Conflicts of Interest in the Financial Markets

Kevin M. Bahr, Ph.D.
Assistant Professor of Finance
University of Wisconsin - Stevens Point

Introduction and Background

This paper discusses recent events that demonstrate conflicts of interest in the financial markets resulting from 1) the relationship between public accounting firms and their clients, and 2) the relationship between security analysts and investment banking activities. The causes of the conflicts of interest, recent legislation, and potential solutions are also discussed.

The Great Depression and financial crises of the late 1920s and early 1930s paved the way for federal legislation regulating the securities markets. The primary objectives were to increase the corporate financial and business information available to investors and to prohibit fraud and manipulation of the securities markets. The Securities Act of 1933, administered by the Securities and Exchange Commission (SEC) since 1934, regulates new public offerings (the primary market). The Securities and Exchange Act regulates the public trading of stocks (the secondary market). In each case, the intent was to provide investors with accurate and adequate financial and business information that could be utilized to make informed investment decisions.

The Securities Act of 1933 generally requires that firms wishing to sell securities to the public must file a registration statement with the SEC. The registration statement will include the following: a description of the firm's business, including its products and markets; financial statements certified by independent public accountants; amount and use of proceeds; business risks which could adversely affect the investor; information on management; and a description of the significant provisions of the security to be offered. The SEC examines the registration statement with the intent that the statement provide adequate information so that potential investors can make an informed decision regarding the firm's securities which are offered for sale. If the SEC approves the registration statement, adequate disclosure has been made and the firm can continue with the sale of its securities. If the SEC feels that the registration is incomplete or inaccurate, amendments to the registration will have to be filed by the firm. If the deficiencies are not corrected sufficiently, the firm may be prevented from selling the securities. A prospectus, which utilizes the information provided in the registration statement, must be provided to potential investors. Theoretically, the prospectus provides the basis for potential investors to make an informed decision when a firm is selling its securities to the public.

The Securities Exchange Act of 1934 requires firms that have sold securities to the public to provide investors with periodic financial and business information.

Quarterly reports (form 10-Q) must be filed with the SEC, and an annual report (form 10-K) containing certified financial statements must also be filed. The information contained in these reports is publicly available so that investors and lenders can make informed investment decisions.

The intent of the Securities Act of 1933 and the Securities Exchange Act of 1934 is to provide the public with relevant information that can be used to make informed investment decisions, and help shareholders monitor management performance. The view is simply that if the public buys the securities of a firm, then the public has a right to know the financial and business condition of that firm.

Unfortunately, investor confidence has recently been shaken by conflicts of interest in the financial markets resulting from 1) the relationship between public accounting firms and their clients, and 2) the relationship between security analysts and investment banking activities.

Public Accounting Firms

Role and Responsibility

The financial statements of a firm provide the basis for financial analysis by investors and lenders, and play a key role in the allocation of capital in the United States economy. Financial statements provide insight into a firm's financial condition, profitability, and cash flow, and can provide the basis for investment decisions. Public accountants are entrusted with the responsibility of assuring that a firm's financial statements have been prepared appropriately; that is, that the firm has used generally accepted accounting principles in the preparation of its statements. Theoretically, utilizing appropriate accounting principles provides accuracy, consistency, and comparability to a firm's financial statements.

In addition, public accounting firms can serve to monitor management behavior for shareholders and reduce agency costs. Jensen and Meckling (1976) developed the agency cost model of the firm, which incorporates and explains management behavior in the context of a separation of ownership and control. The model assumes rational behavior by various parties in the firm who act in their own self-interest, including shareholders and managers. To insure that management will act in the best interests of shareholders, agency costs will be incurred by shareholders to monitor management and assure that they are acting in the best interests of shareholders. The audit process should provide shareholders with financial statements that accurately reflect managerial performance.

Public accountants should be an independent contractor. When hired by a public firm to perform an audit, their goal is to assess and express an opinion as to whether or not the firm has appropriately applied generally accepted accounting principles in the preparation of its financial statements. Public accountants have a client relationship with the firms they audit. However, the *primary* responsibility of public accountants is not to the management of client firms. Rather, the primary responsibility of public accountants should be to provide accurate and credible financial information to shareholders and the public investment community. This is the primary reason the audit practice of public accounting firms exists. It stems from the legal requirement that firms, which have sold securities to the public, provide certified financial statements audited by "independent" public accounting firms, to investors and lenders.

Conflicts of Interest

Unfortunately, recent events indicate that in certain situations, the primary responsibility of public accounting firms was lost. Despite being entrusted with the extremely important responsibility of providing public investors with credible and reliable information, a variety of events strained the credibility of "independently" audited financial statements. A string of scandals in corporate America have shaken investor confidence and contributed to a significant decline in the stock market.

After recording record profits and strong stock prices, Enron Corporation became the largest U.S. company to file for bankruptcy in December 2001. Accounting rules and the firm's accountants permitted Enron to create "special-purpose-entities," which were partnerships that did not have to be consolidated into the firm's financial statements. These partnerships, headed by an Enron executive, enhanced the company's financial results and shifted large amounts of debt off of Enron's balance sheet. The effect was to overstate profits, understate debt, and provide support for the company's stock which peaked at $90 per share in 2000. When the company's questionable and aggressive accounting policies became publicly known, a more realistic financial picture was revealed and the company slid into bankruptcy. The Enron debacle led to the demise of the firm's auditor, Arthur Andersen LLP, which was found criminally negligent.

Enron's dubious distinction as the largest U.S. bankruptcy was short lived. In July, 2002 WorldCom filed for bankruptcy after understating expenses by nearly $4 billion by inappropriately classifying the expenses as capital expenditures. The impact was reversing net income of $1.38 billion in 2001 to a restated net loss. Questionable accounting practices also occurred at Adelphia and Global Crossing, two other telecommunications giants and both on the list of the ten largest bankruptcies in U.S. history[1].

After overstating pretax income by 36%, or $1.41 billion over a five year period, Xerox was forced by the Securities and Exchange Commission to restate earnings. Xerox inappropriately accounted for leases which led to inflated revenues and income. Other notable firms having accounting irregularities have included AOL/Time Warner, Merck, Reliant Resources, Rite Aid, Sunbeam, Tyco International, and Waste Management.

[1] see Bankruptcydata.com

Although questionable accounting practices and corporate scandals are not new, the magnitude and number have grown. According to *Business Week (7/15/02)*, investors have lost nearly $200 billion in the past six years as a result of earnings restatements and stock declines following audit failures. Between 1997 and 2000, the number of financial restatements doubled from 116 to 233.

Investment Banks and Security Analysts

Role and Responsibility

From a broad perspective, investment banking may include a variety of capital market activities, including underwriting, merger and acquisition analysis, business valuation, venture capital, and corporate finance advisory activities. From the public perspective, the investment bank should provide guidance to investors so an efficient allocation of capital occurs in the economy.

Investment banks are financial intermediaries that may incur a financial risk through the underwriting of securities[2]. Investment banks act as the "middleman" between client firms wishing to sell securities and the investing public. This marketing and selling of securities for client firms is perhaps the most important function of investment banks. Without the ability to sell, an investment bank's ability to raise funds for clients would be paralyzed, and its revenue stream severely restricted.

Investment banks perform a variety of functions and services in the financial markets. From a business organization perspective, investment banks can be viewed as performing three interrelated functions. Through its investment bankers, the firm provides corporate finance services to corporate clients that generally include advising on financial and strategic planning, including security offerings and mergers and acquisitions. A second function is research and security analysis, performed by theoretically independent analysts with the goal of providing potential investors with information and recommendations on various stocks and/or bonds, including the securities of corporate finance clients. Finally, a third function, is the selling and distribution of securities. The firm's retail and institutional brokers will often utilize the research reports of security analysts when recommending securities to their clients. Security analysts are responsible for critically and thoroughly analyzing the investment attractiveness of a firm's stock, and consequently issuing an "independent" recommendation to investors for buying or selling the stock.

Accountants are primarily responsible for auditing and certifying historical financial information made public by a firm to the investment community. Security analysts are primarily responsible for providing guidance to the future financial prospects of a firm to the investment community.

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[2] An investment bank may offer the securities of a client firm through a firm commitment or best efforts. In a firm commitment, the investment bank will buy the issue at a negotiated price and sell the issue to investors. If securities are sold on a best efforts basis, the investment bank will use its "best efforts" to sell and market the securities, but will not purchase the securities itself.

Conflicts of Interest

The various financial services provided by investment banks can be very interrelated. If investment bankers recommend to a corporate client that stocks and/or bonds be sold to raise capital, then the investment bank will also distribute, market, and sell the securities. Through their analysis and recommendations, security analysts often play a key role in the marketing of new security offerings. In addition, through their contact with corporate senior management, security analysts can also play a significant role in generating new corporate finance clients for the investment banking firm. Security analysts may be compensated and/or evaluated on the basis of generating investment banking fees. Security analysts may also be compensated on basis of the sales commissions generated by the stocks that they research. If a firm is an investment banking client and issues stock, then a security analyst may also benefit from a significant portion of the issue being sold through the broker network of the investment bank.

Historically, a security analyst's relationship with client senior management could be a source of competitive advantage for the analyst. An excellent source of information, client senior management could potentially provide the analyst with proprietary information which could cast the analyst in a "star" light. In other words, the analyst could be seen by Wall Street and investors as the best source of information on the company.

The potential for conflicts of interest between investment banking and research is exemplified by Morgan Stanley's recent attempt to fend off state regulation of the securities industry. According to the *Wall Street Journal* (6/21/02), Morgan Stanley's Chief Executive Officer, Phil Purcell, lobbied lawmakers on a plan that would prevent state securities regulators from scrutinizing improprieties at Wall Street firms, such as conflicts of interest involving security analysts. The lobbying effort came amidst an investigation by the state of New York regarding whether securities firms, including Morgan Stanley, misled investors with the issuance of overly optimistic stock research on companies that also were investment banking clients. In Morgan Stanley's case, the issue concerned public release of performance reviews and the independence of security analysts given the review process. Firm executives are evaluated by supervisors and peers. In the case of security analysts, the review process includes an evaluation by investment bankers, with whom they may work with to generate deals. The question concerns an analyst's ability to remain critically independent when researching an investment banking client.

Another conflict between investment banking and research concerned a Salomon Smith Barney analyst covering Winstar communications (*Wall Street Journal,* 7/22/02). The National Association of Securities Dealers (NASD), Wall Street's main self-regulatory agency, alleged that the analyst violated securities rules over research on Winstar. Winstar had been a Wall Street favorite, but filed for bankruptcy protection in April 2001. The NASD is investigating whether the issuance of positive research reports by the Salomon Smith Barney analyst were justified despite growing evidence that the company was under financial duress. On January 25, 2001, Winstar stock closed at $17 per share while the Salomon Smith Barney analyst had a price target for the stock of $50 and dismissed criticism of the company by other analysts and investors. Nearly three months later, on April 17, 2001, the stock closed at 14 cents and the company filed for bankruptcy.

Wall Street and security analyst credibility suffered significantly with the rise and fall of Internet (the "dot-coms") companies, which began in the late 1990s. In May 2002, Merrill Lynch & Co. paid $100 million to settle New York state charges that analysts misled investors. The case focused on internal e-mails which Merrill analysts were highly critical of Internet firms, yet issued research reports recommending the stock to investors (*The Economist*, 6/8/02.)

Causes of Conflicts of Interest in the Financial Markets

A variety of factors have contributed to the accounting crisis and loss of investor confidence in financial statements and financial markets.

1. *The Relationship between Public Accounting Firms and Auditing Clients.* Although public accounting firms are supposed to be independent, the audit fees are directly paid by clients. Striving to be independently critical of client accounting practices and procedures may risk the potential of generating future auditing fees. Surely the ethical thing to do, but it may come at a monetary cost. Anytime a dual evaluation process exists, objectivity may be lost.

2. *Consulting Services of Public Accounting Firms.* In an effort to grow fees, many public accounting firms aggressively expanded the array of consulting services offered to potential clients. These services included taxes, information technology, corporate finance services such as mergers and acquisition analysis, strategic planning, and conducting internal audits for clients. According to *Business Week* (4/8/02), by early 2002 approximately 54% of revenues for the Big Five accounting firms were derived from consulting services. The mixing of auditing and consulting services places additional pressure on the accounting firm to compromise the independence of the audit to generate consulting fees.

3. *The Lack of Independence and Expertise of Audit Committees.* The board of directors will appoint an audit committee to oversee the audit of the firm's financial statements by the public accounting firm. The audit committee should theoretically be independent and knowledgeable; that is, it should be able to intelligently, without conflicts of interest, judge the quality of the audit. In the case of Enron's six member audit committee, one member had a $72,000 consulting contract with the company, and two members were employed by universities that received significant charitable contributions from Enron. Enron insiders, including three of the six audit committee members, sold 17.3 million shares for $1.1 billion while issuing financial statements later revealed to be

grossly misleading. Members of an audit committee should be knowledgeable on accounting and financial matters and not have potential conflicts of interest resulting from compensation issues.

4. *Self-regulation of the Accounting Profession.* Historically, the public accounting profession has primarily been self-regulating, with industry boards stipulating principles, guidelines and ethical conduct. Unfortunately, recent events suggest that self-regulation was woefully inadequate. Self-regulation in the accounting industry and generally accepted accounting principles did not prevent accounting irregularities and fraud at some of the largest companies in the United States.

5. *Lack of Shareholder Activism.* Shareholders elect the board of directors who in turn appoint management. Management should be acting in shareholder interests. If shareholders do not like actions by the board of directors and/or management, they could, theoretically, replace the board of directors. However, in many cases company ownership is through a diversified, fragmented shareholder base not dominated by any particular shareholder. In these situations, it may be difficult to organize shareholders to take collective efforts against management and/or the board of directors.

6. *Short-term Executive Greed vs. Long-term Shareholder Wealth.* Despite the long-term damaging consequences of accounting irregularities and inflated profits to the investment community and employees, artificially boosting stock prices in the short-run was potentially rewarding to management. According to the *Wall Street Journal* (6/17/02), Enron paid about $681 million in cash and stock to its 140 senior managers, including at least $67.4 million to former Chairman and Chief Executive Kenneth Lay, in the year up to Dec. 2, 2001, when the company filed for bankruptcy. Not bad for a company that saw its stock decline from $80 in January of 2001 to less that $1 when filing for bankruptcy.

7. *Executive Compensation Schemes: Stock Options, Severance, and Perks.* The accounting treatment of stock options has become increasingly controversial. Although stock options are meant to be an incentive to management and are certainly a form of compensation, they are not treated as an expense on the income statement. In addition, stock options could potentially encourage short-term business strategies, as executives try and ramp up the stock price and cash out their options. Critics of the accounting treatment of stock options, including highly respected investor Warren Buffett of Berkshire Hathaway, feel that a firm's income is overstated. The stock options are a form of executive compensation; thus, they should be part of compensation expense and run through the income statement. In July 2002, Coca-Cola became one of the first major companies to announce that it would begin expensing stock options. TIAA-CREF, a major institutional investor, has lobbied for firms to expense stock options. Excluding stock options from any type of recognition on the income statement arguably leads to an overstatement of net income. In addition to stock options, excessive perks and severance schemes drain shareholder value. Recent revelations

regarding the initial severance contract of Jack Welch from GE, and excessive CEO perks at firms such as Tyco and Home Depot (*The Economist,* 9/21/02) do anything but enhance shareholder value.

8. *Compensation Schemes of Security Analysts.* The interrelated functions of investment banking firms and the compensation structure for security analysts can cause conflicts of interest. "Sell-side" security analysts, that is, analysts working for investment banks that sell securities, must be able to sell their ideas. Although financial analysis is important, an analyst who cannot generate fees and commissions for an investment bank is of little value. Revenue can be generated through sales commissions on security transactions and/or fees from investment banking services. A security analyst can be instrumental in attracting or retaining an investment banking client. Investment banking clients can be an important source of revenue for the investment bank, as fees may be earned through corporate finance services and sales commissions generated in security offerings. In addition, once the securities are sold through the firm's broker network, an excellent opportunity exists to generate future commissions if the stock is sold.

Recent Regulation – Corporate Governance

In July 2002, Congress passed and President Bush signed perhaps the most significant legislation affecting the financial markets since the 1930s. The corporate-governance and accounting-oversight bill is intended to curb corporate abuses with tougher criminal penalties and stricter accounting oversight (*Wall Street Journal*, 7/26/02). The ultimate goal was to increase investor confidence in the stock market and prevent deceptive accounting and management practices. Although the expected ultimate impact of the legislation is open for discussion, it clearly has major consequences for executives, accountants, shareholders and regulators. The legislation increases the power and funding of the SEC, and includes the following key provisions.

- An independent auditing-oversight board is created with oversight by the SEC. The board will have investigative and disciplinary powers, with the ability to request and subpoena documents from audit firms and their clients. This marks a dramatic change for the accounting profession, which primarily had relied on self-regulation in the past.

- Increased responsibility is placed on a firm's audit committee. Members must be independent and will be held accountable for hiring and overseeing the corporation's auditor. Penalties may be invoked on firms failing this responsibility.

- Increased responsibility is placed on a firm's senior management. CEOs and CFOs will be required to certify final financial reports, and forfeit profits and bonuses when earnings are restated due to securities fraud. CEOs and

CFOs are subject to $5 million in fines and prison terms up to 20 years for making falsifying statements to the SEC.

- Increased responsibility and accountability is placed on audit firms, as key audit documents and e-mails must be kept for five years. Violators are subject to a 10-year felony for destroying such documents.

- Conflicts of interest for accounting firms offering auditing and consulting services are reduced, as auditors are prohibited from offering certain types of consulting services and audit partners must be rotated at least every five years.

- Firm executives are prevented from receiving company loans unavailable to outsiders.

- The ability to profit from insider trading is reduced. Corporate insiders must report all company stock trades within two days, and executives are prohibited from selling stock during certain blackout periods.

- Increased protection for wronged investors. The amount of time investors have to file suits is increased, from one year to two years after an alleged fraud has been discovered, and from three years to five years after it occurs.

- Criminal penalties are created or increased for securities fraud, altering records to defraud shareholders, destroying key audit documents and e-mail, providing false statements to the SEC, and defrauding pension funds.

The focus of the bill is on increasing the reliability of historical financial information by firms, reducing conflicts of interest of auditors, and places additional responsibility on corporate management and auditors to reduce and/or prevent fraud.

Regulation FD, introduced by the SEC in 2000, was designed to change how firms could disseminate information to the investment community. The regulation prohibits firms from disclosing material information to one outsider before the market as a whole, thus denying the main source of competitive advantage for an analyst.

Recent Regulation – Investment Banking and Research

In December 2002, key regulators, including the New York Stock Exchange, the Securities and Exchange Commission, and the New York State Attorney General, reached a $1.4 billion settlement with major Wall Street firms, including $900 million in penalties for faulty research, $450 for independent research, and $85 million for investor education (*Wall Street Journal*, 12/23/02). The firms included Citigroup, (owner of Salomon Smith Barney), Credit Suisse First Boston, Morgan Stanley, Goldman Sachs Group and Merrill Lynch & Co.

The objective of the accord is “severing the links between research and investment banking, including analyst compensation for equity research.” Although the accord applies specifically to those firms involved in the settlement, it may eventually provide an industry wide model for the relationship between investment banking and research.

Under terms of the settlement, the brokerage firms must sever the ties between research and investment banking. The new rules for security analysts’ conduct include a ban on analysts accompanying investment bankers pitching for corporate finance deals. Analysts can no longer attend Wall Street organized “road shows,” which are presentations by firm management sponsored by the investment firms during the public offering process. In addition, the settlement also states that analysts cannot be compensated based on investment-banking work or input from bankers. For five years, the investment firms must pay for “independent” stock research that will complement stock reports by their own analysts. Stock ratings from various sources will also be available to investors, and investment firms must disclose analyst ratings and price-targets. Finally, the settlement places a ban on “spinning” initial public offerings, the process of giving hot shares to executives and directors in exchange for corporate business.

Solutions to the Conflicts of Interest

Although its ultimate impact is yet to be determined, the recent corporate governance legislation should certainly help restore investor confidence in financial statements. Limiting auditing firm consulting activities, increasing penalties for securities fraud, creation of an accounting oversight board, increasing the responsibility of auditing committees, and rotation of audit partners should strengthen the independence of auditors. In addition, an increased emphasis should be placed on having a majority of truly independent members comprising the board of directors, with the primary responsibility of acting in the best interests of shareholders, not management.

A variety of academic research has examined the how compensation policy can be utilized to reduce agency costs. Murphy (1985), Brickley, Lease, and Smith (1988), Jensen and Murphy (1990), and Smith and Watts (1992), discuss how the interests of management and shareholders can be aligned through an appropriate packaging of salary and contingent compensation, including bonuses and options. Rappaport (1999) recommends replacing conventional stock options with options that are tied to a market or peer index with the objective to create a closer link between management compensation with managerial performance. Despite the development of agency theory and various compensation plans over time, the agency problem between managers and shareholders has been far from solved. The trick is, of course, to determine and consequently provide appropriate incentives to management to persuade them to act in the best interests of shareholders.

Executive compensation plans should be designed with the *long-term* interests of shareholders in mind. This should be a responsibility of the board of directors. To promote long-term interests, at least some portion of compensation and/or the opportunity to exercise stock options should be deferred for a period of time *after* the executive is no longer employed by the firm. To aid shareholders in the evaluation of management and the firm's board of directors, executive compensation, including salary, perks, stock options and any other type of compensation, should be valued, expensed, and fully disclosed in the firm's financial statements. Given management is working for shareholders, shareholders have a right to know what the full cost of executive compensation is.

The recent settlement involving major Wall Street firms places increased scrutiny on the relationship between security analysts and investment banking. However, it is still primarily *caveat emptor* for investors. The settlement is not an industry wide standard. Even for the companies involved with the settlement, the security analyst compensation may be related to total firm revenues (a function of investment banking activities) and commissions, which are a function of the stocks followed by the analyst and the stock sold through the broker-network of the firm. Analysts will be able to continue answering questions about securities offerings their firms are managing or co-managing. Although investment firms now must provide outside research to investors, there is no guarantee that the outside research will be better. Outside research firms may also have conflicts of interest, for example, if the firm providing the outside research also sells mutual funds.

Complete independence between investment banking and security analysts may be extremely difficult to accomplish. Investment bankers, through underwriting, marketing, and distributing securities, enable client firms to raise needed capital. Security analysts can play a key role in justifying, promoting, and successfully completing the investment banking activity. Without the participation and marketing of security analysts, stock offerings would generally be more difficult to market and sell.

Rather than relying solely on the ethical behavior of investment bankers and security analysts, perhaps additional information disclosure by investment firms could help investors determine the "independence" of a research recommendation. With any report and/or recommendation, a firm's investment banking relationship with the firm should be disclosed, as well as any investment position the investment bank or research firm may have in the firm's stock. Disclosure should also be made as to how an analyst may be compensated, either directly or indirectly, from investment banking deals. However, it should be remembered that even if a firm is not currently an investment banking client, the contacts realized by the security analyst through research may strengthen the opportunity for future investment banking opportunities.

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