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David vs. Goliath:

The Struggle to Keep America's Capital Markets Fair and Transparent

By Katherine McCracken Sinderson

In the wake of the largest corporate crime wave in history, shareholders achieved much-needed additional protections through the increased accountability standards contained in the Sarbanes-Oxley Act of 2002 ("SOX"). Today, however, a mere five years after WorldCom and other scandals wiped out the savings of millions of unsuspecting investors, several high profile business advocacy groups have called for scaling back these protections — generally under the guise of enhancing the "competitiveness" of U.S. capital markets. Aware of the critical importance of shareholder protections and fearful of what could occur in their absence, shareholder advocacy groups have risen to the occasion to respond to corporate America and defend their existing rights.

Ironically, at the same time that corporate America is trying to diminish shareholder rights, corporate abuses such as the options backdating scandal and the meltdown of the subprime mortgage sector have continued unfettered. These abuses have allowed shareholders to gain a foothold and successfully institute significant changes at a few companies. Such successes give hope that these gains might be extended to more firms' governance practices and that existing protections will be preserved. As the future of shareholder rights plays out, investors stand at a crossroads: will they retain the right to hold management accountable though legal action and continue to make strides in corporate governance, or will the anti-investor community succeed in eroding the long-standing right to take legal action when defrauded?

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Defending Shareholder Rights

Sadly, just defending their established rights has become a full-time job for investors these days. Despite record-breaking profits on Wall Street in 2006, corporate America now contends that the U.S. markets are somehow structurally flawed and significantly less competitive than markets abroad. This notion has sparked the creation of a "Committee on Capital Markets Regulation," a Report titled "Sustaining the U.S.'s Global Financial Services Leadership" published by McKinsey & Company and, most recently, a U.S. Chamber of Commerce study entitled "The Commission on the Regulation of U.S. Capital Markets in the 21st Century" (collectively referred to as the "Reports").

According to these Reports, onerous governmental regulations and securities litigation are hurting the ability of American markets to attract new listings. In making these claims, however, these Reports conveniently distort the facts and fail to mention the healthy, thriving state of the American markets. To prevent the deregulation and lack of accountability sought by corporate America, investor advocacy groups are now uniting to respond and debunk the biased assumptions and startling omissions that form the basis for these well-funded anti-investor recommendations.

In a letter sent to House and Senate leadership, a consortium of consumer rights advocacy groups, including Consumer Action, Consumer Federation of America, Consumers Union, and U.S. PIRG, Federation of State PIRGs (the "Consumer Group" — see chart on page 3) joined together to attempt to "set the record straight." The Consumer Group informed the legislators that rather than losing out to the global markets, as anti-regulatory forces claim, U.S. securities markets are thriving — "not despite, but because of, the world class investor protections they offer." For example, contrary to the Reports' claims, the number of U.S. IPOs has risen significantly since the passage of the Sarbanes-Oxley Act. Similarly, the number of foreign companies listing in U.S. markets and the amount of money foreign companies raised in the U.S. has also increased dramatically. Indeed, foreign companies accounted for almost 20% of the IPOs conducted in the U.S. last year. Notwithstanding this documented growth, proponents of deregulation claim that the U.S. share of the world IPO market declined relative to that of the United Kingdom. The Consumer Group refuted this claim by highlighting that this apparent imbalance is largely due to new listings on the London Alternative Investment Market, a market created specifically for small companies that likely cannot meet the requirements to list in the U.S.

With securities litigation filings on the wane, shareholder advocates are rightly demonstrating that the anti-investor movement's fears of litigation are baseless. As noted in communications to a Congressional committee, "this is hardly the picture of a litigation system run amok."

The Consumer Group also soundly dispelled the alarmist fears concerning auditor liability. This concern, the Consumer Group argued, ignores the fact that the number of lawsuits filed in recent years, particularly those against auditors, has declined dramatically. Only one of the 110 securities class actions filed in 2006 (itself a 38% decline from 2005) charged the auditor. This evidence demonstrates that fears of securities litigation bankrupting auditors through ruinous damages awards are baseless. As the Consumer Group noted, "this is hardly the picture of a litigation system run amok."

Further evidence of the flaws in the arguments put forth in the Reports lies in their complete disregard of investor trust. Bernard Wasow of the Century Foundation has argued that investor confidence is an important element to successful financial markets that seems to have been discounted by those concerned about the viability of our markets. According to Wasow, rather than rollback investor protections, our financial markets would be better served by "carry[ing] the momentum of regulatory reform into better regulation" of private benefits. The regulatory failures that were highlighted by the corporate crime scandals of Enron and WorldCom indicate the need for more, not less, accountability of publicly-held companies. Indeed, the Institute for Fraud Prevention sponsored a study of 374 companies accused of securities fraud between 1997 and 2002. The study revealed that an average of seven people were implicated in each case, illustrating what the study's author, Robert Tillman, calls "normalized corruption." According to Tillman, a professor at St. John's University, "It wasn't just a few rogue CEOs. It was a large number of people in coordinated networks of professionals, accountants, bankers, stock analysts and lawyers ... Now is not the time to remove our surveillance of them."

Recently, Senator Jim DeMint (R-SC) introduced a bill that would lower the standards of SOX Section 404 regarding internal controls for most public companies. In response, the Council for Institutional Investors (the "CII") [see chart on page 7], an association of more than 130 pension funds, with combined assets of over $3 trillion, wrote a letter to Senator Christopher Dodd (D-CT), Chairman of the Committee on Banking, Housing, and Urban Affairs. CII's opposition to the DeMint Bill emphasized that smaller public companies have a high frequency of misstatements and restatements of their financial information, which, in turn, makes Section 404's enforced internal control over financial reporting vital to investor confidence in those smaller companies. The CII recommended that, in the interests of investor protection, all public companies should fully comply with Section 404.

Shareholder advocacy groups are using all resources at their disposal to combat the misleading information dispensed by the anti-investor movement. Democratic access to Congressional representatives, combined with well-researched studies exposing the fallacies at the root of the anti-regulation arguments, appears to be effective in garnering support and effecting results. On April 24, the Senate rejected the DeMint amendment. However, notwithstanding investors' success in the halls of Congress, on May 23, 2007, the SEC agreed to roll back rules with respect to smaller companies and

their compliance with SOX Section 404. In doing so, the SEC claimed that "investors will benefit from reduced compliance costs" and "companies of all sizes" will be able to focus on "what truly matters to the integrity of financial statements-risk and materiality." What benefit will be realized as result of the SEC's actions remains to be seen. One thing is certain though — shareholder advocacy groups must remain committed to protect investor rights.

Expanding Shareholder Rights

Proxy Access

Importantly, the recent high-profile efforts to roll back investor rights have not distracted investor advocates from pursuing goals that have been on their agenda for years, such as the nomination of directors. Typically, shareholders face significant barriers to directly nominating directors — they must propose their own separate slate of directors in their own proxy, a prohibitively expensive endeavor. Shareholders in Comverse Technology, Inc. recently broke new ground, obtaining unprecedented rights of control when the company adopted a proxy access bylaw. With certain limitations, shareholders may now directly nominate new directors on the company proxy card. It should be noted that the bylaw amendment occurred in the wake of the stock options backdating scandal that has engulfed Comverse.

However, regardless of its context, the Comverse shareholders' victory is particularly significant given that this is the first time a publicly-traded company has allowed such participation by shareholders. Indeed, the SEC had actually condoned the exclusion of shareholders from the company's proxy slate. (For further discussion of the SEC's role in this battle over investor protections, please see "The SEC: Friend or Foe" authored by Jeffrey Leibell and Adam Wierzbowski, 2nd Quarter 2007 issue.) In September 2006, however, the Second Circuit Court of Appeals ruled

Investor and Consumer Rights Advocacy Organizations

Organization	Description
Consumer Action	Consumer Action is a national non-profit consumer education and advocacy organization founded in 1971, focused on multilingual publications that help people save money and understand and enforce their consumer rights.
Consumer Federation of America	A non-profit organization founded in 1968 to advance the consumer interest through research, education and advocacy.
Consumers Union	An independent, non-profit testing and information organization, founded in 1936, serving consumers in the United States. Its mission is to test products, inform the public, and protect consumers. Its advocacy focuses on issues ranging from product safety to financial services and investing.
U.S. PIRG, Federation of State PIRGs	PIRG stands for Public Interest Research Group; U.S. PIRG is an advocacy non-profit organization in the United States and Canada, composed of self-governing affiliates at the state and province level. The PIRGs focus on the passage of legislation using professional and student/citizen lobbyists in the areas of environmental protection, consumer protection, and political reform.
Council for Institutional Investors	The CII describes itself as "the premier U.S. shareowner-rights organization." Founded in 1985, it is a not-for-profit association of 130 public, labor, and corporate pension funds with assets exceeding $3 trillion, joined together to educate members and the public about corporate governance, and to advocate for strong governance standards on issues ranging from executive compensation to the election of corporate directors.
Institutional Shareholder Services	ISS analyzes and provides information on corporate proxy votes, largely for the benefit of institutional investors. They also make recommendations as to whether it is in a shareholder's best interest to vote for or against particular proxies, and they advise businesses on how to handle corporate governance issues.
The Century Foundation	Founded in 1919 by the progressive businessman Edward A. Filene, The Century Foundation is a nonprofit public policy research institution committed to the belief that a mix of effective government, open democracy, and free markets is the most effective solution to the major challenges facing the United States.
CtW Investment Group	Founded in February 2006, the CtW Investment Group is affiliated with Change to Win (CtW), a federation of unions representing nearly six million workers in the United States. The CtW Investment group seeks to "organi[ze] workers' capital into an effective voice for corporate accountability and retirement security."

that the SEC had improperly allowed the exclusion of a proxy access proposal by the American Federation of State, County, and Municipal Employees (AFSCME). Prior to the court's ruling, the issue of shareholder proxy access had appeared dormant for years.

Since the ruling, however, labor unions have actively promoted a series of proposals at companies to allow shareholder proxy access. For example, AFSCME, along with three state pension funds, won 43 percent support for binding proxy access at Hewlett-Packard in the first proxy access proposal to ever come before shareholders for a vote. This amount of support was a significant success, given that shareholder proposals rarely achieve such numbers during the first proxy season in which they are proposed.

While a great step forward, the Comverse bylaw, the first adopted by a U.S. company, is still more restrictive than those proposed at other companies. Only time will tell whether this bylaw amendment will spread and broaden among other companies. The SEC held three roundtable discussions on proxy access during the month of May, and Chairman Cox has indicated that the SEC plans to complete work on a proxy access rule before the start of the 2008 proxy season. This issue remains open and it remains to be seen how much access the SEC's rule will provide.

Executive Compensation

Proxy access is not the only issue on which shareholders have made progress recently. For example, executive compensation received great attention this year when Home Depot's CEO received a $210 million retirement package despite producing lackluster results duing his tenure. Over the course of this proxy season, "say on pay" proxy proposals, in which shareholders would receive an advisory vote on executive compensation, have received majority votes at Verizon, Blockbuster, and Motorola. Moreover, AFSCME is submitting proposals to more than 60 companies to give shareholders a nonbinding vote on executive pay. AFSCME, along with other shareholder advocates, is determined to have a "say on pay" and more closely link executive compensation with performance.

According to the 2006 Global Institutional Investor Study prepared by Institutional Shareholder Services ("ISS"), U.S. investors, along with investors in Canada, Europe, and Australia, listed executive compensation as one of their top concerns. In response, the ISS has introduced the "Say on Pay Information Center" to provide information and advocate for investor input on executive compensation. According to ISS, shareholders in other markets, including the United Kingdom, the Netherlands, and Australia, have introduced shareholder votes on executive pay to address these exact problems as seen in the U.S.

Last year, the SEC introduced new rules to heighten pay disclosure. The rules provided for new clarity regarding the total amount of compensation given to executives, including pension benefits, perquisites and other personal items. However, the SEC backpedaled on these new disclosure requirements a month after they were approved, by requiring executives to report only those stock options that have vested in the prior year, rather than all options granted.

Lucian Bebchuk of Harvard Law School's Program on Corporate Governance, a dedicated advocate of executive compensation disclosure, testified before Congress, criticizing the customary practice of concealing true executive compensation. Over the last couple of years, Professor Bebchuk has introduced shareholder proxy proposals to provide additional monitoring of executive pay. This proxy season, Professor Bebchuk has introduced proposals at AIG, Bristol Myers, Exxon Mobil and Home Depot to require the approval of CEO pay by a supermajority of independent directors. Bristol Myers and Home Depot have already agreed to Professor Bebchuk's proposals. According to Stephen M. Davis, president of independent governance consulting firm Davis Global Advisors Inc., the speed of acceptance for "say on pay" proposals is unprecedented. "It's taken off like a rocket," he says. "To have the first year of a widespread campaign producing votes with 30% to 50% outcomes is unheard of."

In April, following Professor Bebchuk's testimony before Congress in March, the U.S. House of Representatives passed a bill titled the "Shareholder Vote on Executive Compensation Act." The bill was then introduced to the Senate by Senator Barack Obama. The bill calls for an annual shareholder vote on executive compensation and envisions a non-binding advisory role for investors.

Continued Vigilance in Pursuing Shareholder Protections Is Essential

While there is an organized movement to eliminate important investor protections under the misplaced argument that the U.S. capital market is losing its competitive position, shareholder advocacy groups are uniting to dispel the baseless contentions of these well-organized and well-funded anti-investor groups and are making significant strides in the areas of proxy access and executive pay disclosure. Indeed, the recent success by shareholder-rights activists is truly remarkable given the public relations efforts, political pressure, and resources expended by corporate America. That said, the willful obfuscation displayed by these anti-investor forces make it clear that shareholder advocacy groups must continue to vigilantly and vigorously protect and advance investor rights.

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