May
June
2007

CORPORATE Finance REVIEW

The Anti-SOX Movement
Occam's Razor and Bogle's Wit

Mutual Fund Postacquisition Management Retention

Better Corporate Governance Through Greater "Insider" Participation?

CORPORATE Finance REVIEW

Contributing Editors

Marianne M. Jennings
Professor of Legal and Ethical Studies
Arizona State University

Hank Boerner
Managing Director
Rowan & Blewitt

Editorial Staff

Editor-in-Chief
Morgen Witzel

Senior Director, Financial Reporting and Management Publications
Bruce Safford

Editor
Scott Gates
(212)337-4129
scott.gates@thomson.com

Desktop Artist
Lisa Zolesi

Advertising Sales Manager
Terry Storholm
WG&L Journals Advertising
610 Opperman Drive
Eagan, MN 55123
Phone:(800)322-3192
fax:(651)687-7374
e-mail: terry.storholm@thomson.com

Reprints
Lont & Overkamp
(973) 942-5716

Editorial Advisory Board

Ivan E. Brick
Professor of Finance
Co-Director, New Jersey Center for Research in Financial Services
Graduate School of Management
Rutgers University

James L. Cochrane
Senior Vice President
New York Stock Exchange

Marianne M. Jennings
Professor of Legal and Ethical Studies
Former Director, Lincoln Center for Applied Ethics
College of Business
Arizona State University

Yong H. Kim
Professor of Finance
College of Business Administration
University of Cincinnati

Dixie L. Mills
Professor and Interim Dean
College of Business
Illinois State University

Daniel T. Napoli
Senior Vice President
Global Risk Management
Merrill Lynch Co., Inc.

George J. Papaioannou
Professor of Finance
Co-Director, Merrill Lynch Center for the Study of Financial Services and Markets
Frank G. Zarb School of Business
Hofstra University

Nickolaos G. Travlos
Associate Professor of Finance
Carroll School of Management
Boston College and
University of Pireaus, Greece

Samuel C. Weaver
Associate Professor of Finance
Faculty of Finance and Law
Lehigh University

John Jahera
Chairman, Department of Finance
Auburn University

Anne Jenkins
Durham University Business School

James Pickford
Editor
Financial Times Mastering
Management Review

Francois Mallette
Vice President
L.E.K. Consulting

Stanley Block
Professor of Finance
M.J. Neeley School of Business
Texas Christian University

Deborah Pretty
Principal
Oxford Metrica

CORPORATE FINANCE REVIEW (ISSN 1089-327X) is published bimonthly by Warren, Gorham & Lamont, Division of RIA, 395 Hudson Street, New York, NY 10014. Subscriptions: $240.00 a year in the United States; $280.00 a year elsewhere. For subscription information, call 1 (800) 950-1216; for customer service call 1 (800) 431-9025. Foreign callers (who cannot use our toll-free numbers) should call (914) 749-5000 or fax (914) 749-5300. We encourage readers to offer comments or suggestions to improve the usefulness of future issues. Contact Scott Gates, Editor, RIA, 395 Hudson Street, New York NY 10014; (212) 337-4129.

Editorial Offices: RIA, 395 Hudson Street, New York, NY 10014. All editorial correspondence and manuscripts should be sent to this address. While the utmost care will be given material submitted, we cannot accept responsibility for unsolicited manuscripts. **Web: http://ria.thomson.com/financialreporting/.**

Copyright © 2007 RIA. All rights reserved. No part of this journal may be reproduced in any form—by microfilm, xerography, or otherwise—or incorporated into any information retrieval system without the written permission of the copyright owner. Requests to reproduce material contained in this publication should be addressed to Copyright Clearance Center, 222 Rosewood Drive, Danvers, MA 01923, (978) 750-8400, fax (978) 750-4744. Requests to publish material or to incorporate material into computerized databases or any other electronic format, or for other than individual or internal distribution, should be addressed to RIA, 395 Hudson Street, New York, NY 10014, (800) 431-9025.

Postmaster:
Send address changes to CORPORATE FINANCE REVIEW, RIA, 117 East Stevens Avenue, Valhalla, NY 10595.

THOMSON ™
RIA

THE ANTI-SARBANES-OXLEY MOVEMENT: HAVE CORPORATE-GOVERNANCE REFORMS GONE TOO FAR?

The critical question in Spring 2007 is, How long is long enough? The answer will depend on your point of view and vested interest when the subject is the regulation of securities and US capital markets. Is five years long enough for this cycle of reforms to run its course? Should we begin to weaken, repeal, or perhaps ignore the reforms of the first seven years of the twenty-first century?

Key reforms that began with the passage of Sarbanes-Oxley (SOX) legislation (mostly implemented by Securities and Exchange Commission (SEC) rulemaking) are approaching their fifth anniversary: Should we ease off now? A huge debate is opening up in the US concerning this issue. As parties on all sides of the question maneuver, we provide here a brief update on the events that are shaping this critical debate. There is much, much more to come on these issues.

For some capital-market and corporate interests, the answer is already decided: Yes, SOX should be rolled back. For others with a stake in the capital markets, the answer is, Not yet. And for some investor advocates for reform the answer is equally clear: SOX reforms must stay in place. Some advocates are even calling for more, not less, regulation. Beyond statutes and rules, shareholders are shaping reforms through their demands on boards and the"C-suite," and even lawyers are in the mix effecting changes through litigation.

The impact of globalization on reforms

But post-Enron, the US capital markets are more "globalized" and integrated with capital markets in many other nations. Institutions from the US invest in Europe and vice versa; their points-of-view (be they cultural, political, social) now get embedded in their expectations and activism on more than one continent.

And US market entities now directly compete with foreign-market competitors for investor and corporate dollars—e.g., attracting issuers to the New York Stock Exchange or NASDAQ vs. the London Stock Exchange is one critical example.

As SOX-era reforms "aged" four years in mid-2006 the antireform movement began in earnest, with major players often claiming that the US capital markets and the corporate sector of the United States were becoming less competitive with global competitors because of the corporate-governance-reform movement that began in 2000.

It seems that for a certain group of capital-market leaders, some of the Sarbanes-Oxley-era reforms have now run their course. As we approach the 300-week mark—and roughly 1,500 business days since Congress passed SOX—the anti-SOX forces are mounting a vigorous assault on the numerous statutes, rules, and regulations adopted since 2002.

Weighing in: the call for a rollback of reforms

Powerful voices are leading the anti-SOX parade: There are several separate efforts that are involved.

Count among them US Secretary of the Treasury Henry Paulson, a former managing partner of the New York-based investment bank, Goldman Sachs; New York Stock Exchange (NYSE) CEO John Thain (also a

Corporate Finance Review *Contributing Editor HENRY (HANK) BOERNER is a consultant, researcher, and commentator on corporate governance, corporate social responsibility, financial reporting, and shareholder activism. He can be reached at hank@hankboerner.com.*

former Goldman Sachs banker); and John Thornton, chairman of the board of the Brookings Institution and co-chair of the Committee on Capital Markets Regulation. This last committee focuses on capital-market competitiveness and argues that US capital markets are suffering because of overzealous prosecution and unwieldy governance rules.

THE BACKGROUND OF ALL THE PROS AND CONS OF REFORM IS VERY COMPLEX AND INTERWOVEN WITH BOTH REAL AND POTENTIAL CONFLICTS OF INTEREST.

The Committee on Capital Markets Regulation began its campaign with the issuance in November 2006 of a report outlining thirty-two specific recommendations in four key areas: shareholder rights; the regulatory process; public and private enforcement (including litigation); and Sarbanes-Oxley, particularly Section 404 and the certification of financial controls.[1]

Also joining in the reduce-SOX-reforms chorus are other New York-based capital-market, political, and business interests. These include (surprisingly) the champion corporate and capital-market reformer Eliot Spitzer, former New York State attorney general who wrought huge reforms on Wall Street and the mutual-fund industry, now governor of New York. Also, Senator Charles Schumer (D-NY); and New York City Mayor Michael Bloomberg. This trio joined with Wall Street forces to lash out at year-end 2006 corporate-governance reforms.

The New York interests began their efforts in March 2007 with the issuance of a report sponsored by Mayor Michael Bloomberg and US Senator Charles Schumer: "Sustaining New York's and the US' Global Financial Services Leadership"(prepared by McKinsey & Company). The report "warned that New York financial markets, stifled by stringent regulations, and high litigation risks, are in danger of losing businesses and high-skilled workers to overseas competitors, relegating New York to regional market status and adversely impacting the U.S. economy."[2]

Also weighing in was the United States Chamber of Commerce, which created the Commission on the Regulation of U.S. Capital Markets in the 21st Century. This commission issued a report in March 2007 on the competitiveness (or increasing lack thereof) of US markets. The report followed a schedule of meetings in New York, Washington DC, Chicago, and other cities. The commission looked at seventy years of federal securities regulation and intended to act "before a crisis arises" in the capital markets.[3]

Here is the common central argument against the status quo, from the Committee on Capital Markets Regulation's "Interim Report Summary": "Maximizing the competitiveness of U.S. capital markets is critical to ensuring economic growth, job creation, low costs of capital, innovation, entrepreneurship and a strong tax base in key areas of the country."[4] And here is a statement from the committee's "Interim Report Highlights": "Now there are several viable markets for raising capital, and companies are using cost-benefit analysis . . . including the potential cost of litigation and the complexity of regulation to differentiate among these markets as well as among institutional providers."[5]

The recommendations of the twenty-two-member Committee on Capital Markets Regulation in December 2006 included making changes based on the goals of (1) enhancing shareholder rights and (2) reducing excessively burdensome regulation and litigation.

The background of all the pros and cons of reform is very complex and interwoven with both real and potential conflicts of interest and societal responsibilities.

Critics of this effort loudly proclaimed that there were no shareholder advocates (translate: activist owner representatives) on the Committee on Capital Markets Regulation—only Wall Street and corporate US interests. (For the record, members include respected academics from Harvard business and law schools and the Columbia business school; the CEOs of PricewaterhouseCoopers and Deloitte; James Rothenberg, chairman of Capital Research and Management, etc.)

The NYSE: public company, regulatory body

Critics say this is nothing more than the vested interests looking out for themselves, not investors. Take the case of the New York Stock Exchange's role in the Committee on Capital Markets Regulation's initiatives: NYSE CEO John Thain guided the exchange from its traditional status as state-regu-

lated not-for-profit (since 1972) to a for-profit, shareholder-owned entity.

Did this dramatic transformation erode investor trust in the NYSE as a prime equities trading mechanism? This is still unknown and perhaps even irrelevant in the long term. Forbes.com commentator Jacob Zamansky recently wrote, "the once mighty exchange has dramatically lost its prestige____[CEO John Thain] blames a heightened regulatory environment for the lucrative loss of initial public offerings. But the truth is that many of the recent IPOs overseas are floated by dubious companies, which Sarbanes-Oxley rightfully drove from the reach of American small investors."[6]

Does the change to a for-profit company status help retain or build investor trust when the board and managers of the NYSE—which formerly were entrusted to look out for three capital markets sectors of Wall Street, listed public companies, and investors—now may have as a primary focus their own investors' financial well-being? This is but one example of perceived or real conflicts present in the public debate that was launched in mid-year 2006, as SOX passed its fourth anniversary.

Negative media reaction

The media coverage of the Committee on Capital Markets Regulation's work was initially mostly negative as seen in this article introduction from the *Washington Post:* "Investor groups sounded alarms yesterday after it emerged that a foundation with ties to a pair of well-heeled business donors and an executive battling civil charges had funded a controversial new report seeking to slash corporate regulation."[7]

Another example is a *Fortune* magazine editorial that was headlined as follows: "Stop Whining About SarbOx! Critics want to repeal the law, but it's been a boon to the market. . . ."[8]

Social investors strike back

Reaction to these anti-SOX initiatives was quickly and equally negative among certain institutional investors. The Social Investment Forum (SIF), the institutional investor membership organization for socially responsible professionals and institutions, attacked the various proposals. SIF members directly approached numerous public companies known or believed to be members of the US Chamber of Commerce to protest the publicly stated positions of the chamber and its commission that, in SIF's view, devalued corporate social responsibility and shareholder engagement.

The Chamber of Commerce, noted SIF leaders in a letter to the chamber's CEO, is aggressively speaking out against positions held by a growing number of investors and public companies and in "contradict[ion] to the growing tide of support for increased corporate responsibility and good governance."[9]

The *New York Times* reported that the US Chamber of Commerce was leading efforts to roll back important gains made to protect investors and society.[10] SIF noted that such a rollback would signal "a clear disregard for strong corporate governance practices by disenfranchising shareowners and insulating corporations from investor lawsuits."[11]

THE CHAMBER OF COMMERCE, NOTED SIF LEADERS, IS AGGRESSIVELY SPEAKING OUT AGAINST POSITIONS HELD BY A GROWING NUMBER OF INVESTORS AND PUBLIC COMPANIES.

Has the pendulum swung back?

In February 2007, the New York Society of Security Analysts held its Fourth Annual Governance Conference (the title of the program was "Has the Pendulum Swung Back?").

The gathered analysts explored various reforms that were both regulated and voluntarily adopted, including board-room-originated reforms following the spate of corporate scandals. Many of these reforms, such as adopting majority voting for directors standing for election, were not SOX-mandated but investor-driven.

Speakers included Roger Raber, the retiring CEO of the National Association of Corporate Directors (NACD), who posited that "good governance" really did pay off; a recent study demonstrated that investors will pay an 18% premium for US companies with governance practices that institutions appreciate.

"We have not yet restored public trust in the marketplace," CEO Raber told the analyst audience. "And one of the key questions asked is, Where was the board? Were they first or last to know?" The key to governance reform begins in the boardroom,

SOME REFORMS CONTINUE TO BE EVOLVED THROUGH SHAREHOLDER ADVOCACY, WITH OR WITHOUT STATUTES OR RULES TO EMPOWER THEIR ACTIONS.

he asserted. More may be known about the importance of governance to investors when Yale University and the NACD complete their collaborative study that links performance and corporate governance.

Looking at investor expectations for continuing reforms in corporate US, the managing director of CFA Institute's Centre for Financial Market Integrity, Kurt Schacht, commented, "A key issue for investors is majority voting and access to the proxy ballot. These are tools to hold directors more accountable. And they are meaningful remedies for bad corporate governance."

As an example of changes coming as a result of institutional pressure, Ann Yerger, executive director of the Council of Institutional Investors, cited the 200 public companies that have voluntarily adopted reforms that put majority voting in place for proxy votes (i.e., directors must achieve a majority vote to be elected or remain on the board).

Legislators target CEO pay

Is legislation the answer? When the Democratic Party swept back into power in both houses of congress (November 2006) the political pendulum did swing. Almost immediately after assuming his office as chair of the House Committee on Financial Services, member Barney Frank (D-Massachusetts) reintroduced his perennial bill (dating back to the collapse of Enron) to legislate some aspects of executive compensation.

The "Say on Pay" bill — The Shareholder Vote on Executive Compensation Act — would require the following:

- Full disclosure of the top executive's compensation (in the annual proxy statement);
- Full disclosure of the company's compensation policies for top managers' pay;
- Adoption of policy for requiring any form of incentive compensation to be approved by shareholders in a non-binding vote by the majority.

The bill would not set any artificial limits for compensation but would provide shareholders with more information about management's pay packages, which in turn should encourage shareholders to take action against management abuse and self-dealing. The Frank legislation, HR 1257, would also require companies to include simple compensation language on their public websites.

In an interview with *BusinessWeek,* Congressman Frank said,"Shareholder democracy solves a lot of problems. We're not talking about a lot of individual cranks. We're talking about some fairly responsible people with a lot at stake. They're not interested in damaging a corporation. They're not interested in sacrificing profit for social causes."[12]

Executive association weighs in

CFOs clearly have a stake in the outcome of this debate. Financial Executives International (FEI) recently stated its continuing support of SOX reforms, while voicing caution on the debate surrounding Section 404.

Regarding SOX-era reforms, FEI issued this official statement: "FEI believes that the heightened emphasis on internal controls, corporate governance and the enhanced role of financial executives brought about by Sarbanes-Oxley have all been very positive," said Grace Hinchman, senior vice president of government affairs for FEI. "However, available cost data, including FEI surveys, indicates that the rules and standards related to the implementation of Section 404 of the Act still require significant attention in order to achieve effective and efficient implementation of Section 404 with an approved cost-benefit ratio."[13]

In 2006, FEI surveyed 274 public companies on their SOX compliance and found the average cost for Section 404 compliance — though reduced from previous years—was $3.8 million for FY 2005.[14]

Looking ahead to continuing rule changes, in February 2007 FEI sent letters to the SEC and Public Company Accounting Oversight Board (PCAOB) voicing concern about recent changes to Section 404 proposed by the SEC. The two agencies are revising rules for corporate financial controls in response to complaints; the focus is on the requirement for filers to report on the strength of their internal financial controls. The FEI said the proposed changes could

- Result in external audits that are more conservative than management assessments
- Cause companies to incur unnecessary costs to remain aligned with the external auditor

FEI's Committee on Corporate Reporting supports the risk-based, top-down approach to implementation of rule changes proposed by the SEC and PCAOB and believes that the proposed management guidance allows for a higher level of judgment in applying the principles to individual-issuer situations, moving away from one-size-fits-all approaches (that companies and external auditors have been following).

The continuing debate

The public debate on the future of the Sarbanes-Oxley era of corporate governance and capital-markets reforms can be said to be "fully engaged" as we approach the fifth anniversary of Sarbanes-Oxley.

The issues in focus will be shaped further in the debate by the powerful forces on all sides of the reform issues. The Committee on Capital Markets Regulation set out thirty-two specific recommendations in its November report framing four key areas for debate — these recommendations will be the focus of both proreform and antireform corporate-governance interests in the months ahead. (In late July we will be entering the sixth year of the SOX reform era.)

Some reforms continue to be evolved through shareholder advocacy, with or without statutes or rules to empower their actions. These are important to watch: There is no specific "law" to be repealed.

Two comments help frame the high-stakes debate:

. SEC Commissioner Roel Campos (December 1, 2006, *The Washington Post):* "We can't be guilty of throwing the baby out with the bathwater. It's a dangerous thing to start talking about dismantling something that has worked so well for our country for so long and has produced great benefits in our capital markets."[15]

Stressing the importance of the New York capital markets and the Wall Street point of view, mayor Michael Bloomberg said, "Our capital markets and financial services firms will only enjoy continuing growth — growth that our city expects, needs and demands — if we take seriously the challenges from rapidly-expanding competitors in Europe and Asia."[16]

The outcome of the debate will have a profound impact on the financial officer. We will continue to provide details on the debate (and the issues involved) in future columns in this space. •

NOTES

1 "Interim Report of the Committee on Capital Markets Regulation," The Committee on Capital Markets Regulation maintains a comprehensive website; see http://www.capmktsreg.org/research.html

2 For the Senate's press release concerning the report, see http://senate.gov/~schumer/SchumerWebsite/pressroom/record.cfm?id=267787&&year=2007& ; for the report itself, see "Sustaining New York's and the US Global Financial Services Leadership," at http://www.senate.gov/~schumer/SchumerWeb site/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf.

3 "Report and Recommendations," Commission on the Regulation of U.S. Capital Markets in the 21st Century; available at http://www.capitalmarketscommission.com/portal/capmarkets/default.

4 "Interim Report Summary," Committee on Capital Markets Regulation. See website at note 1.

5 "Interim Report Highlights," Committee on Capital Markets Regulation. See website at note 1.

6 J.H. Zamansky, "Unraveling Wall Street Reforms," Forbes.com (February 8, 2007).

7 C. Johnson, "Report on Corporate Rules Is Assailed: Panel's Business Ties Spark Outcry," *Washington Post* (December 1, 2006): D01.

8 A. Serwer, "Stop whining about SarbOx!" *Fortune* editorial appearing on CNN.Money.com (August 1, 2006).

9 The SIF's letter to the U.S. Chamber of Commerce was sent on November 20, 2006 and is available at http://www.sriadvocacy.org/campaigns/documents/SIFLettertoChamberofCommerce.pdf.

10 S. Labaton, "Businesses Seek Protection on Legal Front," *New York Times* (October 29, 2006).

11 See the SIF letter referenced in note 9.

12 "Barney Frank's 'Grand Bargain,'" *BusinessWeek* Online, (January 8, 2007), available at http://www.businessweek.com/magazine/content/07_02/b4016049. htm?chan=search.

13 " FEI Comments on Proposed Changes to Sarbanes-Oxley," available at http://fei.mediaroom.com/index. php?s=press_releases&item=183.

14 FEI's survey results ("FEI's Survey on Sarbanes-Oxley Section 404 Implementation") are available at http://www2.fei.org/news/404_survey_4_6_06.cfm. For more information regarding Section 404 compliance, see the Sarbanes-Oxley Reporter Service, D 4044.

15 C. Johnson, op. cit. at note 7.

16 See the senate's press release, op. cit. at note 2.

REFERENCE

The New York Society of Security Analysts, "4th Annual Corporate Governance Conference: Has the Pendulum Swung Back?" (February 8, 2007, New York, New York).