



QUARTERLY SUMMARY

This issue of the Corporate Governance Quarterly Review discusses three significant corporate governance actions that occurred during the third quarter. First, the Delaware Supreme Court issued an important ruling for shareholders seeking to place director nominees on corporate boards. The court's opinion on the

case could lead to a reevaluation of proxy access¹ by the Securities and Exchange Commission (SEC).

Second, the SEC proposed a major step toward transitioning U.S. companies to international accounting standards. If approved, the action would phase out the long-standing U.S. financial accounting

standard, Generally Accepted Accounting Principles (GAAP).

Third, the debate over fair value accounting standards intensified as the Treasury attempted to address the global financial crisis by buying billions of dollars in illiquid mortgage securities.

DELAWARE SUPREME COURT RE-OPENS DOOR TO PROXY ACCESS

In July 2008, the Delaware Supreme Court handed down a significant ruling (in *CA, Inc. v. AFSCME Employees Pension Plan*) for institutional shareholders seeking to expand proxy access. The court's decision did not implicitly grant shareholders the right to present their own director or slate of director nominees in the company's proxy statement. However, it opened the

door for the SEC to reconsider the issue² by stating that "the shareholders of a Delaware corporation have the right to participate in selecting the contestants for election to the board."

In June 2008, the SEC requested that the Delaware Supreme Court consider the case after software maker CA, Inc. (formerly Computer Associates) requested no-action

relief³ from a proposal submitted by the American Federation of State, County and Municipal Employees' (AFSCME) pension fund. The AFSCME proposal sought to change the company's bylaws to reimburse shareowners for the costs associated with the successful election of a short slate of directors.

As written, the court ruled against AFSCME's proposal on fiduciary

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¹"Proxy access" means shareholder access to the proxy voting process for the purpose of nominating directors.

²The SEC voted against proxy access in December 2007.

³The Company requested that the SEC authorize "relief" from placing a shareholder proposal on its proxy statement.

⁴"Delaware Supreme Court Ruling Helps Define Parameters of Bylaw Proposals on Proxy Access," Council of Institutional Investors (CII) Alert Volume 13, Number #30, July 24, 2008, 2.

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SEC PROPOSAL TO CHANGE U.S. FINANCIAL REPORTING STANDARDS

In August 2008, the Securities and Exchange Commission (SEC) proposed a multi-year plan to transition U.S. public companies from the U.S. GAAP standard to the International Financial Reporting Standard (IFRS). The plan supports the ongoing efforts of the SEC to create a single accounting and regulatory standard that will improve comparability and transparency in the global financial system.

Efforts to create a global standard have accelerated as markets became more global, especially after Europe was unified in adopting the IFRS. The SEC has considered shifting to a single, worldwide accounting standard for years. Over the past eighteen months, the SEC has published several opinions and held three roundtables to discuss the IFRS, including one that compared the

performance of IFRS versus U.S. GAAP during the subprime crisis.⁶

According to the SEC, the integration of the world's capital markets has resulted in two-thirds of U.S. investors owning securities issued by foreign companies that report financial results using IFRS. One hundred countries currently require or permit IFRS reporting and the SEC now accepts foreign companies to file U.S. financial statements using the international rules.⁷

Some U.S. investors have resisted IFRS saying that the differences between the U.S. and international standards are too great. They believe the shift to IFRS will be too expensive and time consuming for U.S. companies. It will also create significant tax accounting, education, and financial reporting systems issues.

On the other hand, foreign-based corporations have argued in support of a single accounting standard for years. With one global accounting standard, they will no longer be burdened with the cost of reporting financial results in both IFRS and GAAP in order to list on U.S. exchanges. In turn, easier access to U.S. exchanges will expand foreign investing and lower trading costs for U.S. investors.

If the plan is adopted, the SEC and other regulators have agreed to create a monitoring body to fund and oversee the International Accounting Standards Board (IASB). The SEC will be one of seven regulators directing the international board. The SEC will vote on the proposed timeline for IFRS later this year. The final vote on IFRS implementation will occur in 2011 after a trial period of voluntary use by qualifying U.S. companies.

⁶ According to the Council of Institutional Investors (Alert #34), the "general consensus of roundtable participants was that the disclosure and transparency requirements of IFRS stood up well" in the crisis.

⁷ SEC Release No. 33-8879, "Acceptance From Foreign Private Issuers of Financial Statements Prepared in Accordance With IFRS Without Reconciliation to U.S. GAAP," December 21, 2007

FAIR VALUE ACCOUNTING AND ITS ROLE IN THE BAILOUT

The debate over fair value⁸ accounting rules intensified as the Treasury attempted to mitigate the financial crisis by buying billions of dollars in illiquid mortgage securities from financial institutions. The controversy centered on the how to apply the Financial Accounting Standards Board's (FASB) Fair Value Measurements (FAS 157) to securitized mortgage assets. The dispute began in 2006 when FASB issued the standard, and reached full steam during the September 2008 bailout discussions, as legislators argued over how much the Treasury should pay financial institutions for distressed assets.

The main issue in the bailout debate was how fair value should be applied to securitized mortgage pricing, particularly when the sales of these securities were taking place at forced or distressed levels and thus making mark-to-market pricing unreliable. Federal Reserve Chairman, Ben Bernanke, argued that market illiquidity was producing "fire-sale" prices, which should not be solely relied upon to value the securities.⁹ Bernanke's position was criticized by institutional investors who felt that recent trades should be included in determining the price

the Treasury should pay for the assets.

The fair value accounting argument also found its way into the Emergency Economic Stabilization Act of 2008 (EESA). The law stipulated that the SEC study whether mark-to-market rules governing the valuations of distressed assets exacerbated the financial crisis. It also provided the SEC with the authority to suspend the application of FAS 157 "if the SEC determines it is necessary or appropriate in the public interest and is consistent with the protection of investors."¹⁰

Regarding the SEC's authorization to suspend fair value, Mr. Jeff Mahoney, general counsel for the Council of Institutional Investors (CII), stated that the provision was added at the request of bank lobbyists. He warned that if fair value is suspended, the U.S. banking system could have problems similar to what the Japanese banks experienced in the 1990s, after their government asked financial institutions not to write down instruments to market value. Jonathan Snowling, spokesman for the American Banking Association, countered that "We're trying to have

the application of the standard [on fair value accounting] accurately reflect the true value of the assets."¹¹

The CFA Institute argued in a September 2008 comment letter to the SEC that current market prices normally provide the best evidence of fair value. The Institute urged the SEC not to ignore market transactions and further cautioned that "forced transactions, involuntary liquidations and distress sales are rare and evidence is needed before it is determined that a transaction has not taken place at fair value."

As a result of the ongoing controversy, on October 8th, the SEC began a study of the impact of mark-to-market accounting on the bank failures as mandated by EESA and is expected to announce the results early next year.

⁸ FAS 157 defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an "orderly transaction" (unforced and unhurried) between market participants."

⁹ Marine Cole, "Fed to Price Assets However It Pleases", *Financial Week*, September 28, 2008

¹⁰ Unites States Congress, "Emergency Economic Relief Act 2008," HR 1424, Section 132

¹¹ Cole

