GOVERNANCE MATTERS

A Point Of View Column

Wendy’s Suggests An Active Future For CEOs
By Neal Lipschutz

Is Wendy’s International Inc. the face of Corporate America’s future?

Most people simply know Wendy’s as the nation’s third-largest hamburger chain. Some might also know it owns Tim Hortons, a group of doughnut shops mainly located in Canada.

They probably don’t realize Wendy’s is becoming a test case for how much U.S. public company management will be influenced by so-called activist investors who want significant changes in company strategy in the pursuit of large, fast returns for themselves.

Wendy’s management is facing its second onslaught this year from investor groups that maintain the company is underperforming and that the investors have better ideas than company executives about how to maximize profits and boost the share price.

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Biting The Hand That Feeds CEOs
By Tiffany Kary

Director pay has been going up as directors’ work levels go up. But now, shareholders and governance commentators are saying there is a link between high director pay and high chief executive pay, and are demanding that companies take new steps to make sure directors’ fees don’t compromise their judgment.

The Catholic Funds Inc., which runs a $55 million equity fund, has filed shareholder proposals for 2006 proxies requesting that nine companies improve disclosure of directors’ perks and benefits, as well as seeking shareholder approval for any increase in directors’ pay. The companies are Bank of New York Co., Cendant Corp., Exxon Mobil Corp., Georgia-Pacific Corp., Home Depot Inc., Honeywell International Inc., Merrill Lynch & Co., AT&T Inc. (formerly SBC Communications) and Wells Fargo & Co. Georgia-Pacific, which is being bought by privately held Koch Industries Inc., said it won’t have a proxy in 2006.

The proposals to limit director pay are among the first of their kind. And while they target directors, they make it clear board compensation is also being used as a lever to put pressure on the issue of runaway Chief executives. The Catholic Funds says CEO pay is relatively high at the companies it is targeting, and suggests that’s because director pay is high enough to compromise the board’s judgment.

“We have not seen a lot of director pay proposals in the past,” said Patrick ...

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Given the way markets work, the very existence of these groups and their public challenges to management boost the share prices as other investors want in on a possible pay day. So, the activists succeed to an extent by simply announcing an alternative plan. The staying power of such share price increases is yet to be fully tested.

There’s little doubt dealing with savvy investors (mainly hedge funds) that claim to have a better way is going to be one of the most important assignments for U.S. public company chief executive officers and boards. As we’ve seen, such investors don’t have to buy up anything approaching a controlling interest of shares in order to purchase real influence over company behavior.

Corporate democrats and investor-return purists likely see the pluses of the aggressive investor movement. Many managers are complacent and underperform.

Shareholders, whatever the age of their holdings, are in fact the owners of public companies. A public company’s only duty is to maximize the value of shareholders’ interests, the sooner the better.

In the real world, things are more complicated. At the extreme, these activist hedge funds don’t let managers manage. They create crises that call for dramatic actions (sale of the company, spin-offs, big stock buybacks, etc.). No strategy that takes a year or two to show its stripes can play out. The short-term self-interest of the activists may be at odds with longer-term holders, not to mention at odds with other interested groups such as employees.

In oversimplified terms, the so-called “agency” issue posits that hired managers don’t have the same attachment and commitment to the company they run as do the shareholders because managers are employees, not owners. There’s a separation of control and ownership. Stock and stock-option compensation for top managers have been among the less-than-successful attempts to remedy this disconnect.

When well-heeled hedge funds buy into a company’s shares seeking a short-term gain regardless of the longer-term consequences for the company, they flip the “agency” problem on its head. These owners are arguably less committed to the company than the managers.

Back in July, Wendy’s announced a strategic realignment. It said it would make an initial public offering of 15% to 18% of the Tim Hortons chain, one of its biggest successes. The company said it would sell some of the restaurants it owns back to franchisees and close some underperforming stores. It pledged to raise the dividend and buy back $1 billion of stock.

Wendy’s cited a long-in-the-works analysis as the reason for the action, but it was also in line with a plan being pushed on the company by an activist hedge fund, Pershing Square Capital Management LP. In a July 11 letter filed with the Securities and Exchange Commission, Pershing

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Correction

“Blood Thicker Than Disclosure For Some Companies,” an article in the Dec. 7 issue of Dow Jones Corporate Governance, incorrectly reported that several relatives of Citigroup Inc. executives were each paid annual salaries of more than $200,000. However, their annual salaries actually ranged from $143,900 to more than $2 million in 2003, according to the company’s 2004 proxy.
Activist hedge funds may have carried big guns in 2005, but they also walked softly, according to a survey of 2005 governance activity.

Georgeson Shareholder Communications Inc., a proxy solicitation firm, found that on the surface, signs of shareholder activism waned in 2005. But that’s no indication that shareholders aren’t getting a greater say with management, according to Georgeson’s analysis, which attributed declines in shareholder proposals and proxy fights to the new breed of activist that dominated in 2005: the hedge fund. The study also found that activists focused in on how directors are elected, particularly with majority vote resolutions, which took the limelight from proposals on poison pills and stock options, big topics in prior years.

The study, which looked at the first six months of the year, when most companies hold their annual meetings, found that the number of governance proposals voted on was 375, down from 414 in the prior year and 427 in 2003, an all-time peak. The number of proxy contests also declined, to 24 in 2005 from 27 in 2004. But numbers don’t tell the whole story, and may in fact be deceptive, as activists increased their influence in the boardroom this year, settling matters out of the limelight, according to Georgeson’s analysis.

Bruce Goldfarb, senior managing director and general counsel of Georgeson, said he was surprised by the declines in superficial markers of activism, but noted that many dialogues between shareholders and company management get settled behind the scenes and never turn into official proposals on the company’s proxies.

He also observed that shareholders, particularly the hedge funds, seem to be getting better at getting their way. “Overall, I would say the biggest change that we saw in 2005,” Goldfarb said, “is that if a hedge fund ran a proxy contest they were very likely to win or have the contest settled on terms that were favorable to them.”

Some of 2005’s face-offs between hedge funds and managements where dissidents won included Steel Partners’ fight to amend bylaws at BKF Capital Group Inc., and Carl Icahn’s fight to refresh the board at Blockbuster Inc.

Hedge funds also made waves by wielding influence disproportionate to their numbers in M&A deals, the study said, citing situations at Providian...

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Lawyers See No Poison Pill To Feed Hedge Fund ‘Wolf Packs’

By Phyllis Plitch

Corporate America is looking for a new poison.

In the early 1980s, Martin Lipton presciently created the poison pill, sealing his reputation as master of the corporate bar with a potent and lasting legal device to help clients keep hostile raiders at bay.

Two decades later, a new breed of predator - Wall Street’s increasingly hungry hedge funds - seems to have found an antidote to the once effective pill. This time around, lawyers are largely empty-handed. Traditional defensive measures are severely weakened, and there doesn’t appear to be any new or particularly nifty legal tool that can be pulled off the shelf to help clients stand their ground.

It’s not for a lack of trying, lawyers say. It’s just that hedge funds have come banging on the corporate door with methods that don’t lend themselves to an all-purpose legal or governance tactic.

“Hedge funds have reinvented the game - they’ve changed the rules,” said Charles Nathan, a mergers and acquisitions lawyer at Latham & Watkins LLP in New York. “Today, there’s no magic escape.”

Unlike the raiders of old, activist hedge fund agendas are heavily focused on structural or strategic changes and shareholder-friendly corporate finance moves, like hefty share buybacks.

True, hedge funds have made several outright bids to put companies in play, but more often they’re buying stakes in their targets to push changes they’re after. In either case, they typically acquire a stake of less than 10% to avoid triggering a pill and often work in tandem with loose networks of like-minded funds, without forming a formal investment group.

“Hedge funds travel in wolf packs,” said Nathan. “Once you have a leader who starts the ball rolling, others will ride the coattails of the leader and support the leader’s aggressive actions.”

Hedge Funds Are Credible Threat

Contrast that with the classic corporate raider approach in the 1980s, which entailed slowly building up a position and either seeking greenmail or launching a hostile offer for a big block of shares, often accompanied by the threat of a lowball bid for those leftover minority shareholders slow to tender shares into the offer. Greenmail is a premium paid just to the raider for his shares.

The poison pill made one of its earliest appearances, though in the more rudimentary guise of a “cumulative convertible voting preferred stock dividend,” in 1982 in response to then Burlington Northern Inc.’s two-tier tender offer for El Paso Corp.

As devised by Lipton, founding partner of Wachtell Lipton Rosen & Katz in New York, each common share was entitled to a preferred share. The pill was then triggered under certain circumstances, including Burlington’s build-up of a 25% stake. It gave El Paso’s board more leverage by, among other things, guaranteeing that minority shareholders who didn’t sell into the offer would have the power to elect a third of the board.

After the pill was upheld by the courts in the mid-1980s, the characteristics became more uniform and companies en masse rushed to adopt pills of their own. A typical pill gives shareholders the right to buy additional shares at bargain prices, deterring would-be suitors.

These days, hedge funds are often buying up just enough shares to be a credible threat in seeking a change in strategy or board seats.

Take corporate-raider-turned-hedge-fund-activist Carl Icahn’s most recent machinations at Time Warner Inc. Icahn hooked up with several investors, but together they still have less than 3% of Time Warner’s shares in their pockets. Yet, they’re counting on other investors to stand with them in their effort to snatch board seats from management-backed directors, as they call for a big share buyback and a spinoff of its cable-television unit. It’s a strategy that Icahn successfully employed at Blockbuster Inc., where he rounded up hedge funds and other shareholders who helped propel him to victory in his proxy fight.

“If you have five like-minded investors who see similar ways to change the company’s course, they’re a significant force,” said James C. Morphy, managing partner of mergers and acquisitions at Sullivan & Cromwell LLP in New York.

The growth in the number of hedge funds is one of the biggest differences between now and the 1980s. “You just have a completely different investor base - hedge funds with significant positions and therefore a great deal more voting power and willingness to use it than in the ’80s, where the only thing that truly motivated investors, in effect, was a real deal.”

That’s exactly what happened earlier this year at Beverly Enterprises Inc. A consortium of investors - owning more than 8% - made an unsolicited bid for the Fort Smith, Ark., nursing-home company and later floated a slate of alternative directors, never triggering a last-minute poison pill. Roughly half of the company’s shares traded hands after the consortium

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Despite New Efforts, Some Say Independence ‘Not Measurable’

By Tiffany Kary

Institutions in the U.S. are moving to close loopholes in definitions of director independence, but international governance commentators say that there’s only so much good that can do, pointing to the different ways good boards get things done in different countries to prove their point.

The idea of independence is something of a red herring at an international level, said governance specialists who spoke on a recent Standard & Poor’s panel in New York that addressed the difficulty of mandating integrity globally.

“The real point is independence of mind, and that’s not measurable,” said Jochen Sanio, president of the German Federal Banking Supervisory Office.

Masatsugu Nagato, managing executive officer for Mizuho Corporate Bank, noted that in Japan, bringing in outsiders to meet U.S.-copied independence criteria has caused more of a problem. For instance, an outside director may not have expertise at the company, and could be a retired CEO with friendly ties to the company, he said. In Japan, a structure of “cross-shareholding,” where companies hold large stakes in one another and therefore hold each other accountable for any missteps, also changes the equation. In this case, directors might not necessarily be classified as independent, but might nevertheless be very interested in making sure that the company is behaving itself, he said.

George Dallas, managing director and global practice leader of governance services at Standard & Poor’s, said, “Attitudes about independence are often driven by ownership structures at companies.” He noted that in the U.S., where ownership for large-cap companies is fairly dispersed, independent directors are needed to act as the agents in overseeing company management for disparate shareholders. In other countries, stockholders more often have a majority voting stake in the company and a seat on the board, ensuring that shareholders’ voices are heard with management without the need for an intermediary who’s independent of management.

Indeed, some panelists said that director independence shouldn’t be a top criteria in evaluating corporate governance. “I wouldn’t obliterate the notion of independence, but I would subordinate it with the concept of responsiveness to shareholders,” said Eric D. Roiter, senior vice president and general counsel of Fidelity Management and Research Co.

Nevertheless, U.S. institutions are still trying to better define independence, as conflicts continue to arise.

In one recent instance, a shareholder lawsuit at Walt Disney Co., won by the company in August, provided a window into how many challenges to independence get missed by the current rules. One director classified as independent, Reveta Bowers, was the principal of the prestigious Center for Early Education in West Hollywood, a school attended by Eisner’s sons and the children of other Disney executives, who also gave the school donations. Another, Robert Stern, was Eisner’s personal architect and was beholden to Eisner for an immense amount of work from Disney, including designing the new animation building at Disney’s Burbank, Calif., headquarters.

In another, Robert Clark resigned from the board of Lazard Ltd. after the bank was hired by hedge fund activist Carl Icahn to assist in a threatened proxy fight against Time Warner Inc. Clark, who is also a director...continued on page 13
ABA Panel Leans Toward Cos.’ Plans For Director Elections

By Phyllis Plitch

A prominent American Bar Association panel appears poised to throw its weight behind the growing trend of U.S. companies charting their own path on director elections.

The panel, a committee charged with making sure the ABA’s so-called Model Act keeps up with the times, is clearly looking favorably upon a director voting system embraced by Pfizer Inc. and an increasing number of large companies.

As it examines whether the time is ripe for scrapping the current plurality voting model in favor of majority voting, the committee has been looking for “suitable” ways to reinforce such voluntary initiatives, according to an update from committee Chairman E. Norman Veasey.

Final recommendations from the ABA panel are expected out no later than February. Veasey declined to elaborate beyond the release.

“The committee continues to be of the view that the Model Act should facilitate, where appropriate, individual corporate action on a case-by-case basis,” the former Delaware Supreme Court chief justice said in the update.

The committee’s deliberations have been closely followed both by companies and activist investors. While not binding, the ABA’s Model Business Corporation Act provides a blueprint for states to follow, and about 30 states pattern their laws after the ABA’s model business laws. A plurality standard is the default under the model act.

Under plurality voting - still the standard at most companies - directors can win a seat on the board without winning a majority vote. Theoretically, even a single vote would send a candidate into the boardroom.

It has been roughly a year since the ABA’s business law section formed a task force to study whether to change the model act’s default, one of several moving parts on the majority voting question. The task force is co-chaired by a top governance official at Pfizer, Peggy Foran, vice president of corporate governance and corporate secretary, and A. Gilchrist Sparks, a partner at Morris Nichols Arsht & Tunnell in Wilmington, Del.

Beyond Pfizer, a virtual Who’s Who of the nation’s largest companies, including General Electric Co. and Microsoft Corp. jumped on the trend, hammering out their own quasi-majority vote alternative in the last few months, one framed by corporate advocates as a shareholder-friendly move that would still give companies’ flexibility.

Under these newly crafted policies, directors would be asked to tender their resignations if they get more “withhold” votes than “for” votes at annual meetings. In general, a board committee would weigh whether to accept the resignation. In director elections, investors can only check off “for” or “withhold” under a plurality voting model.

This spring, the ABA panel put out a discussion paper that included several potential alternatives for public consideration. The four alternatives on the table were: switching to majority voting; keeping the status quo; adopting a default plurality rule requiring that a director be elected by at least a “minimum” plurality vote; and leaving the plurality vote default rule in place but specifically authorize “against” votes with certain consequences if a director achieves a plurality vote but more “against” than “for” votes.

The latest communication - if carried through - could halt forward momentum of any regulatory changes to institute a majority vote standard, said Carol Bowie, director of the governance research service at the Investor Research Responsibility Center, a unit of proxy advisor Institutional Shareholder Services.

“But it would please those who fear unintended negative consequences that could result from ‘rushing’ into legal changes,” she said, adding that “companies have a natural bias toward maintaining as much flexibility as possible.”

If the panel does go in that direction, it is likely to feel heat from some investor activists who think the new corporate guidelines fall short and that the panel should recommend for the model act what they view as a fundamental shareholder voting right.

“Voluntary-director-resignation policies are not a substitute for a majority vote standard in director elections,” said Ed Durkin, director of corporate affairs for the United Brotherhood of Carpenters and Joiners of America, who has spearheaded a major campaign to blanket U.S. companies with annual-meeting resolutions pressing for the change to majority voting.

“It’s a beautiful thing to hear from some investor activists who think the new corporate guidelines fall short and that the panel should recommend for the model act what they view as a fundamental shareholder voting right.

Such post-election governance policies “fail to establish a fundamental shareholder voting right that enables shareholders to determine which board nominees are elected in corporate board elections,” he said.

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An advisory committee to the Securities and Exchange Commission voted overwhelmingly to recommend exempting about 80% of public companies from a key part of the Sarbanes-Oxley law, saying that small companies were disproportionately burdened by the congressionally mandated requirements.

The preliminary recommendations to give companies a break from strict assessments of internal controls over financial reporting were approved almost unanimously. Only Kurt Schacht, the executive director of the CFA Centre for Financial Market Integrity, rejected the plan.

“It’s easier to say we are better off over-auditing than under-auditing,” said Janet Dolan, chief executive of Tennant Co. and head of a subcommittee that developed the proposal. “However, over-auditing comes at a price, and when that occurs on a large scale across all of our capital markets, the cost to our economy is huge.”

Companies have been complaining about the controversial internal-controls section of the 2002 law for years, with howls growing louder since large companies came under the requirement for the first time last year. Under the measure, company executives are required to assess their internal controls over financial reporting and to hire outside auditors to assess those controls.

The SEC’s advisory committee on smaller public companies voted to recommend rolling back that requirement entirely for companies with a market capitalization of $125 million or less, or about half of the companies in the market. In exchange, these companies would be subject to stricter corporate-governance requirements.

Larger companies - those with a market capitalization of between $125 million to about $750 million and prior-year revenue of no more than $250 million - would also be exempt from hiring an outside auditor to test internal controls under the approved recommendations. Management at larger companies would still have to submit an annual assessment of the quality of their internal controls.

The SEC’s advisory committee on smaller public companies is scheduled to next meet on Jan. 23 and will issue its final, non-binding recommendations in the spring. The recommendations will be published for public comment before the SEC decides whether to adopt some or all of the recommendations.

Schacht suggested that exempting so many companies from a key part of the 2002 Sarbanes-Oxley law could invite a legal challenge. In the event that the recommendations meet with resistance in the SEC, the panel also voted to recommend an alternative approach that would lessen regulations on 80% of public companies without completely relieving them of outside oversight of internal controls.

Under the alternative approach, the U.S. audit oversight board would be asked to develop a new standard for auditing the design and implementation of internal controls at smaller public companies. However, auditors would not be required to test the operational effectiveness of the controls.

The proposal quickly met with resistance from the U.S. accounting industry, partly because accounting firms are concerned about facing liability for internal-controls systems that they haven’t been able to test.

“The development of a new standard in the largest firms is not going to be favorably looked at,” said Mark Jensen, a director at Deloitte & Touche and a member of the advisory committee.

SEC Chairman Christopher Cox has already signaled that he is open to loosening regulations, suggesting in correspondence with Sen. Olympia Snowe, R-Maine., that the agency is focused on instances where the costs of regulations outweigh the benefits.

Large U.S. companies already came under the requirement for the first time last year and many complained that it was both costly and time-consuming. The tiniest companies - those with a market capitalization of less than $75 million - have received several reprieves, with the SEC most recently postponing the requirement for them until mid-2007.
Public companies will not spend nearly as much this year as last to assess internal controls over financial reports, according to a new survey that projects costs will fall by 40% on average, compared to 2004.

Large and smaller companies will see costs in this area fall “substantially” this year, according to the survey, which was commissioned by the Big Four accounting firms and based on a random sample of their public company audit clients.

Forecasts of lower costs come amid complaints about the expense of complying with the internal-controls requirement, which took effect for the first time last year for larger U.S. companies. Smaller firms and those outside the U.S. have yet to come under the same requirement, mandated by Congress in 2002.

The results suggest that a hefty portion of the first-year costs were due to start-up costs and one-time factors that will diminish over time, the Big Four firms said in a letter to Securities and Exchange Commission Chairman Christopher Cox, released along with the survey results.

The survey, by economic consulting firm CRA International, formerly Charles River International, was commissioned by Deloitte & Touche LLP, Ernst & Young International, KPMG LLP and PricewaterhouseCoopers LLP.

Congress ordered public companies to assess internal controls over financial reporting each year, subject to further review by the firm’s outside auditor. Big flaws in controls meant to guard against inaccurate or fraudulent financial reporting must be reported to regulators and shareholders.

Audit firms and companies will test fewer controls, generate less documentation and outside auditors expect to rely more on the work of others, including internal auditors, which should make the whole process less costly, CRA senior consultant Robert Litan said in a telephone press conference recently.

Litan, who also is a director of economic studies at the Brookings Institution, predicted audit quality will remain high despite the cheaper price tag.

Large companies with a market capitalization of $700 million or more will realize the biggest savings, the survey suggests. It projects the big firms will see internal and external compliance costs fall 42% on average, from $7.3 million to $4.3 million. Companies with a market capitalization of $75 million to $700 million will spend about 39% less, according to the survey, with costs dropping from about $1.5 million to $900,000.

Reduced documentation because of work that need not be repeated will generate the bulk of the savings in year two, the survey predicted. It said increased efficiency should provide further savings.

Regulators at the SEC and the Public Company Accounting Oversight Board have not backed off on internal controls, but have urged auditors and companies to concentrate their firepower on high-risk areas that pose the greatest danger to investors.

The survey suggests that message may be getting through. It predicts outside auditors will test fewer “key” controls at public companies, looking at an average of 540 at larger firms, down nearly 20% from the 669 examined on average in the first year. Meanwhile, those larger companies are expected to test about 867 controls themselves, on average, down from 992 in year one.

At smaller companies, auditors will likely test 206 controls on average, down about 22% from the 262 scrutinized in year one, while the smaller companies themselves are projected to test about 298 controls, down 17% from the 359 average last year, according to the survey.

The full survey results are available online at www.s-oxinternalcontrolinfo.com.

Exec Pay: SEC’s Cox Calls For ‘All-Out War’ On Complexity

The Securities and Exchange Commission is developing rules to provide clear information on executive pay packages as part of an all-out war on needless complexity, SEC Chairman Christopher Cox said recently.

In remarks to the Economic Club of New York, Cox said the SEC plans to update rules regarding disclosure of executive compensation. He said the changes will give investors and corporate directors complete, clear and comprehensible information about executive pay and perks.

“It’s about wage clarity,” Cox said. He stressed that the SEC is not going to dictate what executives are paid, leaving that decision to others.

Cox said he will continue to push for clear “plain English” disclosure to help investors understand financial products and he said the SEC will make greater use of technology, including data tagging.

He said the SEC is developing new rules that will provide mutual fund investors with clear and timely fund information at the point of sale by relying on materials available through the Internet.

Cox said that in order for the SEC to help investors, it needs “nothing less than an all-out war on complexity.”
The U.S. Securities and Exchange Commission voted unanimously recently to propose clarifying that payments such as executive severance packages made during a tender offer wouldn’t violate a rule requiring all shareholders to receive the same price for shares they tender.

Currently, the SEC’s “best price” rule requires that all shareholders be offered the same price in a tender offer, preventing anyone making an offer from favoring one group of shareholders over another. Federal courts have split on whether the 1986 rule applies to any payments during a tender offer, including those to reward corporate executives for staying or leaving.

The SEC’s proposal would clarify that employment, severance or other benefit arrangements paid to directors or employees during a tender offer are exempt from the “best-price” rule, as long as the payments relate to their service, not the number of shares they hold.

Securities lawyers say clarification would be welcome since some courts have held that any additional compensation to executives during a tender offer violates the best-price rule. David Sirignano, a partner with the law firm of Morgan Lewis & Bockius LLP in Washington, said that view has made acquiring companies leery of using tender offers to execute mergers.

“If they had to pay every holder what they paid management, the damages would be astronomical,” Sirignano said in a recent interview. He said the SEC’s clarification might spur greater use of tender offers, which allow acquirers to gain control of target companies faster, typically slicing two to three weeks off transactions done in a one-step merger.

Although the rule isn’t directed at ordinary shareholders, SEC corporation finance division director Alan Beller predicted they should benefit from it since investors tend to get paid faster in a tender offer than in other mergers.

The SEC will seek public comment on the proposal for 60 days. Final adoption of the modification to the tender-offer rule requires a second vote by the five-member commission.
Relational Asks SEC To Overrule NYSE, Block Sovereign Deal

By David Enrich

Sovereign Bancorp Inc.’s largest shareholder has asked the Securities and Exchange Commission to block the company’s controversial three-way transaction, arguing that the New York Stock Exchange violated its own rules by letting the deal go through without a shareholder vote.

In the deal, Sovereign is selling a minority stake in itself to Spain’s Banco Santander Central Hispano SA and is using the proceeds to help buy Independence Community Bank Corp. of New York.

Relational Investors LLC, which owns more than 7% of Sovereign’s stock, argues that the transaction violates an NYSE rule requiring shareholder votes on deals that transfer at least 20% of a company’s stock to an outside party. The NYSE last month rejected pleas from top shareholders and ruled that the transaction didn’t cross the 20% line.

But in its latest effort to derail the deal, Relational has filed a petition with the SEC, claiming that the Big Board erred by not counting so-called treasury shares when assessing whether the deal breaches the 20% threshold. Including treasury shares - stock that Sovereign previously repurchased on the open market - Santander is buying a nearly 24% stake in Sovereign, which would require a shareholder vote, according to Relational.

“Unless the commission intervenes, the NYSE’s voting requirements will become a virtual dead letter,” Relational wrote in the 43-page petition. “More generally, evasions of the principles of enhanced corporate governance will have been encouraged.”

In a statement, Sovereign called Relational’s petition to the SEC “nothing more than a desperate attempt...to save a now sputtering campaign to derail two transactions that we believe will significantly increase shareholder value. It is time for Relational to move on.” A Santander spokesman wasn’t immediately available.

Relational argues that by not counting treasury shares toward the overall 20% limit, the NYSE effectively changed its rules without getting the required approval from the SEC. Rule changes require a lengthy approval process, including a period in which the public is allowed to submit comments. If the SEC sides with Relational on the matter, the NYSE would have to either force Sovereign to hold a shareholder vote or try to amend its rules.

The three-way deal infuriated many top investors, who viewed it as destroying value and intended to erode their voting power, and industry observers believe a shareholder vote could doom the transaction.

As with the initial appeal to the NYSE, Relational’s SEC petition is virtually unprecedented. Experts have said it was hard to predict how the SEC would treat such a request. It isn’t clear whether the agency has an established framework for handling these matters.

An SEC spokesman wasn’t immediately available to comment.

Relational officials say they had alerted the SEC in advance about the petition and asked them to handle it on an expedited basis.

Even assuming the SEC upholds the Big Board’s ruling, the ongoing controversy threatens to put an unwelcome spotlight on the NYSE’s self-regulatory arm at a time when the exchange is preparing to transform into a public company.

The Big Board’s regulatory chief, Richard Ketchum, has defended the decision to let the deal go through in a modified form, arguing that the 20% rule wasn’t designed to restrict companies from issuing treasury shares to outside parties.

“I’m quite comfortable the SEC will conclude we properly interpreted the rules,” he said before Relational filed its petition. But he added that the NYSE is concerned about the potential for companies to abuse the provision and said the exchange is reviewing whether to change the rule.

After the petition was filed, an NYSE spokesman declined to elaborate on Ketchum’s comments.

The SEC petition is one of a number of strategies Relational is pursuing as it tries to kill the deal and keep pressure on Sovereign.

Relational recently filed suit against Sovereign and Santander in federal court in New York, arguing that the deal violates provisions of a Pennsylvania anti-takeover law and that the Spanish bank was required to buy all of Sovereign’s outstanding stock for $27 a share - the same price it is paying for the minority stake. Sovereign and Santander say the suit is without merit.

Relational’s most potent challenge to Sovereign remains a proxy contest in the spring. The San Diego money manager is campaigning to replace two Sovereign directors with officials from Relational. That is shaping up to be a fierce battle, as both sides vie for support among retail investors. Many institutional shareholders have voiced support for Relational. cc
Seatholder Cataldo Capozza sued the New York Mercantile Exchange for records detailing the exchange’s proposed stake sale to private-equity firm General Atlantic LLC and its plans to go public next year.

The complaint, filed recently in Delaware - where the exchange’s parent company, Nymex Holdings Inc., is incorporated - raises concerns of bid-rigging last summer as Nymex considered offers from a string of private-equity firms interested in buying a minority stake. The lawsuit seeks documents related to those offers so that seatholders can determine whether Nymex management secured the best deal.

Nymex General Counsel Christopher Bowen defended the bidding process in a recent interview with Dow Jones as fair and transparent. “The whole thing about the process being biased is completely meritless,” he said.

Capozza, a 20-year Nymex veteran who owns three seats worth more than $11 million, hasn’t determined whether to seek class-action status for his suit on behalf of other seat holders. But doing so likely would require more support from those who remain leery about a lawsuit ahead of the exchange’s planned initial public offering.

Firms named in the complaint included The Blackstone Group and Battery Ventures, two private-equity outfits that teamed up to bid on Nymex. General Atlantic, which also was named, won the bidding war and signed a definitive agreement in November with Nymex to buy a 10% equity stake for $135 million. Representatives from all three private-equity firms declined comment.

As part of the deal, General Atlantic agreed to prep the nation’s largest energy and metals exchange for an initial public offering targeted for mid-2006. General Atlantic is a closely held, $10 billion venture-capital firm based in Greenwich, Conn.

“One or more of the individuals familiar with the process followed by Nymex leading up to the board’s acceptance of the GA proposal have suggested - and there is adequate reason to believe - that the bidding process was rigged,” states Capozza’s complaint.

Capozza seeks to investigate whether senior officers and directors of Nymex “seek to gain personally by the GA proposal,” the complaint says.

‘No Credible Basis’

By securing Nymex documents, Capozza also seeks to examine plans by the exchange to rejigger corporate-governance rules ahead of a planned initial public offering that could undercut seatholder rights while significantly strengthening the board.

Nymex laid out the details of those plans in a preliminary proxy statement addressing the General Atlantic deal, filed with the Securities and Exchange Commission in November.

“There are a substantial number of influential Nymex seatholders who are discussing the proposal and concerned about it,” said Capozza’s lawyer, Mark Rifkin of New York-based Wolf Haldenstein Alder Freeman & Herz LLP. “It looks to me like there is a very small number of seatholders and Nymex officials that are trying to seize control of the exchange.”

Capozza’s suit follows Nymex’s recent rejection of an initial request for exchange records. Among other things, Capozza asked for documents detailing Nymex board meetings and advice received by the exchange’s financial advisers in valuing the stake up for sale.

“On its face, the complaint shows no credible basis for any of the claims,” said Nymex in an e-mailed statement. “Our lawyers are still reviewing it, and we will respond in due course in accordance with Delaware law.”

Nymex has reiterated that the stake sale wasn’t meant to be an auction in search of the highest bidder, but a search for a partner who would buy into the exchange and guide it through the IPO process.

Reaction from Nymex seatholders was mixed. Some voiced support for Capozza, while others questioned whether the suit was worthwhile. One person close to the exchange doubted the complaint would go very far.

“Delaware can be very friendly to seatholder complaints, but this looks like a fishing expedition,” the person said. “Either way, while people at Nymex shout at each other, their competition is going to pass them by.”

Question Of Value

Critics of the deal fret that it undervalues Nymex equity and question why the exchange turned down higher bids from other suitors. Seatholders will receive the proceeds of the stake sale.

The price of a Nymex seat has leapt to six consecutive record highs this year, bringing the exchange’s aggregate value to nearly $3.1 billion and raising its profile as a hot IPO prospect.

... continued on page 18
Pardus Expresses ‘Dismay’ At Recent Bally Actions

By Denise Jia

Bally Total Fitness Holdings Corp.’s largest shareholder, Pardus Capital Management LP, sent a letter to the company recently expressing its “grave concern” and “deep dismay” over certain executives recently selling shares while the company is exploring alternatives and considering seeking a buyer.

Pardus Capital, which has filed a preliminary proxy to nominate three candidates for election to Bally’s board, urged the company to appoint these nominees to the board immediately, rather than waiting until the January annual meeting.

Pardus Capital, which holds a 13.9% stake in the Chicago-based operator of fitness centers, also urged the company to separate the positions of chairman and chief executive, according to the letter that was included in a Schedule 13D filed with the Securities and Exchange Commission.

As reported, certain executives of Bally, including Chairman and CEO Paul Toback, exercised options on Dec. 2 and Dec. 5, selling a total of about 1.2 million shares of the company.

Bally has recently engaged JP Morgan Securities and Blackstone Group to explore strategic alternatives, including a potential sale of the company.

Pardus Capital said in the letter that it is concerned that the reported stock sales may indicate that management has a conflict of interest, and the “management may not be motivated to realize the highest achievable value for stockholders because management is planning to be part of a potential bidding group for the company’s assets.”

Pardus Capital also raised concerns on Bally’s decision to “rush to sell” its Crunch Fitness division.

As reported, Bally announced in September a deal to sell its Gorilla Sports brand and its Crunch Fitness division to a private investment group for $45 million. However, the company said last month that it was having trouble meeting some of the conditions of the sale and expressed uncertainty about whether the deal can be completed.

In the letter, Pardus Capital raised the question whether Bally’s management sold Crunch cheaply in an attempt to lower market expectations for the ultimate sale of the company, and thereby “facilitate a low-ball offer by a management-led buyout group.”

Bally Total Fitness recently also initiated lawsuits against Liberation Investments LP, its second largest stockholder, in an attempt to prevent Liberation from preventing stockholders its proposal to remove the company’s CEO.

A state court judge recently refused to issue a quick ruling on whether Liberation’s bid to unseat Bally’s CEO Toback is legal. A federal judge set a Jan. 13 hearing on Bally’s bid to force Liberation to provide shareholders with more adequate information.

Pardus Capital said in the letter that it hasn’t yet taken a position concerning Liberation’s proposal, but it is a strong advocate of stockholder democracy.

“If Liberation’s disclosures are incomplete, and management wants to make its case to stockholders, we fully support that open process,” Pardus Capital said in the letter.

In another recent filing, Liberation filed a proxy statement calling for shareholders to adopt several of the investors proposals, including amending the company’s bylaws to give stockholders the authority to remove the CEO, and increasing stockholder authority with respect to determining the tenure of the company’s officers.

Liberation also called for shareholders to vote against the approval of the board’s 2006 Omnibus Equity Compensation Plan, the filing said.

Liberation, which holds a 10.9% stake in the company, said it has long been concerned about the quality of corporate governance at Bally, and believes that stockholder democracy at the company would be bolstered by providing stockholders with a continuing voice in determining the tenure of Bally’s senior management team, including its CEO and president.

Shareholders will be able to vote on the proposals at Bally’s annual meeting to be held Jan. 26.

inBRIEF

FASB Chairman Herz Calls For Less Complexity In Accounting

Financial Accounting Standards Board Chairman Robert Herz said recently that financial accounting standards are too complicated and must be simplified.

“I feel pretty strongly that the time has come for collective action to address these issues,” Herz said in remarks to the American Institute of Certified Public Accountants.

He said that one of the candidates for simplification is a standard for accounting for leases. “I think we will likely take it on,” Herz said in response to a question from the audience. “Clearly, that is a prime candidate for the issue of reduced complexity.”

The remarks broke little new ground, but stood out for some observers because of their sense of urgency and the emphasis on bringing the Securities and Exchange Commission, the Public Company Accounting Oversight Board, and others into the process.

“I think he was in his own way telling people that now is the time we really, really have to get things moving,” said Raymond Beier, a senior partner at PricewaterhouseCoopers. “I think there’s a strong implication that he’s brokering a process among the key stakeholders to bring greater clarity, more transparency, more understandability into financial reporting.”
Thomas Ray Selected As PCAOB Chief Auditor
By Siobhan Hughes

The U.S. audit oversight board has promoted Thomas Ray to chief auditor, succeeding Douglas Carmichael, who has announced plans to step down at the end of January for personal reasons.

Ray, 45 years old, has been deputy chief auditor at the Public Company Accounting Oversight Board since June 2003. Before joining the board, he had worked as a partner at KPMG in the department of professional practice-assurance in New York.

“I am honored by the board’s confidence in my work, and I look forward to building on the strong foundation set by Doug Carmichael,” Ray said in a statement.

Carmichael was the chief author of a standard used by auditors in implementing the internal-controls requirement of the 2002 Sarbanes-Oxley law. Under the law, companies are required to assess the quality of their internal controls over financial reporting, with documentation and testing by external auditors. Companies are already asking the PCAOB to consider changing the audit standard, saying audit overseers must do more to ensure that audits don’t get bogged down in details that drive up auditing costs.

In an interview, Ray emphasized that his 14-person office would provide continuity for the PCAOB rather than change. “Doug Carmichael and I worked together very well and very closely,” Ray said. “In fact, our entire office of the chief auditor really has worked together exceedingly well as a team over the last two-and-a-half years since I’ve been with the PCAOB, so I think you really shouldn’t expect to see any major changes in the direction or advice that the office of the chief auditor is going to provide to our board members.”

With a second round of internal-controls audits now winding down, Ray also said that the PCAOB would have a chance to gain more information about how the audits were working. The Big Four auditing firms have said that costs will fall by 40% on average this year from the amounts paid in 2004.

“It’s very important for us to get more information as a result of this second round of audits as we consider what, if any, changes may be needed,” Ray said.

Companies must include internal-controls assessments in the annual reports they file with the Securities and Exchange Commission. Those reports will start arriving in the first quarter of next year.

The change in audit chiefs at the PCAOB comes amid a larger change in leadership at the board. Bill Gradison, who once served as a congressman from Ohio, was recently named acting chairman of the PCAOB, filling the vacancy created when William McDonough stepped down on Nov. 30.

Despite New Efforts...
(continued from page 5)

at Time Warner, said he resigned “to eliminate the appearance of a conflict of interest” despite meeting all the rules for independence.

The New York Stock Exchange continues to take steps to better define its own independence rules. It recently moved to have companies disclose more about how they determine a directors’ independence, rather than allowing companies to simply say the director meets its “bright-line” tests. For example, according to current rules, a director isn’t independent if they have a family member who’s received $100,000 in compensation from the listed companies. Under SEC rules, the company would have to disclose the arrangement in its proxy anyway - because it’s above the $60,000 threshold set by the agency. Under newly proposed NYSE requirements, companies would have to disclose that an independent director has no relationships, and in the case of an “immaterial” relationship with the company would need to describe why the relationship is immaterial.

SEC To Issue ‘Objective Criteria’ For Company Fines

The Securities and Exchange Commission is developing guidance that will help clarify when it will fine companies for wrongdoing and may release the guidelines publicly, SEC Chairman Christopher Cox said recently.

SEC fines on public companies are controversial, with some arguing that any penalties ultimately are borne by shareholders, not public companies. The issue has become politically charged, with Republican commissioners sometimes opposing such fines while Democrats uphold them.

Cox told reporters after an SEC meeting that the SEC is working on developing “more clearly expressed objective criteria” for fining companies.

“The purpose is to demystify the process,” both within and outside the SEC, Cox commented. He said the SEC commissioners and staff have been spending a great deal of time on the guidelines and hope to finish their work shortly, although he didn’t specify a timetable or deadline.

Once the guidelines are finished, Cox said they might be issued as a statement from the five-member commission or as “interpretive guidance” by the agency. Alternatively, he said the approach could be detailed in a settled SEC enforcement case.

inBRIEF
The U.S. House on recently passed, 294-132, a wide-ranging pension bill that Democrats warned would allow companies to continue dumping their pension plans on the federal government at a cost to employees and retirees.

The bill would change pension funding rules, increase premiums paid by companies to the Pension Benefit Guaranty Corp. (PBGC), allow companies to automatically enroll employees in 401(k) plans and ease conflict-of-interest rules for pension fund managers.

The bill’s passage was hailed by the Securities Industry Association and the National Association of Manufacturers, but NAM said it had a number of remaining concerns.

The measure has divided business and labor groups, many of whom argue that it would be too strict. Two days before the vote, GOP leaders were refusing to bring the bill to a vote, fearing moderate Republicans from districts with a strong union presence would vote against the bill.

Complicating the matter is opposition to the plan by the Bush Administration, which predicts the bill will actually loosen pension funding requirements while exacerbating the finances of the federal pension guarantor, the PBGC. The administration is now eyeing negotiations between the House and Senate to produce stronger measures in a final bill.

“The legislation must be strengthened with respect to the level of required plan contributions and premiums that are needed to return the PBGC to solvency and avert a taxpayer bailout,” the White House said in a statement released before the House vote.

The bill’s proponents adamantly defended the measures. “This is a good and tough bill that makes companies put their money behind their promises,” said Rep. Sam Johnson, R-Texas.

An agreement brokered by the United Auto Workers, General Motors Corp. and the bill’s authors cleared the way for the vote, but even then Republican leaders balked at a request from Democrats for a vote on their own version of the bill. Rep. George Miller, D-Calif., said Republicans feared the Democratic alternative would pass.

The number of companies abandoning their pension plans to the PBGC each year has remained relatively constant since PBGC’s creation in 1975. But the number of larger pension plans dumped on PBGC has skyrocketed. In the 30 years since its inception, the PBGC has taken over 32 pension plans with benefit obligations greater than $100 million, 21 of which were taken over in the last five years.

Nationally, pension plans are underfunded by an estimated $450 billion, and the PBGC faces its own $22 billion deficit.

House Education and Workforce Committee Chairman John Boehner, R-Ohio, defended the bill he helped write, saying it tread the fine line between assuring that companies meet their pension responsibilities, while not asking so much that they abandon their pension plans entirely.

“If we don’t act we know exactly what will happen: millions of Americans will be at risk they will not have their [pension] plans,” Boehner said.

Boehner said the PBGC estimates of his bill’s impact are based on “purposely-skewed modeling” and that if there is any easing of funding rules, it is to provide a transition to funding requirements that will definitely be tougher over the long run.

Boehner also lambasted Democratic opposition as hypocritical. On the one hand, Democrats cite PBGC analyses concluding that the bill would allow companies to set aside too little for their pension plans, while on the other hand Democrats argued that the bill is so tough that it will drive companies to stop offering pension plans altogether, Boehner said.

“It’s my sincere hope, however, that many of their Democrat colleagues will look beyond the rhetoric and support these long-overdue reforms,” Boehner said.

In the end, 70 Democrats voted for the bill, while only one Republican voted against it.

Rep. David Scott, D-Ga., said he was voting for the bill in order to help Atlanta-based Delta Airlines Inc. The House bill includes no airline provisions, but a Senate version of the plan would give a special break from pension funding rules for underfunded airline pension plans. Scott and other airline proponents say the only way to get the Senate provision signed into law is for the House to vote.

Likewise, Rep. Robert Andrews, D-N.J., echoed concerns that current “law makes it far too easy for failed pension plans to be dumped into PBGC.” But changes in the bill easing funding requirements for pensions offered by multiple employers - such as those in the trucking industry or the various trades - secured his support. cg
SEC Floats Revamp To Help Foreign Cos. Exit US Markets

By Judith Burns

U.S. regulators voted unanimously recently to float changes that would make it easier for non-U.S. companies to exit U.S. markets. The issue has taken on increased urgency as non-U.S. firms soon will face strict internal-control requirements that already apply to larger U.S. companies.

Non-U.S. companies have long complained that U.S. rules make it easy to enter U.S. markets, but almost impossible to leave. Some liken U.S. markets to a “roach motel,” while others say they resemble the “Hotel California.”

Securities and Exchange Commission Chairman Christopher Cox referred to the “Hotel California” analogy at a recent SEC meeting, calling it a great song but “a lousy business model.”

Current rules make it difficult for non-U.S. companies to exit U.S. markets if they have 300 or more shareholders in the U.S. In such cases, companies may delist shares but still have to file quarterly and annual results to the SEC and shareholders. The proposal floated by the U.S. would scrap that standard for an approach that would vary depending on the size of the company and whether it has issued debt or stock in the U.S.

Small, foreign companies eligible for the new exit policy would be free to leave if U.S. residents hold no more than 5% of the company’s shares. Large, well-known non-U.S. companies would be free to leave if U.S. residents hold no more than 10% of a company’s shares and average daily trading volume in the U.S. doesn’t exceed 5% of the average in the company’s home market.

The SEC rebuffed an approach suggested by a coalition of European companies that would have relied on relative trading volumes in U.S. and non-U.S. markets. SEC officials said the two-pronged approach is needed since foreign companies may have low-volume trading in their stock in the U.S., yet have many U.S. shareholders.

Under the proposal, non-U.S. companies would be eligible to exit only if they have been in the U.S. for at least two years, have filed at least two annual reports, haven’t sold securities in the U.S. in a public or private offering in the past year and remain listed on an exchange in their home country.

Debt issuers would be free to leave if their debt is held by fewer than 300 worldwide or in the U.S. and they have filed at least one annual report in the U.S.

As proposed, non-U.S. companies wishing to deregister would file a new form with the SEC, which would temporarily suspend their financial reporting obligation. If the SEC doesn’t object, the suspension would become permanent after 90 days.

Non-U.S. companies that never issued stock in the U.S. or listed on a U.S. market, but whose shares are traded in a U.S. market, such as the Pink Sheets, would face a new requirement to provide home-country corporate documents in English, on their Web sites. Such firms now must supply the SEC with paper copies of such documents in English, so the only change for them is the requirement to use the Internet, which SEC officials said would make it easier for U.S. investors to see such materials.

SEC Commissioner Paul Atkins said the proposed changes go a long way toward addressing concerns raised by non-U.S. companies, but shouldn’t unleash a mass exodus if adopted. He predicted non-U.S. companies might be more willing to enter U.S. markets in the first place if they know “there is a way out.”

“I do not believe that the proposed rules will create a rush to the exits,” agreed SEC Commissioner Roel Campos. He called the proposed changes an “extremely fair” approach to non-U.S. companies that no longer want or need to be in the U.S. market.

About 1,240 foreign companies are registered with the SEC, with Canada and Britain accounting for about half of the total. Those hoping to exit the U.S. objected to the 300-shareholder approach, saying it isn’t practical since many shares now are held by brokers and other intermediaries, making it hard for a company to know exactly how many shareholders it has.

Exiting the U.S. market has become more appealing given the stricter requirements imposed by Congress in the 2002 Sarbanes-Oxley Act. The package of corporate accounting reforms applies to public companies, including those outside the U.S. that have U.S. shareholders. The requirement for companies to make an annual assessment of financial controls, subject to review by their outside auditor, is set to take effect for non-U.S. firms starting in mid-2006.

The SEC will seek public comment on the proposed changes for 60 days. Final adoption of the proposal requires a second vote of the five-member commission. cg
By Sabrina Cohen

Bank of Italy Governor Antonio Fazio has stepped down, just days after prosecutors named him in an insider-trading investigation.

Fazio, 69, said he was resigning “for the highest interest of the nation and the Bank of Italy,” where he has worked since 1960, and which he has led since 1993.

Prime Minister Silvio Berlusconi hailed the move, saying “it had become important and necessary that Fazio step down.”

Fazio is under investigation for abuse of office and insider trading in connection with his stewardship of two foreign takeover bids for big Italian lenders. He stepped down after consulting with the head of the central bank’s governing council.

Fazio has consistently denied wrongdoing, saying he always abided by the law.

According to documents connected with an investigation by Italian magistrates, Fazio and members of his family received Dom Perignon Champagne, a Cartier watch, a Prada handbag, rare religious texts and thousands of dollars worth of other gifts from an Italian banker who later won Fazio’s support for a controversial merger bid.

Gianpiero Fiorani, the former CEO of Banca Popolare Italiana SCARL, presented most of the gifts during the Christmas seasons between 1999 and 2003, according to the documents, seen by Dow Jones.

The gifts shed new light on a close and long-standing relationship between Italy’s central banker and Fiorani. The pair made headlines earlier this year when wiretaps of phone calls between them revealed Fazio went out of his way to support BPI’s unsuccessful effort to acquire Italy’s Banca Antonveneta SpA.

Fiorani was suspended as CEO by a judge in August 2005 after prosecutors alleged he concocted fictitious deals concerning his bank’s finances in a takeover battle that ABN Amro Holding NV of the Netherlands seems poised to win.

The gifts don’t violate the Bank of Italy’s code of conduct because it sets no monetary limit for gifts from individuals or institutions it supervises. However, it does exceed what is allowed by many European government agencies. Other bank executives have said such generosity isn’t part of their normal relationship with officials at Italy’s central bank.

While the gifts included baskets of food, commonly given across Italy at Christmas, prosecutors say Fiorani’s gifts to Fazio also included cream of truffles, vintage wine, antique maps and a cashmere sweater. Fazio’s wife, Maria Cristina, received a Prada Sport bag and a gold Baume et Mercier watch, while their four children received gifts including a Cartier watch and gold Pomellato jewelry.

A person familiar with an investigation into the relationship estimated the value of the gifts between EUR30,000 and EUR50,000. A list of gifts reviewed by Dow Jones Newswires appeared to be worth closer to EUR20,000, excluding rare religious texts and antique books - with writings by St. Thomas and St. Augustine - that experts said would be difficult to value precisely. Some other Bank of Italy officers also received similar expensive gifts from Fiorani.

As Italy’s central banker since 1993, Fazio consistently has blocked foreign banks from acquiring Italian lenders.

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inBRIEF

Delphi’s Exec Compensation Hearing Delayed For 2nd Time

Delphi Corp. has for the second time delayed a court hearing on its controversial executive compensation plan.

The hearing before U.S. bankruptcy Judge Robert Drain has been pushed to Jan. 27 from Jan. 5, according to a Delphi Web site. The auto-parts supplier filed a motion to implement the program, known as the key executive compensation plan, on Oct. 13.

The deadline for filing objections to the plan was Nov. 22, but the objection deadline for the Official Committee of Unsecured Creditors has also been extended, to Jan. 9.

The executive compensation plan has come under repeated fire from the United Auto Workers union, as well as other Delphi creditors who view increased wages and bonuses for executives as unfair in light of the wage and benefit cuts being asked of the hourly workforce by Delphi management. The union has estimated that the executive compensation plan could cost as much as $500 million.

The UAW is threatening a labor strike by its workers if an agreement isn’t reached with Delphi on the proposed wage and benefits cuts.

In a recent meeting with reporters, UAW President Ron Gettelfinger said he still sees the executive compensation plan as a major hindrance to successful negotiations.

Delphi, which filed for Chapter 11 bankruptcy-court protection in October, has said that the executive compensation is necessary to keep good salaried employees from jumping ship. In a court filing last month, the Pension Benefit Guaranty Corp., the federal agency that absorbs pension liabilities of failed companies, also objected to the plan. The PBGC warned that the plan could send hundreds of millions of dollars to executives’ wallets when Delphi is in danger of not being able to fund its pension obligations.
Biting The Hand... (continued from page 1)

McGurn, executive vice president and special counsel of Institutional Shareholder Services, noting that the last time shareholders targeted director pay levels was in the mid-1990s, when they voiced discontent about the generosity of directors’ pension benefits.

Wells Fargo spokeswoman Melissa Morey said in an e-mailed statement that the company doesn’t confirm receipt of any specific proposal, as it may not be included in the final proxy. In regards to CEO compensation, she said, “the board of directors feels [the CEO] is paid appropriately.” Cendant, Home Depot and Merrill Lynch didn’t return calls for comment, while the other companies declined to comment on the proposals.

Dan Steininger, chairman of the Catholic Funds’ equity fund, said the fund chose the companies by screening for CEO pay that appeared high relative to peers and company performance. The proposals vary only slightly from company to company and in most cases refer to a “Forbes” ranking of CEO performance versus CEO pay, a “Business Week” rating of CEO pay relative to shareholder return, and a grade of board effectiveness by research firm The Corporate Library LLC.

In 2004, Exxon Mobil’s CEO made $81.5 million; Wells Fargo’s CEO made $52.1 million; Merrill’s CEO made $32.1 million; Home Depot’s CEO made $28.5 million; Bank of New York’s CEO made $13.2 million; SBC’s CEO made $14.9 million; Georgia Pacific’s CEO made $12.5 million and Honeywell’s CEO made $9.2 million, according to the proposal. In all cases except that of Merrill, the figures include gains from options exercised during the year. The proposals noted that compensation figures would in some cases be higher if they instead included the value of options granted in 2004, they would be higher in some cases. The proposals note that average total compensation for CEOs at 367 of the nation’s largest corporations was $11.8 million.

“This is an attempt by us to get at the heart of the problem, which is that boards are too beholden to CEOs,” said Steininger. “We assume one hand washes the other here. By having shareholders vote on director pay, we feel we can bring some sanity to that process.”

The proposals say directors with high compensation “are more likely to pay excessive CEO compensation” and that high director pay coupled with high CEO pay correlates with underperformance of the company.” As supporting evidence, the proposals cite Harvard professors’ Lucian Bebchuk and Jesse Fried’s study “Pay Without Performance: The Unfulfilled Promise of Executive Compensation” and a study from Rutgers Business School faculty, “CEO Compensation, Director Compensation, and Firm Performance: Evidence of Cronyism?”

The proposals ask the company to hold directors accountable by annually asking shareholder approval for director pay packages, excluding contractual obligations. They also ask companies to identify every benefit and perquisite for directors, including use of company assets and contributions to charities of particular interest to the director. If pay packages fail to get half of the shareholder votes cast, they ask that the company leave the director’s pay package as is until the shareholders approve otherwise.

While the concern is that some forms of pay may go undisclosed, company proxies do reveal a substantial amount of information about director pay. For example, Exxon Mobil’s proxy discloses in writing that directors are paid a base fee of $75,000 a year, and audit and compensation committee members get half of the shareholder votes cast, they ask that the company leave the director’s pay package as is until the shareholders approve otherwise.

SEC OKs Revised Quarterly, Annual Filing Deadlines

The Securities and Exchange Commission voted recently to retreat from plans to have many public companies file quarterly and annual reports on a speedier schedule in 2006.

Under the changes approved at a public meeting, the SEC agreed to have companies that are “accelerated” filers to submit quarterly reports within 40 days, scrapping plans for a 35-day deadline. Plans for a 60-day deadline for annual reports will be retained only for the very largest companies, which will benefit from an additional one-year delay in the shorter deadline.

The SEC’s new approach will limit the 60-day deadline for annual reports to new category of companies with a market capitalization of $700 million or more, starting for reports for fiscal years beginning on or after Dec. 15, 2006. The requirement was to have taken effect for all “accelerated” filers, those with a market capitalization of at least $75 million, starting for fiscal years on or after Dec. 15, 2005. Under the revised approach, other accelerated filers with a market capitalization of between $75 million to $700 million will have 75 days to file 10-K annual reports to the SEC.

Small U.S. companies with less than $75 million in market capitalization and non-U.S. companies will see no change in the deadlines, giving them 45 days after the end of each quarter to produce quarterly reports and 90 days after the end of each fiscal year to file annual reports.

The SEC’s action partly reverses changes it approved in 2002 to shorten the deadlines for companies to produce quarterly and annual reports. The accelerated pace was to have been phased in over a three-year period, but some companies had complained that the speedier pace was unworkable given the increased compliance burden facing public companies.
Based on the market valuation of Nymex’s smaller competitor, IntercontinentalExchange Inc., Nymex equity is worth at least $4.4 billion, according to Capozza’s complaint. That value isn’t reflected in the proposed General Atlantic deal, it says.

IntercontinentalExchange went public in mid-November. Nymex hasn’t disclosed publicly how it values its equity against the trading rights included in the cost of a seat.

General Atlantic won’t be purchasing trading rights as part of the deal.

Rifkin said his law firm plans to pursue Capozza’s documents request on an expedited basis, since Nymex plans to hold a seatholder vote to finalize the deal in January. A majority of Nymex’s 816 seatholders, who own the exchange, must approve the deal.

$15,000 per year, with chairs of those committees getting another $10,000 per year. On other committees, directors receive $8,000 per year for each committee on which they serve, and the chairs receive an additional fee of $7,000 per year. A table also shows they each received restricted stock awards worth $167,240 in the past year and tallies up their committee fees. According to a tally on the table, that meant pay ranged from $269,067 to $290,240 for board members.

Of the other companies cited, some tallied director pay in tables while others did not. For example, Wells Fargo didn’t have a table but said that January 1, 2005, the cash retainer was $65,000, up from $50,000 in the prior year. Directors also received $1,600 for each board or committee meeting attended. Annual fees paid to each of the chairs of the credit, finance, and governance and nominating committees was $15,000; the annual fee to be paid to the chair of the human resources committee was $20,000; and the annual fee to be paid to the chair of the audit and examination committee was $25,000. Directors elected or re-elected at the annual meeting of stockholders also get stock option with a Black-Scholes value of $57,000 each, the proxy said. Other benefits to directors included awards of common stock, liability insurance and the ability to defer compensation into an interest-bearing account or phantom shares of stock with dividends reinvested.

The proposals come amid recent concern that director pay is getting too high in the U.S. overall. George Dallas, managing director and global practice leader of governance services at Standard & Poor’s, has noted that overseas, questions about how that affects U.S. directors’ independence are cropping up.

According to a recent study by consulting firm Pearl Meyer & Partners, average compensation for directors of major U.S. companies surged 11% to more than $195,000 in a second year of double-digit growth. That makes it more than double what directors are paid in Europe, where director pay averaged EUR63,500 in 2005, (about $76,253 at recent exchange rates), according to executive search and consulting firm Heidrick & Struggles International Inc.

ISS’s McGurn said it is currently difficult to tell how pay for committee service, meeting attendance, and so on adds up at the end of the year. He said SEC Chairman Christopher Cox is considering requiring a “tabular” method in filings that would add up all the disparate forms of CEO pay, and noted that the SEC could call for similar information for directors.

Governance experts weren’t so sure that seeking shareholders’ approval of board pay is the answer, though. Dallas said that would marginalize the compensation committee, whose duty it is to decide these things. “I do think we have a pay problem, and I think shareholders should be in a position to articulate discomfort with director pay,” he said. “But the board should ultimately set [director pay].”

The jury is also still out on whether director pay has indeed reached excessive levels. Said McGurn: “If directors are doing the job they are supposed to do, they were underpaid before,” he said. “But if they’re not doing it, they’re overpaid at any price.”
Governance Matters... (continued from page 2)

Square advocated a spin-off of Tim Hortons and the sale of Wendy’s-owned outlets to fund a stock buyback. At the time of the Wendy’s realignment announcement, the managing partner of Pershing Square told Dow Jones: “I’ve had a good morning.”

Now investors calling themselves the Trian Group, featuring long-time investors Nelson Peltz and Peter W. May, want Wendy’s to do more. The group said in a recent SEC filing that the July plan was “directionally correct,” but didn’t go far enough. These investors reiterated the call for a full spin-off of Tim Hortons and want improvements in the core hamburger business, which they said features a “deteriorating operating performance” and underperforms the industry.

Trian Group has an interesting name for what it is trying to do. It calls it “operational activism.”

The group has an interest of 5.5% of Wendy’s, mainly though options. (Wendy’s CEO was quick to point out that the group only actually owns 950,000 shares.)

Trian principals said they tried to arrange a meeting with Wendy’s CEO Jack Schuessler, but were rebuffed. A Wendy’s investor relations executive reportedly framed the denial in a beautiful example of business-speak: Schuessler was too busy “managing the brand” to meet with Trian, the Trian SEC filing states.

Apparently, part of “operational activism” is to not seek control of a company, and Trian said it would not seek to control Wendy’s. “Nevertheless,” the filing states, “if the company’s leadership does not adopt our recommendations, we will discuss those recommendations with other shareholders and may decide to nominate one or more persons to the company’s board.”

For its part, Wendy’s issued a press release in which CEO Schuessler said, “We are extremely confident in our comprehensive plan.” In addition to the announced strategic moves, the company said, “We are focused on further improving restaurant operations and we have outstanding product innovation and marketing plans in place for 2006.”

The question now is whether Wendy’s will go ahead with its plans, or have to stop, reconsider or even change them in response to this latest investor challenge. cg

No Poison Pill To Feed ‘Wolf Packs’... (continued from page 4)

began agitating, however. With a new shareholder base of hedge funds and short-term arbitrageurs sympathetic to the consortium’s view, the company felt compelled to sell itself in an auction and field a bid from the investor group, as part of a level playing-field process.

Lipton: Pill Still Has A Place

Meanwhile, the pill’s inventor still thinks it can be a force when companies are battling back hedge funds in the right situation. For instance, Lipton said Fairmont Hotels & Resorts Inc. - which is facing a hostile attempt by Icahn to raise his stake to 51% - has a pill at the ready.

At the same time, Lipton imagines that the wolf-pack approach may be tamed. Securities and Exchange Commission rules require investors to let the world know when they amass 5% of a company’s shares. If shareholders do have an understanding to work together, they might be in violation of the tender-offer rules, which could give companies one alternative way to foil a hedge fund whose ideas don’t mesh with the company’s.

“I’m sure well-advised companies that come under attack will look at that question and decide whether or not to litigate,” Lipton said.

But in trying to thwart hedge funds, companies are more likely to alienate other shareholders these days, attorneys say. Investors like Icahn are presenting themselves as corporate-governance do-gooders, working against entrenched management for the benefit of fellow shareholders - an idea that has strong resonance in the wake of a string of corporate scandals. That’s in sharp contrast to the ‘80s-style raiders, who often incurred other shareholders’ wrath by walking away with their own sweet side-deals in the form of greenmail.

If someone could think of a structure to move the balance of power back toward corporations, “that would be the holy grail,” Nathan said. “That’s what corporate America wants.”

Even if lawyers developed a new ploy, however, “the minute it gets invented, activists will hate it,” said Nathan. “Investors today have much more power in the governance area than ever before, and it will make any kind of defensive device that much more noxious, because the market is going to see this as taking profit out of the market’s mouth in order to preserve management policy.” cg
Bank Of Italy Chief Resigns...  (continued from page 16)

Fazio, through a Bank of Italy spokeswoman, declined to comment about the gifts. Telephone calls to lawyers for Fazio and Fiorani weren’t returned. A BPI spokesman declined to comment.

The central bank chief has been under pressure to resign since Italian media published wiretap excerpts of phone calls between Fiorani and Fazio and his wife documenting the bank governor’s intervention in the Banca Antonveneta takeover battle. Neither nor Fiorani has been charged with any wrongdoing. Fiorani has been named by prosecutors as a target in their wide-ranging criminal investigation related to the Antonveneta bid.

Fiorani’s gifts, found by prosecutors on the banker’s computer, were first described in a book, “L’Intrigo,” by Italian journalists Giovanni Pons and Giuseppe Oddo that was published in late November and since has received extensive coverage by the country’s media.

In recent interviews, officials at other Italian banks, including Banca Intesa SpA, UniCredit SpA, Sanpaolo IMI SpA and Mediobanca SpA, said they haven’t given personal gifts to Fazio, although some said they’ve sent boxes of chocolates to Fazio’s assistants.

The European Union doesn’t have a unified gift policy for government employees or professionals working for independent government agencies. But most European governments have guidelines about what is acceptable, and expensive gifts have landed officials in trouble in the past.

Former Deutsche Bundesbank President Ernst Welteke was forced to resign in 2004 after Der Spiegel magazine revealed he accepted a four-night stay at a luxury hotel in Berlin from Allianz AG Holdings’ Dresdner Bank unit over New Year’s Eve in 2001. After the disclosure, Germany’s central bank adopted the European Central Bank’s code of conduct for board members and appointed an ethics adviser.

The U.K.’s Financial Services Authority has a policy that employees can’t accept gifts worth more than GBP25. FSA employees who accept speaking engagements can’t be paid more than GBP100, and the money must be donated to a charity. Gifts of wine worth up to GBP60 are approved but must be used for department functions.

The Bank of Spain’s code of conduct says its employees can’t solicit or accept gifts whose value is deemed to be “socially unacceptable.” In practice, a Bank of Spain spokeswoman said, that means employees are not usually allowed to accept gifts “more expensive than a diary.”

Alberto Alesina, a professor at Harvard University and an expert on Italian banking, would go even farther in restricting gifts. “An authority such as the Bank of Italy cannot accept gifts from people or organizations that it supervises,” he says. “No matter what the value of the gift is, it is inappropriate.”

In the wake of Fazio’s resignation, Bank of Italy Director General Vincenzo Desario is going to take over the post temporarily, according to the central bank’s statutes. But Berlusconi said he wasn’t sure who would eventually take the post. Desario is 72 and widely expected to hold the job for an interim period only.

“It should be someone strong that can restore the Bank of Italy’s credibility on the international stage,” said Tito Boeri, a professor at Milan’s Bocconi University.

— Christopher Emsden and Luca Di Leo contributed to this article.

inBRIEF

Chairman Cox Names Nancy Morris As SEC Secretary

Securities and Exchange Commission Chairman Christopher Cox has filled one of several openings at the agency, naming Nancy Morris, currently an SEC attorney, to replace Jonathan Katz as the SEC’s secretary.

Morris has been an attorney fellow in the SEC’s investment-management division since May 2004. She spent more than a decade in the private sector as an attorney at Fidelity Investments and at T. Rowe Price Group Inc., where she was a vice president and associate legal counsel.

Cox’s choice will be “an asset to the Commission,” said Katz, who will retire in early January after 23 years at the SEC.

“I feel honored to have someone of Nancy’s caliber succeed me.”

While the SEC secretary operates behind the scenes, Katz had so much clout that some called him “the sixth commissioner.” Among other things, the SEC secretary schedules votes on enforcement cases by the five-member commission, handles correspondence, keeps notes of meetings and ensures that SEC actions are released to the public and posted to the SEC Web site.

Morris worked at the SEC previously, as an attorney in the general counsel’s office from 1985 to 1987, and as a counsel to SEC Commissioner Joseph Grundfest from 1987 to 1988. She was deputy chief counsel in the agency’s investment management division, which oversees mutual funds and investment advisers, from 1988 to 1992. She holds a law degree from the University of Idaho Law School and a bachelor’s degree from Hartwick College.

Cox has plenty of other openings to fill. Two SEC divisions - market regulation and investment management - currently lack directors and the agency also needs to find a new chief accountant and general counsel.
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The Path To IT Excellence Starts With Governance

By Nick Robinson

As regulators and shareholders continue to demand increased transparency, weaknesses in information technology infrastructure are becoming increasingly visible and harbor the potential to undermine shareholder value. Transparency can be a double-edged sword. It bolsters market confidence, but failures, whether due to operational or technical malfunction, become immediately apparent to users and directly impact business operations.

IT governance is emerging as the antidote to anemic IT performance. It cultivates desirable behavioral patterns and provides the oversight mechanisms to ensure the sound use of IT, operational excellence, and legal and regulatory compliance. When governance is effective, IT becomes a valued asset, inseparable from the business and regarded as an investment, not a cost. In short, IT governance provides the essential bedrock for the effective acquisition and deployment of technology.

The pervasive nature of IT as a business enabler obscures some harsh realities about IT performance. Contrary to conventional wisdom, technology-driven increases in productivity have been meager relative to total expenditures. Lackluster IT performance is manifested in failed or aborted projects, missed deadlines, budget overruns and poor returns on investment (ROI). Increasingly, these indications of low IT effectiveness are shining a spotlight on the need for IT governance. Further fueling the emphasis is the enactment of regulations such as the Sarbanes-Oxley Act, with its requirement for stronger controls and greater transparency in financial reporting.

The goal of IT governance is to create a control environment for desirable actions to drive the effective, efficient, and secure use of information technology. The control environment reflects the tone set by top management and the overall attitude of the board, management, owners and the emphasis they place on control in the company’s policies, procedures, methods, and organizational structure. It is the foundation for all other components of internal control, providing discipline and structure.

IT governance enables an organization to attain three vital objectives: regulatory and legal compliance, operational excellence and risk management.

Regulatory and Legal Compliance. The Sarbanes-Oxley Act, which mandates transparency, clear accountability and rigorous internal controls, highlights the importance of both corporate and IT governance as the vital oversight apparatus for an organization. Other regulations, such as Basel II, with its focus on operational risk, demonstrate that this trend toward disclosure is growing.

Operational Excellence. Senior IT management has grown increasingly frustrated with its inability to clearly and succinctly articulate ROI from IT expenditures. While the goal is to achieve operational excellence, the absence of clearly defined performance measures often leaves leadership ill-equipped to provide an accurate analysis of the state of IT.

Risk Management. To survive and thrive in today’s highly competitive business environment, companies need more adaptive and agile IT solutions. The use of emerging or complex technologies and coupled with highly aggressive delivery schedules inevitably translates into higher levels of technology risk. An IT governance program defines the structure, measures and monitoring framework needed to effectively identify and manage the elevated IT risk.

To attain the vital objectives described above, companies need to focus on the following objectives:

Value. An IT investment and prioritization process provides a way to assess the cost and
benefits of the investment. A formal project management methodology is needed to ensure that IT value is delivered to businesses on time, within budget and at the required level of quality. Operational effectiveness and efficiencies are maximized by the use of service-level agreements for outsourced functions. An integrated internal control and risk management program enables an organization to preserve the value that has been created.

Resource Management. Resource management ensures that the right IT capabilities for business needs are identified and deployed. It targets the need for an integrated, economical IT infrastructure and focuses on people in terms of their availability, training and competencies. Project funds are allocated through an IT investment portfolio process based on a cost-benefit approach.

Performance Management. The need to manage performance spans all of the preceding areas. Measures for strategy implementation, project completion, resource usage, service levels and service delivery can be monitored and analyzed by the use of quality and continuous improvement methodologies.

Oversight. IT governance is an inseparable element of good corporate governance and as such should instill a culture of integrity, accountability and transparency. Effective oversight is achieved by ensuring clarity of roles and by embedding effective decision-making organizational structures throughout the company. It is the role of the board and management to unambiguously communicate these responsibilities and establish where the IT decision-making authority is located within the organization.

Getting Started

IT governance should not be approached in a haphazard manner. Fortunately, companies can ease into IT governance by leveraging various industry standard frameworks that embrace leading practices. One of the most well-established is Control Objectives for Information and Related Technology (Cobit). Developed by the IT Governance Institute, a part of the Information Systems Audit and Control Association, it provides the requisite support materials, in the form of roadmaps, guides and templates, to craft a governance program. While the frameworks are not turnkey methodologies that will magically embed IT governance into your organization, they do provide a robust foundation.

Whichever approach is adopted, companies generally get better results from using established IT governance frameworks instead of flying solo.

Nick Robinson is a manager in Ernst & Young’s Technology & Security Risk Services practice.
Baruch Lev isn’t afraid to state the obvious about estimates. And he’s often surprised to find people thanking him for it.

Lev, director of the Vincent C. Ross Institute of Accounting Research and the Philip Bardes Professor of Accounting and Finance at New York University Stern School of Business, is one of the few people to address how unpredictable and easily manipulated financial estimates are.

From the earnings estimate companies give Wall Street to the panoply of estimates about assets, pensions and debt that go into their income statements, Lev addresses the obvious but little-addressed issue of how global competition, technological change and other uncertainties make such numbers little better than a wild guess. Lev’s research at NYU spans intangible assets, intellectual capital, capital markets, mergers and acquisitions, and other accounting issues, and he’s also worked with the U.S. Securities and Exchange Commission, Financial Accounting Standards Board and the European Union and testified before Congress on Enron Corp. Lev explained the big picture on estimates to Dow Jones Corporate Governance and offered some advice on how boards can tackle the earnings management issue:

It’s frequently acknowledged that the biggest problem in accounting is companies that work their numbers to meet their own financial goals. How can regulators begin to address this issue?

In all these practices, which go by the names of earnings management, earnings manipulation - except in extremes like Enron, where it mostly fabricated - the issue is with the underlying accruals that produce the difference between cash flows and earnings and are based on estimates. About 40% of public companies are either hitting Wall Street’s estimates or beating them by a penny - how is this done without massive management?

You have to shine a flashlight on the estimates. The first, most elemental stage would be a 3-column income statement, breaking out facts compared to estimates. This will be very instructive: for the first time issuers will get a measure of vulnerability. A second stage would be, at a certain point in time, maybe two years after the initial estimate, a company compares key estimates to their realization. For example, if there is an estimate about bad debts, I want to know, what are the real numbers in the end? This will provide an extremely strong incentive not to manipulate the estimates.

You’ve served as an expert witness in several cases where management’s manipulation of accounting was questioned. What did you learn from those situations that you can share with boards?

In practically all the cases, boards took for granted the estimates in financial reports, and in many cases, the communications about them from management. Managers almost constantly speak to capital markets, and at least four times a year in conference calls. Invariably managers are too optimistic. They would say something about the future and then not update it. Boards should keep asking management over time if these estimates still stand, and if not, have them update investors.

You’ve said that it’s becoming more difficult to make reliable estimates due to globalization and competition. Can you elaborate?

People say there was always uncertainty and we somehow coped. But there is now a quantum jump in this uncertainty. Fifteen or 20 years ago, many sectors around the world were basically monopolies - that was not necessarily bad. Companies were highly regulated on issues like commissions, charges they can take from customers. All these regulations were bad from a growth point of view, but they made operations very predictable. In the last few years, all these regulations have virtually fallen by the way side, opening the markets and introducing a huge element of risk and volatility. Added to this is the opening of global markets.

A third factor is the speed of technological change. In the last 20 years things have changed on a scale that took centuries in the past, introducing a huge element of uncertainty into business. For example, take rules on impairment of assets: fixed assets on your balance sheet, such as machinery, have to be tested for impairment and if its value is below that on the balance sheet, you have to write it down. But how do you determine if the machinery is below value? You have to predict future cash flows from the asset, but who knows what will come into the market in servers in the next 18 months that could make all my equipment completely obsolete?

... continued on page 25
Q&A... (continued from page 24)

What’s the significance to investors of the changes the FASB is considering for fair-value accounting?

They’ve updated fair value to differentiate several levels. When assets or liabilities are traded actively in capital markets, you have dependable prices like those for stocks and bonds. The second level, more controversial, is specific assets or liabilities that are not traded but have comparable assets or liabilities - for example, hedging or financial instruments that allow you to infer a value. The concern here is lack of definition about what is comparable. Is a house that you are going to sell comparable to your neighbor’s house?

The most controversial is the third level - when there aren’t even comparables, derivatives or hedges. How do you put a fair value on these things? Most times the companies who sell you these, or the investment bankers who trade in them, will have valuation models, but these are incredible dependent on assumptions and interest rates. Even when you consider honest managers, these are very volatile. For example, even if you try your best to value stock options, we know that there is no good way to do it. You get a huge amount of noise going into the estimate.

You've cautioned about moving to more fair value-based accounting in part because of these difficulties. How should boards look at this issue?

Of course, we have to continue estimating things. But you should be careful when extending fair value into areas that are really just a guess. Most board members are not aware of the huge number of estimates that underlie the financial reports. Somehow people think that accounting is factual, but if you think about the hairy estimate that goes into pension expenses, into the reserves of insurance companies, into the bad debt reserves of banks, this is a major source of risk. Boards should get involved in gauging the magnitude and impact of estimates. If I were an audit board member, I would start by making it clear to management that I’m aware of the issues.

How difficult is it for investors and directors to gauge the proportion of numbers that come from estimates on their balance sheets?

If you look at a General Electric Co. financial report, they tell you in a long footnote to revenue recognition that numbers are to some extent based on predictions, particularly with respect to long-term projects. But what is completely missing is how much, whether all these estimates constitute 5%, 20% or more. It’s an easy number for companies to come up with, but outsiders cannot.

Aside from knowing the magnitude, I would also like to see whether the amounts from estimates increased from year to year - and with any large increases, ask for an explanation. Boards can ask the CFO these questions. If management gives you generalities or don’t satisfy you, bring in an outsider to look into these issues. I don’t expect board members to get involved in all estimates - there are literally hundreds - but they should look at the five to six major ones, rotating from year to year if necessary.

Has anyone tried to estimate what the average is for U.S. companies or companies in a particular industry?

It’s difficult to estimate. I have one test case, from a medium-sized electronics company in New Jersey that volunteered to work through this. We identified 20 or more important estimates that go into the income statement, like amortization and pensions. When you related those estimates to the top line, they made up 5% or 7% of revenue. But by the time you got to the bottom line of earnings, they had a huge impact - about 60% of net income was based on estimates. It’s hard to say what’s an acceptable level until more companies disclose these things.

Why are companies so hesitant to disclose these numbers?

It’s controversial. You always have the same set of arguments from companies: “If we estimate something and it’s seriously off-mark and we disclose it, we could open ourselves to shareholder lawsuits.” Another is, “It’s too costly to disclose,” and the third is, “such disclosure could benefit competitors.” When FASB asks for comments on any proposal, responses always have these three elements. It’s like one person writes all of them. And a fourth is sometimes added, that it will be the end of the U.S. economy because other countries don’t have such a regulation. But all these arguments fall by the wayside for disclosure to boards.
# NEW AND DEPARTING EXECUTIVES AND DIRECTORS

<table>
<thead>
<tr>
<th>Company</th>
<th>Name</th>
<th>Action</th>
<th>News</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank of America Corp.</td>
<td>Tommy Franks</td>
<td>Joins Board</td>
<td>Franks, 60, is a retired four-star U.S. Army general.</td>
</tr>
<tr>
<td>Chevron Corp.</td>
<td>Linnet Deily</td>
<td>Joins Board</td>
<td>Deily, 60, was formerly the deputy U.S. trade representative and ambassador in Geneva and led the U.S. delegation at the World Trade Organization.</td>
</tr>
<tr>
<td>Danaher Corp.</td>
<td>Linda P. Hefner</td>
<td>Joins Board</td>
<td>Hefner has served as EVP, Global Strategy and Business Development for Kraft Foods Inc. since May 2004.</td>
</tr>
<tr>
<td>E.I. Du Pont De Nemours &amp; Co.</td>
<td>There du Pont</td>
<td>Joins Board</td>
<td>Du Pont, 39, is currently president of Wawa Inc.</td>
</tr>
<tr>
<td>El Paso Corp.</td>
<td>Ferrell P. McClean</td>
<td>Joins Board</td>
<td>McClean, 59, most recently held the position of managing director/senior advisor to the head of investment banking for JPMorgan Chase &amp; Co.’s Global Oil and Gas Group.</td>
</tr>
<tr>
<td>General Dynamics Corp.</td>
<td>Deborah Lucas</td>
<td>Joins Board</td>
<td>Lucas is the Donald C. Clark/Household International Distinguished Professor of Finance at Northwestern University’s Kellogg School of Management.</td>
</tr>
<tr>
<td>General Motors Corp.</td>
<td>Frederick Henderson</td>
<td>Named Vice Chmn &amp; CFO</td>
<td>Henderson, 48, currently European chmn, will replace John Devine, 61, on Jan. 1.</td>
</tr>
<tr>
<td>Goodyear Tire &amp; Rubber Co.</td>
<td>Michael R. Wessel</td>
<td>Joins Board</td>
<td>Woods was pres. &amp; CEO of Bessemer Securities from 1989 to 2000.</td>
</tr>
<tr>
<td>OfficeMax Inc.</td>
<td>Ward W. Woods</td>
<td>Resigns From Board</td>
<td>Krulak, 63, is a retired U.S. Marine Corps General.</td>
</tr>
<tr>
<td>Phelps Dodge Corp.</td>
<td>Charles C. Krulak</td>
<td>Joins Board</td>
<td>Vaughan, 49, is the Robb B. Kelly distinguished professor of insurance and actuarial science at Drake University.</td>
</tr>
<tr>
<td>Principal Financial Group</td>
<td>Therese M. Vaughan</td>
<td>Joins Board</td>
<td>Matthews is pres. of Blue Cross and Blue Shield of Georgia.</td>
</tr>
<tr>
<td>Qwest Communications International Inc.</td>
<td>Caroline “Caz” Matthews</td>
<td>Joins Board</td>
<td>Hoover is chmn, pres. and CEO of Ball Corp.</td>
</tr>
<tr>
<td>Qwest Communications International Inc.</td>
<td>R. David Hoover,</td>
<td>Joins Board</td>
<td>Brown, 56, succeeds Mike McGavick, 47, who is leaving to run as a Republican from Washington for the U.S. Senate.</td>
</tr>
<tr>
<td>Safeco Corp.</td>
<td>Joseph W. Brown</td>
<td>Named Chmn</td>
<td>Reynolds is replacing Mike McGavick who running for a U.S. Senate seat.</td>
</tr>
<tr>
<td>Safeco Corp.</td>
<td>Paula Rosput Reynolds</td>
<td>Named CEO &amp; Director</td>
<td>Kidder is a retired chairman and CEO of Borden Chemical Inc.</td>
</tr>
<tr>
<td>Schering-Plough Corp.</td>
<td>C. Robert Kidder</td>
<td>Joins Board</td>
<td>Kidder is a retired chairman and CEO of Borden Chemical Inc.</td>
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*continued on page 27*
## NEW AND DEPARTING EXECUTIVES AND DIRECTORS

<table>
<thead>
<tr>
<th>Company</th>
<th>Name</th>
<th>Action</th>
<th>News</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sempra Energy</td>
<td>Donald E. Felsinger</td>
<td>Named Chmn &amp; CEO</td>
<td>Felsinger, 58, will become chmn Feb. 1, when Stephen L. Baum, current chairman &amp; CEO, retires.</td>
</tr>
<tr>
<td>The Dow Chemical Co.</td>
<td>Geoffery E. Merszei</td>
<td>Joins Board</td>
<td>Merszei is EVP &amp; CFO.</td>
</tr>
<tr>
<td>The Dow Chemical Co.</td>
<td>William S. Stavropoulos</td>
<td>Retires as Chmn</td>
<td>Stavropoulos, 66, will retire effective April 1. Dow’s board has elected Andrew N. Liveris, pres. &amp; CEO, to succeed Stavropoulos as chmn.</td>
</tr>
<tr>
<td>The Raytheon Co.</td>
<td>Vern Clark</td>
<td>Joins Board</td>
<td>Clark, 61, joins the board following 37 years of distinguished military service.</td>
</tr>
<tr>
<td>Tyco International Ltd.</td>
<td>George Buckley</td>
<td>Resigns From Board</td>
<td>Buckley was named CEO of 3M Corp.</td>
</tr>
<tr>
<td>United States Steel Corp.</td>
<td>John P. Surma</td>
<td>Named Chmn</td>
<td>Summa, 51, is also pres. &amp; CEO. He succeeds Thomas J. Usher, 63, who is retiring at the end of January.</td>
</tr>
<tr>
<td>United Technologies Corp.</td>
<td>John V. Faraci</td>
<td>Joins Board</td>
<td>Faraci, 55, is chmn &amp; CEO of International Paper Co.</td>
</tr>
<tr>
<td>Verizon Communications Inc.</td>
<td>Donald T. Nicolaiesen</td>
<td>Joins Board</td>
<td>Nicolaiesen, 61, was formerly chief accountant for the Securities and Exchange Commission.</td>
</tr>
<tr>
<td>Wellpoint Inc.</td>
<td>Larry C. Glasscock</td>
<td>Named Chmn</td>
<td>Glasscock, 57, is pres. &amp; CEO. He succeeds Leonard D. Schaeffer, 60, who resigned.</td>
</tr>
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**Hedge Funds Cited... (continued from page 3)**

Financial Corp., MCI Inc. and ShopKo Stores Inc. where they pressed for a higher price or tried to block the deal entirely.

One of the few forms of open activism that did increase in 2005 was one that wasn’t necessarily done through official routes: the publicity campaign. Shareholders who attempted to influence the results of a proxy solicitation without filing a proxy card rose from 13 to 21.

Georgeson listed 24 contested solicitations during the year where the dissidents distributed their own proxy. In those cases, company management won in only 10 instances. In six cases, dissidents won; in three cases, management and dissidents both made concessions; and five situations were settled.

The study also found that activists have shifted the focus of some of their proposals away from how boards use poison pills and stock options, and concentrated on changing the way directors are elected.

In 2005, sponsors submitted a “majority vote” proposal - wherein only directors receiving a majority of votes cast win or maintain their board seats - to 79 companies. Of those, the majority vote proposal appeared on the proxy ballots of 55 companies. The study also called majority vote proposals a “rousing success,” as they got more than a majority of votes cast at 13 shareholder meetings and averaging 43% of votes cast in favor of the proposal overall.

Another issue which continued to loom large in face-offs between shareholders and management was executive compensation. The study found that they were the most frequent subject of shareholder resolutions, at 36%.

Georgeson predicted that many of the themes of 2005 will loom large in 2006, including pay-for-performance resolutions and modified majority vote proposals. As for hedge funds, the study predicts they’ll become even more active, stealing more thunder from their traditional peers.

“As the majority vote issue crystallizes,” the study said, “expect ‘withhold’ campaigns - long viewed as the province of pension funds - to become yet another weapon in the arsenal of hedge fund managers.” CG
GoverNance Ratings

Institutional Shareholder Services rates 5,500 U.S. companies on a range of criteria to assess the strength of their corporate governance. This table shows in which areas companies were most active in adjusting governance policy over the last month.

<table>
<thead>
<tr>
<th>CGQ Rating Criteria</th>
<th>% of Pharmaceutical Companies Meet Criteria</th>
<th>% of All Companies Meet Criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Board Issues</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Board controlled by a majority of insiders and affiliated outsiders</td>
<td>7.4%</td>
<td>9.9%</td>
</tr>
<tr>
<td>Board controlled by a majority of between 50% and 67% independent outsiders</td>
<td>36.1%</td>
<td>40.9%</td>
</tr>
<tr>
<td>Board controlled by a supermajority of between 67% and 75% independent outsiders</td>
<td>12.4%</td>
<td>10.4%</td>
</tr>
<tr>
<td>Board controlled by a supermajority of between 75% and 90% independent outsiders</td>
<td>14.5%</td>
<td>14.7%</td>
</tr>
<tr>
<td>Board controlled by a supermajority of over 90% independent outsiders</td>
<td>1.8%</td>
<td>4.1%</td>
</tr>
<tr>
<td>Nominating committee composed solely of independent outside advisors</td>
<td>70.4%</td>
<td>64.9%</td>
</tr>
<tr>
<td>Compensation committee composed solely of independent outside directors</td>
<td>82.0%</td>
<td>76.9%</td>
</tr>
<tr>
<td>Audit committee composed solely of independent outsiders</td>
<td>90.2%</td>
<td>87.9%</td>
</tr>
<tr>
<td>Governance committee exists</td>
<td>76.0%</td>
<td>67.9%</td>
</tr>
<tr>
<td><strong>Charter, Bylaw and Antitakeover Measures</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Annually elected board</td>
<td>49.1%</td>
<td>48.0%</td>
</tr>
<tr>
<td>Shareholders have cumulative voting rights</td>
<td>3.6%</td>
<td>7.5%</td>
</tr>
<tr>
<td>Supermajority vote requirement to amend charter/bylaws</td>
<td>47.6%</td>
<td>48.3%</td>
</tr>
<tr>
<td>Supermajority vote requirement to approve mergers</td>
<td>8.3%</td>
<td>21.2%</td>
</tr>
<tr>
<td>Shareholder may act by written consent</td>
<td>27.5%</td>
<td>24.9%</td>
</tr>
<tr>
<td>Dual class capital structure with unequal voting rights</td>
<td>1.2%</td>
<td>4.7%</td>
</tr>
<tr>
<td>Shareholders may call special meetings</td>
<td>29.9%</td>
<td>43.5%</td>
</tr>
<tr>
<td>Company has a poison pill</td>
<td>52.4%</td>
<td>34.4%</td>
</tr>
<tr>
<td><strong>Compensation and Ownership Issues</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>All stock-incentive plans adopted with shareholder approval</td>
<td>82.0%</td>
<td>86.2%</td>
</tr>
<tr>
<td>Executives are subject to stock ownership guidelines</td>
<td>6.5%</td>
<td>12.7%</td>
</tr>
<tr>
<td>Directors are subject to stock ownership requirements</td>
<td>7.7%</td>
<td>14.9%</td>
</tr>
<tr>
<td>Directors receive all or a portion of their fees in stock</td>
<td>94.1%</td>
<td>84.6%</td>
</tr>
<tr>
<td>The average annual burn rate over the past three fiscal years is greater than 2% and exceeds one standard deviation of the industry mean</td>
<td>18.3%</td>
<td>15.5%</td>
</tr>
<tr>
<td>The average annual burn rate over the past three fiscal years is 2% or less, or is within one standard deviation of the industry mean</td>
<td>81.7%</td>
<td>84.5%</td>
</tr>
<tr>
<td>CEO is listed as having a related-party transaction in the proxy statement</td>
<td>13.9%</td>
<td>18.3%</td>
</tr>
<tr>
<td><strong>Progressive Factors</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Governance guidelines are publicly disclosed on the company Web site</td>
<td>30.2%</td>
<td>42.4%</td>
</tr>
<tr>
<td>Performance of the board is reviewed regularly</td>
<td>62.1%</td>
<td>57.3%</td>
</tr>
<tr>
<td>Board approved succession plan in place for the CEO</td>
<td>34.0%</td>
<td>39.8%</td>
</tr>
<tr>
<td>Board has the express authority to hire its own advisors</td>
<td>94.1%</td>
<td>93.5%</td>
</tr>
<tr>
<td><strong>Audit Issues</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-audit related and other fees represent 10% or less of the total fees paid to the audit firm</td>
<td>71.6%</td>
<td>58.5%</td>
</tr>
<tr>
<td>Non-audit related and other fees represent between 10.1% and 30% of the total fees paid to the audit firm</td>
<td>24.0%</td>
<td>33.0%</td>
</tr>
</tbody>
</table>
### ACCOUNTING

#### Corporate Governance December 21, 2005

<table>
<thead>
<tr>
<th>CGQ Rating Criteria</th>
<th>% of Pharmaceutical Companies Meet Criteria</th>
<th>% of All Companies Meet Criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-audit related and other fees represent between 30.1% and 50% of the total fees paid to the audit firm</td>
<td>3.3%</td>
<td>7.1%</td>
</tr>
<tr>
<td>Non-audit related and other fees represent more than 50% of the total fees paid to the audit firm</td>
<td>1.2%</td>
<td>1.4%</td>
</tr>
<tr>
<td>Auditors ratified at most recent annual meeting</td>
<td>82.0%</td>
<td>66.0%</td>
</tr>
<tr>
<td>All of the audit committee members are financial experts</td>
<td>6.2%</td>
<td>8.8%</td>
</tr>
<tr>
<td>One or more of the audit committee members are financial experts</td>
<td>84.6%</td>
<td>79.6%</td>
</tr>
</tbody>
</table>

#### Auditor Changes

This information is taken from regulatory filings and public statements issued by the companies in the last week. Unless otherwise specified, the companies said they had no disagreements with their former auditors, and the former auditors’ reports on the companies’ financial statements contained no adverse opinion or disclaimer of opinion.

- **Company**: Delphi Corp.  
  Hired: Ernst & Young, as of Jan. 1  
  Replaced: Deloitte & Touche LLP  
  Note: pending bankruptcy-court approval  
  Reported: Dec. 13

- **Company**: Alliance Semiconductor Corp.  
  Resigned: PricewaterhouseCoopers LLP  
  Note: PricewaterhouseCoopers identified that the company lacked finance and accounting staff with adequate depth and skill in the application of generally accepted accounting principles with respect to financial reporting.  
  Reported: Dec. 12

- **Company**: Aehr Test Systems  
  Dismissed: PriceWaterhouseCoopers LLP  
  Hired: Burr, Pilger & Mayer.  
  Reported: Dec. 9

- **Company**: Crown Resources Corp.  
  Resigned: Deloitte & Touche LLP  
  Reported: Dec. 8  
  Note: Deloitte & Touche identified material weaknesses in the company’s accounting controls for deferred tax benefits and the company’s investment in Solitario Resources Corp. (SLR.T). The company is seeking a replacement.

- **Company**: Dreyer’s Grand Ice Cream Holdings Inc.  
  Dismissed: PricewaterhouseCoopers LLP  
  Hired: KPMG LLP  
  Reported: Dec. 6  
  Note: KPMG identified a control deficiency, resulting in an adjustment to Dreyer’s financial statements.

- **Company**: Vesta Insurance Group Inc.  
  Hired: BDO Seidman LLP  
  Reported: Dec. 6

- **Company**: Vsource Inc.  
  Dismissed: PricewaterhouseCoopers  
  Reported: Nov. 29

- **Company**: Aceto Corp.  
  Dismissed: KPMG LLP  
  Reported: Nov. 29

- **Company**: Quantum Fuel Systems Technologies Worldwide Inc.  
  Dismissed: Ernst & Young LLP  
  Hired: McGladrey and Pullen LLP  
  Reported: Nov. 23

- **Company**: South Carolina Corp.  
  Dismissed: KPMG LLP  
  Hired: Elliott Davis LLC  
  Reported: Nov. 23

- **Company**: Novoste Corp.  
  Resigned: Ernst & Young LLP  
  Reported: Nov. 18

- **Company**: Zygo Corp.  
  Dismissed: KPMG  
  Hired: Deloitte & Touche LLP  
  Reported: Nov. 18

- **Company**: PPL Corp.  
  Dismissed: PricewaterhouseCoopers LLP  
  Hired: Ernst & Young LLP  
  Reported: Nov. 16

- **Company**: Commerce Energy Group Inc.  
  Dismissed: Ernst & Young LLP  
  Hired: Hein & Associates LLP  
  Reported: Nov. 14

- **Company**: Velocity Express Corp.  
  Hired: UHY LLP  
  Resigned: Ernst & Young  
  Reported: Nov. 10

- **Company**: Old National Bancorp  
  Hired: Crowe Chizek & Co.  
  Resigned: PricewaterhouseCoopers LLP

- **Company**: 99 Cents Stores  
  Hired: BDO Seidman  
  Reported: Nov. 4

- **Company**: Allied Defense Group Inc.  
  Hired: BDO Seidman LLP  
  Reported: Oct. 31

- **Company**: Hanover Direct Inc.  
  Dismissed: KPMG LLP  
  Reported: Oct. 27