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When the Music Stops: Opportunities for Corporate Governance Reform Born Out of a Market Collapse

By David A. Thorpe

"When the music stops, in terms of liquidity, things will be complicated. As long as the music is playing, you've got to get up and dance. We're still dancing."

Former Chairman and CEO of Citigroup Inc., Charles O. Prince, July 9, 2007, four months before being ousted after reporting an unexpected $11 billion write-off of subprime mortgage losses.

The music has now stopped and the world has begun to deal with the complicated web created by the financial markets' collapse, and to determine how to prevent future market catastrophes. One clear preventative measure is to ensure that companies create and support strong, independent and accounting-savvy boards of directors and executives charged specifically with risk management and control. As proxy season begins, concerned market participants are called upon to examine lessons from the largest loss of investment capital since the Great Depression, and enact reforms to better protect shareholder interests and help prevent future financial meltdowns. In proposing any reforms, however, it is necessary to first examine why existing critical governance standards failed to alert investors to a crisis in the markets. Only by learning from these shortcomings will new measures have a chance at preventing another financial disaster.

In the broad context, corporate governance measures failed because of a lack of board oversight. The Organisation for Economic Co-operation and Development (OECD), an association of thirty member nations that accept the principles of representative democracy and a free-market economy, recently attributed the current financial crisis to "failures and weaknesses in corporate governance arrangements which did not serve their purpose to safeguard against excessive risk taking in a number of financial services companies." The OECD's conclusions necessarily raise the need to examine and propose board-level corporate reforms in order to strengthen market integrity and restore shareholder confidence. Immediate reforms are needed with respect to key corporate

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WHEN THE MUSIC STOPS

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governance principles which failed to serve investors' interests during the recent market turmoil; namely, risk management oversight and enforcement, consistent application of enhanced accounting standards, and executive remuneration tied to long term shareholder interests.

Investor advocates must demand direct board-level oversight of corporate risk management and the development of acceptable risk policies. Risk management breakdowns in the current financial crisis were…attributable in large part to boards of directors' limited access to, and understanding of, relevant risk exposure information.

As an initial matter, investor advocates must demand direct board-level oversight of corporate risk management and the development of acceptable risk policies. Risk management breakdowns in the current financial crisis were not due to a lack of sophisticated modeling or technology; rather, they were attributable in large part to boards of directors' limited access to, and understanding of, relevant risk exposure information. Substantial corporate risks were simply ignored or not communicated to boards of directors.

Indeed, the current crisis has made clear that boards of directors of investment banking firms recklessly, or at least negligently, failed to understand that increased exposure to subprime assets exceeded acceptable risk limitations until it was too late.

For instance, in 2008, the Institute of International Finance ("IIF") concluded that "events have raised questions about the ability of certain boards to properly oversee senior managements and to understand and monitor the business itself." In fact, the Securities and Exchange Commission noted that "Bear Stearns' concentration of mortgage securities was increasing for several years and was beyond its internal limits," yet the Bear Stearns Board of Directors did nothing to mitigate this exponential growth to the balance sheet and protect the company's liquidity. Indeed, Bear

Inside Look

The recent financial crisis has once again made it abundantly clear that corporations do not always act in the best interests of their shareholders, and that the government alone is not able to eradicate corporate fraud and mismanagement. Fortunately, shareholders are exercising their ownership power to curb further corporate waste and fraud and redeem the public's trust in corporations that is necessary for our economy to survive.

In "When the Music Stops: Opportunities for Corporate Governance Reform Born Out of a Market Collapse," firm associate David Thorpe examines what can be done to reinstate the key corporate governance principles too often ignored during the recent market turmoil — namely, risk management oversight and enforcement, the consistent application of enhanced accounting standards, and the insistence on executive compensation tied to long term shareholder interests. In "Where Do Investors Stand After the Recent Delaware Chancery Court Decisions in *Citigroup* and *AIG*?," firm associate Amy Miller examines two recent seemingly conflicting opinions in the Delaware Chancery Court, which highlight the difficulties in proving "failure to monitor" claims against Boards of Directors even in instances where the company has collapsed.

Max Berger

Also in this issue, firm associate Laura Gundersheim discusses the SEC's proposal to end the "broker vote rule," a plan that would increase the power of institutional and activist shareholder votes. In addition, we have reprinted an informative *Wall Street Journal* article titled "Policy Makers Work to Give Shareholders More Boardroom Clout" that presents the federal and state plans being advanced to give shareholders more power in corporate boardrooms, particularly in the area of executive pay.

I also direct your attention to the regular "Eye on the Issues" column. Firm associate Takeo Kellar provides a perceptive compilation of the most significant recent developments in securities litigation, regulation and corporate governance.

We trust that you will find this issue of the Advocate both informative and insightful. As always, we welcome your comments, questions and input.

Max W. Berger

Stearns only established a full risk committee of its Board of Directors months before it failed, too late to stanch the rising crisis. Other banks had risk committees, but they were not sufficiently involved to be of use. For instance, the now bankrupt Lehman Brothers had a risk committee, but it only met twice in 2006 and 2007. And at UBS, risk managers were apparently alerted to potential subprime losses during the first quarter of 2007, but it took months for UBS executives to even raise those issues with the corporate board and outline a comprehensive picture of the company's subprime exposure.

In fact, many banks took a "silo approach" to risk management, essentially walling off risk management staff, preventing centralization of information or a clear process for the escalation of red flags. This serves no purpose and chokes the flow of critical information to boards of directors. Given the current economic climate, directors are obligated to assume an active role in managing corporate risk by protecting the integrity of balance sheets and limiting threats to liquidity. To do so, boards must become aggressive and implement risk reporting mechanisms that provide them with company-wide risk assessments in a timely fashion.

As a remedy, risk management must be proactive rather than reactionary. As the OECD indicated, "it is a prime responsibility of boards to ensure the integrity of the corporation's systems for risk management." To fill this need, one innovative proposal is to establish a Chief Risk Officer (CRO) who also operates as a full board member. If independent and experienced, CROs could be extremely useful tools for boards in assessing corporate risk. Additionally, CROs could provide a direct point of risk policy enforcement and immediately raise unacceptable or troublesome exposures. In turn, with information provided by CROs, boards could then quickly assess violations of a company's risk guidelines instead of waiting for untimely and filtered assessments. Accordingly, boards that assume greater responsibilities and gain direct access to risk exposure levels through CROs, or other similar measures, are likely to prevent catastrophic threats to corporate viability.

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Hand-in-hand with an increased board level understanding of risk exposure is the need for more meaningful corporate disclosures. Again, this is a board responsibility that has suffered in recent years. As more and more complex securities entered the marketplace and appeared on corporate balance sheets, boards improperly delegated risk disclosures to others without fully investigating and disclosing the true exposure associated with novel financial instruments such as collateralized debt obligations and credit default swaps tied to toxic mortgage assets. Again, a CRO-style board appointee could operate to review and improve corporate disclosures and augment investor understanding of risk and liquidity.

In addition to increased board oversight of risk management, directors must seek uniform and appropriate application of accounting standards that improve transparency for investors instead of obscuring liabilities. This requires improving the quality of audit committee membership and active supervision of company audits by boards of directors.

For instance, in recent years, banking entities were encouraged to engage in a form of accounting arbitrage by moving deteriorating mortgage assets off balance sheets to various special purpose entities. For example, Citigroup essentially created a liquidity "put" associated with its collateralized debt obligations that allowed buyers to sell back the faltering securities at their original value to Citigroup. This strategy only worked if the value of the assets remained healthy; once the assets' value tanked because they were tied to subprime mortgages, Citigroup was forced to bring back approximately $25 billion worth of toxic assets on to its balance sheet in November 2007. In essence, by

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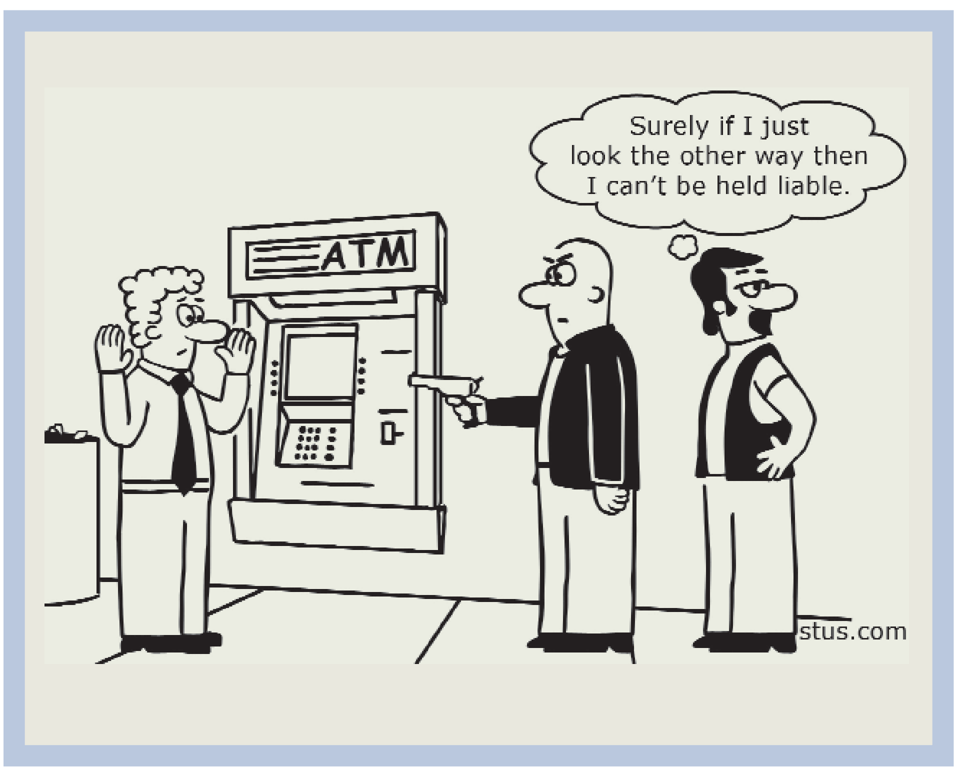
Where Do Investors Stand After The Recent Delaware Chancery Court Decisions in Citigroup and AIG?

By Amy Miller

Despite the fact that these decisions resulted in the opposite outcomes, both the AIG and Citigroup decisions indicate that a board need not care about its oversight duties unless it is confronted with red flags reflecting rampant and obvious fraudulent or criminal misconduct within a company.

The Delaware Chancery Court recently made it even harder for investors to hold directors liable for fiduciary breaches related to their oversight duties. Oversight claims (*i.e.*, "*Caremark* claims") were already regarded as "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment" (*In re Caremark Int'l Inc. Derivative Litig.,* 698 A.2d 959 (Del. Ch. 1996)). Now investors must meet an even higher standard to successfully litigate Caremark claims as a result of the *American International Group, Inc. v. Greenberg,* 965 A.2d 763 (Del. Ch. 2009) and *In re Citigroup Inc. Shareholders Derivative Litig.,* 964 A.2d 106 (Del. Ch. 2009) decisions.

Claims related to directors' oversight failures became known as *"Caremark"* claims after the Delaware Chancery Court's seminal decision. In *Caremark*, the court held that to establish oversight liability, a plaintiff must show that the directors knew they were not discharging their fiduciary obligations or that the directors demonstrated a conscious disregard for their responsibilities such as by failing to act in the face of a known duty to act. A decade later, in *Stone v. Ritter,* 911 A.2d 362 (Del. 2006), the Delaware Supreme Court affirmed the *Caremark* standard and held that a showing of bad faith is a necessary condition to director oversight liability.



In February 2009, the Delaware Chancery Court issued two significant and facially incongruent decisions concerning directors' oversight duties in cases arising out of the recent financial market collapse. In *American International Group,* Vice Chancellor Strine upheld *Caremark* claims brought against AIG's director defendants, while in Citigroup, Chancellor Chandler dismissed *Caremark* claims brought against Citigroup's director defendants. Despite the fact that these decisions resulted in the opposite outcomes, both the *AIG* and *Citigroup* decisions indicate that a board need not care about its oversight duties until it is confronted with red flags reflecting rampant and obvious fraudulent or criminal misconduct within a company.

In *AIG*, the plaintiffs alleged that the director defendants violated their *Caremark* duties by engaging in and supervising schemes to misstate AIG's financial performance in order to deceive investors into believing that AIG was more prosperous and secure than it really was. Vice Chancellor Strine refused to dismiss the plaintiffs' *Caremark* claims, emphasizing that the claims were not based on one instance of fraud, but rather on such a pervasive scheme that the court actually uses the term "criminal organization" to describe the extraordinary wrongdoing alleged in the complaint.

In *Citigroup*, the plaintiffs alleged, among other things, that the defendants had breached their fiduciary duties by not properly monitoring and managing the business risks that Citigroup faced from subprime mortgages and securities, and by ignoring alleged "red flags" that consisted primarily of press reports and events indicating worsening conditions in the subprime and credit markets. Declaring that "oversight duties under Delaware law are not designed to subject directors, even expert directors, to personal liability for failure to predict the future and to properly evaluate business risk," Chancellor Chandler dismissed plaintiffs' *Caremark* claims. Specifically, Chancellor Chandler held that plaintiffs face "an extremely high burden" in bringing a claim for personal director liability for a failure to monitor business risk and that while directors could be liable for a failure of board oversight, "only a sustained or systemic failure of the board to exercise oversight — such as an utter failure to attempt to assure a reasonable information and reporting system exists — will establish the lack of good faith that is a necessary condition to liability." Notably, Chancellor Chandler distinguished the complaint's allegations from those relied upon by the Court in the *AIG* decision by highlighting that "[t]here are significant differences between failing to oversee employee fraudulent or criminal conduct and failing to recognize the extent of a Company's business risk....[s]uch oversight programs allow directors to intervene and prevent frauds or other wrongdoing that could expose the company to risk of loss as a result of such conduct."

A comparison of the *Citigroup* and *AIG* decisions makes clear that in order to successfully bring a *Caremark* claim in the future, plaintiffs must be able to allege that the defendant directors failed to oversee actual and egregious fraudulent or criminal misconduct. The *AIG* and *Citigroup* decisions thus provide little incentive for directors to adequately perform their oversight duties since they are highly unlikely to face liability for their failure to do so. The *Citigroup* decision, in particular, highlights this concern since the Court dismissed the *Caremark* claims against the director defendants despite the fact that the purported misconduct that these directors allegedly failed to oversee largely contributed to the financial crisis at the Company.

While the *Citigroup* and *AIG* decisions clearly make it very difficult for investors to succeed on meritorious claims involving oversight failures, there is a bright spot in the *Citigroup* decision. Specifically, although the Court dismissed plaintiffs' *Caremark* claims, the Court permitted plaintiffs' claim that the Citigroup directors engaged in corporate waste by approving a severance and benefit package valued at over $68 million dollars for Citigroup's former CEO (who was at least partially responsible for Citigroup's financial collapse) to proceed. In so ruling, the Court recognized that "'there is an outer limit' to the board's discretion to set executive compensation, 'at which point a decision of the directors on executive compensation is so disproportionately large as to be unconscionable and constitute waste.'"

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The Delaware Chancery Court

This photograph is published with the permission of Richard K. Herrmann.

Opinions issued by the Delaware Court of Chancery have a significant impact on matters related to corporate transactions, governance and enforcement of the securities laws. Because half of all U.S. publicly-traded companies — and 63 percent of the *Fortune 500* — are incorporated in the state of Delaware, many of the most significant and high-profile transactional, or "deal" cases are litigated in the Chancery Court. The Court's prominent role in M&A and transactional litigation peaked amid the notorious takeover wars of the 1980s, and its rulings continue to have dramatic influence in current corporate transactions.

A comparison of the* Citigroup *and* AIG *decisions makes clear that in order to successfully bring a* Caremark *claim in the future, plaintiffs must be able to allege that the defendant directors failed to oversee actual and egregious fraudulent or criminal misconduct. The* AIG *and* Citigroup *decisions thus provide little incentive for directors to adequately perform their oversight duties since they are highly unlikely to face liability for their failure to do so.

Eye on the Issues

LEGISLATIVE/REGULATORY UPDATES AND RECENT DECISIONS OF INTEREST

By Takeo Kellar

House Of Representatives Works To Curb Excessive Bonuses. On April 1, 2009, The House of Representatives passed a second bill that would prohibit financial institutions receiving funds from the Treasury Department's $700 billion Troubled Asset Relief Program ("TARP") to make payments to executives as part of new or existing compensation packages that are deemed "unreasonable or excessive." The bill follows public outrage after American International Group Inc. ("AIG") paid $165 million in bonuses to top employees and executives after receiving public funds through a $173 billion federal bailout. The compensation restrictions in the bill would last until the institution repays the rescue funds. Approval of the bill comes after the House on March 19 passed a bill that would put a 90 percent tax on bonuses for people who make $250,000 or more at firms receiving TARP funds, which gained little traction in the Senate and drew concerns of its constitutionality. The April 1 bill gives the Treasury far greater discretion than the previous House bill in deciding which bonuses are excessive and avoids the controversial heavy tax penalties in the previous bill. As to Senate approval, *The Wall Street Journal* reports that Senate interest in "clamping down on Wall Street pay has waned in the wake of reports that many AIG executives have given back the disputed bonuses and amid concern that efforts to claw back the payments aren't constitutional." *Text of Bill (H.R. 1664) available at http://thomas.loc.gov (The Library of Congress); The Wall Street Journal, April 2, 2009*

SEC's Oversight To Expand, But Resources Still Lacking. As part of the Obama administration's proposed financial regulation overhaul, the Securities and Exchange Commission ("SEC") would get new responsibilities, which include oversight of hedge-fund advisors, private-equity firms and venture capitalists. The new powers come at a time when the SEC has come under criticism for its handling of financial frauds and the credit crisis and is struggling to keep up with its current responsibilities. According to the SEC, underfunding has left the agency understaffed and lacking the resources to pursue leads, especially compared to the growth seen in the industries it is charged with overseeing. While the SEC has gained additional responsibilities over recent years, the SEC lost 10 percent of its enforcement-division staffing levels. The SEC's new chairman, Mary Schapiro, recently asked Congress for more funds, and acknowledged that the SEC would need additional resources to take on additional hedge-fund oversight. The Obama administration is seeking a 13 percent funding increase, but faces resistance from Congress due to concerns over the rising deficit. *The Wall Street Journal, March 26, 2009 and Feb. 26, 2009; http://www.sec.gov/news/testimony/2009/ts031109mls.htm (March 11, 2009)*

The Financial Industry Regulatory Authority Establishes "Whistleblower" Office. In response to the recent financial scandals, the Financial Industry Regulatory Authority ("FINRA"), the largest independent regulator for all U.S. securities firms, established a new "Office of the Whistleblower" to expedite the review of high-risk tips by FINRA senior staff. The purpose of the Office will be to ensure that tips warranting additional review will receive an expedited regulatory response to improve investor protection and market integrity. FINRA reports that some of its most significant enforcement actions resulted from anonymous or insider tips. Any whistleblower tips that fall outside FINRA's jurisdictional reach will be referred to the appropriate regulatory or law enforcement agencies. Among other things, FINRA performs market regulation under contract for The NASDAQ Stock Market, the American Stock Exchange, the International Securities Exchange and the Chicago Climate Exchange. *http://www.finra.org/ whistleblower (March 5, 2009)*

Corporate Directors' Group Issues Plan To Repair Boards Of Directors. A report by the National Association of Corporate Directors ("NACD"), a directors' trade group, says boards of directors must do a better job of governing corporate America in order "to restore public and shareholder confidence." The report comes amid intensified scrutiny of corporate boards for poor oversight of management leading to the current economic crisis. The NACD report emphasizes four critical areas that boards must improve: handling of risk oversight, development of corporate strategy, approval of executive compensation and investor communications. With respect to executive compensation, the NACD says "Boards need to take a greater stand and realize 'the buck stops with them.'" Among other things, the report suggests directors consider using so-called "bonus banks," which allow annual bonuses to be paid out over a period of time to executives who meet predetermined goals. The report also suggests that directors might "avoid the additional, often exorbitant, compensation costs" paid to CEOs by grooming internal talent and successors, before seeking more costly external candidates. In addition, the report urges greater corporate transparency by increasing communications with shareholders and improving the use of technology to reach investors. *NACD Report available at http://www.nacdonline.org; The Wall Street Journal, March 24, 2009*

Former SEC Chiefs To Lead Investor Task Force On Regulatory Reform. Former chairs of the SEC, William Donaldson and Arthur Levitt Jr., will lead a non-partisan panel that will recommend ways to improve the regulation of the U.S. financial markets. This panel of experts, dubbed the "Investors' Working Group," is sponsored by two investor advocacy groups, the Council of Institutional Investors and the CFA

Institute Centre for Financial Market Integrity. “This group has been established to work with policymakers in efforts to restore public confidence by seeing to it that essential regulatory changes will include consideration of the primacy of investor interest,” said Levitt, who chaired the SEC from 1993-2001. According to Donaldson, who led the SEC from 2003-05: “The Investors' Working Group will serve as a critical sounding board for proposals to improve the framework for financial regulation in the wake of the crippling global credit crisis.” The group plans to issue an initial report and recommendations by late spring. *http://www.cii.org/newsreleases (February 11, 2009)*

Financial Regulators Oversight Weakness Cited In GAO Report. In a recent report, the Government Accountability Office (“GAO”) found that “inadequate risk management” at large, complex financial institutions was one of the causes of the current financial crisis. Moreover, the GAO found that banking and securities “regulators had identified numerous weaknesses in the institutions' risk management systems before the financial crisis began.” For example, regulators identified inadequate oversight of institutions' risks by senior management. However, according to the GAO, “the regulators said that they did not take forceful actions to address these weaknesses, such as changing their assessments, until the crisis occurred because the institutions had strong financial positions and senior management had presented the regulators with plans for change.” Regulators also identified weaknesses in models used to measure and manage risk but may not have taken action to resolve these weaknesses. *http://www.gao.gov/products/GAO-09-499T (March 19, 2009)*

Survey Reveals Growing Restrictions And Limitations On Executive Compensation. With growing public scrutiny and outrage at excessive compensation packages of corporate executives, the number of companies that froze salaries and added clawback policies to their executive pay programs has jumped sharply during the past three months, according to a survey by Watson Wyatt, a global consulting firm. The survey of 145 companies revealed that the number of companies that had frozen executive salaries had grown from 21 percent to 55 percent in the last three months. In addition, 10 percent reported that they actually reduced top managers' pay, up from 2 percent in December. Additionally, 23 percent added a clawback policy. Almost four in 10 of the companies that have already reduced or plan to reduce long-term incentive grants said they did so because it was the “right thing to do in response to shareholder value.” *CFO.com, March 17, 2009; http://www.watsonwyatt.com/news/press.asp?ID=20791*

SEC's Short-Selling Investigations Fall Short. A recent report by SEC's Office of Inspector General (“OIG”) found that, although the SEC received over 5,000 complaints about naked short selling between January 1, 2007 and June 1, 2008, the SEC did not bring a single enforcement action. Short-selling is the practice of borrowing stock and selling it in the hope that its price declines. Naked short-selling occurs when investors sell stock without first borrowing the shares. The practice is illegal when naked short-selling is used to engage in illegal market manipulation, for example, by selling stock short and failing to deliver shares at the time of settlement with the purpose of driving down the stock price. Based on an audit of the SEC's Division of Enforcement, the OIG reported that of 5,000 complaints, only 123 were forwarded for further investigation, and only then because the subjects of the complaints were involved in ongoing enforcement investigations. The OIG found that the SEC's existing complaint receipt and processing procedures “hinder Enforcement's ability to respond effectively to naked short selling complaints and referrals.” *http://www.sec-oig.gov/Reports/AuditsInspections/2009/450.pdf (March 18, 2009 Report); Law360.com, March 19 and 27, 2009*

SEC Settlements Decline in 2008. The number of SEC settlements decreased to 672 for 2008, from 699 in 2007, according to NERA Economic Consulting, an economic consulting firm. This finding represents the second-lowest total since the Sarbanes-Oxley Act of 2002 went into effect. In the fourth quarter of 2008, in particular, the SEC settled with 123 defendants, as compared to 185 defendants the previous year. The report noted that while the rate of settlements decreased, settlement values increased due to large settlement payments involving Ponzi schemes, bribery allegations and other causes of action. According to NERA, in 2008, the mean company settlement amount was $8.4 million, up from $6.5 million in 2007. The median company settlement amount reached $1.3 million, nearly double the $700,000 median of the prior year. NERA reported that about 56% of SEC settlements with companies include monetary payments. *http://www.nera.com (February 11, 2009); Law360.com, February 11, 2009*

Record Number of Subprime Lawsuits. The number of subprime-related lawsuits filed in federal courts, including securities, bankruptcy and employment suits, reached a record level in 2008, topping the total number of cases resulting from the savings-and-loan collapse in the early 1990s, according to a recent report by Navigant Consulting. The total number of lawsuits filed over the credit crisis since January 2007 is 866. Securities actions account for 38 percent of the cases, according to the report. Of the securities cases filed in 2008, 38 percent were securities fraud actions, in which directors and officers were individually named as defendants 95 percent of the time. Other securities cases targeted issuers or underwriters, in connection with the issuance of mortgage-related securities. Suits arising from the collapse of the auction rate securities market in February 2008 accounted for 22 percent of the securities suits. Fortune 1000 companies or their subsidiaries were named as defendants in 59 percent of the 576 cases filed in 2008. *www.navigantconsulting.com; Law360.com, March 11, 2009*

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Reported with permission. This article originally appeared in the March 26, 2009 issue of the *Wall Street Journal.*

Policy Makers Work To Give Shareholders More Boardroom Clout

By Kara Scannell

Federal and state policy makers are advancing plans to give shareholders more power in corporate boardrooms at a time when decisions about executive pay have ignited a public furor.

The Securities and Exchange Commission, Congress and legislators in Delaware — where more than half the nation's public companies are incorporated — all are working on measures that would give shareholders a bigger say in such matters as choosing directors.

If enacted, the initiatives could bring about the biggest changes in corporate governance since the 2002 Sarbanes-Oxley law was passed in the wake of the Enron and WorldCom scandals. They could also usher in a flood of shareholder action, starting in next year's proxy season.

The SEC, which has the most wide-ranging agenda, is working on a series of proposals that would make it easier for shareholders to nominate directors.

The Securities and Exchange Commission, Congress and legislators in Delaware — where more than half the nation's public companies are incorporated — all are working on measures that would give shareholders a bigger say in such matters as choosing directors.

Congress, meanwhile, is discussing legislation that would give holders a say on executive pay. And Delaware legislators are moving to amend the state's corporation law to tip the balance toward shareholders.

The push comes amid public frustration over taxpayer-funded bailouts of financial institutions. Shareholders and regulators increasingly are turning their attention to corporate boards that approved executive-pay packages with incentives that critics say led to excessive risk-taking and, ultimately, to the credit crunch.

The Delaware House has approved changes in the state's corporate law that would allow shareholders to nominate their own directors for corporate ballots, a right known as proxy access.

Shareholder groups have lobbied for proxy access for years, saying it would cut the cost of nominating opponents to the slate chosen by a corporation's board. Business groups oppose it, saying it favors special-interest groups and could interfere in the company's management.

The Delaware House also passed an amendment that would allow shareholders to seek reimbursement of expenses when running proxy contests. The Delaware Senate is expected to pass the legislation, and it could take effect by August.

"Those two changes are an extremely big shift," said Charles Elson, director of the University of Delaware's Weinberg Center for Corporate Governance. "It changes the balance in the election process."

David T. Hirschman, a policy executive at the U.S. Chamber of Commerce, the nation's largest business lobby, said proxy access could hurt companies. "The system is designed for shareholders to entrust the board to do the job right," he said. "Anything that makes it harder for that to happen is a step backward."

Quarterly Quote...

Mr. Lewis: I was instructed that "We do not want a public disclosure."

Q: Who said that to you?

Mr. Lewis: Paulson.

Testimony of Bank of America CEO Ken Lewis, under oath during the New York State Attorney General's investigation in February 2009, indicating that he received pressure from former Treasury Secretary Henry Paulson when asked why he did not inform BOA's shareholders of the massive fourth quarter losses at Merrill Lynch prior the BOA/Merrill merger.

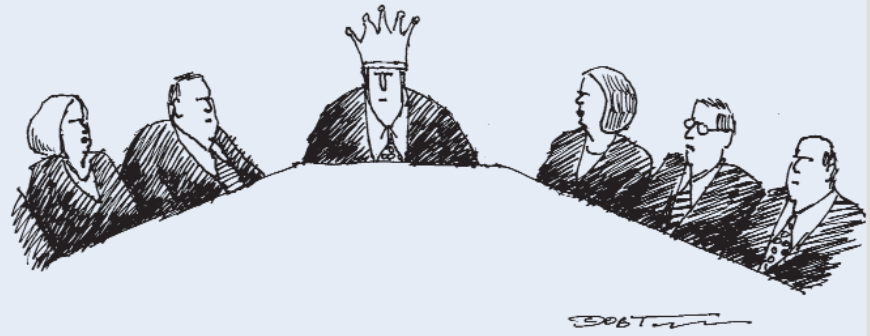
At the SEC, Chairman Mary Schapiro has stepped up the commission's focus on governance issues. Ms. Schapiro brought in Kayla Gillan, a former general counsel at the California Public Employees' Retirement System, to lead several projects including establishing an Investor Advisory Council. Ms. Gillan is also overseeing the agency's deliberations on proxy access and a rule that could give shareholders an advisory vote on executive-compensation packages.

The SEC could propose a proxy-access rule by mid-May. It is now weighing whether to allow certain shareholders to directly nominate directors or whether to have shareholders submit proposals to include directors — or a combination of the two. The SEC's proposal is likely include a tiered approach, based on the size of the company involved. For example, a shareholder might need to own 2% of a large company to propose nominees on the ballot, while shareholders of a smaller company would need to own just a 5% stake.

Three of the five commissioners have publicly said they support proxy access, making its passage likely despite the opposition from business groups. It isn't clear if the business community would file a lawsuit to challenge the rule.

The SEC is also exploring a rule to require companies to disclose a director's qualifications for a board seat beyond the basic biographical information that is now required. It is also considering requiring disclosures about a corporate board's role in overseeing risk management, how executive pay is tied to performance and conflicts of interest that exist with compensation consultants.

The SEC has also revived a long-dormant proposal to stop the practice of brokers voting for shareholders who haven't voted their shares for uncontested directors. Currently, on routine matters at annual meetings, including uncontested director elections, shares that aren't voted by shareholders can be voted by the brokers who maintain the accounts where the shares are held.



When Mr. Wirthmore began wearing a crown at board meetings, no one said a word about it...but they did vote unanimously to up their D&O policy limits.

c.06CharlesFincher11.22 Scribble-in-Law at LawComix.com

Richard Ferlauto, director of corporate governance and pension investment at the American Federation of State, County and Municipal Employees, said discussions on Capitol Hill about pay caps and bonuses "wouldn't be on the table now" if boards better controlled compensation. "The boards brought this on themselves," he said.

Brokers generally vote for management's recommendations, under the theory that if shareholders opposed management they would vote. But in recent years, voting margins have narrowed and broker votes have been criticized as watering down shareholder's intentions. The comment period expires Friday and the SEC could approve the change by mid-April. On Capitol Hill, House Financial Services Chairman Barney Frank is planning to introduce a bill that would give shareholders a non-binding vote on corporate pay packages, known as "say on pay." A new law requires "say on pay" at financial institutions that receive government aid.

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"The boards brought this on themselves," he said.

Edward J. Durkin, a governance official at the United Brotherhood of Carpenters, said say-on-pay will distract from "thoughtful investigative work on comp plans."

SEC's Plan to End Broker Vote Rule is a Huge Win for Institutional Investors

By Laura Gundersheim

Typically, brokers have voted in favor of entrenched managements and boards. The SEC's rule change will give institutional and activist investors significantly more power to determine who sits on corporate boards.

The Securities and Exchange Commission ("SEC") recently announced plans to eliminate a longstanding rule that allows brokers to vote on their clients' behalf in director elections; the so-called "Broker Vote Rule." Since 1937, the SEC has permitted brokers to vote their clients' shares. Typically, those brokers voted in favor of entrenched managements and boards. The SEC's rule change will give institutional and activist investors significantly more power to determine who sits on corporate boards. Until now, uncontested director elections have been considered routine. The SEC's proposed rule change states that such elections are no longer routine items and brokers cannot vote the stock either way without shareholder instructions. Since many small shareholders simply do not vote in elections, institutional and activist shareholders who do vote will have significantly more power to effectuate change.

The issue of broker votes is significant because an estimated 70 to 80 percent of U.S. company shares are held in "street name" and managed by brokers. Under the current rules, if the underlying beneficial owners fail to provide voting instructions within 10 days of a company meeting, then the brokers are permitted to vote their shares on "routine matters," including uncontested elections, as they wish. During 2008, 16.5 percent of shares were voted with broker discretion, according to Broadridge Financial Solutions. Brokers overwhelmingly vote for management, on the theory that any shareholder who opposed the company's position would have given the brokers explicit voting instructions. In the U.S., about 80 percent of investors' stocks are held at brokerage accounts.

The change to the Broker Vote Rule has long been sought by large shareholders and activists who want to make it easier to vote out underperforming boards or pass proposals geared toward increasing good corporate governance and instituting executive pay caps at companies. The rule change, first proposed in 2006, is slated to take effect before the 2010 proxy season.

The Broker Vote Rule has gained added importance in recent years as many large, U.S. companies have adopted provisions that require board nominees to receive a majority of votes cast in uncontested elections. While most directors receive minimal opposition, discretionary broker voting can blunt the effect of "vote no" campaigns.

This rule change is the first of what is expected to be a series of changes under way at the SEC. Although the broker vote change was first proposed in 2006, it stalled under former SEC Chairman Cox, and was never finalized. Reviving the broker vote proposal was one of SEC Chairman Schapiro's first moves since taking the helm in January. The issue was delegated to the SEC staff to approve and did not require the five commissioners to weigh in.

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Quarterly Quote...

"I am not worried about fringe elements taking over corporate boards. It's hard to imagine more damage than we've experienced in the past year. I believe the owners of the corporations need to have a meaningful opportunity to nominate directors."

Securities and Exchange Commission Chairwoman Mary Schapiro, May 4, 2009, discussing the expected SEC proposal which will give institutional and long term investors greater ability to nominate directors on corporate boards at a Mutual Fund Directors Forum conference in Washington.

WHEN THE MUSIC STOPS

Continued from page 3.

moving liabilities off balance sheets, investors were never informed of the immense risk posed by faltering mortgage assets. Clearly, in such instances, the audit committee was missing in action, thwarting transparency and failing investors.

While regulatory proposals are in the works to clearly articulate the use and risk of special purpose entities, boards of directors remain responsible for maintaining adequate accounting standards. For instance, the Financial Accounting Standards Board issued new guidelines requiring enhanced disclosures for securitization and asset backed financing arrangements. The

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increased disclosure requirements are intended to provide more information to investors concerning the risks of special purpose entities and the accounting associated with off-balance-sheet transactions.

At the same time, enhanced disclosures require audit committees to exercise objective and independent judgment, test accounting assumptions, question audit findings, and not merely rubber stamp audits or perform purely ministerial functions. Several steps need to be taken to reach these goals. For example, it is clear that, at a minimum, given the complex financial instruments in the financial markets, audit committees must be staffed by independent appointees with accounting experience sufficient to ensure proper oversight of corporate audits.

Moreover, executive compensation needs to be restructured so that executives are not rewarded for short term profits at the expense of long term health. Rewarding risk provides tantalizing rewards for both executives and investors, but taking unacceptable risks for short term gains erodes shareholder value, and can reward failure. Corporate boards can play a key role in revising executive pay by aligning long term strategy goals with compensation packages. In this regard, boards should look to reduce bonus systems tied to immediate financial returns in favor of a system that measures compensation "on a risk-adjusted basis," favoring deferred compensation structures and aligning executive performance targets with long term shareholder value. Moreover, rather than delegating this task to a compensation committee, boards should look to include remuneration considerations as a function of either the risk or audit committees to more closely align pay with capital risk and its financial impact. Indeed, independent auditor KPMG has noted that "[w]hile oversight of compensation plans may generally fall within the responsibility of the remuneration committee, audit committees are focusing on the risks associated with the company's incentive compensation structure." Given this, risk or audit committees should review executive pay to understand the true impact that incentive programs play in encouraging unacceptable capital risks and put an end to such behavior on the part of executives.

Failure of corporate boards to manage risk and properly account for liabilities threatens the viability of a free market democracy. Investors now know that there were woefully insufficient risk controls in place, and that the lack of risk control allowed the financial crisis to get out of hand. Investors will only be willing participants in the capital markets if financial transparency and oversight are restored by corporate America. Enhanced corporate oversight is necessary starting from the top down. Boards of directors must become more robust and independent in order to ensure that shareholders are protected. Only then will markets revive and trust be restored.

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