

The Pomerantz Monitor

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The Pomerantz Firm provides monitoring, counseling and litigation representation to institutional investors. The Firm is nationally known for its securities, derivative, antitrust, and healthcare litigation practices on behalf of plaintiffs.

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FANNIE MAE AND HOME DEPOT: A TALE OF TWO GROSSLY OVERPAID CEOs

By H. ADAM PRUSSIN

We are sick and tired of writing about obscenely overpaid CEOs, but they continue to make headlines and we can't keep from adding our two cents.

After a three-year investigation, the SEC and the Office of Federal Housing Enterprise Oversight (OFHEO) have settled their case against Fannie Mae, the mortgage giant, in exchange for a payment of \$400 million in penalties and the imposition of a variety of regulatory restrictions. The settlement was with the company only, and proceedings continue with respect to individuals at Fannie Mae who, regulators believe, threw restraint, and accounting rules, overboard in a determined effort to juice Fannie Mae's results enough to maximize their own bonuses.

Concurrent with the settlement, OFHEO issued a 340-page report which provided chapter and verse of all the alleged manipulations. The result, according to the report, was that earnings for the period 1998-2004 were overstated by over \$10 billion, enabling Frank Raines, the CEO at the time, to receive \$52 million in unearned bonuses, an amount representing more than half his total compensation. "You could argue that none of it was deserved", the acting director of OFHEO was quoted as saying. The settlement requires that the company make a formal determination of whether to "claw back" unearned bonuses from any of the executives mentioned in the report, and OFHEO vowed that they themselves would "vigorously pursue" those responsible for cooking the books.

The situation at Home Depot is different: the government is not alleging financial fraud. Yet the CEO, Bob Nardelli, has reportedly received over \$250 million in compensation over the past 5 years, during which time the company stock price has declined by 12 percent. As in a similar case involving Pfizer Corporation, which we reported on two months ago, the disconnect between pay and performance generated a stockholder backlash, in the form of a concerted effort to withhold votes from the directors

deemed responsible. Institutional investors led the Home Depot campaign, spearheaded by AFSCME, the Connecticut State Pension Fund, CalPERS and Institutional Shareholder Services.

The votes are now in, and they amount to a resounding slap in the face for Home Depot's directors: over 30% of the votes were withheld from all 10 of the directors up for re-election. An AFSCME spokesman later commented that "those are huge 'No' votes. This was a very strong rebuke of the Home Depot directors across the board." An executive vice president of Institutional Shareholder Services commented that "this is the largest compensation [related 'no' vote] we've seen at a company this year - and possibly ever." Another proposal to give shareholders an advisory vote on the compensation committee's annual report received 40 percent of the votes cast; one that sought shareholder approval for any "future extraordinary retirement benefits for senior executives" received 45% approval.

Perhaps most significantly, a shareholder resolution to require directors to receive a majority of votes cast actually passed -- and a chastened Home Depot has announced that it will actually comply.

Release of the vote totals followed lurid press accounts of the shareholder meeting held on May 25, at which not one of the Home Depot directors dared to show up, and Nardelli refused to respond to any of the inquiries from the floor.

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A front page article that appeared in the *New York Times* a few days before the meeting blamed the excessive compensation on "clubbiness" of the six-member Home Depot compensation committee. Most of those members were selected by Home Depot's "lead director" Frank Langone, who is also a director at GE, from which Nardelli was recruited five years ago. Two of the six compensation committee members also have connections to GE; and others hold other board seats at companies where Langone is also a director.

In addition, five of the six compensation committee members are current or former CEOs of other companies, a factor which, many believe, biases them towards approving lavish CEO pay packages.

Curiously, Mr. Langone himself is not an officer of Home Depot. He fills the position of lead outside director, a relatively recent creation of the corporate governance reform movement. The idea was to wipe out the very type of incestuous relationships on the board that seem to exist here. At Home Depot, at least, this reform appears to have backfired.

EXEMPTING SMALL COMPANIES FROM SARBANES-OXLEY: A BAD IDEA WHOSE TIME HAS NOT COME

The Securities and Exchange Commission took an important stand against fraud and for investors last month when it announced that small companies would not be exempted from Section 404 of the Sarbanes-Oxley Act of 2002. Section 404 requires management to establish and maintain effective financial controls, and requires auditors to attest to those controls. The SEC did grant a temporary reprieve, postponing compliance for non-accelerated filers (companies with a market capitalization of less than \$75 million) until annual reports filed after December 16, 2006.

SEC Chairman Christopher Cox explained that the decision was "designed to further improve the reliability of financial statements and to better protect investors while making the Section 404 process more efficient and cost effective." He stated that the Commission "would consider the special needs of all companies that fall under [the SEC's] jurisdiction - large and small, foreign and domestic." However, all companies would ultimately be required to comply with Section 404.

The Commission's move came as a welcome surprise. Only a month earlier, its Advisory Committee on Smaller Public Companies issued a 241-page report recommending that, because of the cost of compliance, small companies be exempted from Section 404 of Sarbanes-Oxley. The report also recommended that the proposed exclusion be broadened to cover all companies with market capitalizations of less than \$125 million, and many companies with market capitalizations of \$125 - \$250 million.

Having failed to convince the conservative SEC Chairman to water down Sarbanes-Oxley by regulation, critics of the Act immediately shifted their efforts to the legislative branch. Only hours after the Commission's announcement, Representative Tom Feeney (R-Fla.) introduced H.R. 4505, a bill intended to overrule the Commission's decision and cripple Section 404. H.R. 4505, if passed, would exempt most companies with market capitalizations of less than \$700 million (the vast majority of public companies) from any compliance with Section 404. A similar bill was introduced in the Senate by Jim DeMint (R-S.C.). Both measures are backed by business lobbyists such as the Mortgage Bankers Association and the Small Business & Entrepreneurship Council.

These critics ignore three crucial factors:

Markets as a whole have flourished since the adoption of Section 404: Markets have not been hurt by Section 404, which began to apply to all accelerated filers in November 2004. To the contrary, as investors once again began to see United States markets as the "gold standard," they awarded premium valuations to listed companies and major indexes posted significant gains. The S & P 500 Index gained nearly 20% and the Russell 2000 Smallcap Index gained over 30% from November 2004 through April 2006.

The benefits of Sarbanes-Oxley have accrued not only to markets, but also to individual companies. Compliance services firm Lord & Benoit studied 2,481 public companies that completed at least two Sarbanes-Oxley Section 404 internal control audits. The study showed that the average share price of companies with clean Section 404 internal controls climbed 28% over a two year period starting with the year before the controls were required. In contrast, stocks of companies with adverse Section 404 control opinions decreased 6%. Additionally, the market rewarded companies that transitioned from a first year adverse report to a clean second year report with an average 25% increase.

Now, as investors' confidence is shaken by daily reports of options backdating, rolling back Section 404 could signal to markets that the SEC is asleep at the wheel, and put these gains at risk.

Compliance costs are coming down: While the costs of complying with Section 404 are often substantial in the first year, evidence is mounting that these costs decrease in subsequent years. The Lord & Benoit study found that Section 404 compliance costs dropped an average of 26% in the companies they studied in the following two years.

SEC waivers and exemptions historically have led to disastrous unintended consequences: Many large regulatory failures can be traced to small SEC exemptions or waivers. For example, the Enron accounting scandal relied in large part on an SEC exemption that allowed the company to mark-to-market its illiquid investments. Similarly, the SEC exacerbated the conflict between invest-

Exempting Small Companies
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ment bankers and analysts by issuing "No Action Letters" condoning analyst coverage of companies involved in investment banking transactions with the same firm. We should learn from these mistakes and exercise great caution before poking holes in the regulatory scheme.

Joshua B. Silverman

NYSE STUDIES ELIMINATING BROKERS' POWER TO VOTE CUSTOMER SHARES IN DIRECTOR ELECTIONS

For as long as anyone can remember, brokers have had the right to vote, as they see fit, shares held in customer accounts if their customer has not given voting instructions. Needless to say, billions of shares are held in brokerage accounts, many shareholders do not bother to return their proxy cards, and brokers, if left free to vote these shares, will vote with management almost every time. Because brokers may hold 20-30% of all outstanding shares of a company in customer accounts, this rule is one of the biggest obstacles to efforts by shareholder activists to oust lackadaisical directors or rein in excessive compensation.

For NYSE-listed stocks, the power of brokers to vote their customers' shares comes from a 70-year old rule giving them the right to vote customers' shares on "routine" matters if they have not forwarded voting instructions 10 days in advance. The election of directors has been deemed "routine," allowing brokers to have enormous say in those elections. Until recently, of course, director elections were almost always routine, with the "plurality" vote rule assuring that management's slate would go through every time.

But that is true no longer. For one example, broker votes may have just saved the Home Depot directors from the indignity of having a majority of votes withheld from them at the annual meeting. More and more companies are adopting majority voting requirements: directors can be "voted down" if the number of withheld votes exceed the number of "yes" votes. Even some companies that have formally not embraced such a rule, such as Disney, have bowed to pressure if heavy percentages of "withheld" votes are received. In more and more cases, the reelection of directors can no longer be considered automatic or routine at troubled companies.

Recently an advisory committee to the NYSE recommended that the broker vote rule be changed, and the Exchange voted to seek comments on revising or abolishing the rule. In the past, publication of an advisory group report recommending a rule change has usually led to a change. Let us hope that history repeats itself.

H. Adam Prussin

SHAREHOLDER PICKS AND PANS



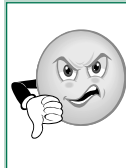
Gretchen Morgenson reports that proposals to require a majority vote for election to the board were presented at 140 corporate annual meetings. They were approved at several companies, including Bank of America, Borders Group, EMC, International Paper, Raytheon and Verizon.



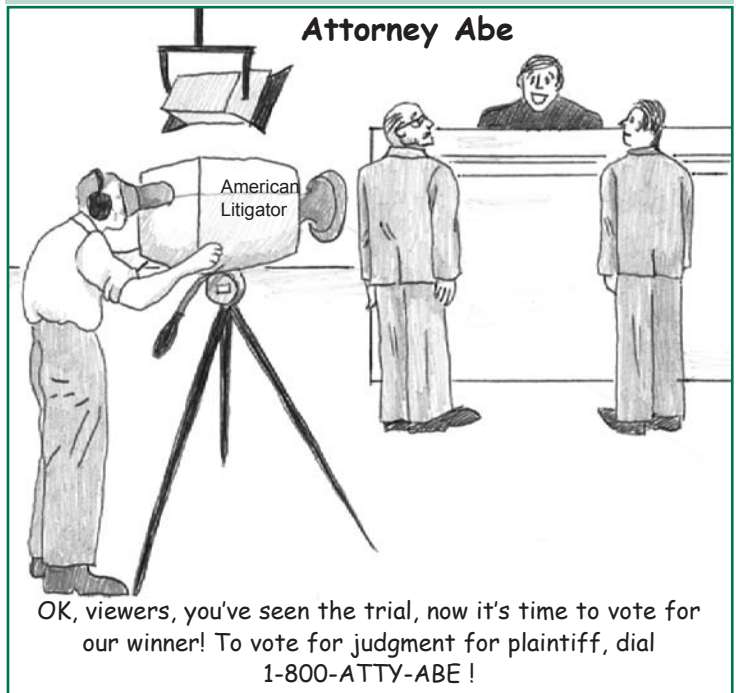
At ExxonMobil's recent shareholder meeting, a non-binding resolution to require a majority of the votes cast to elect directors received 52.2% of the votes cast, and about 20% of the votes cast withheld approval of the re-election of the four compensation committee members. This was a protest over their approved the \$98 million retirement package for former chairman Lee Raymond.



At GM's annual meeting, a proposal requiring that directors be elected by majority vote received 58% of the votes cast, and another proposal that would allow cumulative voting by shareholders also passed, with 54% of the vote. A proposal to recoup bonuses paid in the past received 42% of the votes cast, but another, to require splitting the posts of chairman and CEO, received only 18% approval. None of the proposals is binding, but GM announced that it would consider adopting those that received a majority vote.



As discussed elsewhere in this issue, Home Depot's shareholder meeting was an utter fiasco, with none of the directors in attendance and the CEO refusing to answer any questions. Once again, shareholders approved a requirement that directors receive a majority of votes cast, and over 30% of the votes were withheld from all directors seeking reelection.



PomTrack © Update

The Pomerantz Firm, through its proprietary **PomTrack ©** System, monitors pending class action litigations and settlements for institutional clients. The **PomTrack ©** System is designed to assist trustees of pension funds to fulfill their fiduciary duties to their plan members.

With the passing of the PSLRA Act of 1995, Congress has sought to encourage institutional investors to participate in class action litigation. New studies show that private litigation actually builds strong markets. A selection of recently filed securities class action cases are listed below. If you believe your fund is affected by any of these cases, contact Pomerantz for a consultation.

<u>COMPANY</u>	<u>CLASS PERIOD</u>	<u>LEAD PLAINTIFF DEADLINE</u>	<u>COMPANY</u>	<u>CLASS PERIOD</u>	<u>LEAD PLAINTIFF DEADLINE</u>
American Tower Corp.	02/01/06 - 05/24/06	July 31, 2006	InfoSonics Corp.	05/08/06 - 06/12/06	August 14, 2006
CSK Auto Corp.	09/02/04 - 03/24/06	August 8, 2006	Kinder Morgan, Inc. 2	05/30/06 - 05/30/06	July 31, 2006
Herley Industries, Inc.	10/01/01 - 06/14/06	August 14, 2006	Vonage Holdings Corp.	05/24/06 - 05/24/06	August 1, 2006
Home Depot Inc.	05/29/01 - 02/22/05	July 11, 2006	Xerium Technologies Inc.	05/16/05 - 11/15/05	August 7, 2006
Image Innovations Hldgs.	04/13/04 - 03/16/06	July 14, 2006			

Studies have shown that approximately only one-third of all institutions eligible to participate in class action settlements actually file proofs of claim to recover their share of available funds. The following class action settlements were recently announced. If you purchased stock during the listed class period, make sure a proof of claim is filed on your behalf. **DON'T LEAVE YOUR MONEY 'LYING ON THE TABLE.'**

<u>COMPANY</u>	<u>CLASS PERIOD</u>	<u>CLAIMS DEADLINE</u>	<u>COMPANY</u>	<u>CLASS PERIOD</u>	<u>CLAIMS DEADLINE</u>
Allegheny Energy Inc.	04/23/01 - 10/08/02	August 14, 2006	Global Crossing, Ltd.	12/09/03 - 10/08/04	August 16, 2006
AT&T Corp. (Salomon)	11/29/99 - 06/14/02	Sept. 12, 2006	Interpool, Inc.	03/31/99 - 12/26/03	August 24, 2006
Carreker Corp.	07/30/99 - 12/10/02	October 2, 2006	Magma Copper Company	05/16/95 - 06/14/95	Dec. 31, 2006
CNL Hotels & Resorts	08/16/01 - 08/16/04	November 3, 2006	Razorfish, Inc.	05/24/99 - 05/24/01	October 6, 2006
EcoSciences Corp.	09/30/98 - 09/30/98	November 9, 2006	Staar Surgical Company	10/06/03 - 01/05/04	Nov. 22, 2006

POMERANTZ HAUDEK BLOCK GROSSMAN & GROSS LLP, with offices in New York, Chicago, and Washington, D.C., is acknowledged as one of the premier firms in the areas of corporate, securities, antitrust, and healthcare litigation. Founded by the late Abraham L. Pomerantz, who was known as the 'dean of the class action bar,' the Pomerantz Firm pioneered the field of securities class actions. Today, more than 50 years later, the Pomerantz Firm continues in the tradition that Abe Pomerantz established, fighting for the rights of victims of securities fraud, breaches of fiduciary duty, and corporate misconduct.

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