*calamity, debacle, disaster,* due to *reckless behavior* and *unaccountability* by those entrusted with their assets. And on an increasing basis, a public consensus is forming, with this construct: These events came about because of the risky behavior of corporate boards and chiefs; because of the Federal Reserve making too much easy money too available for too long; because of certain federal regulators (SEC, FDIC, OCC, and others) relaxing enforcement of existing regs; because many borrowers abandoned good sense to take on too much debt, in particular real estate mortgages that they could not afford; and because too many investors forgot that no investment is a "sure thing," and that bubbles eventually burst, with unfortunate results for everyone.

These characterizations in some cases may be over-simplifications of the underlying causes and the facts on the ground—but the popular wisdom now is that "something must be done" to prevent "this" from ever happening again, and that the "guilty" (whoever they may be) must be punished. And so the American political scene is an arena of contested ideas about what must happen next. There is an oft-quoted (and probably apocryphal) story about the creation the two houses of the US Congress. Thomas Jefferson asked George Washington why he favored creation of two houses of the national legislature and Washington answered Jefferson, "Why do you pour your coffee in the saucer before drinking it? To cool it down." That is what the upper house is intended to do, and so in 1787 the US Senate was created and today is living up to its reputation.

Say-on-pay—anger, acceptance, perhaps resolution

Reacting to rising public outrage, especially at the size of bonuses awarded by financial services companies receiving federal bailout and rescue funds, members of the House of Representatives acted. Known as the "House of the People," members passed a bill on July 31, 2009 that would (1) require public corporations to schedule advisory (nonbinding) votes on executive compensation, and (2) give federal regulators new powers to limit corporate executive compensation that seemed onerous. The bill was referred to the Senate for passage of a companion piece where the debate continues with no action taken yet.

In the interim, the Wall Street names granted $20 billion in 2009 bonuses to their staff, an increase of 15% over 2008, a significant portion of the $50 billion in profits generated in 2009 by the large financial services supermarkets. As eight million jobs have disappeared in the market collapse on Main Street, elected officials and voters voiced their anger at Wall Street.

Voluntary approach to reforms by owners and issuers

The "say-on-pay" approach was proving very popular with people as 2010 began, and especially among a growing number of activist institutional shareowners. Not waiting for federally imposed mandates, more than fifty US companies have voluntarily adopted say-on-pay voting provisions—many under pressure from their owners or internal and external asset managers that the owners entrusted with portfolio management.

A coalition of institutions came together in 2007 on the executive compensation issue, comprising public employee pension funds, organized labor pension and investment funds, asset managers, foundations, faith-based investors (such as religious denomination funds),

and socially responsible investment mutual funds and asset managers.[2]

The first say-on-pay shareholder-sponsored resolutions were filed in recent annual proxy campaigns; by 2008, with Aflac (insurance) setting the pace, six companies voluntarily agreed to hold an annual advisory vote (not waiting for congressional action). By 2009, the number of corporate adoptees totaled nineteen companies. As the 2010 proxy season approached, more than fifty companies have agreed to hold such votes. (All public companies receiving TARP monies are required to hold the vote.) So far for spring 2010 elections, there are more than seventy proxy votes scheduled on the issue and more are expected as the annual meetings progress.[3]

In 2009 more than seventy-five say-on-pay shareholder resolutions came to a vote, averaging more than 46% support, with twenty-four majority votes achieved. This followed the 2008 proxy season, with seventy-five shareholder proposals (average 41% support and eleven majority votes). And in 2007, the first year's effort, more than fifty shareholder proposals averaging more than 42% support with nine majority votes registered.

"Corporate boards have a primary responsibility to their shareholders," noted Connecticut State Treasurer Denise L. Nappier, an activist investor. "That includes getting input from shareholders on how well the company's executive compensation ties pay to performance. The fifty companies deserve credit for listening to their owners," she concluded. Treasurer Nappier's state is home to a number of large insurance companies, including Aetna (AET) and The Hartford Financial Services Group (HIG).

One of the primary organizers of the coalition is Timothy Smith, senior vice president of Walden Asset Management (a unit of Boston Trust). Here is his observation on the momentum building for voluntary adoption of say-on-pay: "It's been a natural evolution for companies to embrace a relatively new idea like say-on-pay. But now we are reaching a tipping point. Less than one year ago only a handful of companies adopted the vote; now more than fifty have agreed to do so, with more stating a higher comfort level with this concept."

In announcing the decision of the board of directors of Colgate-Palmolive Company on February 26, 2010, company Chief Executive Officer Ian Cook said: "By providing shareholders with an advisory vote in 2010, Colgate continues its long-standing commitment to good corporate governance." Colgate will continue to monitor developments regarding the advisory vote, including pending legislation that would mandate an annual advisory vote. (Colgate's decision is to hold the advisory vote every other year.)

Walden's Tim Smith observed that the Colgate board decision grew out of "constructive dialogue with shareholders and the Company's participation in the Working Group on the Advisory Vote" that was organized by the investor coalition for dialogue with almost 100 public companies, the majority large-cap.

Last year, shareholders of Wells Fargo approved executives' pay packages in a nonbinding advisory vote, and there will be another vote on the matter in 2010. Chief Executive Officer John Stumpf's compensation topped all of its large financial services competitors (at $18 million-plus), but shareholders were not in a retaliatory mood despite the company's share price swings between $7.80 and $431.53 over the year.

"Our stockholders have always been able to communicate with the board on matters of interest to them," said Steve Sanger, chair of the board's human resources committee. "This year's (2010) advisory vote gives them an additional opportunity for participation in the Company's compensation process."

2010 public policy issues

The range of issues being debated by the US Congress, with the president of the United States often weighing in, is focused on the enhancement of existing law and regulations, such as the provisions of the 1933 and 1934 securities protection acts, and on proposed new

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statutes to protect investors and the financial systems.

Meanwhile, it seems that at least *some* investors and issuers are agreeing on *some* things, including allowing shareowners a say in the setting of executive compensation. Perhaps this was *anger* from the shareholders leading to *acceptance* (and *resolution)* by companies and owners—a "reform," if you will, without becoming the law of the land. There is still much disagreement over reform issues among and between the corporate sector, the public sector, and the institutional shareowner community, but with say-on-pay collaboration, tiny steps are being taken toward reform in 2010. ■

NOTES

1 E. Kubler-Ross, *On Death and Dying* (Simon & Schuster/Touchstone: 1969).

2 The investor coalition includes the following: members of the Interfaith Center on Corporate Responsibility (ICCR); the American Federation of State, County and Municipal Employees (AFSCME), AFL-CIO employees pension plan; Walden Asset Management/Boston Trust & Investment Management Company.

3 Financial firms adopting the advisory vote include the following, as of March 1, 2010: American Express, Bank of New York Mellon, Goldman Sachs, JPMorgan Chase, State Street, SunTrust Banks, and Wells Fargo, Aflac, Ameriprise, Apple, Bristol-Myers Squibb, CVS Caremark, ConocoPhillips, Hewlett-Packard, Honeywell, Ingersoll-Rand, Intel, Motorola, Valero Energy, and Verizon.