Financial Remedies: Telecom Recovery

Agenda

- Beyond Telecoms
  - Wall Street
  - Financial reforms
  - Corporate governance
  - Regulatory institutions/others
  - Bankruptcy

Agenda (continued)

- Telecoms Issues
  - Legacy management
  - Valuations
  - Cost structure of industry
  - Regulation

Beyond Telecoms: Wall Street

- Wall Street Issues
  - Malfeasance/pump & push
  - Inappropriate incentives
  - Quid pro quo for clients
  - Short-term perspective
  - Wrong valuations techniques

Governance/Incentives

- Bankers' Abuses
  - Valuations
  - Pushing growth
  - IPO allocations
  - Undervaluing IPO's
  - Price manipulation

Investment Bankers/Analysts

- Valuations
  - "Eye balls"
  - Capital expenditures
  - Capacity
  - Market potential
  - ...

James Alleman                               Columbia University & University of Colorado
Investment Bankers/Analysts

- Valuations
- Pushing growth
  - Over extended
  - Bigger fees
  - Out after IPO

Valuations Remedies

- Transparency
- State-of-the-art
- Results available to the public

Separation from Bankers

- Compensation not tied to banking
- Forbid quid pro quo with client

Disclosure of Conflicts

Wall Street Remedies: Analysts

- Valuation Methods:
  - Transparent
  - State-of-the-art
  - Results available to the public

- Separation from Bankers
  - Compensation not tied to banking
  - Forbid quid pro quo with client

- Disclosure of Conflicts

IPO Allocations

- Friends & family
- Reward to clients
- E.g. Ebbers -- $200 million

- Undervaluing IPO's
  - Thirty percent (30%)
  - Not to corporation
  - Friends & family/Reward to clients

Price manipulation

- Tying
- Laddering

Investment Bankers/Analysts

- Valuations
- Pushing growth
- IPO Allocations
- Undervaluing IPO's

Investment Bankers/Analysts

- Valuations
- Pushing growth
- IPO Allocations
- Undervaluing IPO's
- Price manipulation

- Ten percent (10%)
- Not to corporation
- Friends & family/Reward to clients

- Tying
- Laddering
Wall Street Remedies: Analysts (continued)

- Certified/Qualified Analysts
- Significant Penalties for Abuse
- Anonymous Whistle Blower
- Independent Research Institute?

Beyond Telecoms: Financial Reforms

- Financial Issues
  - Management stock reporting
  - Buy/Lie/Sell High (D. Quinn Mills)
  - Pump & push
- Stockholders' Lawsuits
- Bankers of Bankruptcy

Beyond Telecoms: Financial Reforms

- Management Stock Reporting
  - Buy/lie/sell high; Pump & push
  - Barons of bankruptcy
    - Global Crossing - Gary Winnick $735
    - WorldCom - Scott Sullivan $49.4 million
    - McLeodUSA - Clark McLeod $99 million
    - ___ Richard Lumpkin $116 million
    - Qwest - Phil Anschutz $1,570 million
    - ___ Joe Nacchio $230 million

Reforms: Management Remedies

- Transparency
  - Immediate reporting of stock sales
  - Expensing of stock options
- Match Compensation to Performance
- Constraints on Management
  - Limits on Executive Loans
  - Constraints on IPO Allocations

Precipitating Events: Incentive Structure

- Stockholders' Class Action Lawsuits Difficult
  - Private Securities Litigation Reform Act of 1995
  - False and misleading statements harder to prove

Precipitating Events: Incentive Structure

- Stockholders' Class Action Lawsuits Difficult
  - ...
- Remedy: Amend the Private Securities Litigation Reform Act of 1995
Precipitating Events: Incentive Structure

- Stockholders' Lawsuits
- Stock Options
  - Tax treatment of options
  - Cap on deduction of compensation
- Remedies
  - Reform Tax on Options
  - Reform Corporate Tax Treatment of Compensation

Corporate Governance

- Corporate Governance Issues
  - Loss of oversight & control
    - Boards instrument of management
    - Management controls board
  - Inappropriate incentives
    - Compensation beyond all reasonableness
    - Not tied to performance
    - Stock options flawed (see below)
  - Interlocking directorates

Governance/Incentives Issues

- Principal/Agent Problem
  - Separation of ownership & control
  - Board of directors
    - Rolodex boards
    - "Collegiality trumps independence"
  - Interlocking directorates
    - Compensation Committees
    - Audit Committees

Governance/Incentives

- Principal/Agent Problem
- Corporate Abuses
  - Compensation
  - Perks
  - IPO Allocations
  - Self-dealing
    - Supply side
    - Borrowing

Corporate Governance Remedies

- Governance Remedies
- Regain Oversight & Control
- Independent Board:
  - No "Rolodex" board
  - Independent committees
  - Rotating audit & compensation committees
  - Chair & CEO separate

Corporate Governance/Board Remedies

- Independent
- Knowledgeable Board
  - Audits/accounts -- audit committee
  - Compensation experts -- compensation committee
  - etc..
- Beyond Sarbanes-Oxley Act
Corporate Governance Remedies

- Regain Oversight & Control
- Independent Board
- True Election of Board by Stockholders
  - Broad list of candidates
  - Not selected by Chair or CEO
  - More candidates than California's Recall

Stock Options Issues

- How Reported?
  - Expensed?
  - Dilution effects on shareholders?
- What Terms to Executives?
- Options' Exercise Price?

Stock Options Issues: Remedies

- Financial Reporting: Options
  - Expensed
  - Black-Scholes type formula
  - Dilution reported upfront
- Terms
  - Not based on market performance
  - Executives outperform cohorts
  - Restricted for at least 5 years

Corporate Governance Remedies

- Regain Oversight & Control
- Independent Board
- True Election of Board by Stockholders
- Correct Management Incentives
  - Realistic levels of compensation
  - Performance based compensation
  - Eliminate self-dealing
  - Stock options, restricted
Regulatory Institutions & Controls

- Security & Exchange Commission
  - Improved enforcement
  - Improved regulations
- Audit Houses
  - Independent of consulting
- Credit Rating Agencies
  - Open Agencies to Competition

Bankruptcy

- Bankruptcy Revalues Assets
  - Correct method
  - Competitors can bid for capacity, & chose not to operate it
- Rescinded/Loss of Licenses for Criminal Behavior/Fraud
- Penalties Greater Than Gain
- Beware of Bankruptcy Spiral

Agenda

- Beyond Telecoms
  - ...
  - Bankruptcy
- Telecoms Issues
  - Legacy Management
  - Cost structure of industry
  - Regulation
  - Valuations (see Wall Street section)

Telecoms Issues

- Legacy Management
- Cost Structure of Industry
- Regulation

Telecoms Issues: Legacy Management

- Legacy Management
  - Competition unfamiliar
  - Unfamiliar with uncertainty
  - .......

Telecoms Issues: Cost Structure

- Legacy Management
- Cost Structure of Industry
Telecoms Issues: Cost Structure

- Cost Structure Issues
  - Large fixed/sunk costs
  - Low marginal costs
  - Prices driven to marginal cost
  - Unable to cover total costs
    - Price wars
    - Price deflation
    - Price < costs
    - Spiral toward bankruptcy

- Cost Structure Remedies
  - State-of-art valuations methods
    - Will avoid making over capacity decisions
    - Keep delay & other options open
    - CapEx lowered & delayed
  - Improve management's/analysts' understanding

Telecoms Issues: Regulation

- Legacy Management
- Cost Structure of Industry
- Regulation

- Regulation Issues
  - Delays
  - Slow
  - Decisions litigated
  - Gaming of process
  - Asymmetrical information
    - Lack of knowledge
    - Mistakes
  - Increases uncertainty

- Regulation Remedies
  - Short process
    - Smaller commission
    - Direct appeals
    - Expert mediators
  - Scenario planning
    - Contingency planning
    - Dynamic thinking

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