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# SECURITIES FRAUD MONITOR

B E R M A N D E V A L E R I O P E A S E T A B A C C O B U R T & P U C I L L O

## Monitoring the Monitors: Evaluating the Positive Economic Benefits of CalPERS' Institutional Activism

The California Public Employees' Retirement System has taken substantial heat from critics who deride its institutional activism, accusing the pension



Prof. Brad M. Barber

fund of harboring a special interest agenda. In a blistering op-ed in 2004, for example, the president of the U.S. Chamber of Commerce

railed against

CalPERS as a self-appointed "arbiter of good corporate governance."

But institutional activism apparently reaps economic benefits.

A University of California-Davis professor has found that CalPERS' activism has created short-term wealth of \$3.1 billion over 14 years – and that is his *conservative* estimate. Long-term benefits could be as high as \$89.5 billion.

Brad M. Barber, a finance professor and director of the university's Center for Investor Welfare and Corporate Responsibility, analyzed stock performance of companies named on CalPERS' Focus List between 1992 and 2005.

The Focus List, which targets companies for reform based on poor financial and corporate governance performance, included 115 companies over this period. This year's list names

Brocade Communications, Cardinal Health, Clear Channel Communications, Mellon Financial, OfficeMax and Sovereign Bancorp.

Although CalPERS embarked on its path of shareholder activism in 1987, it did not announce its first list of targeted companies until 1992. Barber's study, released this spring, begins with that 1992 Focus List.

While many institutions now consider themselves activist funds, CalPERS arguably has the highest profile and is widely recognized for what has been described as the "CalPERS effect." Barber set out to review the theory and the empirical evidence

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underlying the motivation for institutional activism.

According to Barber, the benefits of institutional activism depend on two critical agency costs. The first cost arises from conflicts of interest between shareholders and corporate managers. These

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## Firm Adds Public Pension Fund Clients

In the first six months of this year, Berman DeValerio has added half a dozen new institutional clients to its roster, including the Arizona State Retirement System (ASRS), the California Public Employees' Retirement System (CalPERS), and the Pennsylvania State Employees' Retirement System (SERS).

Berman DeValerio now represents more than 55 public and union pension fund clients that collectively manage over \$1 trillion in retirement assets for millions of teachers, police officers, firefighters, public employees and union

workers. Our clients include:

- Public employee retirement systems in 21 states;
- Three of the four largest U.S. public pension funds and 11 of the top 20;
- Twenty-five funds with more than \$10 billion in assets under management; and
- Twenty-two percent of all U.S. public funds managing more than \$1 billion.

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Berman DeValerio Pease Tabacco Burt & Pucillo prosecutes class actions nationwide on behalf of institutions and individuals, chiefly victims of securities fraud and antitrust law violations. The firm, which was founded in 1982, has offices in Boston, San Francisco and West Palm Beach. In addition to conducting litigation, the firm provides securities fraud monitoring, evaluation and advisory services to public pension funds and other institutional investors.

The *Securities Fraud Monitor* is published by the law firm of Berman DeValerio Pease Tabacco Burt & Pucillo, One Liberty Square, Boston, MA 02109, (800) 516-9926. This newsletter is designed to inform Berman DeValerio's clients and friends about current securities fraud and corporate governance issues. It is not a substitute for legal advice.

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# THE NUMBERS

## A Look At 2005 Class Action Trends

According to the latest analysis from PricewaterhouseCoopers, securities case filings were down last year while settlements went up – way up. Institutional investors, meanwhile, continued to play an increasingly strong role in these cases. The following are highlights from PwC's Securities Litigation Study, released in May.

**168** Number of new cases filed in the US – the lowest in nine years

**46%**

Percentage of accounting cases among new cases, the lowest since 1996

**37**

Number of securities lawsuits involving restatements – lowest since 1996

**\$37 BILLION**

Amount of total settlements since enactment of the Private Securities Litigation Reform Act of 1995

**11** Number of settlements over \$100 million

**68**

Number of cases filed with public or union pension funds as lead plaintiff

**20**

Number of settlements over \$60 million

**\$71.1 MILLION**

Average settlement amount – an increase of 156% from 2004

**35**

Record number of cases settled with public or union funds as lead

Number of securities cases against foreign issuers, down from 29 in 2004

**19**

# Critics of Shareholder Lawsuits Caught in a Time Warp

By Glen DeValerio

The recent indictments of Milberg Weiss Bershad & Schulman and two of its senior partners have made some members of the business lobby giddy with delight. They see these indictments as the moment they have been waiting for – a golden opportunity to revive old stereotypes and discredit a profession whose mission is fighting corporate fraud.

The inevitable attacks on all plaintiffs' law firms and all shareholder lawsuits are potentially harmful to investors.

The business lobby would like the public to believe that law-abiding companies are the victims of a shakedown game that needlessly drives up the cost of doing business. They have been rehashing these same talking points for two decades: lawyer-driven litigation, races to the courthouse, pennies on the dollar, exorbitant fees, etc., etc., etc. . .

There's only one problem with these criticisms. They do not reflect reality in the current securities class action environment.

The fact is that institutional investors now run many of these lawsuits, much as Congress intended when it passed two so-called "tort reform" laws aimed at securities litigation in 1995 and 1998.

And these institutional clients – public pension funds, mostly – oversee the litigation process as diligently as they guard their investment portfolios.

These institutional investors are fiduciaries and function as such. They recognize the need for responsible private litigation as a valid method of enforcing the federal securities laws.

Since the Private Securities Litiga-

tion Reform Act of 1995 was enacted, institutional investors have steadily increased their participation as lead plaintiffs in securities fraud class actions. According to PricewaterhouseCoopers, public and union funds were appointed lead plaintiffs in 40% of cases filed in 2005. That compares to a 14% share in 1996-1997.

Echoing other analysts, PwC also recorded a nine-year low in new cases last year, debunking yet another myth – that of lawsuits forever spiraling out of control.

Moreover, multiple studies from academics and national think tanks – including those not usually friendly to the plaintiffs' bar – have demonstrated that these institutional lead plaintiffs are significantly raising settlement amounts while lowering attorney fees.

A recent examination of 230 securities class action settlements by Michael A. Perino, of St. John's University, for example, found that the mean attorneys' fee award was approximately 20% of the recovery in cases with a public pension fund lead plaintiff. That compared to 27% for other lead plaintiffs. (For more on Perino's findings, see the winter issue of our newsletter.)

Institutional investors appear to drive larger settlements, as well. According to NERA Economic Consulting, cases with institutional lead plaintiffs settled for a third more money, on average, than those with other plaintiffs. A sec-

ond study by law professors James D. Cox of Duke and Randall S. Thomas of Vanderbilt found a statistically significant increase in settlements in those cases led by institutional plaintiffs, after adjusting for size.

Meanwhile, corporate fraud continues to cost investors money and shake their confidence. Glass Lewis & Co. found 1,200 financial restatements last year – almost double the 2004 amount. About half the restatements involved companies that also reported problems with their internal accounting controls.

The "reformers" who hoped the PSLRA would eliminate shareholder lawsuits in the 1990s now want to use the indictment of a single law firm as a springboard for even more restrictions on investors' rights. But the checks and balances are already in place.

Public pension funds and other large institutional investors should continue to exercise their power to hire and fire lawyers, pick and choose cases, and negotiate attorney fees.

They already do an excellent job in all of those areas, ensuring that only the most professionally ethical firms represent them as lead plaintiffs. More legislative interference is totally unnecessary. ■

*Glen DeValerio is managing partner of the Boston office of Berman DeValerio.*

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# Backdating Stock Options Is Latest Corporate Scandal

Clearly, the Enron trials have not closed the book on corporate fraud. A new boardroom scandal is roiling Wall Street: stock options backdating.

Dozens of companies – including UnitedHealth Group, Converse Technology, Vitesse Semiconductor and Affiliated Computer Services – have caught the eye of the Securities and Exchange Commission and the Department of Justice for the timing of their stock option grants.

The question: did these companies backdate options grants – and falsify records – to make them more lucrative for their top employees? Or did a lot of CEOs just have amazingly good luck?

A stock option gives the recipient the right to purchase stock at a set price. That exercise price, or strike price, usually takes one of three forms: the closing price on the day of the grant; an average of the highs and lows of the day; or the closing price from the previous day.

The lower the strike price, the greater the potential for making money when exercising the options.

Take this example, from *The Wall Street Journal*, which began investigating the practice last fall: "Suppose an executive gets 100,000 options on a day when the stock is at \$30. Exercising them after it has reached \$50 would bring a profit of \$20 times 100,000, or \$2 million. But if the grant date was a month earlier and the stock then was at, say \$20, the options would bring in an extra \$1 million."

Such backdating is not necessarily illegal. But it could lead to a false disclosure, which may, in turn, violate federal securities laws. Company stock option plans are on file with the SEC,

with a description of how the strike prices are calculated. But if the company later provides options at another price without further disclosure, then the company is violating its own plan.

Backdating may also violate accounting rules because the stock options, which are equal to extra pay, affect the company's bottom line. By failing to include these options in their books, companies may be overstating their profits – and may, ultimately, have to restate their financials.

Plaintiffs' law firms have already filed a number of securities class actions and derivative lawsuits on the backdating issue.

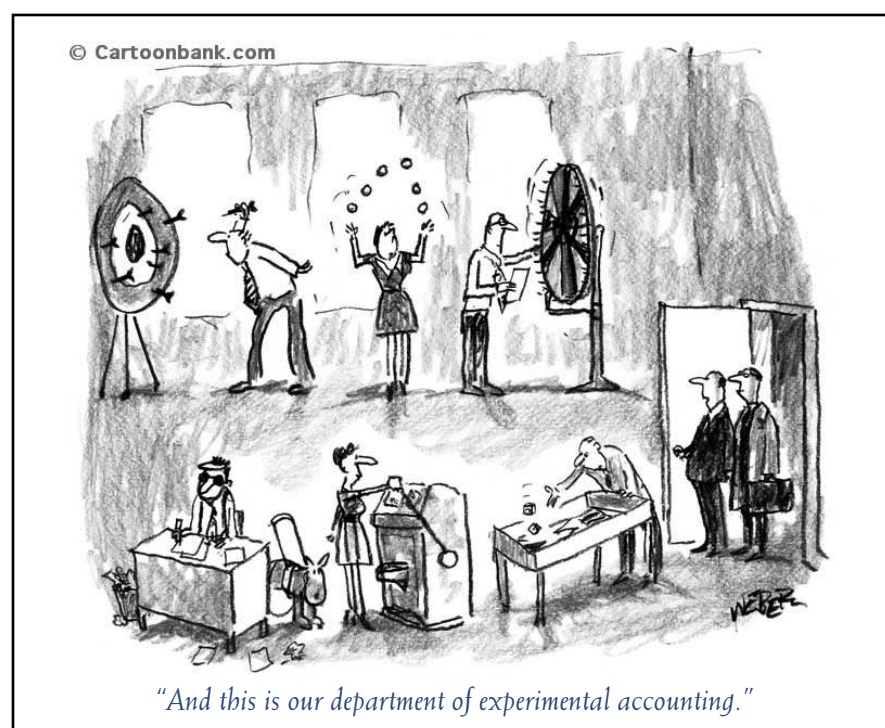
"It's pretty sad to see that so many executives, after convincing their shareholders to approve stock incentive plans, thought they could get away with rewriting the terms," said Peter Pease, a partner at Berman DeValerio. "That's just plain theft, and it makes the

incentive plans meaningless."

The *Journal*, for example, analyzed the stock options grants of Jeffrey Rich, CEO of Affiliated Computer Services. All six of his option grants between 1995 and 2002 were dated prior to a rise in stock price. The odds of this happening are about one in 300 billion. The odds of winning the Powerball lottery, meanwhile, are one in 146 million, the newspaper reported.

Corporate board members, who are notorious for self-promotional back scratching of chief executives, are guilty of either approving these excesses or looking the other way. The auditors who failed to notice or to stop these potential violations may be equally culpable.

A number of chief executives already have been forced out or have resigned over the backdating issue. Some observers have said this is just the tip of the iceberg. ■



# Strong Internal Controls Benefit Shareholders

Since the enactment of Sarbanes-Oxley, public companies have been complaining about a provision requiring proof of effective internal controls. Too expensive, critics have moaned. Too time-consuming, they have argued.

New research suggests their energies may be better spent complying with the law than fighting it. The study shows shares of companies with clean internal controls perform better than their peers.

Lord & Benoit LLC analyzed the share prices of 2,481 companies that submitted at least two years of reports, as required by Section 404 of the Sarbanes-Oxley Act. The research covered about half of the entire market capitalization of all publicly traded companies in the United States.

The research and compliance firm calculated an average share price for each company on three dates: the year prior to Section 404 compliance; and the first two years after. What they found gives even more ammunition to proponents of strong internal controls.

According to the study, companies

that reported effective controls in both years saw a 27.67% increase in their average share price. Companies that reported ineffective 404 controls in both years, meanwhile, saw a 5.75% decrease.

The Russell 3000 Index, by comparison, increased 18% during this same time period.

Even companies reporting problems the first year saw substantial gains if they corrected their deficiencies in the second year. Those with ineffective controls the first year and effective controls the next saw a 25.74% increase in average stock price.

Robert Benoit, the firm's founder and author of the report, said one would expect an increase in valuation following a clean bill of health, "just as a pro athlete coming off an injury might expect higher compensation after proving through an in-depth physical that he is free from that suspected injury."

Somebody should tell the Securities and Exchange Commission. The SEC has been hosting roundtable discussions and soliciting comments from com-

panies, investors, auditors, and others on Section 404 compliance. It plans to revise its internal control auditing standards to make them more efficient and more cost effective, particularly for smaller companies and those based overseas.

"By providing practical guidance to companies, by working with the Public Company Accounting Oversight Board on their forthcoming revised standard for auditors, and by examining how the PCAOB inspection process is succeeding in increasing the efficiency and cost-effectiveness of the audit process, we will take a giant step toward 'getting it right' when it comes to Section 404 compliance," SEC Chairman Christopher Cox said in a recent statement.

The costs of compliance, meanwhile, are dropping. According to a study released in April by the four major accounting firms, the costs of auditing internal controls fell by 44% from the first year to the second year of reporting compliance. The average large company paid \$4.77 million in 2005, versus \$8.51 million the previous year. A large company was defined as one with annual revenue of more than \$700 million.

For smaller companies (revenues of \$75 million to \$700 million), the average cost dropped by 31%, from \$1.24 million to \$860,000.

Last year, we argued against abolishing Section 404. At least, the SEC now seems committed to keeping the provision around. We continue to hope they don't cave to pressure and water it down. As the Lord & Benoit study demonstrates, the benefits of Section 404 for shareholders far outweigh the costs. ■

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## Firm Adds Public Fund Clients

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The firm currently represents institutional or individual investors as lead or co-lead counsel in roughly a dozen cases around the country, including major fraud cases against Xerox and Fannie Mae. Since the PSLRA took effect, we have represented 23 pension fund clients as lead or co-lead counsel in

securities matters.

Public funds are attracted to Berman DeValerio because of our excellent record of results, our philosophy of selective case filing, and a state-of-the-art portfolio monitoring system that enables them to get timely information about their losses in new and settled cases. ■

## CalPERS' Activism

*Continued from page 1*

managers might pursue projects that benefit themselves – not shareholders. Institutions that properly monitor corporate managers can reduce costs and benefit their own investors and investors overall, he said.

The second cost derives from the conflicts of interest between the fund's own board and investors. In this scenario, fund directors may pursue investment policies that will benefit their own objectives – not those of their members.

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*"At the end of the day, one needs to make sure that the activism pursued is in the best interests of the beneficiaries. When it's squarely focused on corporate governance-related issues, there's strong research to suggest that it's a useful thing to do. But when it extends beyond governance, funds need to look at the economics to see if this makes sense."*

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"At the end of the day, one needs to make sure that the activism pursued is in the best interests of the beneficiaries," Barber told the *Monitor*. "When it's squarely focused on corporate governance-related issues, there's strong research to suggest that it's a useful thing to do. But when it extends beyond governance, funds need to look at the economics to see if this makes sense."

To analyze the effectiveness of institutional activism, Barber used two methods: short-run analyses based on immediate market reaction to the Focus List; and long-run analyses of targeted

company stock returns.

In the short run, he found that CalPERS' activism resulted in small but "reliably positive" market reactions on the day that the pension fund announced its Focus List. But "small" is a relative term, translating into total wealth creation of \$224 million annually – or \$3.1 billion over the 14-year period studied.

Barber said the long-run analysis was less conclusive, but nonetheless intriguing. Market vagaries and volatility make it difficult to determine whether a stock's success can be directly linked to CalPERS' involvement. So Barber adjusted for a variety of characteristics of each targeted firm – such as large or small cap, value or growth firm. If the stock market returns "are causally linked to the activism of CalPERS, the wealth creation is enormous – as much as 20 times greater than the short-run benefits and as large as \$89.5 billion through December 2005," he writes.

"I think the early results of activism are encouraging," Barber said in a telephone interview. He noted, however, that further analysis is needed to state conclusively that institutional activism has a long-term, positive effect.

Widespread institutional monitoring can also deter corporate malfeasance, Barber said. Companies may be less likely to engage in practices that reduce shareholder value if they know that institutions "stand ready to publicly excoriate" them, he writes in the study titled "Monitoring the Monitor: Evaluating CalPERS' Shareholder Activism."

"The deterrence benefits of activism are exceedingly difficult to measure, but nonetheless provides additional justification for institutional activism," the study says.

Yet pension funds need to be mindful of their reasons for institutional involvement, particularly when it comes

to sensitive moral or political issues, Barber cautioned. Portfolio managers must follow the interests of their investors, rather than their own.

He cites as an example CalPERS' 2000 vote to divest all of its tobacco firm holdings. This decision, Barber says, was motivated by moral and not

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investing considerations. "There is no evidence – theoretical or empirical – that tobacco firms should or do earn sub par rates of return," he writes, noting that past performance is not a reliable indicator of future performance.

Barber argues that institutional activism should be limited to situations where there is strong theoretical and empirical evidence suggesting that proposed reforms will boost shareholder value.

"Institutional activism is a double-edged sword. When prudently applied, activism can provide effective monitoring of publicly traded corporations. When abused, portfolio managers can pursue their personal agendas at the expense of those whose money they manage," he writes. "Moral issues are challenging and nettlesome. But do not throw the baby out with the bath water. Institutional activism can provide important and effective monitoring of publicly traded firms." ■