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STAY TUNED . . . Waves of Change in 2005 … Tidal Waves for the IRO

by Hank Boerner

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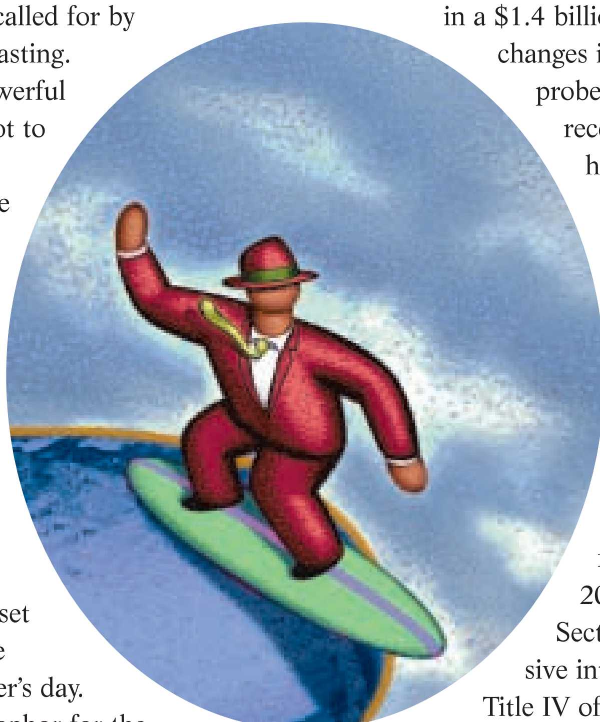
STAY TUNED TO ...
Waves of Change in 2005 ...
Tidal Waves for the IRO

By Hank Boerner

What kind of year will 2005 be for IROs? Another tumultuous and unpredictable year? As the corporate governance and accountability revolution continues, you can count on it. And if the equities market turns hockey stick up, will all this go away? Don't bet on it — the reforms being put in place or called for by organized reformers are long-lasting.



As we created our list of powerful forces to watch in 2005, we got to thinking about surfing. When devotees of the boards hear the cry of "surf's up!" all eyes turn to the sea. Surfers well know that the waves to ride come in short intervals called *sets.* Friction created by wind and water, along with the pull of gravity, creates the powerful *wave sets* on which a surfer joyously rides. The joy of the sport comes with catching the right set of six or more waves. Offshore storms can really wreck a surfer's day.

Surfing could be an apt metaphor for the IRO operating environment in 2005, as we look on as powerful wave sets wash over the corporate sector. Adventure ahead? Yes — but, watch out: Some of those wave sets in 2005 could be tsunamis that will swamp sectors or companies.

IROs have experienced many storms over the past three years: the impact of SOX; the fall of Enron and the financial collapse of WorldCom, affecting almost every congressional district; and the overnight collapse of global giant Arthur Andersen, to name but a few.

And don't forget New York Attorney General Eliot Spitzer's investigations of Wall Street investment banks (and the practices of their financial analysts), resulting in a $1.4 billion settlement and dramatic changes in analyst processes. Sweeping probes of leading mutual funds and, recently, major insurance companies have taken their turn in the media spotlight — tsunamis all, for those involved.

Their effects continue in 2004. Here are some wave sets — and maybe tsunamis — approaching the corporate shoreline in 2005.

STAY TUNED ... to Sarbanes-Oxley-driven regulations being fully implemented throughout 2005. In November, the notorious Section 404 (mandating comprehensive internal controls as required under Title IV of the 2002 statutes) *finally* went into effect, with most companies not ready for compliance, according to several industry surveys. Early in 2005, the majority of companies reporting on a calendar-year basis will have to formally assess (and attest to) the effectiveness of their controls over financial reporting and certify the results — and outside auditors will have to provide an independent opinion and certification, as well.

The very complex provision was twice delayed. Will financial analysts take 404 noncompliance into account — or will individual investors care? Will it matter if literally *hundreds* of companies remain out of full compliance? This could end up being a ripple on the shoreline … or a tsunami for some unfortunate companies caught in the spotlight.

STAY TUNED … to the effects of greater disclosure by mutual fund advisers. We think wave sets will occur by the dozens. Recall that mutual fund advisers are now required to report to investors (1) their corporate governance voting policies (for proxy votes), and (2) the record of their votes on an annual basis. (The first required filing was on Aug. 31.) This important development could be vexing for fund managers who also manage 401(k) plans for a corporation's employees — and who are often asked by other institutions to join in an anti-management voting campaign. This is also a problem for the corporation: Large shareholders could well be voting against the management slate of candidates or management's "Yes" or "No" resolutions in 2005.

CalPERS will apply systematic pressure to the SEC, the financial exchanges and compensation consultants to address issues of transparency and the design of corporate compensation systems.

Want a peek at the future waves that may be coming your way? The AFL-CIO Office of Investment just released its "Behind the Curtain" report on how the 10 largest mutual fund families voted when "presented with the opportunity" to curb CEO "pay abuse" in 2004. When voting on proxy proposals designed to curb skyrocketing CEO pay, said the AFL-CIO, there is significant variation among fund families. American Century, for example, won a 100 percent approval rating, while Putnam Funds got the lowest mark (20 percent).

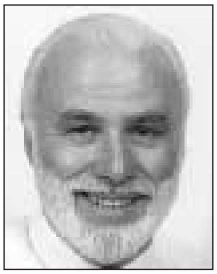
Fidelity received only a 25 percent score, while Vanguard was No. 2 with a 75 percent approval rating. The AFL-CIO also determined that of the 120 proxy-voting decision-making examined in its study, 25 involved a mutual fund adviser also doing business with companies in his portfolio. According to the union: "These widespread conflicts of interest not only underline the importance of transparent proxy voting by mutual funds, but also point to the need to [further] enhance the SEC rule to require mutual funds to disclose business relationships with portfolio companies."

Company votes examined included Delphi, Union Pacific, Lucent, PeopleSoft, Sprint, CSX, Bear Stearns and Kohl's. AFL-CIO provided a breakdown of proposals and votes for these and other companies. Tsunami in 2005? Don't bet against it. (For a copy of the full report, go to www.aflcio.org/corporateamerica/paywatch/upload/BehindtheCurtain.pdf.)

STAY TUNED … to more financial sector and corporate investigations by AG Spitzer and officials in other states. More tidal waves are gaining momentum. Take Connecticut Attorney General Richard Blumenthal, who has opened broad investigations into the insurance market workings, reaching into corporate suites of both domestic and global insurers. Subpoenas galore have flowed from AG Blumenthal's Hartford office (home to many large insurers). He has also asked each of Connecticut's local mayors about the insurance their municipalities have purchased over the past five years and the names of all providers.

AG Michael Hatch of Minnesota also has insurance investigations under way, and this bandwagon could grow quite crowded as more state prosecutors jump on board in 2005. In California — the trendsetter state — Insurance Commissioner John Garemendi has probes under way of major insurance company practices. The National Association of Insurance Commissioners has formed a task force focused on insurance reform, which could harness the immense power of state attorneys general and state regulators on the insurance industry, sending tsunamis through that sector. Since much of the insurance industry is regulated at the state level, the combination of attorneys general and insurance commission probes could end up with even more impact on companies and the markets than the recent Spitzer probes of Wall Street and the mutual fund industry. This could well be a combination of SOX and Spitzer's probes for companies in the spotlight in 2005!

STAY TUNED … to demands for greater transparency for your company's finances, operations, marketing plans, sales results and other factors important to investors, whether voluntary or not. We recommend an important book for your reading — *The Naked Corporation* by Don Tapscott and David Ticoll (Free Press, 2003), in which the authors analyze "open" enterprises operating with greater transparency versus "closed" companies with opaque financials and internal operations. Corporate leaders can either harness the power of transparency, Tapscott and Ticoll argue, or engage in battle with their numerous stakeholders to preserve the opacity that members of management believe serves them better.


Hank Boerner

The struggle between corporate opacity and transparency is very real and increasing every day, thanks to advances in technology. There are really few secrets in American business, Tapscott and Ticoll argue; they believe that "open" corporations perform better, and that transparency is a new form of power that pays off when harnessed … and can do significant damage when it is not embraced by the enterprise. Smart firms choose to be open, in their view, as they spell out for managers "the transparency imperative."

STAY TUNED … to greatly increased shareowner activism (for the coming 2005 proxy season). We're going to see year-round proxy seasons, especially for activists among public employee pension funds, labor funds, socially responsible mutual funds and several hundred faith-based institutional investors.

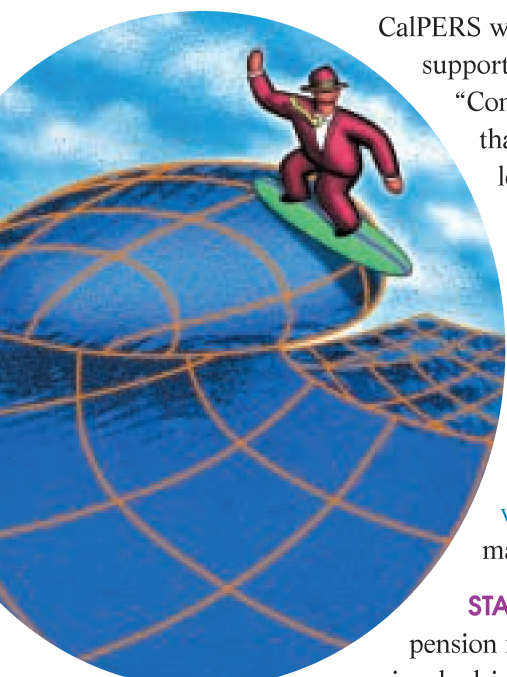
We shared thoughts with you recently on the nation's largest public employee pension fund — California Public Employees' Retirement System with assets of more than $168 billion. Still more news coming now from this 800-pound gorilla among institutional investors: CalPERS just served notice on corporate America that it has a clear, focused plan to begin to rein in "abusive compensation practices" and will hold directors and compensation committees "more accountable" for their actions regarding CEO and senior management pay in 2005.

CalPERS will apply systematic pressure to the SEC, the financial exchanges and compensation consultants to address issues of transparency and the design of corporate compensation systems. This is a three-year, six-step campaign. In a carrot-and-stick approach, CalPERS will wage aggressive campaigns against select individual companies it believes have the worst compensation practices (specifically targeting board compensation committees) and will recognize a company that is a leader in pay-for-performance policies.

A limited number of companies in 10 market sectors will now be targeted for intense action; CalPERS will also withhold proxy vote support for individual directors.

CalPERS cites the *Business Week* surveys of CEO pay, noting that their salaries have grown to 535 times the average worker's salary in 2000 (versus a 42-1 ratio in 1980). CEO median pay was up 14 percent to $2 million annually, according to an Equilar study of S&P 500 companies.

CalPERS promised a "focused approach to today's most serious problem," according to President Sean Harrigan. A limited number of companies in 10 market sectors will now be targeted for intense action; CalPERS will also withhold proxy vote support for individual directors. "Compensation can be so obscene that we need to tackle the problem structurally and hold accountable selected individual directors who create and support abuse pay packages. We are calling on institutions and allies to join in the campaign," said Investment Committee Chair Rob Feckner. See www.calpers.ca.gov for information on the campaign.



STAY TUNED … to the swelling pension fund overhang that could seriously drive down corporate earnings in 2005 and beyond. Talk about tsunami — this tidal wave has real potential to inflict serious damage on the corporate sector. Some news accounts have declared large individual companies "technically insolvent" when all pension fund liabilities are toted up and matched against present market cap. Said the *New York Times:* "Tens of thousands of Americans are discovering, as they approach retirement, that money they were promised [in defined-benefit pension plans] is not forthcoming. This is a national problem."

In 2005, this translates into national attention on corporate plans — from labor, members of Congress, think tanks and others looking to shape public policy. If corporations are forced to contribute chunks of money to underfunded plans, short-term earnings could be dramatically affected. Balance sheets will be greatly distorted by required adjustments. There are potential pressures on pension fund balances resulting from social change — think tsunami again. New York State is moving to recognize same-sex marriage for its pension fund beneficiaries. Comptroller Alan Hevesi — sole trustee of the NYS public employee pension fund — ruled that the state plan would treat gay couples with Canadian wedding licenses as it treats other married couples in terms of benefits.

Remember when the city of San Francisco pressured companies doing business with the city to treat same-sex partners the same as heterosexual couples? What could happen to corporate plans in 2005 if companies were pressured by states to significantly expand coverage to address social issues? (CalPERS, it's worth noting, is set to follow the New York fund's example in 2005.)

To complete our surfing metaphor for 2005, recall the words of the Beach Boys' anthem in 1963: *"Everybody's gone surfin'… Surfin' USA!"* Most of us will indeed be staying tuned to the coming wave sets — and potential tsunamis — of 2005. Happy New Year! IRU

Hank Boerner is managing director-NY of Rowan & Blewitt, where he provides corporate governance and accountability counsel to public companies. The views expressed here are his own. He can be reached at hank@pb.net.