1. INTRODUCTION

1.1. Overview

While much of the Report has explicitly focused on the telecommunications sector, many of the drivers of malfeasance and of nefarious behavior lie outside the sector – in the inappropriate practices of the finance community, and its “supporting” infrastructure: accounting and audit houses, the self-regulating bodies such as the Financial Accounting Standards Board and even its regulator – the Securities and Exchange Commission (SEC). The financial sector: investment banks, analysts for the banks, accounting and audit houses, the Securities and Exchange Commission (SEC), credit rating agencies all had a part to play in the volatility and collapse of the information technology and communications (ITC) sector. In addition, relaxed corporate governance – corporate boards which failed to monitor and control management – legislation which protects management, regulatory rules that address the wrong issues or are ineffective; lack of enforcement of existing laws – primarily due to under funding of the regulatory agencies by the Congress, were all contributing factors.

The internet bubble received more publicity, but the telecommunications bubble was more costly in terms of lost value. Moreover, its consequences are more serious because it impacts one of the key economic infrastructures – it dried up funding in the sector and has created an unhealthy economics environment for research and development, and for growth and development of the economy.

The other modules have addressed the causes, their consequences, and point to remedies within the context of the modules. This module will address issues that transcend the telecommunications industry but are vital to its support – the financial sector and the
infrastructure which supports it. We then turn to the issue of corporate governance. Much of the malfeasance has been a result of conflict of interests in both the financial and corporate communities coupled with weak or non-existent enforcement of existing laws and weak corporate governance. While the two sectors are discussed separately, there is a synergy between then. After describing these issues and problems, we then suggest remedies.

Our thesis is that much of the inappropriate behavior in these bodies can be attributed to the wrong or incorrect incentive structures. If the incentive structure is corrected, many of the notorious practices of the past can be reduced or eliminated. This is not to say that we will not have “crooks” in the future or that the issues discussed in other sections of the Report do not need to be addressed, but changing the incentive structure will dampen the inherent volatility of the ITC sector.

1.2. Organization

This module will outline the improper practices and behaviors, identify the incentives which drive them, and suggest remedies to rectify them in each of the areas. In this approach, we are searching for solutions to the problems, not the symptoms. Moreover, correcting the incentive structure will ease the regulatory burden, since the temptation for malfeasance will be reduced significantly.

The paper is organized as follows. The first section addresses issues in the financial sector, then it examines the infrastructure which regulates or supports the financial and corporate communities; next we examine issues of corporate governance. We then make recommendations for changes. First we suggest remedies for the problems in the financial sector, then its supporting infrastructure, and finally the corporation structure. While we believe this is an important aspect of the financial collapse of the telecommunications sector, we are not as detailed in our critique as other modules, but this should not be taken as a sign that these issues are any less important than those addressed elsewhere in this Report. Because they are of a wider scope, many of these issues have been considered. We have surveyed and critiqued this literature and developed our recommendations based on our assessment of this review.

2. Financial Sector Issues

2.1. Overview

The financial sector, or Wall Street, as it is commonly referred to, is composed of a variety of firms which raise money for corporations either through debt or equity issues. Firms such as Bear Sterns, CS First Boston, Morgan Stanley, Salomon Smith Barney, J.P. Morgan, Goldman Sachs, Merrill Lynch, UBS, Piper Jaffray, and Lehman Brothers are among the investment banks which will bring new issues of stock or corporate debt to the market for a percentage of the offering – seven percent is the standard. Analysts evaluate the desirability of these offerings as well as analyze and make recommendation on whether to purchase stock in corporations – the “buy” side analysts. The credit agencies evaluate the credit worthiness of companies and rate the quality of their debt. The stock exchanges have their own requirements to be listed on their exchange. For
example, the New York Stock Exchange has more stringent rules concerning corporate governance than the federal government’s rules and regulations. The National Association of Securities Dealers (NASD) is a self-regulating body of the industry, whereas the Securities and Exchange Commission is the federal government’s formal regulator of the industry.

Each piece of this sector has its distinct issues and problems which we detail below. In most instances, they involve inappropriate incentives or conflict of interest or what the economist terms an agency problem. We begin with the investment bankers.

### 2.2. The Bankers of Bankruptcy/Investment Bankers’ Abuses

Because of the manner in which investment bankers are compensated, they have an incentive to overcapitalize their client. When a company comes to the bank with its business plan, the bankers may encourage the company to push for more growth and a greater reach. This means that the securities offering will be larger, and hence, the bank’s fees larger. This was particularly true during the internet/telecommunications boom. For example, the now-bankrupt Winstar, a wireless CLEC, was encouraged to expand its market to 75 cities, rather than the modest 12 cities in its own initial business plan. The pushing of growth, overextended the new companies, but allowed the banks bigger fees. The banks’ work was finished after the initial public offerings (IPO) were issued. The banks have a short-term perspective with this type of transaction.

On the other hand, these IPOs offered the opportunity to “give” major clients a bonus—some would say a bribe—to be part of these offerings. The new shares’ prices increased significantly just after issuance. The bankers’ had a “friends-and-family” allocation of the new shares which they could distribute to their better clients (including institutional investors) with the understanding that further debt and equity issues would be handled by the banks in return for these allocations. The clients received the shares at the initial offering price and could turn around and sell the stock the same day at a substantial profit—a practice known as IPO spinning. An example in the telecommunications sector is Bernie Ebbers’ and WorldCom’s investment in Rhythms NetCommunications at its IPO price which jumped 229 percent the first day (Partnoy 2003, p. 294). Ebbers, at the time the head of WorldCom, made on the order of $200 million on such sweetheart deals. Another example is Michael Dell who earned $60 million on one offering with the implied promise that he would bring business to an investment bank. The “friends-and-family” beneficiaries of this largesse would be expected to purchase other stock from the bank at very high commissions, in other words, return some of the profit they had made—usually one dollar for every three, at least in the case of CS First Boston. This was another quid pro quo required to participate in these undervalued IPOs (Partnoy 2003, pp. 279-280). Apparently, seven percent for the bankers was not enough!

In addition to being ethically wrong, it was detrimental to the offering company. Because the issue was undervalued, the gains from the higher stock price went to those with the “friends-and-family” allocations rather than to the issuing corporation. In 1999, this averaged seventy percent (70 percent) on the first day of trading (Ritter and Welch 2002, p. 1797; Partnoy 2003, p. 274). (During the seventies, the average undervalue was approximately five percent.) Had the corporation received the higher value for its stock,
it would have been in a much better position to compete in the market place and, since a number of these firms went bankrupt, these extra funds might have kept it out of the bankruptcy court. Ritter and Welch estimated the cost to the issuing corporations to be sixty-six billion dollars, and the under-pricing of the shares to be 65 percent during the 1999 to 2000 period (2002, p. 1797). While not dismissing asymmetrical information problems altogether, they lay the blame for this situation on “agency conflicts” – share allocations provided the *quid* for the expected *quo* of banking business, which rewards the wrong incentive structure. James Surowiecki summarized the issues.

It’s an open secret that the current I.P.O. system is broken. As things stand, when a company goes public the investment bank that is underwriting the offering effectively sets the price of the I.P.O., after canvassing big investors to find out how much they’re willing to pay. Then it determines who gets to buy shares. In theory, the system is reasonable enough. In practice, it is deeply flawed, because it creates a conflict of interest between the investment bank and the company. The company wants to get the highest price possible for its stock so that it can raise as much money as possible. The bank has other priorities. It has personal relationships with institutional investors it wants to keep happy. It has clients to reward. If it keeps the offering price down, it can use the I.P.O. shares to curry favor and drum up new business. (Surowiecki 2003, p. 62).

But why were the firms undervalued? All part of the irrational exuberance of the “New Economy” when traditional valuations went out the window? No. We concur with the view of Ritter and Welsh that the agency conflicts are the root cause of the problems.

2.3. Analysts for the Banks

With respect to the analysts, who resided in the banks and, in at least one case, reported directly to the investment bank side of the firm, the incentive structure was skewed in the wrong directions. Evidence suggests that analysts’ pay was tied directly to the investment banks’ earnings (Partnoy 2003, pp. 285-6; Morgenson 2002). Clearly a conflict of interest. The analysts were (and are) to determine a company’s prospects. Was it a buy, hold or sell stock? Analysts, such as Harry Blodget and Jack Grubman, could move markets on their pronouncements. A promise of buy rating on a company could be used to entice it to do business with the bank; increased business for the bank meant increased earnings for the analyst. If you took your business elsewhere, your rating could have fallen dramatically (Partnoy 2003, pp. 285-6).

… [Analysts] were simply responding to an incentive system that rewarded them financially for making positive comments, and punished them for making negative ones. Analysts began inflating ratings for the same reason children acquire good manner. (Partnoy 2003, p. 286)

2.4. Conflicts with Companies

Many conflicts exist between the analysts and the corporate executives. We have already discussed the conflict between the companies offering an initial public offering and the bankers vis-à-vis the banks’ other clients (Partnoy 2003, p. 287). Analysts and bankers have to rely on, in large part, the executives for information. Of course the executives want to show the best face of the firm (even if they have to slant the facts). Moreover, the executive would like to meet the quarterly earnings per share – “the number” – that the analysts have set. This has led to extraordinary measures on the part of upper
management to meet “the number” for the quarter, most likely to the detriment of the long-term interest of the corporation and its stockholders.\(^5\)

3. **FINANCIAL SECTOR INFRASTRUCTURE SUPPORT**

3.1. **Security & Exchange Commission (SEC)**

The Security and Exchange Commission (SEC) is the regulatory body for the securities industry. The SEC was created in 1934 to ensure that the markets were well regulated. It was designed to bring trust back to the market. It appears to be ineffective in carrying out its oversight duties.\(^6\)\(^7\) Enforcement of these laws and regulations is within the mandate of the SEC, but it failed to act. It tackles the easy targets such as the teenager who promoted stock on the internet in much the same manner the analysts do, although the analysts do not get sanctioned (Lewis 2002). To be fair, the Agency appears to be under funded and understaffed.\(^8\)

The change in leadership in 2003 at the SEC is promising for better control of the financial sector. Mr. Donaldson comes from the investment community. He understands the industry and many of its foibles. But to make changes in the rules and regulations can be difficult. He has encountered resistance to many of his proposed reforms. One of his predecessors, Arthur Levitt, recommended expensing options several years ago, but was met by resistance from corporations. Ultimately, Levitt’s proposal failed (Partnoy 2003).

With the passage of the Sarbanes-Oxley legislation in 2002, the agency has been given additional responsibilities, but not the proportional additional funding and staffing to handle these new duties.\(^9\) Moreover, the Sarbanes-Oxley requirements have provided a false sense of closure to the governance issue – the law is passed, nothing more needs to be done, or as expressed by a former Chief Account at the SEC: “In a way, it was the best thing that happened to the business community because they can go out and say it’s all fixed.” *(Financial Times 2004a)* It is not.

3.2. **Audit Houses**

Where were the auditors when the companies were “cooking-the-books”? Apparently, aiding and abetting the process (at least in some cases). The major concern is with the auditors’ consulting arm. Most audit houses have consulting arms as large as or larger than their accounting arms. For example, Arthur Anderson received $1.2 million in audit fees, but ten times that much from non-audit work for Global Crossing in 2000 (Partnoy 2003, 361). This gives rise to conflicts. The auditors may “go along” with dubious accounting practices for fear of losing the lucrative consulting practice.

For example, WorldCom swapped transmission capacity (Indefeasible Right to Use or IRU) with other carriers, which were booked as revenue on one side of the income statement, but the costs were capitalized on the other side of the income statement. When expenses are capitalized, it makes earnings look better. Global Crossing had similar practices. Its auditors, Arthur Anderson, did not flag the flagrant treatment of “revenues” and expenses.\(^10\) (But then again, did it want to jeopardize its twelve (12) million dollar non-audit income? It only received $1.2 million for its audit services.) Qwest used IRU
swaps with Global Crossing. Qwest was later forced to restate its earnings by about one billion dollars lower because of these transactions. In addition to using IRUs, among its nefarious practices, Enron, inter alia, used special purpose entities to hide debt, (Partnoy 2003, pp. 351-363). For investors, it became difficult to obtain full disclosure of the risks and opportunities, even if the SPE’s are known. Audit houses did not expose these problems. In large part, these failures, we feel, are a result of a conflict between the audit and non-audit (consulting) sides of the business.

3.3. Credit-rating Agencies

Credit-rating agencies have a tight oligopoly in the financial community; only three major agencies exist and are approved by the regulators – Moody's Investors Service, Standard & Poor's and Fitch Ratings – but their services are required by the community (Partnoy 2003, pp. 402-404). Without their high ratings (investment grade), it costs companies a premium to finance debt (“junk” bonds). Thus, the agencies can command high fees.11 These firms rate the quality of the debt and equity of the companies. These agencies should serve as an early warning signal to investors when there are problems with a company. However, they, too, have failed miserably. Enron was only down graded a few days before it declared bankruptcy. Global Crossing maintained it high rating until just prior to bankruptcy as did WorldCom. Similar stories can be told with other companies just prior to bankruptcy (Partnoy 2003, p. 352 and p. 385).

In addition, they failed to correctly identify the riskiness of credit-derivative securities (Collateralized Debt Obligations) – a repackaging of investment and non-investment grade debt – which, in many cases these credit-derivatives were composed of WorldCom, Global Crossing, and Enron debt (Partnoy 2003, p. 389). When these companies went bankrupt, it placed a strain on the companies holding the CDOs.12

Finally, the question of conflict of interest arises, since the agencies are paid by the companies they evaluate. The agencies may fail to perform their duties effectively, but yet regulators defer to their judgment.

4. CORPORATE GOVERNANCE

The typical American corporation is a stockholders’ republic in the same way that China is a people’s republic. (Surowiecki 2003b)

What a CEO really expects from a board is good advice and counsel, both of which will make the company stronger and more successful; support for those investments and decisions that serve the interests of the company and its stakeholders; and warnings in those cases in which investments and decisions are not beneficial to the company and its stakeholders.” Kenneth Lay (as quoted in The Economist 2003c)

4.1. Overview

Our discussion in this section will focus on the mechanics of governance and how these mechanisms interact with human factors, and have the potential to bring out inappropriate behavior on the part of management. One cannot isolate the causes or parse out all their effects. They are complex, dynamic, and interact with one and another.
As with the Wall Street community, the real issue in the current wave of scandals in the business community is a systemic problem in the incentive structures within business that is reinforced by government laws and regulation and compounded by complex financial derivatives.

The role of management is to maximize stockholders’ value, but this is not necessarily in the interest of the managers. Management has its own objectives – which may include increasing salary levels, manager’s emoluments, and other prerogatives of the position. The goals of management and stockholders do not coincide – known as the principal-agent problem or agency conflicts. Management, the agent, should do the bidding of the principal, the stockholder, but the stockholder does not have access to all of the relevant information about management’s actions or the resources of management. Control mechanisms and incentive structures can be designed to direct management behavior to match the goals of the stockholders, but none of these are perfect mechanisms.

We begin by examining corporate governance. The corporate board is the first line of defense of the stockholders to ensure that management serves the stockholder. Ideally, the board is composed of stockholders who are independent of management, have sufficient interest in the outcomes, and adequate information about corporate behavior to monitor management’s performance.

4.2. Corporate Boards

Corporate boards have not changed much since the nineteenth century, but in the wake of Enron, WorldCom and other evidence of malfeasance, the pressure for change has increased (and this is not simply a USA phenomenon). More stockholders are making demands on boards and management, particularly, with respect to compensation and management benefits – for the most part with little success. Why?

4.3. Independence

The answer may lie in the lack of independence of the board from the management it is designed to monitor/control. The composition of corporate boards has involved “Rolodex” lists in which friends and family connections take the place of independent-minded members. Or as Warren Buffet puts it: "Collegiality trumps independence" (Financial Times 2003, p.25). This has several knock-on effects: For example, the members of the audit and compensation committees are less likely to be critical of inappropriate practices. They are more likely to approve “over-the-top” compensation (and, since upper management is on the member’s board, they will provide the quid pro quo.)

...A survey by the New York Times found that, in 420 of a selection of 2,000 large American public corporations, the board's compensation committee, which determines the boss's pay, includes relatives or people with ties either to the boss or to the company.
4.4. Compensation – Hubris and Invidious Comparison

Executive compensation is the most egregious manifestation of the divergence between managements’ and shareholders’ values. Compensation has many components. The principle of economics would suggest that compensation is related to the value the executive provides to the firm. But a cursory look at compensation scales suggests this is not true (see, for example, Lowenstein 2002). One egregious but not atypical example was the head of American Airlines who, when American Airlines stock was whirling down the drain, awarded a retention bonus for seven executives and protected pensions in the event of bankruptcy for himself and 44 other executives (The New York Times 2003). The Corporate Library, a watchdog group reports that after the bubble, corporate compensation has not suffered. Indeed, it while executive compensation for the largest 500 US companies grew by a median of 22 percent, their companies’ earning growth was less than half of that (9.6%) (Financial Times 2004a and Hodgson 2004). Within the telecommunications sector the comparable numbers were X and Y. Clearly an indication that compensation was not awarded for improving earnings, but more likely a sign that the control of the corporate boards are still in the firm control of management.

Other signs of loss of control include the manner executives are compensation on the bases of the price of the company’s stock. If the stock price increases, the top executives receive higher compensation. If it falls, they also receive an increase. In the latter case, the rationale is that they have to “take the company through hard times.”

4.5. Stock options/ Pump and Dump

The rationale for stock options is that they motivate the managers to perform in the company/stockholders’ interest by allowing them to appropriate a portion of the stock’s gain. That is, it addresses the principal–agent problem. A practical reason is that in order for a company to receive a tax deduction on executive compensation above one million dollars, the additional compensation must be based on performance under the Private Securities Litigation Reform Act of 1995. Moreover, the executive does not have to pay tax on the option until it is exercised. And, until recently, most corporations did not report options as an expense, but only acknowledged them in the footnotes of Annual Reports. However, stock options as structured do not accomplish the intended job. They create the wrong incentives.

4.6. The Barons of Bankruptcy

Many executives would praise their company’s stock while simultaneously selling large blocks of their shares. For example Global Crossing’s Gary Winnick made over $735 million on sale of his stock before the company filed for bankruptcy. Other insiders at Global Crossing made over four and a half billion dollars ($4.5 billion) on their Global Crossing shares (Partnoy 2003, p. 357). (Because of the method of handling these transactions, under the current securities rules, these sales did not have to be reported immediately.) Other examples in the industry abound, including Qwest’s Phil Anschutz and Joe Nacchio who received $1.2 billion and $250 million, respectively; McLeodUSA’s Clark McLeod’s and Richard Lumpkin’s gain of $99 million and $116 million, respectively; and WorldCom’s Scott Sullivan who made a gain of $49.4 million.
numbers are staggering – sixty-six (66) billion dollars – but the public was in the dark. Table 1 below summarizes some of the larger gains in the ITC sector.

Table 1

Sales of Stock by Executives/Directors of selected Communications Companies

<table>
<thead>
<tr>
<th>Company</th>
<th>Executive/Director</th>
<th>Title</th>
<th>Sales (millions of dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qwest Communications</td>
<td>Phil Anschutz</td>
<td>Director</td>
<td>1,570</td>
</tr>
<tr>
<td>Broadcom</td>
<td>Henry Samueili</td>
<td>CTO</td>
<td>810</td>
</tr>
<tr>
<td>Broadcom</td>
<td>Henry Nicolas</td>
<td>CEO</td>
<td>799</td>
</tr>
<tr>
<td>Global Crossing</td>
<td>Gary Winnick</td>
<td>Chairman</td>
<td>508</td>
</tr>
<tr>
<td>AOL Time Warner</td>
<td>Steve Case</td>
<td>Chairman</td>
<td>475</td>
</tr>
<tr>
<td>ATT</td>
<td>John Malone</td>
<td>Director</td>
<td>348</td>
</tr>
<tr>
<td>Nextel</td>
<td>Craig McCaw</td>
<td>Director</td>
<td>343</td>
</tr>
<tr>
<td>Cisco Systems</td>
<td>John Chambers</td>
<td>President/CEO</td>
<td>239</td>
</tr>
<tr>
<td>Qwest Communications</td>
<td>Joe Nacchio</td>
<td>CEO</td>
<td>230</td>
</tr>
<tr>
<td>AOL Time Warner</td>
<td>Bob Pittman</td>
<td>COO</td>
<td>225</td>
</tr>
<tr>
<td>AOL Time Warner</td>
<td>Jim Barksdale</td>
<td>Director</td>
<td>213</td>
</tr>
<tr>
<td>Yahoo</td>
<td>Tim Koogle</td>
<td>Director/CEO</td>
<td>160</td>
</tr>
<tr>
<td>Yahoo</td>
<td>Jeff Mallott</td>
<td>COO</td>
<td>148</td>
</tr>
<tr>
<td>Juniper Networks</td>
<td>Scott Kriens</td>
<td>Chairman/CEO</td>
<td>148</td>
</tr>
<tr>
<td>Sycamore Networks</td>
<td>Gururaj Deshpande</td>
<td>Chairman</td>
<td>137</td>
</tr>
<tr>
<td>Sycamore Networks</td>
<td>Dan Smith</td>
<td>President/Director</td>
<td>129</td>
</tr>
<tr>
<td>Sycamore Networks</td>
<td>Chi Kong Shue</td>
<td>EVP</td>
<td>122</td>
</tr>
<tr>
<td>Yahoo</td>
<td>Gary Valenzuela</td>
<td>CFO</td>
<td>116</td>
</tr>
<tr>
<td>McLeodUSA</td>
<td>Richard Lumpkin</td>
<td></td>
<td>116</td>
</tr>
<tr>
<td>Juniper Networks</td>
<td>Pradeep Sindhu</td>
<td>Vice Chairman/CTO</td>
<td>108</td>
</tr>
<tr>
<td>McLeodUSA</td>
<td>Clark McLeod</td>
<td></td>
<td>99</td>
</tr>
<tr>
<td>Juniper Networks</td>
<td>Peter Wexler</td>
<td>VP</td>
<td>87</td>
</tr>
<tr>
<td>Cisco Systems</td>
<td>Judith Estrin</td>
<td>CTO</td>
<td>72</td>
</tr>
</tbody>
</table>


4.7. Agency Issues

The separation of ownership from control has been recognized for sometime as a serious problem in the control of the corporation. More than sixty years ago, Berle and Means (1931) presented their basic theme that the managers control companies. And, while the managers are the agents who are hired to increase stockholders’ value, they often failed to do so. Since Berle and Means’ writing, recommendations and policies have been
implemented to steer control back to the stockholders. Stock options are a good example which, in turn, led to other problems.

**FINANCIAL SECTOR REFORMS/ POTENTIAL REMEDIES**

4.8. Goals

Financial sector and corporate remediation should be designed around four goals: Trust, transparency, accountability and enforcement/penalties.

The public’s trust is required to restore confidence in institutions and corporations. The recent exodus of funds from mutual funds when the timing scandal was exposed shows the necessity for restoring trust. A key element in ensuring trust is transparency. That is the availability of information to all the parties. For example, Regulation Full Disclosure (Reg FD) is an attempt to ensure transparency. Lack of transparency results in lack of trust. Indefeasible Right to Use (IRU), Special Purpose Entities (SPE), and other such corporate devices are used to blind the investor to the economic realities of the corporation and are the antithesis of trust. When uncovered, trust is broken. The aim of transparency is to eliminate asymmetries in knowledge and to not allow those “in-the-know” to take advantage of this knowledge.

Accountability should be designed to ensure that executives are accountable to stockholders and the public. Finally, for those who do not follow the rules, quick and sure enforcement should be practiced. Illegal activities should be prosecuted quickly and effectively. Penalties should be greater than the gains from fraud and deceit, currently, they are not.

These principles are easy to state, but much harder to implement. As we repeatedly emphasized, we believe the key is to ensure that the correct incentive structures are in place so that they will direct individuals to the right choices.

4.9. Significant Penalties for Abuse

Overall, the society has been soft on crime – white collar crime. In part because the “criminals” look a lot like us – white, educated, middle-class wearing shirts and ties. How can we lock them up with the drug dealer and other “riffraff,” the black and Hispanic, the poorly educated who do not dress as we do? But the magnitude of the fraud and misconduct in dollar terms is orders of magnitude greater than anything the drug dealer could ever hope to earn. Our recommendation is to severely punish the white-collar criminal. As it stands now, white collar crime pays. We should increase the penalties, both monetarily and in terms of prison time.

4.10. Wall Street Remedies

Transparency of actions and analysis is imperative for ensuring that the public is well informed about investment risk. If markets are to work efficiently, a necessary condition is the availability of information to their participants. This implies that the knowledge be publicly available and easy to access. Reg FD is a move in this direction, but it too could be strengthened. This would include providing methods and data used to determine
valuations of stocks. During the dot.com boom valuations were opaque. Moreover, they were not state-of-the-art.18

4.11. Analysts/Investment Bankers

Analysts. With the decline in need and value of research reports from analysts, they turn out to be promoters for the banking side of the business. This conflict of interest can be addressed by separation of the analysts from the investment bankers’ side of the business. This means that the analysts’ compensation cannot be tied in any way to the banking business. In addition, analysts should provide full disclosure of any conflicts of interest. A system to certify or otherwise qualify analysts might also be considered. This would have an ancillary advantage in that fraudulent actions could result in loss of certification and the ability to operate in the industry. Finally, quid pro quo arrangements with clients or potential clients should be forbidden. This applies on the investment banking side as well and should apply to the corporate executives who take part in such transactions. In addition, in the interest of transparency, the methodology used by analysts should be made easily available to the public.

Investment bankers. For the banking side of the business, eliminating the quid pro quo arrangement with clients (or potential clients) is a top priority. This applies on the analyst side as well, and, should also apply to corporate executives.

Some movement in this direction has occurred with the settlement in April 2003 between ten investment banks and the New York State Attorney General (and the securities industry regulators). It remains to be seen if this is sufficient.19 Thus the remedies should include:

- Separation of bankers’ investment function from buy-side analysts
- Disconnection of analysts’ compensation from the successes of the investment bank.

4.12. Valuations

Analysts generally determine stock prices by estimating the future cash flow of the companies they are following, and discounting the flows appropriately. However, during the internet boom, this metric was abandoned. And other methods were used. For example, some analysts would use the number of “eye-balls” that saw the company’s website. Some even measured the amount of investment in the company – this metric is of course absurd, since what the investor wants to know is how much money this investment will generate.20

By making it easier to examine analysts’ assumptions and spreadsheets, it may be easier to detect wild exaggeration of the numbers. Perhaps, much of Grubman’s hype would have been exposed if the information had been more easily available. Thus,

- Make analyst’s calculations available to the public in both an electronic and hard copy form (for example, a spreadsheet file and pdf file)
Set penalties for misleading investors at levels that exceed the gains from fraudulent transactions.

Jack Grubman paid a fine of $15 million for his behavior during the time of irrational exuberance, but received at least $80 million during the same period. Upon leaving Salomon he received a severance package of approximately $32 million (NASD 2002). Not a bad return! Crime pays! Penalties should be greater than the gains made from fraudulent transactions.

While the investment bankers settled with New York state (and the SEC and other regulators) to the tune of 1.4 billion dollars (How much did the investment banks earn from the actions for which they were fined?), it is not clear that any instructive message has been received. Immediately after the announcement of the settlement, the head of Morgan-Stanley, Phillip J. Purcell, announced that it was “clean.” Mr. Purcell had to back track, but his attitude is indicative of the hubris of the financial sector (Morgenson 2003d). Gretchen Morgenson continues to remain suspicious of Wall Street behavior. She reported that an analyst at Smith Barney, a subsidiary of Citigroup, changed his target price from $1.75 to $2.00 on Lucent, a large change for a company whose stock he considers expensive and which continues to burn cash. Less than three weeks later, Citigroup managed a $1.53 billion convertible bond deal for Lucent (2003c).


- Increase funding
- Increase staffing and its compensation
- Improve oversight of industry

The major problem with the SEC is its lack of oversight and enforcement. This can be attributed to two causes: A lack of staff and a lack of funding. While the agency has enormous responsibilities, and literally tens-of-thousands of firms for which it is responsible, it has never been adequately funded. In addition, as the mutual fund scandal has revealed, the staff may have been lax in its oversight of the industry. The obvious correction is to increase the funding and staff of the agency. Moreover, it should improve its enforcement activities and improve its regulations. Given its low budget and the length of time it took to put in place the accounting oversight board as required under Sarbanes-Oxley legislation, investor confidence is not assured by this agency.

4.14. **Audit Houses**

Audit houses have sullied their names with their failure to identify nefarious practices of corporations. In many cases, they aided and abetted in these practices, and gave them their imprimatur. In addition to wanting to retain the audit business, these firms have significant revenues from the same companies through their consulting practices. An easy and clear remedy for this is to forbid the two branches of an audit firm from serving the same client at the same time. Also, the auditors should be rotated out of the firm on a scheduled basis. Just as the literature on “regulatory capture” addresses how the
regulator has sympathy for the corporation it monitors, rather than for the public whose interest it is defending; the audit house becomes sympathetic to the company, but its real client is the investing public. Rotation of audit houses can mitigate this problem.22

Accounting and Audit firms

- Forbid the accounting firm from conducting audits of an enterprise for which it also provides consulting services.
- Rotate audit houses periodically.
- Allow the same accounting/audit/consulting house to perform only one function – accountant, auditor, or consultant – for the same firm at the same time.

Credit Rating Agencies

The shame and loss of reputation are, apparently, not sufficient to improve the performance of the credit-rating agencies. Their role is vital. Here the solution would be to open the field to competition. Remove the current roadblocks which give the current agencies their oligopoly power, whereby only the top three are “approved” for rating debt and equity issues.

Anonymous Whistle Blower

Establish an anonymous whistle blower program. Thus, if an executive, analyst, etc. who uncovers an illegal act perpetrated by her organization, which the organization ignores or refuses to correct; she can report it without jeopardizing her career. Such a program might have affected both the Enron and Global Crossing meltdowns (Partnoy 2003).

Others

- Forbid quid pro quo dealing between corporations
- Forbid indefeasible right to use swaps and special purpose entities and other measures which disguise the corporation’s financials

As detailed in the Audit House section, the carriers were swapping transmission facilities in the form of IRUs from each other. These were simply accounting devices to make the firm’s quarterly numbers. Special purpose entities were used to hide debt (Partnoy 2003, pp. 357-360). For investors, it became difficult to obtain full disclosure of the risks and opportunities, even if the SPE’s are known.23

5. CORPORATE GOVERNANCE REMEDIES

5.1. Corporate boards

Part of the answer to the financial problems lies in making the board independent of the management it is designed to monitor/control. The idea of a board is that it represents the stockholders and is elected by them to look after the interest of the stockholders. In
reality, as we indicated, the boards are made up of acquaintances of the CEO. Election is *pro forma*, since management votes the majority of the shares. When the board members are less than independent, the will of management holds prevails (*The Economist* 2003b). This has been well documented and addressed by the recent Sarbanes-Oxley legislation. Are the boards independent? Is this new legislation effective? No (Oesterle 2003)! More must be done. The lack of independence and expertise about the company that boards are to monitor colors their decisions and in particular those of the compensation and audit committees. Remedies for these issues are suggested below.

Corporate boards should be:

- Independent

Corporate boards should not be: beholden either to the CEO or the Chairman for their position, nor should the corporate boards overlap in membership i.e. no interlocking directorates.

- Knowledgeable.

Many board members are appointed for their titles or because of their prestige. They do not take an active interest in the corporation. They accept the honorarium, but not the responsibility. They must invest time and energy to understand the corporation they govern.

- Knowledgeable in their field.

If board members serve on the audit committee, they should have a strong knowledge of accounting and financial matters. If they serve on the compensation committee, they should have a strong knowledge of remuneration practices. And more importantly there should be neither the substance nor the appearance of a conflict of interest, e.g. the CEO who sits on the compensation committee of the board member’s corporation.

Specific recommendations include:

- The Chief Executive Officer (CEO) should not also hold the title of Chairman. This avoids obvious conflicts. After all, the Chair’s role is to oversee the CEO.

5.2. Compensation

Management has most of the control over the magnitude of its own compensation with little or no relationship to the executives’ performance. As we noted earlier the principle of economics would suggest that compensation is related to the value the executive provides to the firm. Thus, we propose to:

- Eliminate friends and family from compensation committees.

- Allow approval of top executive pay by stockholders.

- Tie compensation to “true” company performance.

Executive salary, stock options, and other compensation should be based on the market price of shares only after the elimination of the general trend in the stock market namely; management should be out performing the market to obtain additional compensation. Executive compensation should be tied to the actual performance of the company, and
not to the overall level of the stock market. That is, when the stock market as a whole moves up, taking the company’s price with it, the executive should not be rewarded. Only when he/she can do better than the market should the executive be rewarded. Remove the average return on the stock from its relation to other stocks in its class of stocks, and base performance compensation incentives on the company’s risk, the so-called “alpha” in financial theory (Bodie and Merton 2000).

5.3. Stock options

As noted earlier, the rationale for stock options is that they give the managers the incentive to perform in the company/stockholders’ interest by allowing them to appropriate a portion of the stock’s gain. However, stock options as structured do not accomplish the intended goal. Indeed, they may create the wrong incentives.

First, the performance criteria are flexible. If the company’s stock price falls, quite often, the exercise price of the option is reduced, to put it “in the money.” A recent example is AT&T Wireless. When actual performance was below the targets, the compensation committee reset the measurements (Morgenson 2003c).

Second, the options are usually short term – that is they must be exercised within a year or two of receipt. This can encourage management to push up the short-term price of the stock, without regard to how these measures affect the long-term value of the company. Michael Jensen, who was among the first to suggest options as an incentive mechanism, has now taken the position that any stock or options provided to executives should have a long retention period before the executive can cash out the stock (Jensen and Meckling 1976 and Jensen 2000).

The flexible performance criteria associated with stock option and the short-term nature of the options can encourage a “pump and dump” mentality. Options have an impact on the value of stock – the more options are exercised, the more the stock is diluted. Thus, options dilute stockholders’ value, and not by a trivial amount. Outstanding options represent approximately five percent of total outstanding stock. Granted and approved options amount to 13 percent of outstanding shares (Shapiro 2002). Thus, we recommend:

- Extend the holding period of stock options and retention period of any stock given to management as compensation.
- Expense stock options
- Immediate reporting of stock sales (not the current regulation which allows revelation 12 months later, nor paying off loans from the company without notification, nor calls on margin accounts with the company’s stock.)

As noted previously, many executives would praise their company’s stock while simultaneously selling large blocks of their shares. They used various “tricks” to maintain legal reporting requirements, such as taking a loan from their company collateralized with their stock or options, and then paying off the loan by selling the
stock. Under the securities rules these sales did not have to be reported immediately. The investing public was in the dark.

_Audit Committees_

Audit Committees

- Ensure audit committee members are expert in audits.
- Rotate audit committee members periodically

Audit committees, those charged with ensuring that the books of the company are proper, often have no experience in accounting, let alone audits. Sarbanes-Oxley legislation has attempted to correct this deficiency. It is not clear if this legislation is enough (Oesterle 2003).

_Quid pro quo dealing_

- Forbid “friends-and-family” allocation of IPO’s for executives of corporations who are (or plan to be) clients of the banks.

Bernie Ebbers and his banker, Salomon Smith Barney, had an arrangement whereby he would receive IPO allocations, presumably in exchange for WorldCom’s banking business, which amounted to hundreds-of-millions of dollars for Salomon Smith Barney. As noted above, the IPO’s were under priced meaning that “friends & family” such as Ebbers received the largesse, not the issuing company. It was a way to reward clients of the bank. Just for Ebbers, this was a 200 million dollar windfall. Sixty-six billion dollars was not available to the issuing corporation in the 1999-2000 period because of this under valuation. This was money that the offering company would never see.

_Self-dealing_

- Independence and competence of corporate boards (see above)

The activities of Lucent and American Airlines have been cited to illustrate self-serving to the detriment of the equity and debt holders. Other telecommunications executives were no less guilty of such activities of this nature; for example, WorldCom’s Bernie Ebbers structured loans from WorldCom at below cost interest rates for over 400 million dollars. Even as he left the company under a cloud of bankruptcy, he was granted a significant severance package. Other examples of self-dealing abound in the industry.

6. SUMMARY/CONCLUSION

The systemic issues continue: the loss of control over executive management by the boards which are intended to monitor and control them; laws with unintended consequences such as the Private Securities Litigation Reform Act of 1995 which capped the tax deductible earnings of executives and turned them to stock options as a compensation vehicle; and tax laws which encourage options by not treating them as an
expense nor as dilution of shareholders’ value. Stock options, indefeasible rights of use swaps, or special project entities are but of a few of the culprits.

… three changes – increasing complexity, loss of control, and lack of regulation – would become the most important issues in the financial markets during the next decade [the decade of the ‘80’s]. Financial instruments became more complex and, increasingly, would be used to avoid legal rules; control and ownership of companies would move further apart, leaving individual managers unable to monitor increasingly aggressive employees; and markets would become deregulated, as prosecutors continued to avoid complex financial cases, and accounting firms and banks were insulated from private lawsuits. (Partnoy 2003 pp. 34-35)

The lack of response to financial fraud and the relaxing of the legal constraints in the mid-nineties led to

… corporate executives in the United States became much more willing to ‘cook the books’ inflating income and hiding expenses… Most executives—especially those willing to commit accounting fraud—did not yet comprehend how recent financial innovations could be used to further their schemes. (Partnoy 2003, p. 186)

But they soon would and did.

TO BE COMPLETED AFTER REVIEWED BY OTHERS.
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NOTES

12 What we do not address in this Report is the notion of “recovery,” certainly, recovery cannot mean prices should reach the heights of the stock market during the early March of 2000, but companies with good financials and strong expectations should be able to raise funding.

Elliot Spitzer, the New York State Attorney General, has been a more aggressive enforcer of securities laws under provision of New York state laws. He has made significant settlements with investment banks. The Massachusetts Attorney General has exposed the problems of market timing and stale price arbitrage in the mutual fund industry which were not identified by the SEC.