

VOTE WITH YOUR FEET

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Two recent articles, in the *Wall Street Journal* and the *New York Times*, caused me some alarm.

The first article, "Probes of Backdating Move to Faster Track" in the *Journal* dated February 16, 2007, was warning Number One. I was reminded that, to date, 140 public companies have been found to have Option backdating problems -- a widespread phenomenon. This is important because, whether the companies are prosecuted or not, the practice of backdating has already profited management at the expense of the shareholders.

The article states, "On January 4, 2002, the CFO of Broadcom Corporation tapped out an email about stock Options to his Chief Executive and others. 'I very strongly recommend that these Options be priced as of December 24,' he wrote. The article points out that by selecting the earlier date (backdating), the Option recipients automatically received an immediate gain on their Options of 23%. Whether this transaction was legal or not may be a question for our judicial system, but the fact is that when management decided to give themselves a 23% bonus, it came out of the pockets of the shareholders without their approval or knowledge. Needless to say, as a shareholder, I would have liked to be part of the approval process.

Of course, we reassure ourselves that our interests will be safeguarded by the Board of Directors, who are elected by the shareholders and presumed to be responsible to them, and the SEC, whose sole purpose is to ensure that investors are treated fairly.

On March 1, 2007, that bubble was burst. The *New York Times* ran an article, "Is the SEC Changing Course?" focusing on SEC Chairman Cox. The article points out that Mr. Cox (a) has decided against tighter regulation of hedge funds (a highly unregulated environment, and (b) has urged the Supreme Court to adopt tougher standards for allowing investors to sue corporations.

The article failed to point out that Mr. Cox had dragged his feet with respect to penalties for companies, company Directors, or management involved in the Option backdating scandal. And yet, in response to criticism, Mr. Cox claims (appropriately so) that the SEC's role as a government agency is to be the investors' advocate. I am left with the uncomfortable feeling that Mr. Cox talks the talk but fails to walk the walk.

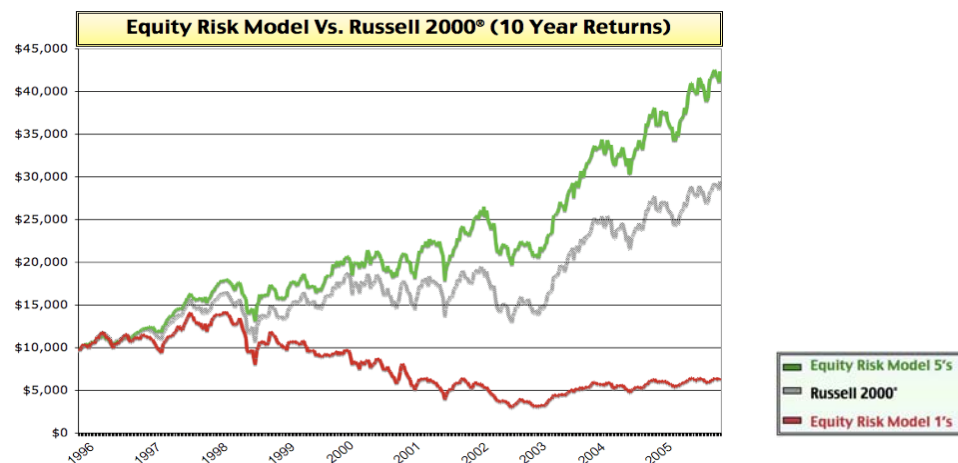
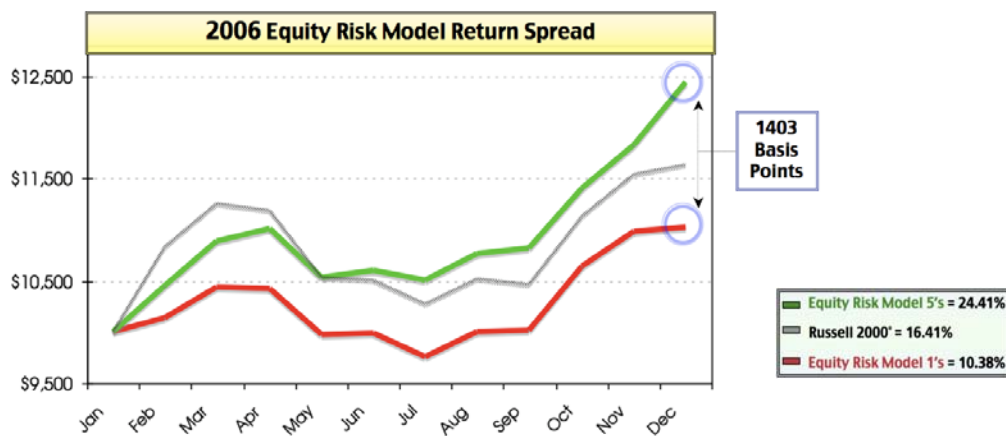
In the current circumstances, I think it may be unwise to rely on the SEC as a primary source of protection for shareholders. What is the alternative? Of course, as a shareholder, I should be able to turn to the Board of Directors, who are elected by the investors. Unfortunately, "Board independence," is an oxymoron. As a shareholder I am asked to approve a slate of Directors selected by management, which often includes the managers themselves, and which invariably comprises individuals supportive of management's interests.

Shareholders recognize they are offered no representation and therefore, until recently, rarely voted. But lately, with increasing exposure of management malfeasance, shareholders (particularly of large public pension plans) are starting to take a more active role with some very positive results.

As long as Directors are appointed by and work for management, we as shareholders have a weak advocate with a limited voice. Two potential solutions to this problem are (1) to change the method of selecting candidates for Directorship (an unlikely possibility) or, (2, the more likely solution), to begin holding Director representatives responsible for the action or lack of action they take on behalf of their constituency – the shareholders. It is time that company Directors use their independence and authority. If not, they -- not management or shareholders -- should pay the price.

Until shareholders have a real advocate, they will vote with their feet, abandoning those companies that have little regard for shareholder interests and flocking to those that do. Unfortunately, when malfeasance is obscured by a lack of corporate transparency, shareholders only move their feet after having been damaged by a restatement, drop in stock price, enforcement action, or other costly event.

The charts below illustrate the dramatic difference in returns over a one-year and ten-year term between those companies that are transparent – i.e., consider themselves accountable to their investors (Model 5's) -- and those that do not (Model 1's).



*The Audit Integrity Equity Risk Model is comprised of the highest and lowest rated companies in the AGR® -based universe of 9,000 publicly traded corporations. As shown here, the Accounting and Governance Risk (AGR®) rating is a proven measure of the overall risk related to corporate accounting and governance practices. Aggressive (less transparent) companies are shown to have lower returns over time, as they are more likely to face litigation, financial restatement, and costly reputational damage.