Investor Protection

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The financial turmoil that our economy faces today is, in large part, the byproduct of an ideology of deregulation that, over the past three decades, has grown to decisively influence the actions of federal regulatory agencies, many U.S. judges, and past majorities in Congress. This ideology dictated that U.S. capital markets should operate in an environment free of regulatory constraints and under a regime where corporate boards and executives had unlimited authority to dictate how shareholders' money is spent, while the ability of shareholders to influence corporate actions was severely constrained. The result of the implementation of this ideology was twofold. First, regulatory frameworks designed to ensure the integrity of our capital markets were systematically dismantled. Second, free of any accountability, corporate boards and executives caused corporations to undertake unreasonable risks in the pursuit of short-term financial goals devoid of economic substance or any long-term benefits.

To restore investors' confidence in our capital markets, it is necessary to reject the ideology of the past and to implement meaningful reforms designed to return responsible oversight and necessary accountability to American corporations. The reforms outlined below are designed to do just that. Through needed changes in corporate elections to give shareholders an option to nominate directors, compensation policies to promote long-term profitability instead of meaningless short-term goals, and overall accountability to end corporate malfeasance, you can provide shareholders with the tools needed to act as responsible owners of publicly traded corporations.

Reestablish the SEC as the Principal Investor Protection Agency

Revitalize and Enhance the Consumer and Investment Protection Functions of the Securities and Exchange Commission (SEC). Recent discussions about the need for a new regulatory framework have not addressed the question of consumer and investor protection. While the prudential regulation of the capital markets must remain a high focus, the need for an independent investor protection agency is equally strong. Subsuming these important activities within a larger regulatory body such as the Federal Reserve will only further erode important investor protection functions. The SEC should be retained as a free standing regulatory body, even perhaps absorbing the functions of the CFTC, with greater resources for enforcement and oversight. The agency has a history of being substantially underfunded given its broad mandate for enforcement and disclosure reviews. Most important, we need an SEC that provides real protections to both institutional and retail investors. Most Americans now own stock through IRAs and 401k plans, so a "voice" and agenda that is "on their side" is vital to rebuilding popular confidence in future financial security.

Create a far reaching Disclosure Initiative. The SEC must compel the continuous flow of data to investors about all aspects of corporate risk exposure. A start could be with regulation S-K, which should be updated and expanded to reflect the current set of risks faced by firms. The Division of Corporation Finance, when reviewing registrants' 10-K and 10-Q filings, should devote particular attention to the adequacy, under existing regulations, of disclosures concerning a variety of investor risks, including credit, financial opacity, energy and climate change, health impacts, community relations and human resources, and those reflecting the financial challenges to the economy as identified by the transition team and the new administration. For example, the Division should compare disclosures of firms within an industry, and make further inquiries of registrants that have failed to disclose potential material information that their competitors have disclosed.

As it did after Enron and WorldCom scandals, Congress should assess the funding needs of the SEC and then take steps to bring the agency as quickly as possible to the point that it can fully carry out its mission of oversight of the markets and financial professionals. In addition, the SEC should be authorized to prosecute criminal violations of the federal securities laws where the Department of Justice declines to bring an action. Too often, the Department of Justice passes on securities-related cases because its own resource constraints and competing priorities. Also, the SEC's current authority to bring actions for aiding and abetting liability under the Securities Exchange Act of 1934 should be extended to allow for such actions under the Securities Act of 1933.

Reform Director Elections at U.S. Companies

Make true majority voting in uncontested elections mandatory for all publicly traded corporations. Corporate directors are the elected representatives of shareholders who are responsible for overseeing management. Under the default rule applicable to virtually every corporation in the United States, however, corporate directors are elected through a standard that guarantees that a director could be elected with even a single affirmative vote, even if that director's candidacy is opposed by the overwhelming majority of shareholders. While many corporations have adopted policies that would require a director to receive support of the majority of shareholders to be elected, most corporations—particularly those not in the S&P 500—have not. And many corporations that have adopted some sort of majority voting have adopted policies that nevertheless allow incumbent directors to remain on corporate boards even if their reelection was opposed by a majority of shareholders. True majority voting should be mandatory in every uncontested director election at all publicly traded corporations. If a director's candidacy is not supported by a majority of shareholders, that director should not serve on the board.

Implement "proxy access" now. The process for nominating directors at American corporations is dominated by incumbent boards and corporate management. This is because corporate boards control the content of the materials that companies send to shareholders to solicit votes (or "proxies") for director elections, including the identification of the candidates who are to be considered for election. This results in a situation where corporate directors often are selected based on their allegiance to the policies of the incumbent board, instead of their responsiveness to shareholder concerns. Without launching an expensive independent proxy solicitation, shareholders have little say in selecting the directors who are supposed to represent their interests. An effective and inexpensive solution to this problem would be to enable shareholders, under certain circumstances, to require corporate boards to identify candidates nominated by shareholders on the company's proxy solicitation materials. Legislation is needed to give shareholders access to the company's proxy solicitation materials for the purpose of nominating director candidates where the nominating shareholders have a meaningful investment in the corporation.

Eliminate broker voting in director elections. Under existing rules, stockbrokers who as a convenience hold shares in their own name for their client investors have no real economic interest in the underlying corporation. Nevertheless, such brokers are permitted to vote these shares held in "street name" to elect corporate directors. Such brokers can frequently determine the leadership of corporate boards, even though they have no direct economic interest in the corporations. Moreover, brokers almost universally vote for managements' nominees and proposals and, in effect, interfere with shareholder supervision of the corporations they own. The New York Stock Exchange (NYSE) has proposed rule changes designed to solve this problem, but the Securities and Exchange Commission (SEC) has refused to let the NYSE implement the rule change. Legislation is needed to either eliminate broker voting in director elections or to force the SEC to permit NYSE enactment of the proposed rule.

Allow shareholders to submit resolutions addressing risk. Beginning in 2003, the Division of Corporate Finance too often has issued no-action letters omitting shareholder proposals that ask management to undertake a risk assessment or review the financial implications of an array of environmental, community, public health and human rights concerns and issues. The SEC has based its ruling on ordinary business grounds (rule 14a-9(i)(7)). In doing so, the SEC staff has disregarded the reasonable and principled approach that had governed SEC rulings in this area for decades and replaced it with a radical interpretation. Explaining to its shareholders how it is addressing strategic risks linked to major environmental and social policy issues, such as climate change and human rights, is an important dialogue every corporation needs to engage in with its shareholders. In this way, the SEC has effectively closed the door on this engagement with its change in policy. Therefore, the SEC needs to review these rulings and issue a new staff bulletin with guidance that once again gives shareholders the ability to submit proposals on these important topics.

Implement Compensation Practices That Ensure Executive Accountability

Implement "Say on Pay". Corporate compensation policies that encourage short-term risk-taking at the expense of long-term corporate health and reward managers regardless of corporate performance have contributed to our current economic crisis. Shareholders should have the opportunity to vote for or against senior executive compensation packages in order to ensure managers have an interest in long-term growth and in helping build real economic prosperity. So-called shareholder "say on pay" is established practice in the United Kingdom, and currently is in place at 74 publicly traded corporations in the United States. "Say on pay" proposals were introduced at over 90 companies in 2008 and received an average support of over 40 percent, receiving majority support at 11 out of 74 annual meetings, as of

Nov. 12, 2008. Say on pay legislation was introduced in the 110th Congress by President Osama when he was a Senator from Illinois. Now is the time for the 111th Congress to reconsider say on pay legislation and include it as part of needed reforms to encourage executive accountability.

Adopt Effective Clawback Provisions

Legislation should be adopted to allow for the forfeiture of incentive compensation and bonuses paid to corporate executives based on fraudulent corporate results, and should provide for enforcement through a private right of action. There is no reason why directors and executives should not give back ill-gotten gains when innocent shareholders are victimized by crippling losses. If they know their compensation is "on the line," corporate managers and directors will be less likely to engage in, or turn a "blind eye" toward, fraud and other wrongdoing.

Strength the Private Right of Action to Enhance Investor Protection

Protect shareholders' private right of actions. Corporate and financial wrongdoers in recent years have effectively denied compensation to victims of fraud by requiring customers to sign away their rights to access federal courts as individuals and participate with other victims in class actions when their individual claims are small. Even when individuals' claims are small, the costs to society and the economy of a fraud may be in the hundreds of millions or billions of dollars. Yet, absent the ability to proceed collectively, individuals have no means of redress because – as the wrongdoers know – it is frequently economically impossible for victims to pursue claims on an individual basis. Private investors form a key front-line defense against financial fraud and abuse as they are in the unique position to identify and take action against unlawful conduct. The ability of investors to take civil actions against market wrongdoers provides an effective adjunct to securities law enforcement and serves as a strong deterrent to fraud and abuse. Legislation should ensure that all individuals have the right to access federal courts individually or as a member of a class action.

Stop culpable parties from avoiding liability by manipulating disclosure. When corporate wrongdoers lie to investors and inflate the value of publicly traded stock through fraudulent and misleading accounting statements and other chicanery, those culpable parties should be held responsible for the damage wrought on the investing public that is caused by their fraud. Recent judicial decisions, however, have impaired the ability of shareholders to hold corporate wrongdoers accountable by enabling them to avoid liability altogether through the manipulation of disclosures designed to drive down a company's stock price before the true fraud is revealed to the market. Legislation is needed to ensure defendants cannot escape accountability to their shareholders for fraudulent conduct simply by cleverly timing the release of information affecting a company's stock price.

Restore aiding and abetting in securities cases. Private "aiding and abetting" liability is well established in criminal law, and private liability for engaging in an unlawful and fraudulent scheme is widely recognized in civil law. In cases of civil *securities* fraud, however, judicial decisions have effectively eliminated private liability of so-called "secondary actors" – even when they knowingly participated in fraud schemes. Eliminating the private liability of such "secondary actors" as corporate accountants, lawyers and financial advisors has proven disastrous for investors and the economy. Such "gate keepers" who traditionally have had a responsibility to watch investors' interests and once faced real costs when they failed to do so, have come to believe they cannot be held accountable—even in large frauds such as Enron in which the "books were cooked" and "secondary" actors knowingly helped managers design *fake* financial transactions to hide *real* economic losses from investors. Most recently, in the sub-prime mortgage-backed securities debacle, bond rating agencies — who were paid by the very investment bankers who created the securities they were asked to rate — knowingly gave triple-A ratings to junk sub-prime debt instruments in order to generate more business from the junk marketers. Legislation should eliminate the immunity from private liability that these culpable third parties currently enjoy.

Protect whistleblowers and confidential sources. Confidential informants — sometimes called "whistleblowers" — are of immeasurable value in discovering and redressing corporate wrongdoing. The information provided by these individuals may be crucial to victims' ability to prove their claims. Often, these individuals only come forward because they believe their anonymity will be preserved. If their identities were known, they would be open to retaliation from their employers and/or others with an interest in covering up the wrongdoing. Whistleblowers might lose their job or suffer other harm. Recent judicial decisions, however, have overly restricted the ability of shareholders to use confidential sources in presenting cases of corporate wrongdoing, and have created much uncertainty among whistleblowers as to their actual protection. Legislation is needed to clearly state that the corporate whistleblowers and other confidential informants will be protected when they step forward. In short, witnesses to securities fraud should be provided the same level of protection of their identities and against retaliation given to "whistleblowers" in other types of fraud.

Eliminate preemption as a defense to civil liability. The previous decade saw the greatest shift in governmental authority away from the states and to the federal government in our history. The unstated goal of this shift was to deny individuals their legal rights under state laws and to protect corporate defendants. Corporate interests and an administration devoted to the ideology of deregulation used the "doctrine of preemption" (that federal law supersedes state law) to bar action at the state level that could have stopped many of the abuses in sub-prime mortgage lending that are now at the heart of our economic crisis. Indeed, state attorneys general were blocked from prosecuting sub-prime lenders who violated state laws. Legislation is needed to restore the integrity of state law, and the ability of both state actors and shareholders to pursue remedies available under state law. The federal Congress should make clear that state law exists coextensively with federal regulations, except only where state law directly contradicts federal law.

Prevent culpable wrongdoers from hiding evidence from shareholders when such information is disclosed to governmental investigators and other third parties. In 1995, Congress enacted the Private Litigation Reform Act ("PSLRA") that established sweeping reforms to securities litigation. Although largely laudable in purpose and effect, one aspect of the law has had unintended consequences through in its exploitation by culpable corporate defendants. Under the PSLRA, shareholders who bring securities actions are not entitled to obtain discovery in support of their claims until a court first determines that the shareholder has adequately stated a claim. Significant corporate fraud, however, often results in governmental investigations, shareholder derivative actions, and claims asserted by employees that are not governed by this discovery stay. Accordingly, while shareholders prosecuting securities cases must sit on their hands while a court considers their case, corporate defendants often are sharing important information with governmental investigators and with plaintiffs in other ongoing litigation as well. Such information could be useful in supporting a securities fraud claim, yet shareholders are precluded under the PSLRA from obtaining access to it. Shareholders prosecuting securities fraud claims should, at the very least, be entitled to the same set of documents produced by corporate defendants to governmental investigators and other third parties even while a court considers the adequacy of a shareholder's initial pleading.