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PROTECTING SHAREHOLDERS AND ENHANCING PUBLIC CONFIDENCE BY IMPROVING CORPORATE GOVERNANCE

HEARING

BEFORE THE

SUBCOMMITTEE ON
SECURITIES, INSURANCE, AND INVESTMENT

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

ON

EXAMINING THE IMPROVEMENT OF CORPORATE GOVERNANCE FOR THE PROTECTION OF SHAREHOLDERS AND THE ENHANCEMENT OF PUBLIC CONFIDENCE

JULY 29, 2009

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PROTECTING SHAREHOLDERS AND ENHANCING PUBLIC CONFIDENCE BY IMPROVING CORPORATE GOVERNANCE

WEDNESDAY, JULY 29, 2009

U.S. SENATE,
SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 2:35 p.m., in room SD–538, Dirksen Senate Office Building, Senator Jack Reed (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN JACK REED

Chairman REED. Let me call the hearing to order and welcome our witnesses. Thank you, ladies and gentlemen. We expect momentarily that the Ranking Member will arrive, and I thank Senator Corker and Senator Menendez for joining us.

Today's hearing will focus on corporate boardrooms and try to help us better understand the misaligned incentives that drove Wall Street executives to take harmful risks with the life savings and retirement income of so many people. This Subcommittee has held several hearings in recent months to focus on gaps in our financial regulatory system, including the largely unregulated markets for over-the-counter derivatives, hedge funds, and other private investment pools.

We have also examined problems that resulted from regulators simply failing to use the authority they had, such as our hearing in March that uncovered defective risk management systems at major financial institutions.

But although regulators play a critical role in policing the markets, they will always struggle to keep up with evolving and cutting-edge industries. Today's hearing will examine how we can better empower shareholders to hold corporate boards accountable for their actions and make sure that executive pay and other incentives are used to help companies better focus on long-term performance goals over day-to-day profits. In this latter regard, this is a timely hearing based on the action yesterday of the House Financial Services Committee.

Wall Street executives who pursued reckless products and activities they did not understand brought our financial system to this crisis. Many of the boards that were supposed to look out for shareholders' interests failed at this most basic of jobs. This hearing will

help determine where the corporate governance structure is strong, where it needs improvement, and what role the Federal Government should play in this effort.

I will ask our witnesses what the financial crisis has revealed about current laws and regulations surrounding corporate governance, including executive compensation, board composition, election of directors and other proxy rules, and risk management. In particular, we will discuss proposals to improve the quality of boards by increasing shareholder input into board membership and requiring annual election of and majority voting for each board member.

We will also discuss requiring "say-on-pay," or shareholder endorsements of executive compensation. We need to find ways to help public companies align their compensation practices with long-term shareholder value and for financial institutions overall firm safety and soundness. We also need to ensure that compensation committee members who play key roles in setting executive pay are appropriately independent from the firm managers that they are paying.

Other key proposals would require public companies to create risk management activities on their boards and separate the chair and CEO positions to ensure that the CEO is held accountable by the board and an independent chair.

I hope today's hearing will allow us to examine these and other proposals and take needed steps to promote corporate responsiveness to the interests of shareholders, and I welcome today's witnesses and look forward to the testimony.

Now let me recognize Senator Bunning.

STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. Thank you, Mr. Chairman. I am sorry I am just a little late. Phone calls are a pain right now.

This is a very important topic for us, but a hard one to deal with. While we may be able to make some reforms that will promote good long-term performance and responsible behavior, we will not, I say, be able to prevent bad decisions or failures. After all, we cannot legislate good judgment or ethics. And we already have the ultimate form of accountability through bankruptcy.

In general, pay should promote good long-term performance, and shareholders must share in the gain, not just executives and traders. Boards must be more involved—I say that again: Boards must be more involved and be an effective check on management. Proxy access must benefit the majority of stockholders and encourage long-term values. If we are not careful, those changes could have the exact opposite effect by empowering a minority of shareholders to strip the company of value and encourage risky behavior in search of short-term profits.

While we are right to be outraged at what has gone on in the financial sector, we must be careful that efforts to rein in Wall Street's behavior do not put handcuffs on other businesses that have different needs and challenges. Corporate law for the first 230-plus years of this country has been handled pretty well at the State level, and if we are going to change that, we should be sure of what we are doing. And I am sure looking forward to hearing what our panel has to say.

Thank you.

Chairman REED. Thank you very much, Senator Bunning.

Senator Corker, do you have any opening comments?

Senator CORKER. As always, I prefer to listen to the witnesses and ask questions, but thank you all for being here.

Chairman REED. Thank you, Senator.

Senator Schumer has arrived, and I know he has taken a leadership role on this issue of corporate governance with his legislative proposals and his constant attention. In fact, it was Senator Schumer's suggestion that we hold this hearing, so I want to recognize him for any comments that he might have.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Well, thank you, Senator Reed, and let me express my profound gratitude to you for holding this hearing and to Ranking Member Bunning for being here as well on such an important subject.

As you acknowledged, Mr. Chairman, corporate governance is of great importance to me, and I introduced the Shareholder Bill of Rights with Senator Cantwell earlier this year. The bill was supported by 20 major pension funds, consumer groups, labor unions, and just yesterday, the House Financial Services Committee passed a "say-on-pay" bill similar to the "say-on-pay" we have in the Shareholder Bill of Rights. So I am glad to see Congress is moving forward in this process, and today's hearing is a great opportunity to get a chance to explore these issues in more detail.

In the last year-plus, we have talked a great deal about the failures of regulation and Government oversight in the financial system. But our dynamic economy and capital markets also depend on internal oversight by vigilant boards of directors who ensure that management is steering the ship in the right direction.

Unfortunately, there are far too many cases recently where boards of directors, not just regulators, were asleep at the wheel, or even complicit in practices that caused great harm to our economy and shook public confidence in our capital markets. Executives who encouraged risk-taking that they did not understand were not checked by their boards. Compensation packages that rewarded short-term actions but not long-term thinking were not undone by their boards.

Fundamentally, too many boards neglected their most important job: prioritizing the long-time health of their firms and their shareholders and carefully overseeing management. In other words, there was widespread failure of corporate governance that has proven disastrous not just for individual businesses but for the economy as a whole.

And there are many in this room on both sides of the aisle who say, you know, the Government cannot get involved in the details of what a company does. And that is right. That is our free market system. But the place that there is supposed to be a check is in the board of directors, and when over the years in too many companies—there are many companies that have good boards and many companies that already have implemented many if not all the reforms in our bill. But in too many companies, the boards did not do the job.

And the damage. What if the board of AIG had checked some of its actions? What is the board of Bear Stearns had checked some of its actions? The taxpayers probably would have saved hundreds of billions of dollars. So it affects all of us. It is not just the internals of the company.

And so Senator Cantwell introduced our bill. It makes corporate boards accountable to the shareholders whose interests they are supposed to protect. The Shareholder Bill of Rights will go a long way to making sure that these failures do not happen again, and as everyone knows, there are six key components in our bill. I am not going to read them. I am going to save that in the interest of time.

Several elements of the bill have already been in place, as I said, by many corporations, and that is important to remember, because for many corporations, these are already best practices. Well-run companies do not fear their shareholders because they recognize that boards, management, and shareholders share the same interests: long-term growth and profitability. The greatest damage occurs not when boards are too active, but when they are not active enough.

I think the Shareholder Bill of Rights will go a long way to ensuring that companies are responsive to their shareholders' interests. I thank you and congratulate you, Chairman Reed, for putting together an excellent panel. I look forward to the hearing, the testimony of the witnesses, and I would ask that my entire statement be put in the record.

Chairman REED. Without objection, all statements will be put in the record.

Senator Corker, do you have a comment?

Senator CORKER. Mr. Chairman, this is an unusual request. I do not really know what those six elements are, and I think since it sounds like——

Senator SCHUMER. Since you ask——

Senator CORKER. This has not been a highly debated bill. Since I sense this hearing has a lot to do with the fact that this bill is being introduced, it might be good for all of us to know what those six elements are?

Senator SCHUMER. OK. May I read them, Mr. Chairman? It will take a minute.

Chairman REED. Absolutely. This is——

Senator SCHUMER. Unusual.

Chairman REED. Unusual. Usually, you do not need encouragement.

[Laughter.]

Senator CORKER. Let me say this. I want to, for the record, note that I usually do not like to hear any opening comments, but in this case, since——

Senator SCHUMER. Yes, well, thank you. And I was going to say, similar to what Jack Reed said, this is the first time that someone has asked Chuck Schumer to say more on a subject than he has said. Here they are.

First, we require all public companies hold an advisory shareholder vote on executive compensation and obtain shareholder approval for golden parachutes.

Second, we instruct the SEC to issue rules allowing long-term shareholders with significant stakes in the company to have access to the company's proxy form if they want to nominate directors to the board. If you are going to try to keep the board honest, you ought to have access to proxies. Now it is next to impossible for people to get.

Third, it requires boards of directors to receive a majority of the vote in uncontested elections in order to remain on the board. It makes no sense for board members to be reelected if the majority of shareholders casting ballots vote against them.

Fourth, it eliminates staggered boards which insulate board members from the consequences of their decisions by requiring all directors to face election annually.

Fifth, it requires public companies to split the jobs of CEO and chairman of the board and requires the chairman to be an independent director. That one has gotten the most pushback from the corporate world. That surprised me, but that is the facts.

And, sixth, and finally, requires public companies to create a separate risk committee containing all independent directors to assess the risks that the company is undertaking.

Thank you, Mr. Chairman. Thank you, Senator Corker.

Chairman REED. Thank you both.

We have been joined by Senator Warner. I wonder if you have any opening comments, Senator.

Senator WARNER. I will—have I missed testimony already?

Chairman REED. No, you have not.

Senator WARNER. I am anxiously looking forward to the testimony.

Chairman REED. Thank you. Now let me introduce our witnesses.

Our first is Ms. Meredith B. Cross, the Director of the Division of Corporation Finance at the U.S. Securities and Exchange Commission. Prior to joining the staff in June 2009, Ms. Cross was a partner at Wilmer, Cutler, Pickering, Hale & Dorr in Washington, DC, where she advised clients on corporate and securities matters, was involved with the full range of issues faced by public and private companies in capital raising and financial reporting. Prior to joining Wilmer Hale, Ms. Cross worked at the SEC from 1990 to 1998 in various capacities, including chief counsel and deputy director of the division she now leads.

Our next witness is Professor John C. Coates. Professor Coates is the John F. Cogan, Jr. Professor of Law and Economics at Harvard Law School. He joined the faculty in 1997 after practicing at the New York law firm of Wachtell, Lipton, Rosen & Katz where he was a partner specializing in mergers and acquisitions, corporate and securities law, and the regulation of financial institutions. He is a member of the Legal Advisory Committee of the New York Stock Exchange, and he is the author of a number of articles on corporate, securities, and financial institution law and for 7 years coauthored the leading annual survey of development and financial institution M&A.

Our next witness is Ms. Ann Yerger. She is the Executive Director of the Council of Institutional Investors, an organization of public, corporate, and Taft-Hartley pension funds. Ms. Yerger joined

the council in early 1996 as the Director of the Council's Research Service before being named Executive Director in January 2005. Her prior experiences include work at the Investor Responsibility Research Center and Wachovia Bank.

Our next witness is Mr. John J. Castellani. Mr. Castellani is the President of the Business Roundtable, an association of chief executive officers of U.S. companies. Mr. Castellani joined the Business Roundtable in May 2001 and had led the group's efforts on public policy issues ranging from trade expansion to civil justice reform to fiscal policy. Prior to becoming President of the Business Roundtable, Mr. Castellani was Executive Vice President of Tenneco, Incorporated.

Our next witness is Professor J.W. Verret. Professor Verret is an Assistant Professor of Law at George Mason University School of Law. He has written extensively on corporate law topics, including a recent paper cowritten with Chief Justice Myron T. Steele of the Delaware Supreme Court. Prior to joining the faculty at George Mason Law School, Professor Verret was an associate in the SEC Enforcement Defense Practice Group at Skadden Arps in Washington, DC, and also served as a law clerk for Vice Chancellor John W. Noble of the Delaware Court of Chancery. This forum is critical for disputes between shareholders and directors of Delaware corporations—which, by the way represents about 70 percent of the publicly traded corporations.

Our final witness is Mr. Richard C. Ferlauto. Mr. Ferlauto is Director of Corporate Governance and Pension Investment at the American Federation of State, County, and Municipal Employees, AFSCME, where he is responsible for representing public employee interest and public retirement and benefit systems. Mr. Ferlauto is also the founder and chairman of ShareOwners.org, a nonprofit, nonpartisan shareholder education organization. Prior to joining AFSCME, Mr. Ferlauto was the Managing Director of Proxy Voter Services/ISS, which provides proxy advisory services to Taft-Hartley and publicly funded plan sponsors.

I appreciate all of your appearance here today and let me recognize Ms. Cross.

STATEMENT OF MEREDITH B. CROSS, DIRECTOR, DIVISION OF CORPORATION FINANCE, SECURITIES AND EXCHANGE COMMISSION

Ms. CROSS. Good afternoon, Chairman Reed, Ranking Member Bunning, and Members of the Subcommittee. My name is Meredith Cross, and I am Director of the Division of Corporation Finance at the U.S. Securities and Exchange Commission. As you noted, I just rejoined the SEC staff in June of this year after more than 10 years in private practice here in Washington. I worked at the SEC for most of the 1990s, and I am delighted to be back at the agency at this critical time in the regulation of our financial markets. I am pleased to testify on behalf of the Commission today on the topics of corporate governance and the agency's ongoing efforts to assure that investors have the information they need to make informed voting and investment decisions.

Good corporate governance is essential to investor confidence in the markets, and it cannot exist without transparency—that is,

timely and complete disclosure of material information. In responding to the market crisis and erosion of investor confidence, the Commission has identified and taken steps over the past months in a number of significant areas where the Commission believes enhanced disclosure standards and other rule changes may further address the concerns of the investing public.

Two months ago, the Commission voted to approve proposals designed to help shareholders more effectively exercise their State law right to nominate directors. Under the proposals, shareholders who otherwise have the right to nominate directors at a shareholder meeting would, subject to certain conditions, be able to include a limited number of nominees in the company proxy materials that are sent to all shareholders whose votes are being solicited. Shareholders also would have an expanded ability to include in company proxy materials shareholder proposals addressing this important topic. In addition, the Commission recently proposed amendments to its proxy rules to enhance the disclosure that is provided to shareholders in company proxy statements, a key document in shareholders' voting decisions on the election of directors.

Under the proposals, shareholders would receive expanded information about the qualifications of directors and director candidates, the board's leadership structure and role in risk management, and potential conflicts of interest of compensation consultants, in addition to enhanced disclosure concerning the company's compensation policies and whether they create incentives for employees to act in a way that creates risks that are not aligned with the company's objectives. The proposal also would improve the reporting of annual stock and option awards to company executives and directors and would require quicker reporting of shareholder vote results.

The Commission also recently proposed amendments to the proxy rules to clarify the requirements consistent with the Emergency Economic Stabilization Act of 2009 for a "say-on-pay" vote at public companies that have received and not repaid financial assistance under the TARP and approved changes to the New York Stock Exchange rules to prohibit brokers from voting shares held in street name in director elections unless they have received specific voting instructions from their customers.

Finally, the Commission has asked the staff to undertake this year a comprehensive review of other potential improvements to the proxy voting system and shareholder communications rules. The Commission looks forward to hearing from the public on the outstanding proposals and to carefully considering all views in moving forward over the coming months.

Thank you again for inviting me to appear before you today and for the Subcommittee's support of the agency in its efforts at this critical time for our Nation's investors. The Commission will remain vigilant in its efforts to support strong corporate governance and disclosure practices and also stands ready to lend whatever assistance it can to the work that is going on outside the agency on these important topics.

I would be happy to answer any questions you may have.

Chairman REED. Thank you very much, Ms. Cross.

Professor Coates.

STATEMENT OF JOHN C. COATES IV, JOHN F. COGAN, JR., PROFESSOR OF LAW AND ECONOMICS, HARVARD LAW SCHOOL

Mr. COATES. Thank you, Senator Reed, thank you, Ranking Member Bunning, and the rest of the Members of the Committee who are. I very much appreciate the opportunity to talk about corporate governance.

Good corporate governance is an essential foundation to economic growth, and so this could not be a more important time for the Congress to be focusing on it.

There are a large number of reforms—six in Senator Schumer's bill alone, and there are many others—that we could talk about. I am going to talk about a few. I am happy to talk about others that you may have questions about or want to explore. But before I talk about specifics, let me make two general remarks that I think should be kept in mind in thinking about any particular reform.

First, and maybe a little controversially, I think it is fair to say that the academic perspective on corporate governance would view financial firms differently than other kinds of corporations, and not in the straightforward way that you might think; that is to say, shareholders of financial firms want financial firms to take risk and want them to take more risk than may be appropriate from the perspective of the taxpayer. That is because many of the large financial institutions are, as we have learned, too big, too complex to fail, so that from the shareholders' perspective, if things go well with the risks that the companies take, they are on the upside; and if things go badly, then in the end it is the taxpayer who helps defray the costs to the shareholders.

As a result of that, I do not think that it would be a good idea to give shareholders considerably more power in the governance of large financial institutions. I think, in fact, if anything, financial regulators should be given more authority to check the power that shareholders have, at least on particular issues—compensation being one. The compensation structures and incentives that shareholders, even if the boards are doing exactly the right thing for shareholder, that shareholders want of large banks are not the ones that are going to be the most safe and most sound from the perspective of the American public. So that is the first general remark.

Second is across the board on this, I think it is fair to say that academic and scientific research more generally is quite weak. It is evolving. There is almost no nontrivial issue in corporate governance about which there is not fierce academic as well as political argument. That cautions against passing rules that are fixed, mandatory, and are hard to change over time. Instead, it cautions for giving shareholders the ability to adopt rules for their own companies, facilitating collective action by them—and that is an important role, I think, that regulation can play. Shareholders of public companies are dispersed, cannot easily act on their own, and often face entrenched boards who are unwilling to make changes when they are, in fact, the best thing for the companies.

The caution about the weakness of the scientific evidence is also not a reason to do nothing because what I just said is one thing that there is general consensus on. Disperse shareholders have a hard time acting for themselves as the number of shareholders in-

crease. And the other general consensus, I would say, across the board is that corporate governance in the United States in the last 10 to 20 years has not performed terribly well at a large number of companies. And so there is need for change, and there is need for carefully considered moderate reforms of a kind that can be revised over time as learning on these subjects grows.

So on the specifics, let me say quickly, I think the evidence that we do have is that "say-on-pay" is a good idea, and I am happy to expound on that beyond that bottom-line conclusion.

I would say for large companies, splitting CEOs from chairmen has some evidence behind it that that is a good thing. Smaller companies, I am not so sure the evidence is there. But as long as the SEC is given appropriate authority to tailor any legislation in this area, I think that would be a good thing to pursue.

I would say that staggered boards, the evidence, if anything, runs against eliminating them. They are an important option between, on the one hand, a fully contestable corporate governance structure where every director is up for election every year, and a governance structure where essentially the insiders have complete control, as in the case of Google, which is a reasonably successful company. In between, staggered boards have proven to be a type of governance structure that investors and new IPOs have been willing to put their money behind, and to ban them across the board I don't think is supported by the evidence at the moment.

On shareholder access, just to wrap up, frankly there is no evidence, and I think there is—that is a reason to proceed, but to proceed cautiously, to proceed through the SEC, and here I think the SEC already has adequate authority to pursue this topic. But the one thing Congress probably could clarify is exactly what their authority is in this area, and I think that would be a good thing.

With that, thank you.

Chairman REED. Thank you very much, Professor Coates.

Ms. Yerger.

STATEMENT OF ANN YERGER, EXECUTIVE DIRECTOR, COUNCIL OF INSTITUTIONAL INVESTORS

Ms. YERGER. Good afternoon. Thank you very much for the opportunity to share the council's views on the very important issues under consideration today.

By way of introduction, council members are responsible for safeguarding assets used to fund the retirement of millions of individuals throughout the United States. They are capitalists, responsible for an aggregate portfolio of somewhere north of $3 trillion in assets. They have a very significant commitment to the domestic markets, on average investing about 60 percent of their portfolios in stocks and bonds of U.S. public companies. And they are long-term, patient investors due to their long investment horizons and their very heavy commitment to passive investment strategies.

Council members have been very deeply impacted by the financial crisis, and they have a vested interest in ensuring that the gaps and shortcomings exposed by this crisis are repaired. Clearly, a review and restructuring of the U.S. financial regulatory model are necessary steps toward restoring investor confidence and protecting against a repeat of these failures. But regulatory reform

alone is insufficient. Corporate governance failures also contributed to this crisis, and as a result, governance reforms are an essential piece of the reform puzzle.

Failures of board oversight, of enterprise risk, and executive pay were clear contributors to this crisis. In particular, far too many boards structured and approved executive pay programs that motivated excessive risk-taking and paid huge rewards, often with little or no downside risk, for short-term results. Current corporate governance rules also failed by denying owners of U.S. companies the most basic rights to hold directors accountable. The council believes governance reforms in four areas are essential, and, Senator Schumer, they will be familiar to you.

First, Congress should mandate majority voting for directors of all U.S. public companies. It is a national disgrace that under most State laws the default standard for uncontested director elections is a plurality vote, which means that a director is elected even if a majority of the shares are withheld from the nominee. The corporate law community has taken baby steps to accommodate majority voting, and some companies have volunteered to adopt majority voting, but sometimes only when pressured by shareowners.

But while many of the largest U.S. companies have adopted majority voting, plurality voting still dominates at small and midsized U.S. companies. This is a fundamental flaw in our governance model. Given the failure by the States, particularly Delaware, to lead this reform, the council believes that the U.S. Congress must legislate this important and most basic shareowner right.

Second, Congress should affirm the SEC's authority to promulgate rules allowing owners to place their director nominees on management's proxy card. The council believes a modest proxy access mechanism would substantially contribute to the health of our U.S. governance model by making boards more responsive to shareowners, more thoughtful about whom they nominate, and more vigilant about their oversight responsibilities.

The council commends the SEC for its leadership on this important reform, but, unfortunately, the SEC may face unnecessary, costly, and time-consuming litigation in response to any approved access mechanism. To ensure that owners of U.S. companies face no needless delays over the effective date of this critical reform, the council recommends congressional affirmation of the SEC's authority.

Third, Congress should pass legislation mandating annual advisory votes on executive pay, explore strengthening clawback standards, and support the SEC's efforts to enhance executive pay disclosures.

Council members have a vested interest in ensuring that U.S. companies attract, retain, and motivate the highest-performing employees and executives. But as highlighted by this crisis, they are harmed when poorly structured pay programs reward go-for-broke, short-term performance that ultimately harms the company's long term.

The council believes executive pay issues are best addressed by: first, requiring companies to provide full disclosure of key elements of pay; second, ensuring that directors can be held accountable for their pay decisions through majority voting and access mecha-

nisms; third, by giving shareowners oversight of executive pay via annual nonbinding votes; and, fourth, by requiring disgorgement of ill-gotten gains.

One technical suggestion. We recommend that legislation mandating annual advisory votes stipulate that these are a nonroutine matter for purposes of New York Stock Exchange Rule 452.

Fourth, Congress should mandate that all corporate boards be chaired by an independent director. The council believes separating these positions appropriately reflects differences in the roles, provides a better balance of power between the CEO and the board, and facilitates strong, independent board leadership and functioning.

In closing, empirical evidence from around the globe supports these reforms. The experiences in other countries and, where applicable, here in the United States are powerful evidence that these reforms are not harmful to the markets and, of note, these measures do not reward short-termism. On the contrary, they are tools to enable owners to think and act for the long term.

Thank you for your consideration of these important issues, and I look forward to answering any questions.

Chairman REED. Thank you very much, Ms. Yerger.

Mr. Castellani.

STATEMENT OF JOHN J. CASTELLANI, PRESIDENT, BUSINESS ROUNDTABLE

Mr. CASTELLANI. Thank you. Good afternoon, Mr. Chairman, Ranking Member Bunning, Members of the Committee. I am John Castellani, President of the Business Roundtable.

The Business Roundtable has long been at the forefront of efforts to improve corporate governance. We have, in fact, been issuing best practice statements in this area for more than three decades. All of those best practice statements are driven by one principle: To further U.S. companies' ability to create jobs, product service benefits, and shareholder value that improve the well-being of all Americans.

At the outset, I must respectfully take issue with the premise that the most significant cause of the current financial crisis was problems in corporate governance. The financial crisis likely stemmed from a variety of complex factors, including failures of the regulatory system, over-leveraged financial markets, a real estate bubble, as well as failures in risk management.

The recently established Financial Crisis Inquiry Commission is just starting its work, and any attempt to make policy in response to the purported causes would seem premature. In fact, to do so could well exacerbate factors that may have contributed to the crisis, such as the emphasis on short-term gains at the expense of long-term sustainable growth.

Moreover, the problems giving rise to the financial crisis occurred at a specific group of companies, financial institutions. Responding by enacting a one-size-fits-all corporate governance regime applicable to all 12,000 publicly traded companies really does not make much sense. This approach fails to consider a number of factors that I would like to spend the remainder of my time this afternoon discussing.

First, there has been sweeping transformation of corporate governance practices in the past 6 years, many of which have been proactively adopted by companies. For example, the average board independence of S&P 1500 companies increased from 69 percent in 2003 to 78 percent in 2008. That same group of companies that have a separate chairman of the board increased from 30 percent in 2003 to 46 percent in 2008. Many companies have appointed an independent lead or presiding director who, among other things, presides over executive sessions of the independent directors. Companies have adopted majority voting standards for the election of directors. In fact, more than 70 percent of the S&P 500 companies have done so. And many companies have moved to the annual election of directors.

Second, applying a single one-size-fits-all approach to corporate governance regardless of a company's size, shareholder base, and other circumstances simply will not work. While there is a multitude of guidance about best practices in corporate governance, each company must periodically assess the practices that will best enable it to operate most effectively to create long-term shareholder value.

In this regard, we share the concerns recently expressed by New Jersey Investment Council in the letter to SEC Chairman Schapiro, that it is, quote, "troubled by the proliferation of rigid, prescriptive responses which are costly, time consuming, unresponsive to individual fact settings surrounding specific companies and industries, and which may correlate only randomly with the creation of shareholder value."

Third, for more than 200 years, State corporate law has been the bedrock upon which the modern business corporation has been created and has thrived. It remains the most appropriate and effective source of corporate governance. In large part, this stems from the flexibility provided by its enabling nature and by its responsiveness in adjusting to current developments. The amendments to Delaware and other States' laws over the past several years have facilitated majority voting and director elections, and the very recent amendments in Delaware law to facilitate proxy access and proxy reimbursement bylaws are examples of this responsiveness and flexibility.

Fourth, to the extent that shareholders desire change in a particular company's corporate governance, many avenues are available to them to make their views known and for companies to respond. For example, shareholders may seek to have their proposals included in company proxy statements. In recent years, many companies have responded to these proposals by adopting significant corporate governance changes, including majority voting for directors, special meetings called by shareholders, and the elimination of super-majority voting requirements. Recently, some companies have implemented an advisory vote on compensation, so-called "say-on-pay," in response to shareholder proposals. Shareholders often engage in withhold campaigns against particular directors. And further, shareholders can engage in proxy contests to elect their director nominees to a company's board.

Finally, the SEC has an important role in seeing that shareholders receive the disclosures that they need to make informed de-

cisions. In this regard, the SEC has issued a number of corporate governance-related proposals that are aimed at improving disclosure about director experience, board leadership structure, oversight of risk management, executive compensation, and potential conflicts of interest with compensation consultants. The Business Roundtable generally supports those.

Another more controversial SEC proposal seeks to amend the proxy rules to permit shareholders to nominate directors in a company's proxy materials. We have serious concerns with this proposal, and we will share those concerns with the SEC in our comments. But briefly, we believe that the adoption of this proposal could promote short-termism, deter qualified directors from serving on corporate boards, and lead to the election of special interest directors, increase the influence of the proxy advisory services, and highlight voting integrity problems in the system.

In closing, let me emphasize the Roundtable's commitment to effective governance practices and enabling U.S. companies to compete globally, create jobs, and generate economic growth. However, we must be careful that in a zeal to address our current financial crisis, we do not adopt a one-size-fits-all approach that can undermine the stability of boards of directors and place companies under even greater pressure for short-term performance. We must be cautious that we don't jeopardize the engine of American wealth and prosperity.

Thank you.

Chairman REED. Thank you very much, Mr. Castellani.

Professor Verret, please.

STATEMENT OF J.W. VERRET, ASSISTANT PROFESSOR OF LAW, GEORGE MASON UNIVERSITY SCHOOL OF LAW

Mr. VERRET. Chairman Reed, Ranking Member Bunning, and distinguished Members of the Committee, I appreciate the opportunity to testify in this forum today. My name is J.W. Verret. I teach corporate law at George Mason Law School. I am a Senior Scholar with the Mercatus Center Financial Markets Working Group, and I also run the Corporate federalism Initiative, a network of scholars dedicated to studying the intersection of State and Federal authority in corporate governance.

I will begin by addressing proxy access and executive compensation rules under consideration, neither of which address the current financial crisis and both of which may result in significant unintended consequences. Then I will close with a list of factors that did contribute to the present financial crisis.

I am concerned that some of the corporate governance proposals recently advanced impede shareholder voice in corporate elections. This is because they leave no room for investors to design corporate governance structures appropriate for their particular circumstances and particular companies. Rather than expanding shareholder choice, the proxy reform and "say-on-pay" proposals before this committee actually stand in the way of shareholder choice. Most importantly, they do not permit a majority of shareholders to reject the Federal approach.

The Director of the United Brotherhood of Carpenters said it best. Quote, "We think less is more. Fewer votes and less often

would allow us to put more resources toward intelligent analysis." The Brotherhood of Carpenters opposes the current proposal out of concern about compliance costs. The proposals at issue today ignore their concerns, as well as concerns of many other investors.

Consider why one might limit shareholders from considering alternative means of shareholder access. It can only be because a majority of shareholders at many companies might reject the Federal approach if given the opportunity. Not all shareholders share the same goals. Public pension funds run by State elected officials and union pension funds are among the most vocal proponents of the proposals before this committee. There are many examples where they used their power, their existing shareholder power, toward their own special interests. Main Street investors deserve the right to determine whether they want the politics of unions and State pension funds to take place in their 401(k)s.

The current proposals also envision more disclosure about compensation consultants. Such a discussion would be incomplete without mentioning conflicts faced by proxy advisory firms like RiskMetrics, an issue the current proposals have failed to address.

In addition, I will note that there is no evidence that executive compensation played a role in the current crisis. If executive compensation were to blame for the present crisis, we would see significant difference between compensation policies at those companies that recently returned their TARP money and those needing additional capital. We do not.

Many of the current proposals also seek to undermine and take legislative credit for efforts currently underway at the State level and in negotiations between investors and boards. This is true on proxy access, the subject of recent rule making at the State level, and it is true for Federal proposals on staggered boards, majority voting, and independent chairmen.

We have run this experiment before. The Sarbanes-Oxley Act passed in 2002 was an unprecedented shift in corporate governance, designed to prevent poor management practices. Between 2002, when Sarbanes-Oxley was passed, and 2008, the managerial decisions that led to the current crisis were in full swing. I won't argue that Sarbanes-Oxley caused the crisis, but this does suggest that corporate governance reform at the Federal level does a poor job of preventing crisis.

And yet the financial crisis of 2008 must have a cause. I commend this Committee's determination to undercover it, but challenge whether corporate governance is, in fact, the culprit. Let me suggest six alternative contributing factors for this Committee to investigate.

One, the moral hazard problems created by the prospect of Government bailout.

Two, the market distortions caused by subsidization of the housing market through Fannie Mae, Freddie Mac, and Federal tax policy.

Three, regulatory failure by the banking regulators and the SEC in setting appropriate risk-based capital reserve requirements for investment in commercial banks.

Four, short-term thinking on Wall Street, fed by institutional investor fixation on firms making and meeting quarterly earnings predictions.

Five, a failure of credit-rating agencies to provide meaningful analysis caused by an oligopoly in the credit-rating market supported by regulation.

Six, excessive write-downs in asset values under mark-to-market accounting, demanded by accounting firms who refuse to sign off on balance sheets out of concern about exposure to excessive litigation risk.

Corporate governance is the foundation of American capital markets. Shifting that foundation requires deliberation and a respect for the roles of States in corporate governance. Eroding that foundation risks devastating effects for capital markets.

Thank you for the opportunity to testify and I look forward to answering your questions.

Chairman REED. Thank you very much, Professor.

Mr. Ferlauto, please.

STATEMENT OF RICHARD C. FERLAUTO, DIRECTOR OF CORPORATE GOVERNANCE AND PENSION INVESTMENT, AMERICAN FEDERATION OF STATE, COUNTY, AND MUNICIPAL EMPLOYEES

Mr. FERLAUTO. Good afternoon, Chairman Reed and Members of the Committee. My name is Rich Ferlauto. I am Director of Corporate Governance and Pension Investment for AFSCME, the public employee union.

Our union has a long-term abiding interest in the health of the capital markets. Our 1.6 million members are invested through public pension systems that have assets over $1 trillion. They depend on those assets for long-term retirement security. Those public pension systems have got time horizons of 20 to 30 years in which they need to pay out our member benefits so that we are a long-time, long-term investor with those types of time horizons.

I might also mention that AFSCME and the AFSCME Pension Fund early on sued AIG over proxy access rights because we understood that the board had failed to do the type of risk disclosure that we felt was necessary and part of the responsibility of directors.

I am also Chairman of Shareowners.org, a new nonprofit, nonpartisan social networking organization designed to give voice to retail shareholders who rarely have opportunities to communicate with regulators, policy makers, and companies in which they are invested.

I am here today to urge your focus on corporate governance. We believe that corporate governance reform is essential to good performing capital markets, and, in fact, with greater corporate governance and shareholder rights, we could have avoided some of the $11 trillion in asset loss that was faced and felt dearly by our members and certainly the U.S. households.

According to a recent public opinion survey by the Opinion Research Corporation conducted for Shareowners, investors want to see Congress take strong action to fix financial markets and to clean up Wall Street. Such action, we believe, is essential in order

for you to rebuild confidence in the markets. Capital markets will not work without investors. Investors will not come back if they don't have confidence that the markets are running appropriately.

Support for such action is strong across all age, income, and educational and political affiliations. Thirty-four percent of the investors that we surveyed used the term "angry" to describe their views. The number one reason for the loss of investor confidence in the market, we found, were "overpaid CEOs and/or unresponsive management and boards" at 81 percent. Six out of ten investors said that strong Federal action would help restore their confidence in the fairness of the markets.

When we queried them about policy preferences, the survey found that four out of five American investors agreed that shareholders should be permitted to be actively involved in CEO pay. Eighty-two percent agreed that shareholders should have the ability to nominate and elect directors. And 87 percent of investors who lose their retirement savings to fraud and abuse should have the right to go to court to reclaim that money.

Fully consistent with these findings, we think that the Committee should focus on fixing corporate governance. The core to fixing corporate governance is to focus on the directors and the responsibility between asset owners and their agents, directors on corporate boards. The most critical change to do that is to create a proxy access right so that shareholders, particularly long-term shareholders who own patient capital in the markets, so that they may cost effectively nominate candidates for election to boards.

We are very encouraged that the SEC is in the process of rule making on this issue but also believe that this is such an important right that it should not become a political football for future commissions. There needs to be long-term consistency in securities laws and the Exchange Act is the appropriate place to clearly codify the authority that the Commission has to require disclosure of nominees running for board seats. Proxy access is fundamental to free and fair election for directors.

Second, shareholders should have a right to "say-on-pay," a vote on the appropriateness of CEO compensation. We are excited that we saw the vote in the House the other day, expect to see a full vote this week, and as Ann Yerger from CII said, we think it is absolutely essential that broker votes not be included in the total so that a change to 452, excluding broker votes on "say-on-pay," would be a tremendous enhancement to see on the Senate side.

I could make other comments, but let me wrap up by saying we thank you, Mr. Chairman, for the opportunity to testify today. Rebuilding investor confidence in the market depends on thoughtful policymaking that expands investor rights and authorizes the SEC to strengthen its advocacy role on behalf of all Americans and their financial security.

I would be happy to answer any questions.

Chairman REED. Thank you very much, Mr. Ferlauto.

Let us do a 6-minute initial round with the intention of doing a second round so we can quickly get everyone to ask some questions. We are extremely fortunate your testimony collectively and individually has, I think, advanced this argument and debate significantly.

Ms. Cross, one of the issues here that has been alluded to by Professor Verret and others is the interaction between the SEC and States, primarily Delaware, since they have 70 percent of the public corporations. Can you comment upon this? In fact, I think I noted in your proposed rules that they are subject to the State corporate law, is that correct?

Ms. CROSS. That is correct. Under the access proposal, you would have a right of access to include nominees in an SEC proxy—SEC-filed proxy only if you have a State law right to nominate directors. So we start with the State law and then we enable shareholders to exercise their State law rights through the Federal proxy rules.

Chairman REED. That raises the issue, really, of since the proxy rules are Federal rules and not required by any States, I don't think, I think this is a principal sort of issue between whether or not there should be the ability of the SEC to require these rules even if the State doesn't. Is that something that you can't do now under present law or you choose not to do?

Ms. CROSS. That is a good question. Under State law now, recent changes in Delaware include an ability for shareholders to decide to vote to require the proxy access. We have authority under our current rules, under the 34 Act, to also require companies to include nominees in their proxy statement and we believe these do coexist. The way we have done our proposal assures that shareholders would have immediate access to the proxy to nominate their holders if they satisfy our requirements. They still could vote under State law to have—to relax the standard so that more shareholders can do so.

Chairman REED. Professor Verret, I think you are interested in this topic. Your comments?

Mr. VERRET. Mr. Chairman, I would only offer that the SEC's proposal does include references to State law, but specifically, the SEC's proposal says, sure, you can adopt a bylaw that would describe how proxy access will work only if it complies with the SEC's mandate. So it is very clear on that. It runs roughshod, I think, over State corporation law determining election rights, and so I think it expressly—you might find references in there to State law, but the references are intended to make clear that the SEC determines how proxy access is going to work and if there is any—you can certainly make up your own rules, only if they comply completely with the SEC's rules on this essentially State corporate law matter.

Chairman REED. Well, there are State corporate laws, but I think you recognize that the proxy process is a result primarily of Federal laws.

Mr. VERRET. Well, the proxy process, sure, and the proxy process was intended mostly about issues of disclosure. And I would offer a quote from Justice Powell in *CPS v. Dynamics.* You don't have to listen to me. Take Justice Powell's word for it. No principle of corporate law is more firmly established than a State's authority to regulate domestic corporations, including the voting rights of shareholders. So Justice Powell, at least, is with me on that one.

Chairman REED. Do you agree with all of his opinions?

Mr. VERRET. Well, no. No. I wouldn't say that.

[Laughter.]

Mr. VERRET. But I like that one.

Chairman REED. Let me shift to Professor Coates and Mr. Castellani. You have described—in fact, you might comment on this issue, too, Professor Coates, and then I have another question.

Mr. COATES. I think it is, as I said in my opening remarks, I think that if Congress were not to act, the SEC were to adopt proxy access, it is almost certainly the case that someone will challenge their authority to do so precisely along the lines that Professor Verret has suggested. I think that challenge will lose because I think the proposal is about communication. It is allowing shareholders to exercise rights that they clearly do have under State law.

The SEC's proposal would allow, contrary to what was suggested earlier, any State to change its law and make it clear that shareholders would not have the right to nominate directors in this fashion and then the SEC's rules would not override that State law decision. So the proposal, at least the way I read it and the way I believe that a court would read it, would not, in fact, conflict with State law on this issue.

Chairman REED. Let me follow up on one of the comments you made in your statement, and that is that we assume, I think, that—at least there is a general assumption that shareholder participation the way we describe would enhance the performance of the company. But you suggest in certain situations, financial institutions, for example, that it could have perverse effects.

It seems to me that there are three or four different decisions here. You can pay dividends. You can pay the executives instead of paying dividends. Or you can reinvest and increase shareholder value, *et cetera.* The shareholders, I think, would be interested in dividends and maybe also, second, long-term value, but less interested in compensation for executives. But that is just a sort of prelude to the question of what are the—what specific disincentives do you see if shareholders can vote like this?

Mr. COATES. I mean, there has been a longstanding economic theory about which there is a fair amount of evidence that suggests that in a company's capital structure, there are conflicts between the shareholders who are entitled to all upside beyond the fixed payments that creditors are entitled to and the creditors. The U.S. Government, because it insures the deposits of all the banks that it insures, which is most of them, is fundamentally a creditor of the large banking institutions, and so there is, in fact, going to be on many occasions a conflict of interest between shareholder interests and the interest of the taxpayer with respect to insured depository institutions. That is the fundamental conflict.

And to the extent that the proposals go toward increasing shareholder power, that simply makes the bank regulators' jobs in restraining risk taking by those banks at the behest of shareholders and boards who are seeking to maximize share value, even if it is long-term share value, that much harder. So any effort in this area, I submit, should be accompanied by clear authority for the banking regulators to at least moderate the way these things play out for banking institutions.

Chairman REED. Thank you. My time has expired.

Senator Bunning. And we will do a second round.

Senator BUNNING. Thank you, Mr. Chairman.

Professor Verret, if we are going to make proxy access easier for shareholders, what restrictions would you recommend to make sure that the SS benefit a majority of shareholders and the long-term value of the company and does not just benefit small groups of investors and lead to short-term profits?

Mr. VERRET. Well, Senator Bunning, I would offer that the best person to make—the best group to make that assessment is the shareholders themselves. And so I would leave it to shareholders to determine how proxy access should work, how it should operate.

And so for that reason, I think the innovations at the level of Delaware and in the Model Business Code, which forms the basis for 20 to 30 other corporate law codes of other States, are on the right track. And I think also Commissioner Paredes has offered a proposal to the SEC to help buttress this development, to permit access for shareholder election bylaws to the corporate ballot.

So in other words, instead of saying this is how the elections should work, we say shareholders can put forward a bylaw that should say how the election should work. All the shareholders should determine how that election should work. In many ways, it is similar to the Constitutional Convention. Rather than choosing—the people got to choose the mechanism by——

Senator BUNNING. You are not suggesting we go back to a Constitutional Convention——

Mr. VERRET. No, no, but——

[Laughter.]

Senator BUNNING. Not now.

Mr. VERRET. But in effect, a ratification of a shareholder election bylaw is kind of like a Constitutional Convention for shareholders. I think that is an apt analogy.

Senator BUNNING. Professor Coates, in your written testimony—written—you raised an interesting idea. Rather than forcing a structure on all companies, you suggested an opt out vote by shareholders every few years for some governance proposals. That idea could be applied to proxy access and advisory vote procedures as well, instead of Government deciding what the rules will be.

I want to know what each of you think of that approach, of a mandatory opt in or opt out vote every few years to decide certain matters. Let us start with you, Professor Coates. Since you seem to have expressed this idea, now I would like to hear your comments on it.

Mr. COATES. Sure. Thank you for the—obviously, I like my idea, but——

Senator BUNNING. Well, I hope so.

Mr. COATES. ——to explain, I don't think of it as necessary to prevent imposing Government regulation, because I don't think that is actually the intent of any of the proposals that are currently being debated. I do think it would be a good idea to preserve flexibility in what sorts of corporate governance structures companies are either required or induced to adopt, and one way to achieve that is to let shareholders, who, after all, this is meant to be in the interest of shareholders, so if shareholders every 5 years are given the option of rejecting a particular idea on the ground that it is too expensive, for example, too cumbersome, or simply inapt for their

company, and here I would join Professor Verret in saying I think that is a reasonable approach.

The key point, though, is it needs to be opt out, because as I alluded to in my opening remarks, shareholders on their own, despite the 20, 30 years of efforts by organizations like the one led by Ms. Yerger, have had a very hard time getting companies to be responsive. It has been 20 years since proxy access has been proposed by leading institutional shareholders and only now is it being taken seriously. So I have to, with all due respect, disagree with the Business Roundtable's suggestion that, in fact, corporate boards are generally responsive to shareholder desires. Start with a good rule——

Senator BUNNING. Ms. Cross.

Mr. COATES. Sorry.

Ms. CROSS. Thank you, sir. It is an interesting idea and I think with respect to our proxy access proposal, which is the one that we have on the table right now, we include requests for comment in our proposal about whether or not you should be able to opt out and have the shareholders choose a different access mechanism, and we very much look forward to receiving comments on that. This is a proposal as we——

Senator BUNNING. How much more time do we have?

Ms. CROSS. On the proposal?

Senator BUNNING. No, to make suggestions or to comment.

Ms. CROSS. The comment period runs through August 16 or 17, I believe.

Senator BUNNING. Thank you very much.

Ms. Yerger.

Ms. YERGER. I have a couple of observations. First of all, I am not a lawyer, so I come at this from a different perspective——

Senator BUNNING. Good. I am very happy to hear that.

[Laughter.]

Ms. YERGER. Our belief is that the board of directors is the cornerstone of the corporate governance model and the primary rights assigned to owners, aside from buying and selling their shares, is to elect and remove directors. And the fact is that we do not have those tools here in the United States. And that is why we advocate majority voting and access to the proxy. We think these are two principled rules. They are applicable to all companies at all times.

In terms of an opt out idea, I mean, I don't see how an opt out would be relevant at all to majority voting for directors. I mean, I just believe fundamentally that if a director does not win support of a majority of the votes cast, that director should not stand——

Senator BUNNING. Thank you.

Ms. YERGER. ——on the board. But one quick point on access. There is already a——

Senator BUNNING. I have only got 35 seconds, and I have got one more question.

Ms. YERGER. OK, sorry.

Senator BUNNING. That is OK. This is for Professors Coates and Verret. Several weeks ago, Professor Henry Hu raised an interesting problem before this Subcommittee. He pointed out that with derivatives, the voting rights of shares can now be separated from the economic right of the shares, setting up a situation where the

person voting has no interest in the long-term health of the company. What can and should be done about that? Take a shot at it, both of you.

Mr. COATES. I have a negative 5 seconds.

Senator BUNNING. Well, that is all right.

Mr. COATES. That is all right. OK.

Senator BUNNING. You get to answer.

Mr. COATES. Henry's issue is a serious one. It is one that has affected a number of companies in the past—in the recent years during the financial turmoil because it allows hedge funds' short-term speculators who have distinctly different interests than the long-term shareholders represented at this table——

Senator BUNNING. They can have a negative interest.

Mr. COATES. Exactly. Now, I believe that if the SEC is given time to address the issue adequately, they already understand that this is a significant problem. There are no simple fixes to this, just as there are no simple fixes to most problems in the market.

Senator BUNNING. You have not made a suggestion yet.

Mr. COATES. Well, disclosure is usually the place the SEC does and should start. That is the place where I would start on addressing the problem.

Senator BUNNING. Disclosure.

Mr. COATES. Yes, full disclosure of hedge fund positions.

Mr. VERRET. I would echo that disclosure is—that sunlight is the best disinfectant and that the central mission of the SEC is disclosure. And, in fact, that is part of the reason why I am opposed to the SEC's current proposal on proxy access, and it is proxy access through legislation so that it goes beyond the central mission of the SEC for disclosure.

Senator BUNNING. Thank you.

Chairman REED. Thank you, Senator Bunning.

Senator Schumer, please.

Senator SCHUMER. Thank you. I thank all the witnesses. Very informative testimony. I am going to make two comments—one to Professor Verret, one to Professor Coates—to which you can comment in writing, because I do not have much time and I want to ask other questions.

To Professor Verret, "Let the shareholders decide," as Ms. Yerger points out, is a tautology. Shareholders do not decide now, so just saying let us leave it up to the shareholders and whatever they decide happens happens, in too many instances they just do not have the ability to decide now. Our rules are supposed to let them decide, and you are sort of proposal, well, whatever they say is what they want—not under these rules. You can respond in writing.

[*Ed. note:* Answer not received by time of publication.]

Senator SCHUMER. To Professor Coates, this idea that financial firms, because they could be bailed out, the shareholders would have a different structure, I would like you to ask the shareholders of Citigroup or AIG, former, if they feel that they have done quite well because they have let risks go too far and they were bailed out. In other words, most companies, by the time they are bailed out, their shares are worth very, very little. And I do not think they would have a different structure, and I would argue that the recent history would undercut your argument even further, and

that is, allowing risk—because you are a financial firm and you might be bailed out allows you to take risk, and that is fine for the shareholders? They are going to be very wary of risk over the next 5 years, whether they are bailed out or not, because shares went way down.

You can respond in writing to that one, but I just do not think the facts, the recent history bears out that hypothesis.

Response: One of the most basic and widely accepted principles of corporate finance is that shareholders—who are entitled to all of the upside if a company does well—would rather that the company take more risks than do the creditors, who are generally entitled only to receive back the principal and preset interest on their loans. See R.A. Brealey and S.C. Myers, *Principles of Corporate Finance* (5th ed. 1996) at 492 ("stockholders of . . . firms [with debt] gain when business risk increases. Financial managers who act strictly in their shareholders' interests (and against the interests of creditors) will favor risky projects over safe ones. They may even take risky projects with negative [net present expected value]"). Nothing in the recent crisis has affected that general conclusion. Higher risk generally means higher return for shareholders, but for creditors, whose return is fixed, risk-taking by corporate borrowers just increases the odds that they will not get repaid in full.

Generally, creditors protect themselves against shareholders pressuring companies to take too much risk by negotiating for explicit restrictions in their contracts. For example, a bank loan may forbid a company from reducing its cash on hand below a set level, or from making large new investments without creditor approval. The U.S. Government, as back-stop creditor of all of the major commercial banks (and, as it turned out, AIG, too, even though AIG was not an insured bank), tries to protect itself against excessive risk-taking by setting capital requirements and imposing other forms of regulation on banks. Existing regulations have not proven effective, and many proposals under consideration would strengthen those regulations, and limit further the risks that banks may take with taxpayer funds. Strengthening the hand of shareholders of major banks may undercut those efforts.

You are right that not all risks turn out to be good ones for shareholders, and that there are risks that turn out badly for shareholders as well as creditors, as has been the case in the recent crisis. But when the managers of large financial institutions are making decisions, they do not know how the risks will play out. Imagine a manager can choose between two investments, each to be financed partly with $5 of shareholder money and partly with a $5 loan from the creditor. One investment will pay off $5 100 percent of the time—it has no "risk", but it also promises no return to the shareholders, since the whole return will go to creditors. The second investment will pay off $10 90 percent of the time, and will generate a loss of $100 10 percent of the time. The second investment is clearly better for shareholders, since (in expectation) it is worth $5 90 percent of the time ($10 less the $5 loan), and -$5 10 percent of the time (loss of their $5 investment). But the second investment involves a risk to the creditors (*e.g.,* the U.S. taxpayers) since it involves a potential loss and an inability by the company to pay back the loan, and is worse for society as a whole. Suppose the managers nevertheless choose the second investment, and it pays off badly—*i.e.,* it generates a loss. With hindsight, shareholders have lost, too, along with the creditors. But that doesn't mean that the investment was bad for the shareholders. It is only after the loss has appeared that the investment looks bad. If they had to do all over again, most diversified shareholders generally would have the managers choose the second investment. This example is stylized, but it is no different in kind than the investment decisions that financial institution managers make every day.

Corporate governance rules are changed rarely—you will be writing legislation not for the next 5 years, but for decades, through recessions and boom markets alike, and will apply to a range of publicly held companies. If the managers are forced by strong corporate governance reforms to follow more closely the directions of shareholders, they will tend, on average, to take more risks than they would if shareholder power were weaker. For most companies, creditors can take care of themselves, through contract, and in principle, as the bank regulators can offset any general increase in risk-taking by managers caused by shareholders, by requiring higher capital ratios or imposing more restrictive regulations. But the tendency of bank regulators has been, unfortunately, to fail to impose strict enough regulations to cope with the pressure of incentive compensation and other techniques for tying managers' interests to shareholder goals. General corporate governance changes of the kind being discussed should be written with that unfortunate fact in mind.

Senator SCHUMER. Ms. Cross, the SEC has proposed "say-on-pay" for TARP recipients but not for other public companies. If "say-on-pay" is a good idea when the Government is a shareholder, why isn't it a good idea for all shareholders?

Ms. CROSS. Chairman Schapiro has indicated that she supports "say-on-pay" for all public companies, and we do not have authority to require "say-on-pay" at public companies beyond the TARP companies.

Senator SCHUMER. But you would be supportive of it.

Ms. CROSS. I cannot speak for the Commission, and the Commission has not taken a position.

Senator SCHUMER. OK. But Chairman Schapiro is supportive of it.

Ms. CROSS. Chairman Schapiro has said she supports it, and we stand ready to implement it if Congress enacts it.

Senator SCHUMER. OK, good.

Mr. Castellani, you note that some of the proposals—and I think that is significant, and I appreciate that. You note that some of the proposals in the Shareholder Bill of Rights are already being adopted by your member companies and reflect an emerging consensus on best practices in corporate governance. Well, if that is the case, then what are you so afraid of? If this is the trend anyway, if you seem to indicate this is the right thing to do, what is wrong with pushing those—you know, I had a discussion with one of your members, and I will not reveal who it is, but he said, "Look, I am not"—and then he named his predecessor. "You do not have to legislate for me." I said, "That is my whole point. We are not legislating for you. You are a good CEO, and whether your shareholders made you be a good CEO or not, you would be. But what about your predecessor?"

So, question: Doesn't the Shareholder Bill of Rights create a competitive advantage for the companies that follow the best practices? And why does the Roundtable, most of whom comply, I think overwhelmingly, with some of our proposals, and many comply with just about all of our proposals, why are they going so far to defend the outlier companies for whom the laws are needed most?

Mr. CASTELLANI. Senator, in fact, many of the Roundtable companies do and have adopted many of the practices that are in your proposal. The difference—

Senator SCHUMER. And you cite that with pride.

Mr. CASTELLANI. Yes, absolutely. The difference is those——

Senator SCHUMER. That is not a very good argument against my proposal.

Mr. CASTELLANI. Well, those who have not have made—those who have and those who have not have made the determination that that is best for their company. Their directors have made that determination, that that is best for their company under their circumstances.

For example, the issue that you cited in the separation of the chairman and the chief executive officer, in some instances it makes very good sense to separate the chairman and chief executive officer, particularly where it is a transition event. But in other circumstances, boards feel that it makes best sense to have both to-

gether, but protect against the downside by having a presiding director or——

Senator SCHUMER. As I mentioned—and I am——

Mr. CASTELLANI. So the question is: Why require it?

Senator SCHUMER. I do not have much time, and I cannot stay for a second round. I am going to have to ask you another question. I understand. I mean, the one, as I said, that got the most kickback and that I am open to listening to change on or proposals on is the CEO and the independent director. You noted that 75 percent of your member organizations, 70 percent of S&P 500 companies, have adopted majority voting, and roughly half of the S&P 500s now hold annual director elections. Yet you argue that the one-size-fits-all approach simply will not work.

Can you give me one good reason that a director who gets only one vote at an annual meeting should be allowed to continue as a director?

Mr. CASTELLANI. I cannot give you any good reason why any director who does not receive a majority vote of the shareholders should be seated, unless—unless—it jeopardizes the ability of that company to be able to operate and that board to operate.

For example, many companies who have adopted majority voting put in a safeguard for their companies such that if they require that particular director—that may be the only director that has the financial expertise that is required on the audit committee, the only director that would have the compensation expertise that is required on the compensation committee. If that would force the company to be in noncompliance, then what companies do is——

Senator SCHUMER. How about take away that exception? Any other justification? Let us assume we wrote into the law——

Mr. CASTELLANI. Not as long as the board can function and the company can function.

Senator SCHUMER. OK, thanks. Well, good, we have won you over on at least two-thirds of one of our proposals.

Mr. VERRET. And, legally, Senator, I would offer that failure to seat a quorum could result in a wide variety of legal circumstances, including, for instance, it could be an event of default under the company's debt obligation.

Senator SCHUMER. I am sure we could deal with that, particularly with the quorum issue, in the interim until there was another election.

Thank you, Mr. Chairman. My time has expired.

Chairman REED. Thank you, Senator Schumer.

Senator Corker, please.

Senator CORKER. Thank you, Mr. Chairman, and to the Senator from New York, I appreciate you offering something to look at.

I do want to observe the staggered board issue I think has not been universally accepted, and I think we have a body on the other side of the Capitol that does not have staggered boards, and sometimes things come out of there pretty hot, like the 90-percent tax on the AIG bonuses. So I think there is some merit in that and hope you might consider that particular piece evolving. But I want to say one other thing.

Professor Coates, I know that to assume that the folks who own AIG today are the same folks who might have encouraged the risk

would not be a good assumption. I mean, those guys sold out high, and the folks that are left behind—so, again, I do not think you can make that assessment. So I hope we can look at some of those things, and I look forward to really trying to work with you on something that we both might consider to be improved.

We talked to Carl Icahn on the phone some time ago—I shared this with Senator Schumer—and he is obviously someone who cares a great deal about corporate governance. He has written about this, or I would not relay our conversation. It is certainly something he publicly feels. But the whole issue of where companies are incorporated seems to be an issue that is maybe even bigger than anything that has been laid out today. And I wonder if a couple of you might respond to that.

Obviously, companies incorporate in States in many cases that give them many protections and keep shareholders from being able to make huge changes. And I wonder, Professor Coates and Professor Verret, if you might both respond to that, and anybody else who might have something salient.

Mr. VERRET. Well, I am aware that Mr. Icahn has funded North Dakota's Business Incorporation Act. He hired a lawyer to write it for him, and he hopes to get companies to reincorporate to North Dakota.

Having clerked for the Delaware Court of Chancery, I am a bit biased. I think Delaware is a very effective court for litigating corporate governance issues—mostly due to the intelligence and superior talent of their law clerks. But I would also offer that, to some extent, I think some of what is behind some of this effort is short-termism, some of the short-termism that got us into this problem in the first place: Let us cash out on dividends rather than invest in R&D.

And sometimes hedge fund activism is very effective in long-term growth and in sort of rattling the saber a little bit and getting things moving. And sometimes hedge fund activism, though, kills companies that should continue to survive and strips them of their assets. And so I think that is part of what is behind the approach.

Also, I think we——

Senator CORKER. In essence, then, you are saying that you like some activism on behalf of shareholders, but not too much.

Mr. VERRET. Absolutely, and I am a little bit suspicious of Mr. Icahn's motives, at some of his activism in activism in favor of State incorporation.

Senator CORKER. Thank you.

Mr. Coates.

Mr. COATES. So it has been true for a long time that shareholders cannot force a reincorporation from one State to another on their own. They need the board to go along with it. And the board cannot do it on their own; it has got to be a joint decision. And as a result, there is actually relatively little movement between States once they have chosen their initial State of incorporation.

At the moment before they go public, that is really the crucial decision point, and for that reason I think that fact that Delaware has a 70-percent share of the market, so to speak, it reflects well on Delaware. I think it is actually a reasonably healthy sign that

Delaware is being responsive, as best it can, to balancing the interests of both shareholders and the managers that have to run them.

One thing, however, I would note about Delaware and its permissiveness toward a little bit of activism is it only passed that enabling legislation in the past year, and it did it in response to the threat of Federal intervention coming from this body. And so I do not think you should think about Delaware acting on its own to help shareholders. I think you should think about Delaware acting in relationship to this body, and things that you do are going to very much impact it.

Senator CORKER. Mr. Castellani, I have served on several public company boards, certainly not of the size of AIG or some of the other companies we have had troubles with. But I do not think there is any question that boards in many cases—not all, and yours, I am sure, is not this way. But it ends up being sort of a social thing. I mean, you are on the board because the CEO of this company and the CEO of that company is on the board, and, you know, it is sort of a status thing in many cases. The CEO in many cases helps select who those board members are. And most of the time these board—many of the times, these board members have their own fish to fry. They have companies that they run, they are busy with, and, for instance, a complex financial institution, there is no way, like no possible way that most board members of these institutions really understand some of the risks that are taking place. With the limited number of board meetings, even if they are on the audit committee, very difficult to do.

So some of these things need to be addressed certainly by governance issues that we might address here, hopefully not too many. Some of them need to be addressed, obviously, internally at the companies. I know you have advocated that in the office. But that issue of sort of the culture of the way boards in many cases are. Not in every case. I wonder if you might have a comment there, and then add to that—I am familiar with a company that makes investments in large companies, and one of the rules they have is they do not allow the CEO himself to actually serve on the board. They report to the board. They are at the meeting. But they do not allow them to serve on the board. So I would love for you to respond to both of those inquiries.

Mr. CASTELLANI. I think, Senator, for your first question, what you are reflecting may have been the experience when you served on the boards. But what I think it does not reflect is the tremendous change that has occurred in the boardrooms over the last 8 years.

We now see boards of directors, in the case of Business Roundtable companies, that are at least 80 percent independent, and that is, the directors are independent of the company management.

Indeed, the governance committees or the nominating committees that nominate the directors by requirement of the listing standards and the SEC are made up entirely of independent directors. So the nomination of a board member, a prospective board member, is no longer—if it indeed every was—controlled by the chief executive officer.

And then, third, I would point out particularly the amount of time that is involved and the amount of expertise that is involved.

It is not only the specific requirement of the expertise that is in the listing standards and the SEC requirements, but indeed what boards themselves are demanding and what companies and their shareholders are demanding has resulted in not only greater expertise in specific areas, but a tremendous increase in the amount of time.

For example, I was recently talking to the chair of the audit committee of a large U.S. company. That chair spent 800 hours of, in this case, his time as the chair of an audit committee over the last year because of some very complex financial issues. So the board members are spending more and more time. So I would submit to you, sir, that it is very different than when you served on the boards.

And in terms of the boards being able to have the CEO as a member of the board, the CEO as a member of a board, in fact, the CEO and chairman where companies choose it, is a very, very important nexus between the governance of a corporation and the management of a corporation.

We have found and experience has shown over a long period of time that if you separate the governance from the management, you get precisely the kinds of problems that this Committee is trying to avoid. So having the CEO on the board is a very, very important nexus. In many cases, companies and boards believe that having the CEO as chairman of the board is also very important.

Again, my point would be what I have said in my testimony: That is up to every company to decide, and their board of directors representing the shareholders to decide, rather than be prescriptive, because it is not always right, but it is always right for the company that makes the right decision, and they should be allowed to make that decision.

Senator CORKER. Thank you.

Chairman REED. Thank you very much, Senator Corker.

Senator Menendez, please.

Senator MENENDEZ. Thank you, Mr. Chairman. Thank you all for your testimony.

Let me ask you, I understand that in a previous question, most of you—I understand just one or two objections, but most of you said that you support the SEC's May 20th rule to allow certain shareholders to include their nominees and proxies that are sent to all the other shareholders. Do you think that goes far enough? Or is to too far? If you support it, I assume that it goes far enough, it is sufficient. But is there something that should be done than that? Does that embody what we want to see?

Mr. FERLAUTO. Senator Mendendez, I think it is an appropriate use of rule making, which is purely disclosure-based, which is very important; that is that it leaves up to the States the creation of rights in terms of the nomination of directors, but it empowers shareholders to be informed through shareholder communications about the fact that those elections are indeed occurring, and then votes through the proxy materials on that right. So I think that is a good balance.

In addition, something that we have not talked about, the rule goes further, and it empowers shareholders to make binding bylaw amendments to improve those shareholder rights for the election of

directors so that this disclosure right at 1 percent—or actually it is a tiered system that they have in the disclosure rule right now for comment—becomes a floor of disclosure, and then at the State level, through an election system based on a shareholder proposal or a board proposal, they can increase or tweak that right in an interesting way.

For example, I talked about ShareOwners.org being interested in retail shareholders. They can never hope to get 1 percent. But as in the U.K., you might be able to get 100 shareholders, retail shareholders, each owning $5,000 or $10,000 worth together who might be an appropriate group to create different types of rights.

So that there is flexibility, which I think is quite welcome.

Mr. VERRET. Senator Menendez, I would offer that Commissioner Paredes of the SEC has offered a competing proposal to the Chairman's proposal, and I think Commissioner Paredes' proposal is much more reasonable in that it considers facilitation of State law rights rather than running roughshod over them and sort of keeping the lion's share of the meat and leaving the table scraps for the States. And I think Commissioner Paredes' proposal also strikes a balance in limiting the ability of special interests to hijack the corporate ballot. And so I would offer that for this Committee's attention.

Senator MENENDEZ. Does anyone else have any opinion on it?

Mr. CASTELLANI. Yes, Senator, I was not one of the majority who supported that, and I just wanted to make sure that you knew that.

Our concern is that what the SEC is proposing to give access to the shareholders does preempt what has been traditionally done in the States. And, quite frankly, we think that there is symmetry in the argument that says if we trust the shareholders to elect the boards of directors, which we do implicitly, then we ought to trust the shareholders to set the threshold at which shareholders can nominate those board of directors candidates.

Ms. YERGER. I would just note that, as I said earlier, we think this is a core right that should be federalized. The States have failed investors too long, Delaware in particular, and it really only acted when it had to. And I think it is important that the SEC take action on this important reform.

Senator MENENDEZ. Let me ask in a different context. In practice, a corporation serves multiple masters, right? It has shareholders, it has corporate management, its creditors, the public in general. There are many cases where what is best for corporate management may not necessarily be the best for shareholders. Or there are also cases where what is best for shareholders is not what is best for the general public or the financial institution as a whole.

How do we reconcile those tensions?

Mr. CASTELLANI. That is a very interesting question that has been discussed—I am the oldest on the panel, so I can say this—for at least most of my corporate career.

Senator MENENDEZ. There is no one seeking to claim objection, I notice.

[Laughter.]

Mr. CASTELLANI. I am used to it.

Senator MENENDEZ. You have created compromise already.

Mr. CASTELLANI. There was particularly a very important topic in the 1980s, particularly when there was as lot of activity related to hostile takeovers, and that is, to whom is a board of directors and a management responsible? And the argument was a stakeholder argument, that there were shareholders, there were employees, there were communities, there were suppliers, there were customers, all of which had a legitimate position in the decisions.

I would think it is fair to say that in the 1990s and the early part of this decade, that balance switched more to the shareholders, but what happened is the nature of the shareholders has changed very, very considerably. And that is, the average holding period, for example, of a New York Stock Exchange-listed company is about 7½ months. So if your management and your board—you are really dealing with share renters and traders as much, if not more, than shareholders. And I think what we are all discussing here and we all have a perspective on is: Going forward, what is the correct balance between those who have a very, very short-term interest in very quick gain out of a company and may want to do some of the things that have been discussed here? You give access, you give rights to small percentages of shareholders. We already know in many cases how they act. Some funds come in and say, "We own 5 percent of your company. What we want you to do is leverage the company, buy back the shares, give us about a 10-or 20-percent jump, and we are out of here, quickly." As opposed to other shareholders who say, "I think there is a value-added."

I do not know that anybody is in the long term. I do not know that any of us know the right answer to that. But I think, quite frankly, that is the question that is at the crux of what this Committee should be looking at. Obviously——

Mr. FERLAUTO. And, Senator, I—interestingly enough for here, this is where the Business Roundtable and certainly AFSCME, and I think some members of CII agree. It is all about how you empower long-termism and long-term shareholders, which we believe that proxy access ultimately will do, so that the best interests of the company to achieve long-term shareholder value is achieved. And the way you do that, actually, in terms of this long-termism, is getting into the DNA of the board. How does the board become most effective by being diverse, by being able to absorb many different points of view, by being—to evaluate itself to make sure that it is focused on long-term strategic implementation and that CEO pay incentives are aligned with that long strategic vision? And when we see a company that fails, we see a failure in all of those areas, which is bad for the shareholders, which is bad for the employees, which is bad for management, and for all other stakeholders in the process.

So we want proxy access to fix boards because they cannot self-evaluate, because they are not diverse enough to share the interests of their stakeholders, which ultimately they need in order to achieve long-term shareholder value, and because their DNA is warped enough that it only serves management or a minority of shareholders and not achieve value for the long term. And that is the very essence of why we want proxy access and we need it now.

Senator MENENDEZ. Thank you.

Mr. VERRET. Senator, may I just also add quickly, I want to commend Senator Warner and Senator Corker for the introduction of the TARP Recipient Ownership Trust Act. Shareholders and boards are complicated enough. When Government becomes a shareholder, things become even more tricky, and I want to commend the introduction of that act as dealing with some—going down the road to dealing with those unique conflicts.

Chairman REED. Thank you very much. Thank you, Senator Menendez.

Senator Johanns.

Senator JOHANNS. Mr. Chairman, thank you. To all the panel members, thank you very much for being here.

What I am trying to figure out as I listened to this very interesting dialogue between the Senators and each of you, is this: I kind of look at this as maybe a little bit black and white. There are big players here, and there are small players here. But they are all affected by the decisions we make here.

Now, Mr. Ferlauto, if I could start with you, how much money do you have under investment, say at this point in time?

Mr. FERLAUTO. AFSCME itself is a rather small player. Our employee pension system itself has got less than $1 billion in it. But most importantly is that we are concerned about the retirement security of our members, and our members depend on well-functioning capital markets and boards to achieve value. In order for them to pay the benefits, all of our members want a market that will succeed, that has got the ability to achieve a value over time. We are not speaking and we are not active on the part necessarily of what is in our portfolio, but what is in the interests of not only our members, but all American families seeking to achieve long-term financial security. And those are the people that I speak on behalf of.

Senator JOHANNS. Great. Well, I have never had $1 billion under management, so I see you as a big player. What if some institution out there who has $1 billion under investment or $10 billion, or whatever—let us say they are a big player, like I think you are. Let us say you decide that you think the worst possible course of action for a company is to be pro-trade, and there are some that very openly espouse that theory, that trade has really cost jobs and hurt America and this and that.

If you have access to the proxy, you then have the right to elect somebody who espouses that view. Would that be correct?

Mr. FERLAUTO. No, not necessarily. What we have the right to do is to potentially nominate somebody, but in order for somebody to be elected, they would have to be elected by a majority of everybody who is voting, and then presumably all the owners, as in a regular election, would assert their choices based on what is in their self-interests. So that I would assume that a minority player working on any—you know, any motivated self-interest would not be able to achieve victory.

Senator JOHANNS. Here is what I am trying to get to, and I am not trying to be coy about this. I am trying to be very, very direct about this. I have got 100 shares; you have got $1 billion worth of shares. I am pro-trade, let us say, and whoever this institution is—I am not say AFSCME is this, but whoever this institution is, it

takes a very, very different view than I do that may not be in the best interest.

Mr. FERLAUTO. It is actually a very good point, but who I am concerned about are actually the large financial intermediaries, particularly mutual funds, who are seeking to do business, you know, with other large companies to sell their investment products through their 401(k) plans so that they actually may cast their votes in a way that would be looked kindly on by the CEO because they are not voting against his compensation plan, rather than voting in the interests of all the small individual investors who put their money into that fund, you know, thinking that that is the way to achieve value. And those are the kinds of conflicts that are rife in this system that we are very concerned about.

Senator JOHANNS. Yes, and I am going to be very direct again. You and I are going to have an easy time agreeing that there are a lot of ways to be self-interested. A lot of ways. So, Mr. Castellani, let me turn to you. Based on your corporate experience, what impact does that have on your company if there is, for lack of better terminology, ease of entry here?

Mr. CASTELLANI. One of the things that we are concerned about is that it would politicize the board. The board is legally required to represent all shareholders. So each member of the board is to represent all shareholders, not a particularly constituency of shareholders. But, in fact, there are constituencies of shareholders, people who want short-term gains, people who want—you were giving an example, my company, Tenneco, owned Newport News Shipbuilding. We had a shareholder, a nice little group from Connecticut, a group of nuns who owned $2,600 of the company and wanted us to get out of the nuclear shipbuilding business. And every year, they would have that on the proxy.

The point is that dissension first costs the shareholders money, because that is who pays for the proxy process. It doesn't come out of the management's pocket. It doesn't come out of the Government's pocket. The shareholders pay for the dissension.

But second—directly, they pay for the proxy process—but second, boards best operate when they operate by consensus, when there is an agreement among the board of the strategic direction of the company and who should implement that strategic direction. It doesn't mean there isn't discussion. It doesn't mean there isn't questioning, that there isn't dissension. But when they make a decision, companies operate best when you don't second-guess, until there is reason to second-guess, the direction the company is going.

Senator JOHNSON. I am out of time, and I won't press that too much today because we have been given extra time today, but I want to offer one other thought on a totally different approach. I was on a panel yesterday in this room, and as I started my questioning, I said to the panelists, I said, I am going to warn you. I am a former Governor. It just astounds me how we have this philosophy here—and I am very new to this Senate job—it just astounds me how we think all of the best solutions are here in Washington with a Federal approach. This really does impact States in a very, very significant way. That in itself is a very, very profound issue. And yet we just kind of jump right in the middle

of it with this new approach that just casts aside 50 State corporate laws.

And I will share this with you. When I started as Governor many years ago, I decided that I wanted to be a State that attracted business to my State. We needed jobs and we needed economic growth in the State of Nebraska and I decided I was going to take on Delaware to try to make that happen. You know what I realized about Delaware? They had one heck of a good start and they were doing more things right than they were doing wrong and it was going to be very, very difficult to dent that.

And yet in this hearing, again, whether it is Delaware or Nebraska or Wyoming or California, whoever, we have a very, very profound impact on the history of corporate governance in this Nation and I just don't think we should do that lightly. I think you would have 50 Governors in those seats back there ready to come to the table to chew on us about that, because it does have very significant consequences for the States where the jobs do exist, where the jobs are created, where hopefully the businesses grow and expand and create economic opportunities for the people out there who then pay the taxes that allow us to come here and do the social and other programs that we just love to do.

So I just think it is really an important philosophical issue and that is my little sermonette at the end of the questioning. Thank you.

Chairman REED. Thank you, Senator Johanns.

Let us begin the second round.

Ms. Yerger, what is the status of majority voting on Delaware law now? Is it——

Ms. YERGER. Under Delaware, and again, I am not a lawyer, it is not the default standard, but the laws do accommodate majority voting so companies can adopt it voluntarily.

Chairman REED. They can adopt it voluntarily. But under the—and Ms. Cross, under the SEC's proposal, that would not upset Delaware law if you were talking about majority voting. It would be optional.

Ms. CROSS. We don't have a proposal on majority voting. The way it would work with our proxy access is that if there were more people running than there were slots, you would usually revert to plurality voting because majority wouldn't work.

Chairman REED. OK. Thank you.

Mr. Castellani, again, thank you for being here and for your testimony. I think the core of the issue is who knows best about the company, the directors or the shareholders. Under the present arrangement, and we have got enough lawyers who can criticize my legal analysis, is that the directors essentially control access in most companies to the proxy unless you want to mount a very expensive proxy fight. They decide in most cases and in most companies what will get on as an issue and what won't get on as an issue. So the current practice, unless we do something, will leave sort of the directors with critical control of the process and then on both sides of this argument we are talking about empowering shareholders. So your comments, and then I will open it up to the panel.

Mr. CASTELLANI. Sure. First, for the record, let me state I am a scientist and engineer, not a lawyer.

Chairman REED. Well, Senator Bunning, again, thank you on his behalf.

Mr. CASTELLANI. I want to say that as often as I can.

In fact, the directors do not control access to the proxy for all issues. In fact, the SEC controls. Therefore, companies like Tenneco get proposals. All companies get proposals related to social issues, governance issues, economic issues, labor issues, environmental issues. But I don't think that is what you are talking about.

What you are talking about is the access for the purposes of nominating directors and we have to talk about that in the context of any group of shareholders, any single shareholder has an ability, if they can afford it, and it is an expensive proposition——

Chairman REED. Yes.

Mr. CASTELLANI. ——to nominate directors and run in competition to the directors that are nominated by the Nominating Committee. That is how we do takeovers and that is how the companies make sea changes, or investors make sea changes.

What I am concerned about and what we are concerned about is we have, by majority vote, by and large, directors who are elected to represent all shareholders. Those directors are, by and large, elected every year. And so if the shareholders elect the directors and the shareholders can remove the directors under majority voting, then how does the company best operate on behalf of the shareholders?

Is it best operated in letting those directors make, in their collective judgment, decisions about who should be on the board representing the shareholders, who should manage the company, or do we subject those directors or a portion of them—a significant portion, 25 percent of them—to a reelection challenge every year and turn them into essentially corporate politicians, because these are contested elections. They are somehow going to have to be run as contested elections.

And what does that do to the director? Does that then distract her from the business that we all want her to do, which is overseeing the shareholders' interests in that board room, or does she have to be more concerned because the conflicting nominee was elected because they didn't want us to be in the nuclear shipbuilding business, in my case, or they didn't want us to do business in a particular part of the world, or they wanted our product lines to change, or they wanted some practices to change.

What our concern is is that boards should be free to do and responsible for doing what the shareholders want them to do, and that is be good stewards of their investment in the company.

Chairman REED. Well, my sense is—and you are right to narrow down my focus to the directors' election because social issues, they do get on the board because the SEC has required that and there is an argument they could require the directors also to be subject to proxy access.

But the other side of the argument is there is a group of directors that essentially nominates the Nominating Committee. Usually the Nominating Committee is directors——

Mr. CASTELLANI. Right.

Chairman REED. ——who then choose other people they think are sympathetic to them and their views and the shareholders, unless they are not in a proxy fight, generally they either have to accept this board, and many times, as you pointed out, the board is not elected by a majority. In fact, there are many times where less than a majority of shareholders, a small number of shareholders even vote, and I think there has been a lot of discussion back and forth about motivation for voting, but most shareholders don't know—it is not the politics as practiced elsewhere. Most shareholders are reflecting on their dividends, their share value, what they think the company should be doing economically for their benefit. It is quite self-interested.

Mr. CASTELLANI. I think, Senator, another point I should make—two other points I should make is that good boards, and certainly I would include our companies, have means by which they communicate and allow shareholders to suggest directors. And in fact, that is something that all of our member companies do now.

So small groups of shareholders—and let us not kid ourselves. I mean, any management, any board that is worth anything, that can wake up and make their own breakfast in the morning, when a large shareholder comes in and says, we want to talk to you about the make-up of the board, by God, we listen, because you forget, we are in the business of trying to sell our shares to members and convince investors that we are a good company to invest in. So we listen to investors.

The problem that we have is that sometimes in these discussions, you are talking about individual investors and we have to be responsive to our largest investors, which are institutional investors. And so the desires of individuals come through intermediaries, the mutual fund and the fund managers, and that message is very different than what some of the things that you are describing.

Chairman REED. This is a conversation that could go on at length, but I am going to stop and recognize Senator Bunning. Thank you.

Senator BUNNING. Thank you very much.

Professor Verret, there has been a lot of talk about giving shareholders a vote on pay packages but little discussion on the details. If we were to require such a vote, what specifically should we vote on and how often should we vote?

Mr. VERRET. Well, notably, I think one thing I would draw out is that there is a big difference between "say-on-pay" and say on severance packages. I think those are two distinct issues. There is a healthy debate about both of them, but I think it is a mistake to lump them in together. I think the big difference between say on severance is that severance packages are used to facilitate efficient mergers and acquisitions. Basically, sometimes when a good M&A deal goes through, the CEO of the target has to go. It is, you have got to leave and here is some walking-away money. And those deals are great, and most of the——

Senator BUNNING. But that isn't my question.

Mr. VERRET. OK. So my first answer is, I would differentiate "say-on-pay" and say on severance.

With respect to "say-on-pay," I think one of the details is how often would you approve "say-on-pay," and I am aware that the

United Brotherhood of Carpenters, at least, wants it every 3 years. I think some groups prefer it every——

Senator BUNNING. Every 3 years?

Mr. VERRET. Yes. They would prefer the pay package——

Senator BUNNING. By the time the second year came around, maybe the company would be in Chapter 11.

Mr. VERRET. Well, perhaps, but what they propose is that typically, pay packages are negotiated over longer terms, so "say-on-pay" should be negotiated over the longer term. You don't necessarily reapprove the pay package every year. Sometimes they are longer term. Sometimes they are 5 or 10 years.

So one of the things I would suggest is that you leave open the boards of directors and the shareholders to determine how they want "say-on-pay" to work.

Senator BUNNING. Then you think they should be left open to the boards in negotiating with whoever they want as their CEO?

Mr. VERRET. I worry about the effects of one-size-fits-all packages, and I think we have seen that effect in Britain with their "say-on-pay" rules.

Senator BUNNING. And you think the negotiations on golden parachutes should be different completely?

Mr. VERRET. They should be, because sometimes you have to do them very quickly, not enough time to get approval for the package to deal with the specific merger.

Senator BUNNING. Would you like to comment?

Mr. COATES. Very briefly. "Say-on-pay" is advisory votes only. There is no need for speed. There is no need for prior voting. The U.K., the Netherlands, Australia have successfully implemented this for years, and in fact, the evidence from the U.K. suggests that it almost never has a bad effect on companies, that almost all of the time, shareholders approve the pay package as presented. There are a few outliers that get their pay packages voted down and the result of that has been a better alignment of shareholder and manager interests over the past 5 years in the United Kingdom. So I think the U.K. model is working and I think it is a reasonable place to start.

Mr. VERRET. Although as I am sure Professor Coates might be aware, the shareholder electorate in the United Kingdom is very different from the United States—

Senator BUNNING. No. This is not a discussion between—we have to ask the questions.

Mr. VERRET. Sorry. He is my old professor and he gave me a "B" in corporate law, so I have to——

Senator BUNNING. A "B"? That is pretty good.

[Laughter.]

Senator BUNNING. Unbelievable. I will give you a chance to talk again.

As States respond to concerns about corporate governance issues with changes to their own laws, is there really a need to federalize business law?

Mr. VERRET. Well, I would agree, and I think we haven't even had time to see the effect of the State changes on proxy access operate after Delaware and the other States facilitated majority voting in 2006. From 2006 to 2007, we saw an increase in majority

voting at companies from 20 percent of the S&P 500 to 50 percent. So Delaware just amended its code in, I think, March, and the ABA is about to change the Model Business Code. So there hasn't been enough time to see, I think, all the proxy access bylaws that I think we are going to see adopted by boards.

Senator BUNNING. Ann, would you like to comment?

Ms. YERGER. I firmly believe that the problem here are the problem companies and——

Senator BUNNING. Yes, we know about them.

Ms. YERGER. ——and that is why I believe these issues should be federalized, frankly.

Senator BUNNING. Yes, but they are at the trough every time they have a problem, whether they are a finance company or whether they are an insurance company, whether they are an auto company. If you think they are too big to fail, then the Federal Government is the backstop. And if they are a GSE, we are the backstop for sure. So do you have some other suggestions that we might not have to be the backstop?

Ms. YERGER. Suggestions regarding specifically—I am sorry. I have lost the question here.

Senator BUNNING. You lost the question. Well, about the laws being changed in the States on corporate governance.

Ms. YERGER. I feel that majority voting, we have had plenty of experience and the fact is that there are many companies—in fact, most small companies have not adopted it. We think it is a core owner right and as a result it should be federalized.

I also believe that proxy access should be federalized. The fact is, when council members invest in domestic companies, they are not doing a portfolio of Delaware companies or Nebraska companies. They are doing a portfolio of the U.S. companies, and we either make a decision that these are basic rights we should be offering to owners of any company here in the United States or not. And I think the Council firmly believes that——

Senator BUNNING. The fact that if I live in Kentucky, where I live, you want me to come in and say, the Federal Government should make the rules for every company in Kentucky.

Ms. YERGER. Regarding access on majority voting——

Senator BUNNING. Yes.

Ms. YERGER. ——yes, sir.

Senator BUNNING. You do.

Mr. FERLAUTO. If I may, another——

Senator BUNNING. It won't sell.

Mr. FERLAUTO. Another approach to this which I think might sell is that give shareholders the power to decide what State they will incorporate in, and therefore you can——

Senator BUNNING. Well, they do have the power.

Mr. FERLAUTO. No, they don't, actually, is that right now, it is the boards through the IPO——

Senator BUNNING. Oh, you mean beforehand, before they incorporate.

Mr. FERLAUTO. Maybe every 5 years. You talked about one way to do this is to give them a right every four or 5 years, similar to Mr. Coates's idea, that rather than opting in and opting out of a variety of laws, they actually have a right to decide on whether the

charter and powers of a particular State are appropriate for them at a particular moment and allow shareholders to decide on their own——

Senator BUNNING. You, as a billion-dollar investor, you as a person who controls $1 billion worth of investment, would say that to the shareholders after the fact, after they have already incorporated?

Mr. FERLAUTO. I agree that there should be more—that the State of incorporation should be a greater factor when IPOs are made and that there is not enough emphasis or focus on corporate governance during the IPO process, and I think that would be something very interesting for the SEC to look at for perhaps new rule making. But if you are talking about empowering the States, one thing that you might consider to do is to give them real power and create real competition among Delaware and Nebraska and North Dakota and California and every other State by making State corporation real and let them compete. The only way you can let them compete is by giving shareholders, the owners of these companies, real power to make a decision about what laws are most appropriate to them.

Senator BUNNING. It won't sell.

Mr. FERLAUTO. It is a market-based——

Senator BUNNING. It won't sell. We can't sell it, because we would have 50 Governors up here every day trying to tell us to mind our own business.

Mr. FERLAUTO. Yes, but——

Senator BUNNING. Thank you. Thank you, Mr. Chairman.

Chairman REED. Senator Corker.

Senator CORKER. Thank you all for your testimony, and again, both of you, for having the hearing.

I think what—well, based on backgrounds, Mr. Ferlauto and I might have a difference of opinion on many things. I think what you were trying to communicate is giving shareholders—you can domicile. You can change the corporate domicile at any time you wish. It doesn't matter where you are incorporated.

I actually think that Senator Johanns was referring to a race to the top and I do think that, while I realize my friend from Delaware may disagree, it actually does give shareholders the ability to influence things and I hope that we will—I am not sure it wouldn't sell and I hope it is something we will understand. I am not sure I understand enough about it myself to support it, but I do know that it certainly would give shareholders much greater freedoms.

I do want to say to you, Mr. Verret, that I think you were dead on in your opening comments that here we are talking about lots of things, but really what has driven this has been moral hazard, has been what happened with GSEs, and many of the policies we put in place here, the failure of regulators, short-term thinking, credit-rating agencies that didn't do what everyone thought they were doing, and I am not sure about the mark-to-market issue. We might debate that some.

But I hope that we don't go overboard with what we do here because it is other factors—many other factors—that have created this. I do, on the other hand, think that boards are the final governance issue, and if you have good boards that actually under-

stand the risk, especially at financial institutions, I think we might actually look at differentiating things that have to do with large companies, financial companies that offer systemic risk. We may look at those a little differently.

But let us get down to this risk. Senator Schumer is close to our Chairman. My guess is that just knowing how things work around here, that he may to defer to him on some of these corporate governance issues. He laid out six things. My sense is that the shareholder "say-on-pay" issue as advisory was not particularly controversial amongst most here, is that correct, as an advisory issue.

The shareholder input didn't seem to be——

Mr. CASTELLANI. Why do it every year? Why require it for all companies?

Senator CORKER. And maybe there is a size issue. By the way, I am not agreeing myself necessarily with all these. I am just asking you all. The independent chairperson seemed to be somewhat agreed by half and somewhat disagreed, especially Mr. Castellani, is that correct, thought that was a bad idea.

Mr. CASTELLANI. We believe that it should be up to every board of directors and every company to decide what is best for them.

Senator CORKER. Does anybody other than him disagree with what was put forth there?

Ms. CROSS. If I could note, I am not—on behalf of the SEC, I am not expressing views. The Commission hasn't expressed views on all these points.

Senator CORKER. I understand.

Ms. CROSS. By my silence, I am not commenting.

Senator CORKER. I have got you.

Ms. CROSS. Thank you.

Ms. YERGER. We are believers in one-size-fits-all on this issue.

Senator CORKER. You are believers in that.

Ms. YERGER. Yes.

Senator CORKER. The stagger board issue, I hope stays in place and is not eliminated, personally. The majority voting issue didn't seem to be a big issue to anybody here. Mr. Castellani, since you represent——

Mr. CASTELLANI. Most of our members have majority voting.

Senator CORKER. So not a big deal. So the risk committee is the one issue I think we haven't touched on——

Mr. CASTELLANI. It is very important.

Senator CORKER. ——and I just wonder if, since I think we have got pretty good input from you all in these other areas, what are your thoughts, in whatever order you want to give them, on the risk committee issue?

Mr. CASTELLANI. Senator, if I might start, I think there probably is going to be pretty close to—well, I don't know whether we would all be unanimous. The fundamental issue, which is whether or not a board of directors should regularly and thoroughly analyze the risks that face the company and its shareholders is not one on which there is any argument. That is one of the fundamental purposes of a board of directors.

What Senator Schumer in his bill prescribes, however, is not appropriate, and that is that you create a separate committee to do that. Some companies choose to do it within separate committees,

but other companies think that it is better done within its audit committee because its greatest risk may be in its financial structures. Some companies do it, because of the nature of the products, in different committees because their greater risk may be either the products or the markets in which they serve as opposed to financial risk.

So our suggestion is that it is done, but don't specify that you create another committee, particularly where we have already run the risk of being so prescriptive to how many committees and what type of committees boards should have that we run the risk of being the best at governance compliance and the worst at governance implementation.

Senator CORKER. I understand. Is there anybody that strongly disagrees with the position he just put forth?

Mr. FERLAUTO. Let me just add one caveat to that. I think John is right that there needs to be some flexibility, but there also needs to be some very explicit disclosure about who is responsible for risk, what committee is responsible for it, what is their charter, what powers that they have, how they will review risk, and that needs to be disclosed much more heavily than it does right now.

Senator CORKER. So you would moderate the bill in that way and specify that it doesn't have to have a separate committee, but that function has to take place within the board——

Mr. FERLAUTO. And it needs to be disclosed to shareholders in a very precise way, OK.

Senator CORKER. So, since I am the last questioner——

Chairman REED. Go ahead.

Senator CORKER. ——let us go back to this issue of the State thing again, which longer-term advocates of shareholder rights have said, look, if we could just give shareholders the ability to race to the top, as Senator Johanns, I think was alluding to, I am not positive—I certainly asked the question earlier in the same light—Mr. Castellani, how do you feel about shareholders being able to say that you are not going to be domiciled in whatever State you are in but you are going to be in Texas because it gives great shareholder rights?

Mr. CASTELLANI. Senator, if the majority of the shareholders want to change the logo to pink and make me stand on one leg, I change the logo to pink and stand on one leg. So it really is what the majority of the shareholders. But I think it is not a decision—I think we kid ourselves that this is a decision that is based on what Mr. Icahn is advocating, which is the ability of greater ease of change of control.

One of the reasons why Delaware is very attractive to corporations is Delaware has an infrastructure, with all deference to my colleague here, that is very efficient in adjudicating issues between companies and shareholders, and shareholders and shareholders, prior to annual meetings or whenever they need to be adjudicated. Delaware is very, very good. They have—what have they got, ten judges and a couple hundred staff people that make decisions very, very quickly. So it is not just the structure of the law that is attractive but it is the ability of the State to implement its law and make decisions when issues are in contention very quickly and very efficiently.

Senator CORKER. But while you are selling Delaware, and I am sure the Chambers of Commerce up there like that——

Mr. CASTELLANI. Well, let me give equal. New Jersey is also very good. Ohio is very good——

[Laughter.]

Mr. CASTELLANI. ——and I am sure——

Senator CORKER. Their pension funds must invest in your company.

Mr. CASTELLANI. ——Tennessee is very good.

Senator CORKER. But back to the issue of whether they are good or not, and my guess is some of those are not so good that you just mentioned, but giving the shareholders the ability to do that is, in your opinion—and, by the way, by law? You have no problem with that?

Mr. CASTELLANI. Yes, I would. Why, again, prescribe for all shareholders of all companies something that they already have the right to do within the States where they are incorporated if the States allow it.

Senator CORKER. Does anybody strongly disagree with that?

Mr. COATES. Just so we are clear, currently, shareholders do not have the right——

Mr. CASTELLANI. Do not have the right.

Mr. COATES. ——do not have the right to force a reincorporation over the objection of the board, and I actually think for once I am on sort of the management side of the Business Roundtable, at least if I heard his comment earlier. I don't think that would be a good idea to introduce. It would be more powerful and more disruptive on behalf of shareholders than anything the SEC is proposing in the current environment.

Senator CORKER. So you think that is a really bad idea?

Mr. COATES. Well, I just—I think it would require a great deal of thought about how exactly it would be implemented, and I think to think of it as somehow a weaker version of shareholder proxy access is just descriptively a mistake. It would be actually more empowering——

Senator CORKER. No, I agree.

Mr. COATES. OK.

Senator CORKER. It is the most empowering thing, I think, that——

Mr. CASTELLANI. And I want to make very clear that I associate myself with those remarks, that that is—I can't imagine what the benefit would be compared to the costs or the disruption.

Senator CORKER. Do you want to make a comment?

Mr. FERLAUTO. I was just going to say, I think that is true. I think the moderate form is establishing the disclosure right for proxy access. But to go all the way to keep Governors happy, if you will, is to create competition amongst the States by fully empowering shareholders.

Ms. YERGER. As radical as the Council is, I have to tell you, this is not an issue we have endorsed at this point, is giving owners the right to reincorporate an entity. We are studying it, but I think that it is a complex issue that I would be very surprised the corporate community would support.

Mr. FERLAUTO. This is the moderate version.

Mr. VERRET. I would also offer that proposals and changes of State of incorporation get introduced from time to time and the results are always there is pretty low shareholder interest in that.

Senator CORKER. OK. Listen, I want to say that while I ask numbers of questions, I am going to give the same disclosure as the SEC. None of them necessarily represent my point of view. It is just the best way to sort of understand what a very diverse panel of six people think about an issue and I very much appreciate all of your input today.

I hope that if we do anything on corporate governance, I hope that it is modest and we realize that at the end of the day, a lot of factors led to the failures that we have had today, much of which, candidly, was generated out of this body and those who came before. I hope that we don't create a similar problem or another type of problem by over-legislating how the private sector governs itself. But I thank you all for your testimony.

Chairman REED. Thank you, Senator Corker.

I want to thank all the witnesses. This has been a very insightful panel, and I particularly thank you for the time and effort you put into this. It was quite obvious from the testimony and from your response to questions.

Let me say for the record, witnesses' complete written testimony will become part of the hearing record and we are happy to include supporting documentation for the record. The record will remain open for 1 week, until August 5, 2009, for Members to submit their own personal written statements or additional questions for the witnesses. We ask that witnesses respond to any written questions that are sent within 2 weeks and note that the record will close after 6 weeks in order for the hearing print to be prepared.

With that, I thank you again and thank my colleagues. The hearing is adjourned.

[Whereupon, at 4:38 p.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

PREPARED STATEMENT OF CHAIRMAN JACK REED

I want to welcome everyone, and thank all of our witnesses for appearing today.

Today's hearing will focus on corporate boardrooms and try to help us better understand the misaligned incentives that drove Wall Street executives to take harmful risks with the life savings and retirement nest eggs of the American people.

This Subcommittee has held several hearings in recent months to focus on gaps in our financial regulatory system, including the largely unregulated markets for over-the-counter derivatives, hedge funds and other private investment pools. We have also examined problems that resulted from regulators simply failing to use the authority they had, such as our hearing in March that uncovered defective risk management systems at major financial institutions.

But although regulators play a critical role in policing the markets, they will always struggle to keep up with evolving and cutting-edge industries. Today's hearing will examine how we can better empower shareholders to hold corporate boards accountable for their actions, and make sure that executive pay and other incentives are used to help companies better focus on long-term performance goals over day-to-day profits.

Wall Street executives who pursued reckless products and activities they did not understand brought our financial system to its knees. Many of the boards that were supposed to look out for shareholder interests failed at this most basic of jobs. This hearing will help determine where the corporate governance structure is strong, where it needs improvement, and what role the Federal Government should play in this effort.

I will ask our witnesses what the financial crisis has revealed about current laws and regulations surrounding corporate governance, including executive compensation, board composition, election of directors and other proxy rules, and risk management. In particular, we will discuss proposals to improve the quality of boards by increasing shareholder input into board membership and requiring annual election of, and majority voting for, each board member.

We will also discuss requiring "say-on-pay," or shareholder endorsements of executive compensation. We need to find ways to help public companies align their compensation practices with long-term shareholder value and, for financial institutions, overall firm safety and soundness. We also need to ensure that compensation committee members—who play key roles in setting executive pay—are appropriately independent from the firm managers they are paying.

Other key proposals would require public companies to create risk management committees on their boards, and separate the chair and CEO positions to ensure that the CEO is held accountable by the board and an independent chair.

I hope today's hearing will allow us to examine these and other proposals, and take needed steps to promote corporate responsiveness to the interests of shareholders. I welcome today's witnesses and look forward to their testimony.

PREPARED STATEMENT OF MEREDITH B. CROSS

DIRECTOR, DIVISION OF CORPORATION FINANCE, SECURITIES AND EXCHANGE COMMISSION

JULY 29, 2009

Introduction

Good afternoon Chairman Reed, Ranking Member Bunning, and Members of the Subcommittee. My name is Meredith Cross, and I am the Director of the Division of Corporation Finance at the U.S. Securities and Exchange Commission. I just rejoined the SEC staff in June of this year after more than 10 years in private practice here in Washington. I worked at the SEC for most of the 1990s, and I am delighted to be back at the agency at this critical time in the regulation of our financial markets. I am pleased to testify on behalf of the Commission today on the topics of corporate governance and the agency's ongoing efforts to assure that investors have the information they need to make educated investment and voting decisions.

Investor confidence is critical to our securities markets. In the context of the issues that the Subcommittee is discussing today, investors need to feel confident that they have the information they need to make educated decisions about their investments, including whether to reelect or replace members of the board of directors. Good corporate governance is essential to investor confidence in the markets, and it cannot exist without transparency—that is, timely and complete disclosure of material information. In responding to the market crisis and erosion of investor confidence, the Commission has identified and taken steps over the past months in

a number of significant areas where the Commission believes enhanced disclosure standards and other rule changes may further address the concerns of the investing public.

Shareholder Director Nominations

A fundamental concept underlying corporate law is that a company's board of directors, while charged with managerial oversight of the company, is accountable to its shareholders who have the power to elect the board. Thus, boards are accountable to shareholders for their decisions concerning, among other things, executive pay, and for their oversight of the companies' management and operations, including the risks that companies undertake. While shareholders have a right under State corporate law to nominate candidates for a company's board of directors, it can be costly to conduct a proxy contest, so this right is only rarely exercised.

The Commission's proxy rules seek to enable the corporate proxy process to function, as nearly as possible, as a replacement for in-person participation at a meeting of shareholders. With the wide dispersion of stock prevalent in today's markets, requiring actual in-person participation at a shareholders' meeting is not a feasible way for most shareholders to exercise their rights—including their rights to nominate and elect directors. Two months ago, the Commission voted to approve for notice and comment proposals that are designed to help shareholders to more effectively exercise their State law right to nominate directors. [1]

Under the proposals, shareholders who otherwise have the right to nominate directors at a shareholder meeting would, subject to certain conditions, be able to have a limited number of nominees included in the company proxy materials that are sent to all shareholders whose votes are being solicited. To be eligible to have a nominee or nominees included in a company's proxy materials, a shareholder would have to meet certain security ownership requirements and other specified criteria, provide certifications about the shareholder's intent, and file a notice with the Commission of its intent to nominate a candidate. The notice would include specified disclosure about the nominating shareholder and the nominee for inclusion in the company's proxy materials. This aspect of the proposals is designed to provide important information to all shareholders about qualifying shareholder board nominees so that shareholders can make a more informed voting decision.

To further facilitate shareholder involvement in the director nomination process, the proposals also include amendments to Rule 14a-8 under the Exchange Act, which currently allows a company to exclude from its proxy materials a shareholder proposal that relates to a nomination or an election for membership on the company's board of directors or a procedure for such nomination or election. This so-called "election exclusion" can prevent a shareholder from including in a company's proxy materials a shareholder proposal that would amend, or that requests an amendment to, a company's governing documents regarding nomination procedures or disclosures related to shareholder nominations. Under the proposed amendment to the shareholder proposal rule, companies would be required to include such proposals in their proxy materials, provided the other requirements of the rule are met.

The proposing release seeks comments from the public on the rule proposals generally and also includes numerous specific questions. The comment process is a critical component of every rule making, and one that the Commission takes very seriously. We sincerely want to hear from all interested parties and truly believe that the rule-making process is better informed as a result of the comments that we receive.

Proxy Disclosure Enhancements

One of the key disclosure documents for shareholders in deciding how to vote in the election of directors is the proxy statement. This document, which includes information about the directors, certain board practices, executive compensation, related party transactions, and other matters, is a critical component of the U.S. corporate governance landscape. The Commission, on July 1, voted to propose a series of rule

[1] "Facilitating Shareholder Director Nominations", Securities Exchange Act Release No. 34-60089 (June 10, 2009). The Commission's vote was 3–2 in favor of the proposal, with Chairman Schapiro and Commissioners Walter and Aguilar voting to approve the staff's recommendation to propose rules, and Commissioners Casey and Paredes voting not to approve the staff's recommendation. For the Commissioners' statements regarding the proposal at the Commission meeting at which the proposal was considered, see *http://www.sec.gov/news/speech.shtml#chair*.

amendments that are designed to significantly improve proxy disclosures, thereby enabling shareholders to make more informed voting decisions.[2]

One area that has garnered significant public attention and can drive investors' investment and voting decisions is executive compensation. The Commission's existing disclosure rules are designed to elicit comprehensive and detailed information about all elements of a company's compensation practices and procedures with respect to its most senior executives. This information includes a "Compensation, Discussion and Analysis"; detailed tables followed by related narrative disclosure; and a report from the Compensation Committee. Based on this information, investors can form opinions about a company's executive compensation policies, including whether the board of directors has acted appropriately in setting incentives and rewards for management.

Today, if material, a company must discuss the risk considerations of its compensation policies and decisions with respect to its "named executive officers." ("Named executive officers" generally include the chief executive officer, chief financial officer, and next three highest paid officers.) Some have argued, however, that the recent financial crisis has demonstrated that a company's compensation practices beyond these five named executive officers can have a dramatic impact on its risk profile; the manner in which some trading arms of financial institutions have been compensated would be an example. Therefore, the Commission has proposed requiring disclosure about how the company incentivizes its employees—beyond the named executive officers—if its compensation policies may result in material risks to the company. This disclosure is intended to enable investors to gauge whether the company's compensation policies create appropriate incentives for its employees, as opposed to creating incentives for employees to act in a way that creates risks not aligned with the risk objectives of the company.

The Commission's recent proxy enhancement proposals also would require expanded information about the qualifications of directors and director candidates, about the board's leadership structure and role in risk management, and about potential conflicts of interests of compensation consultants. The proposals also would improve the reporting of annual stock and option awards to company executives and directors, and would require quicker reporting of shareholder vote results. The Commission believes that all of this information would enable shareholders to more intelligently exercise their proxy vote, thereby further enhancing corporate accountability.

Broker Discretionary Voting

Also on July 1, the Commission approved changes to New York Stock Exchange Rule 452, which governs broker discretionary voting, to prohibit brokers from voting shares held in street name in director elections unless they have received specific voting instructions from their customers.[3] NYSE Rule 452 generally allows brokers to vote such shares on behalf of their customers in uncontested director elections, as such elections are currently deemed to be "routine;" under the revised rule, such elections will no longer be deemed to be routine. This amendment, which the NYSE approved at least in part based on recommendations from the NYSE's Proxy Working Group, will become effective on January 1, 2010.

The Commission also has asked that the staff undertake—this year—a comprehensive review of other potential improvements to the proxy voting system and rules governing shareholder communications, including exploring whether issuers should have better means to communicate with street name holders. With over 800 billion shares being voted annually at over 7,000 company meetings, it is imperative that our proxy voting process work well, beginning with the quality of disclosure and continuing through to the integrity of the vote results.

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[2] "Proxy Disclosure and Solicitation Enhancements," Securities Exchange Act Release No.34-60280 (July 10, 2009).

[3] "Order Approving Proposed Rule Change, as modified by Amendment No. 4, to Amend NYSE Rule 452 and Corresponding Listed Company Manual Section 402.08 to Eliminate Broker Discretionary Voting for the Election of Directors, Except for Companies Registered Under the Investment Company Act of 1940, and to Codify Two Previously Published Interpretations that Do Not Permit Broker Discretionary Voting for Material Amendments to Investment Advisory Contracts with an Investment Company," Securities Exchange Act Release No. 34-60215 (July 1, 2009). The Commission's vote was 3-2 in favor of the proposal, with Chairman Schapiro and Commissioners Walter and Aguilar voting to approve the rule change, and Commissioners Casey and Paredes voting not to approve the rule change. For the Commissioners' statements regarding the proposal at the Commission meeting at which the rule change was approved, see *http://www.sec.gov/news/speech.shtml#chair*.

Say-on-Pay for TARP Companies

Also on July 1, the Commission proposed amendments to the proxy rules to set out the requirements for a "say-on-pay" vote at public companies that that have received (and not repaid) financial assistance under the Troubled Asset Relief Program.[4] Under the Emergency Economic Stabilization Act of 2009, these companies are required to permit an annual advisory shareholder vote on executive compensation. Consistent with the EESA, the Commission's proposals would require public companies that are TARP recipients to provide a separate shareholder vote on executive compensation in proxy solicitations during the period in which any obligation arising from financial assistance provided under the TARP remains outstanding. These proposals are intended to clarify what is necessary under the Commission's proxy rules to comply with the EESA vote requirement and help to assure that TARP recipients provide useful information to shareholders about the nature of the required advisory vote on executive compensation.

Conclusion

As governance and compensation practices continue to evolve, the Commission will remain vigilant in seeking to assure that our disclosure rules provide investors with the information they need to make informed investment and voting decisions. We know that there also is a great deal of thought and work outside the agency regarding corporate governance and executive compensation best practices, and we stand ready to lend whatever assistance we can in those efforts.

Thank you again for inviting me to appear before you today and for the Subcommittee's support of the agency in its efforts at this critical time for the Nation's investors. I would be happy to answer any questions you may have.

PREPARED STATEMENT OF JOHN C. COATES IV

JOHN F. COGAN, JR., PROFESSOR OF LAW AND ECONOMICS, HARVARD LAW SCHOOL

JULY 29, 2009

Introduction

Chairman Reed, Ranking Member Bunning, and Members of the Subcommittee, I want to thank you for inviting me to testify. Effective corporate governance is a crucial foundation for economic growth, and I am honored to have been asked to participate.

A. Are There Any General Lessons for Corporate Governance from the Financial Crisis?

Some have described the ongoing financial crisis as reflecting poorly on U.S. corporate governance, as with the accounting scandals and stock market bubbles of the late 1990s and early 2000s that led to the Sarbanes-Oxley Act. Unlike those episodes, however, the ongoing financial crisis has not exposed new and widespread problems with the basic governance of most U.S. publicly held corporations. Outside the financial and automotive sectors, most companies have suffered only as a result of the crisis, and did not contribute to or cause it. Stock prices have fallen across the board, but most price declines have more to do with the challenges facing the real economy, and the spillovers from the financial sector on companies in need of new capital, and little to do with any general problem with corporate governance. As a result, we have learned relatively little about many long-standing concerns and debates surrounding the governance of publicly held corporations—and there are few if any easy lessons that can be drawn from the crisis for corporate governance generally.

I do not mean to minimize those concerns and debates, or suggest lawmakers should remain passive in the field of corporate governance. To the contrary, the crisis makes reform more important and urgent than ever, because well-governed companies recover and adapt more readily than poorly governed firms. But the best reform path will need to attend to differences between governance across industries, and ways that corporate governance interacts with industry-based regulation—and in particular, financial industry regulation—if legal changes are not to make things worse, rather than better. Governance flaws at Citigroup differed dramatically from governance flaws at GM, and attempts to fix the problems at firms like GM through laws directed at all public companies could make things worse at firms like Citigroup.

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[4] "Shareholder Approval of Executive Compensation of TARP Recipients," Securities Exchange Act Release No. 34-60218 (July 1, 2009).

One important problem at financial firms was excessive risk-taking, stemming from a so-called "bonus culture" of compensation practices strongly linked to share prices. But the risks that financial firms took on were harmful for the Nation as a whole because the financial firms were so important (and complex) and existing resolution authority so weak and poorly designed that those financial firms could not generally be allowed to fail. As a result, in economic terms, financial firms' compensation practices did not take into account the external effects on taxpayers in the event of insolvency. In effect, financial firms were allowed to gamble with taxpayer money. This would have been true even if managers of those firms had been perfect stewards of shareholder wealth. The suggestion of my colleagues Holger Spamann and Lucian Bebchuk (2009)—praised by the *New York Times* editors earlier this week—that financial firms be required to link compensation to returns on their bonds as well as their common stocks reflects this point. Shareholders are not the only important corporate constituency to consider in setting corporate governance rules for banks.

At most public companies, the diagnosis has not been the same. If anything, the conventional critique of the governance of nonfinancial companies is that boards and managers have tended (from the shareholder perspective) to be excessively resistant to change, and to have tied executive compensation too weakly with performance. When commentators attempt to link compensation at firms like AIG and claims about excessive executive compensation at public companies generally, they fail to acknowledge that most shareholders do not mind if executives make an enormous amount of money, as long as shareholders also gain. Efforts to increase shareholder power to encourage managers more strongly to pursue shareholder wealth could—at financial firms—undermine efforts by bank regulators to restrain risk-taking by those same firms. The most important practical lesson of the financial crisis is, then, this: whatever form general corporate governance reform takes, careful thought should be given to exempting—or at least allowing relevant financial regulatory authorities to exempt or override—financial firms from those reforms.

B. Evidence on Policy Options

Turning from the general lessons of the financial crisis to some of the specific governance reforms that have been discussed or proposed in the last few years, it is important to bear in mind that corporate governance is not rocket science—in fact, it is much more complicated than rocket science. Corporations are in their simplest sense large groups of people coordinating their activities for profit. Science has a hard enough task tracking inert matter moving through space; it has a harder time predicting the behavior of a single actual or typical human; and it has the hardest time of all attempting to describe or predict how large groups of people will act—if for no other reason than researchers cannot experiment on large groups of people in realistic settings. As a result, there are few consensus views among researchers about any nontrivial topic in corporate governance, and evidence tends to emerge slowly, is rarely uncontested, and is subject to constant (and often dramatic reevaluation). As a result, everything that you do in setting rules for corporate governance should keep the fragility of the evidence in mind: set rules that can be changed by delegating to regulatory agencies; direct those agencies to review and reassess their own rules regularly; and provide "opt outs" and "sunsets" to governance mandates that are expected to last indefinitely, as at many corporations.

As one example, to my knowledge, there is no reliable large-scale empirical evidence—good or bad—on the effects of shareholder access to a company's proxy statement, along the lines proposed by the SEC and mandated by S. 1074, H.R. 3269 and H.R. 2861, because there has no been no significant observed variation in such a governance system within any modern developed economy. This does not mean that there is no information relevant to evaluating how such a system would operate in practice, or that there is no basis on which such a system could be recommended or adopted. Rather, the absence of observed variation means that there is no general body of data that is capable of revealing whether such a system would consistently have good or bad effects on shareholder welfare—and no such data will exist unless and until a large number of companies voluntarily adopt such a system or are required to by law. That is generally true of many corporate governance proposals, and to require such data before adopting rule changes would effectively freeze laws governing corporate governance in place indefinitely, preventing further inquiry or development of evidence.

Nonetheless, there are some corporate governance topics about which evidence is better than others. Here I set out what is necessarily an abbreviated summary of the evidence on three topics addressed in one or more bills pending in the current Congress, including the Shareholder Bill of Rights Act of 2009 (S. 1074): (a) "say-

on-pay," (b) mandatory separation of the chairman and CEO positions, and (c) mandatory annual board elections.

a. Say-on-Pay

The proposed requirement that shareholders be given an advisory vote on executive pay has the advantage that it is very similar to a requirement adopted in another jurisdiction (the United Kingdom (U.K.)) that has capital markets and laws that are otherwise similar to those applicable in the United States.[1] This fact enables a research approach that is otherwise unavailable: a before-and-after test of board and shareholder responses, compensation practices, stock market reactions and shareholder returns, and other items of interest surrounding the adoption of "say-on-pay" in the U.K.. Different researchers have conducted several investigations of this kind and the results published at least informally. Those researchers report that "say-on-pay's" adoption in the U.K.:

- improved the link between executive pay and corporate performance (Ferri and Maber 2007);
- led firms (both before and after relatively negative shareholder votes) to adopt better pay practices (*id.*);
- led activist shareholders to target firms with weak pay-performance links and those with higher-than-expected executive compensation levels (*id.;* Alissa 2009);
- did not reduce or slow the overall increase in executive compensation levels (Ferri and Maber 2007; Gordon 2008).

Together, these findings suggest that "say-on-pay" legislation would have a positive impact on corporate governance in the U.S. While the two legal contexts are not identical, there is no evidence in the existing literature to suggest that the differences would turn what would be a good idea in the U.K. into a bad one in the U.S.

Researchers have also exploited the introduction of earlier "say-on-pay" legislation in the U.S. to examine stock price reactions to the prospect of such a governance reform. Consistent with the U.K. findings, they report that stock investors appear to have viewed the proposed legislation as good for firms with higher-than-typical executive compensation, firms with weak pay-performance links, and firms with weak corporate governance measured in various ways (Cai and Walkling 2009).[2] They also report data showing that the market reacted positively at most sample firms to the proposed legislation. The same researchers also report that shareholder-sponsored efforts to introduce "say-on-pay" rules at individual firms—particularly when sponsored by unions with low stock holdings in the targeted firms—were not well-received by the stock market, in part because they were not directed at firms with higher-than-typical executive compensation or firms with weak pay-performance links, but instead simply at companies that happen to be large. The researchers suggest that their findings show that one-size-fits-all "say-on-pay" legislation may be harmful, but this implication does not in fact follow from their findings. If anything, the U.K. evidence summarized above suggests that general "say-on-pay" legislation will weaken the ability of special interest shareholder activists to exploit executive compensation as an issue, and will lower the costs of the broad run of shareholders to use their advisory votes on pay to target firms that are most in need of pressure to improve pay practices.

b. Mandatory Separation of Chairman and CEO Positions

In comparison to research on "say-on-pay" rules, the evidence on the proposal to mandate the separation of the chair and the CEO of public companies is more extensive and considerably more mixed. At least 34 separate studies of the differences in the performance of companies with split *vs.* unified chair/CEO positions have been conducted over the last 20 years, including two "meta-studies." Dalton *et al.* (1998) (reviewing 31 studies of board leadership structure and finding "little evidence of systematic governance structure/financial performance relationships") and Rhoades *et al.* (2001) (meta-analysis of 22 independent samples across 5,271 companies indicates that independent leadership structure has a significant impact on performance, but this impact varies with context). The only clear lesson from these

[1] Say-on-Pay legislation has also been adopted in Australia, Norway, Sweden, and the Netherlands. Deane (2007).

[2] The authors report that firms with the very weakest corporate governance ratings did not exhibit negative stock price reactions to steps toward to the passage of "say-on-pay" legislation, and plausibly suggest that this may be because such firms may not respond to advisory shareholder votes.

studies is that there has been no long-term trend or convergence on a split chair/CEO structure, and that variation in board leadership structure has persisted for decades, even in the U.K., where a split chair/CEO structure is the norm.

One study provides evidence consistent with one explanation of the overall lack of strong findings: optimal board structures may vary by firm size, with smaller firms benefiting from a unified chair/CEO position, with the clarity of leadership that structure provides, and larger firms benefiting from the extra monitoring that an independent chair may provide given the greater risk of "agency costs" at large companies. Palmon *et al.* (2002) (finding positive stock price reactions for small firms that switch from split to unified chair/CEO structure, and negative reactions for large firms). If valid, this explanation would suggest that it would be a good idea for any legislation on board leadership to (a) limit any mandate to the largest firms and (b) permit even those firms to "opt out" of the requirement through periodic shareholder votes (*e.g.,* once every 5 years).

c. Mandatory Annual Board Elections

The evidence on the last legislative proposal I will address—mandatory annual board elections (*i.e.,* a ban on staggered boards)—is thinner and at first glance more compelling than that on board leadership structure, but on close review is just as mixed. There have been at least two studies that focus on the specific relationship between annual board elections and firm value (Bebchuk and Cohen 2005; Faleye 2007), and a number of other papers that include annual board elections in studying the relationship between broader governance indices and firm value more generally (*e.g.,* Gompers *et al.,* 2003; Cremers and Ferrell 2009). Most (but not all[3]) conclude that annual board elections (either on their own or in combination with other governance practices) are associated with higher firm value, as measured by the ratio of firms' stock prices to their book values.[4] The governance-valuation studies, however, generally suffer from a well-known "endogeneity" problem—that is, it is difficult (and given data limitations, sometimes impossible) to know whether annual elections improve firm value, or firm value determines whether a company chooses to hold annual elections. While there are statistical techniques that can address this issue, none of the studies to date have presented compelling evidence that annual elections lead to better performance, at least in the last 20 years, during which time public companies rarely switched from annual to staggered elections. Moreover, the longer a given study of this type has been available for others to attempt to replicate, the more fragile the findings have appeared to be, suggesting that the bottom-line conclusions of more recent studies may not hold up in the face of continued research.

Evidence on annual elections is further complicated by the fact that companies that "go public" for the first time continue to adopt staggered board elections at high rates, as late as 2007.[5] Since the evidence regarding the purported ability of staggered boards to improve firm value has been known for some time, and since shareholders have the ability to adjust the prices they pay for newly issued IPO shares to reflect governance practices, the fact of continued adoption of staggered board elections prior to IPOs suggests that there may be a social advantage to permitting these structures, at least when adopted before a company goes public. Other researchers have made a similar point about "dual class" capital structures, which give low or no votes to public investors, while letting founders or their family members retain high vote stock. SEC rules and stock exchange listing standards have for a long time permitted such structures to be adopted in the U.S. only prior to a company going public, and not once a company has gone public. Such structures, as with staggered board elections, have long been thought to reduce firm value, measured by reference to public stock prices. Yet, as with staggered boards, some companies continue to adopt dual class structures—and some have done quite well by their shareholders (*e.g.,* Google Inc.—still up over 300 percent since its IPO despite the recent market meltdown).

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[3] Ahn, Goyal, and Shrestha (2009) (finding that annual board elections reduces pay-performance sensitivity and investment efficiency in firms with low monitoring costs, while having the opposite effects on firms with high monitoring costs).

[4] Some suggest that the difference in firm value follows from the fact that annual board elections make hostile takeovers easier. *See* Bebchuk, Cohen, and Ferrell 2009. *See* also Bebchuk, Coates, and Subramanian 2001 (finding that staggered board elections reduce hostile bid completion rates, conditional on hostile bids being made).

[5] *See* data available at SharkRepellent.Net, which reported that despite general declines in takeover defenses at public companies in the 2000s, defenses at firms going public continued to increase, with almost ¾s of newly public companies adopting staggered boards. *See* also Coates 2001.

The best explanation offered by academic researchers to explain the continued use of dual class structures and staggered board elections is that they provide founders assurance of continued control, which they value more than the stock price of their companies might reflect. Such private value may arise because of particular attachments the founders have toward the companies they have helped build from scratch, or because they hope to pass control of their companies to their children, or because they have developed "firm-specific capital" that they would lose if the company were acquired (and which would be hard to value by outsiders). Some evidence has been developed consistent with these explanations (*see* Coates 2004, reviewing prior research). This evidence is worth considering not only because dual class structures are analogous to staggered board elections—and interfere with hostile takeovers and shareholder voting rights even more than do staggered board elections—but also because any to mandate annual board elections would also require a ban on dual class structures, or else it would simply push companies to adopt the more restrictive dual class structure in lieu of staggered boards.

C. Recommendations

My recommendations flow from my review of the implications of the financial crisis and my review of evidence above:

First, any corporate governance reform that attempts to shift power from boards or managers to shareholders should either not include financial firms, or should include a clear delegation of authority to financial regulators to exempt financial firms from these power shifts by regulation. Simply directing financial regulators to regulate the same governance practices (as in H.R. 3269) may not suffice to prevent shareholder pressure from encouraging firms to craft ways around those regulations. It would be better more generally to moderate the pressure of shareholders on financial firms to maximize short-term profit at the potential expense of the financial system and taxpayers.

Second, "say-on-pay" legislation is likely to be a good idea. By enabling shareholders across the board to provide feedback in the form of advisory votes to boards on executive compensation, such a requirement would be likely to increase board scrutiny on one element of corporate governance that has the greatest potential for improving incentives and firm performance in the long run. At the same time, it should be recognized that "say-on-pay" is not likely to achieve general distributive goals—wealthy CEOs will continue to earn outsize compensation, as long as their shareholders benefit. If the goal of Congress is to reduce wealth or income disparities, "say-on-pay" is not the right mechanism, and executive compensation is only a relatively minor part of the picture. For that reason, efforts to use corporate governance practices—which after all only affect a subset of all U.S. companies, those that have dispersed shareholders—to force a linkage between CEO and employee pay seem to me misguided. It would be better to address pay disparities in the tax code.

Third, while mandating a split between the chair and the CEO is not clearly a good idea for all public companies, it may well be a good idea for larger companies. Because shareholders of those same companies may find it difficult to initiate such a change, given the difficulties of collective action, a legislative change requiring a split leadership structure but permitting shareholder-approved opt outs may improve governance for many companies while imposing relatively minor costs on companies generally. Requiring that companies give shareholders a vote on such a choice episodically (*e.g.,* every 5 years) would also be a way to help solve shareholders' inevitable collective action problems without forcing a one-size-fits-all solution on companies generally.

Fourth, mandating that all public companies hold annual elections for all directors is not clearly supported by evidence or theory. It perhaps bears mentioning that other important institutions (the SEC, the Fed, the Senate) permit staggered elections for good reason, and that any rule mandating annual elections would ride roughshod over State law—in Massachusetts, for example, companies are *required* to have staggered board elections unless they affirmatively opt out of the requirement. In prior writing, I have suggested it be left to the courts to review director conduct with a more skeptical eye at companies that adopted staggered boards prior to the development of the poison pill (Bebchuk, Coates, and Subramanian 2001), and I have also suggested elsewhere reasons to consider "re-opening" corporate governance practices put in place long ago (Coates 2004). Both approaches would be better than an across-the-board annual election mandate, which would be likely to lead new companies to adopt even more draconian governance practices without any clear net benefit.

Finally, precisely because there is no good evidence on the potential effects of shareholder proxy access, it would seem to be the best course to move cautiously

in adopting rules permitting or requiring such access. For that reason, the most that would seem warranted for a hard-to-change statute to achieve is to mandate that the SEC adopt a rule providing for such access, and thereby to clarify the SEC's authority to do so. Any shareholder access rule will need to address not only the length of the holding period and ownership threshold required to obtain such access, the ability of shareholders to aggregate holdings to obtain eligibility, rules for independence of nominees and shareholders using the rule, and the availability of the rule to those seeking control or influence of a company. Efforts to specify rules for such access at a greater level of detail will probably miss the mark, and be difficult to correct if experience shows that the access has either provided too much or too little access to accomplish the presumed goal of enhancing shareholder welfare.

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PREPARED STATEMENT OF ANN YERGER

EXECUTIVE DIRECTOR, COUNCIL OF INSTITUTIONAL INVESTORS

JULY 29, 2009

Chairman Reed, Ranking Member Bunning, and Members of the Subcommittee: Good morning. I am Ann Yerger, Executive Director, of the Council of Institutional Investors (Council). I am pleased to appear before you today on behalf of the Council.

My testimony includes a brief overview of the Council followed by a discussion of our views on the following issues that you informed me were the basis for this important and timely hearing:

- What weaknesses has the financial crisis revealed about executive compensation, board composition, proxy rules, or other corporate governance issues?
- What key legislative and regulatory changes should be considered to ensure shareholders are adequately protected and appropriate incentives exist for optimal long-term performance at companies?
- What information exists about the potential impact of various approaches to improving corporate governance regulation?

The Council

Founded in 1985 the Council is a nonpartisan, not-for-profit association of public, labor and corporate employee benefit funds with assets exceeding $3 trillion.[1] Today the organization is a leading advocate for improving corporate governance standards for U.S. companies and strengthening investor rights.

Council members are responsible for investing and safeguarding assets used to fund retirement benefits of millions of participants and beneficiaries throughout the U.S. They have a significant commitment to the U.S. capital markets, with the average Council member investing approximately 60 percent of its entire portfolio in U.S. stocks and bonds.[2]

They are also long-term, patient investors due to their investment horizons and their heavy commitment to passive investment strategies. Because these passive strategies restrict Council members from exercising the "Wall Street walk" and selling their shares when they are dissatisfied, corporate governance issues are of great interest to our members.

Council members have been deeply impacted by the financial crisis. As a result, they have a vested interest in ensuring that the gaps and shortcomings revealed by the financial crisis are repaired.

What weaknesses has the financial crisis revealed about executive compensation, board composition, proxy rules, or other corporate governance issues?

The Council believes the financial crisis has exposed some very significant weaknesses in the regulation and oversight of the U.S. capital markets. Gaps in regulation, inadequate resources at existing regulators and failures of regulatory will were key contributors. But so were failures in the corporate boardroom.

Council members, U.S. citizens, and investors around the globe, have paid the price for these failures. Not only have they suffered trillions of dollars in investments losses, they have also lost confidence in the integrity of our markets and in the effectiveness of board oversight of corporate management.

A comprehensive review and a meaningful restructuring of the U.S. financial regulatory model are necessary steps toward restoring investor confidence in our markets and protecting against a repeat of these failures. But regulatory reform alone is insufficient, because vigorous securities regulation on its own cannot solve many of the issues that led to the current crisis. The Council believes that many corporate governance failures contributed to this financial crisis. And as a result, the Council believes corporate governance improvements are a critical component of the necessary package of reforms.

In some cases corporate boards failed shareowners. Some failed to adequately understand, monitor and oversee enterprise risk. Some failed to include directors with the necessary blend of independence, competencies, and experiences to adequately oversee management and corporate strategy. And far too many corporate boards structured and approved executive compensation programs that motivated excessive risk taking and yielded outsized rewards—with little to no downside risk—for short-term results.

Current rules and regulations also failed shareowners. Today, shareowners around the world—including in countries with far less developed capital markets than the U.S.—enjoy basic rights that shareowners of U.S. companies are denied. Rights such as requiring directors to be elected by majority vote, giving owners advisory votes on executive pay, and providing owners modest vehicles to access management proxy cards to nominate directors are noticeably absent in much of corporate America. Their nonexistence weakens the ability of shareowners to oversee corporate directors—their elected representatives—and hold directors accountable.

The U.S. has long been recognized as a leader when it comes to investor protection, market transparency, and oversight. But the U.S. has fallen short when it comes to corporate governance issues. The Council believes that corporate govern-

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[1] *See* Attachment 1.

[2] Council of Institutional Investors, Asset Allocation Survey 2008 at 2, *http://www.cii.org/UserFiles/file/resource%20center/publications/2008%20Asset%20Allocation%20Survey.pdf.*

ance enhancements are a long overdue and essential component of the bold reforms required to restore confidence in the integrity of the U.S. capital markets.

What key legislative and regulatory changes should be considered to ensure shareholders are adequately protected and appropriate incentives exist for optimal long-term performance at companies?

The Council believes a number of key corporate governance reforms are essential to providing meaningful investor oversight of management and boards and restoring investor confidence in our markets. Such measures would address many of the problems that led to the current crisis, and more importantly, empower shareowners to anticipate and address unforeseen future risks. These measures, rather than facilitating investors seeking short-term gains, are consistent with enhancing long-term shareowner value.

More specifically, the governance improvements that the Council believes would have the greatest impact and, therefore, should be contained in any financial markets regulatory reform legislation include:

- *Majority Voting for Directors:* Directors in uncontested elections should be elected by a majority of the votes cast.
- *Shareowner Access to the Proxy:* A long-term investor or group of long-term investors should have access to management proxy materials to nominate directors.
- *Executive Compensation Reforms:* Recommended reforms include advisory shareowner vote on executive pay, independent compensation advisers, stronger clawback provisions and enhanced disclosure requirements.
- *Independent Board Chair:* Corporate boards should be chaired by an independent director.[3]

Majority Voting for Directors

Directors are the cornerstone of the U.S. corporate governance model. And while the primary powers of shareowners—aside from buying and selling their shares—are to elect and remove directors, U.S. shareowners have few tools to exercise these critical and most basic rights.

The Council believes the accountability of directors at most U.S. companies is weakened by the fact that shareowners do not have a meaningful vote in director elections. Under most State laws the default standard for uncontested director elections is a plurality vote, which means that a director is elected in an uncontested situation even if a majority of the shares are withheld from the nominee.

The Council has long believed that a plurality standard for the election of directors is inherently unfair and undemocratic and that a majority vote standard is the appropriate one. The concept of majority voting is difficult to contest—especially in this country. And today majority voting is endorsed by all types of governance experts, including law firms advising companies and corporate boards.

Majority voting makes directors more accountable to shareowners by giving meaning to the vote for directors and eliminating the current "rubber stamp" process. The benefits of this change are many: it democratizes the corporate electoral process; it puts real voting power in hands of investors; and it results in minimal disruption to corporate affairs—it simply makes board's representative of shareowners.

The corporate law community has taken some small steps toward majority voting. In 2006 the ABA Committee on Corporate Laws approved amendments to the Model Business Corporation Act to accommodate majority voting for directors, and lawmakers in Delaware, where most U.S. companies are incorporated, amended the State's corporation law to facilitate majority voting in director elections. But in both cases they stopped short of switching the default standard from plurality to majority.

Since 2006 some companies have volunteered to adopt majority voting standards, but in many cases they have only done so when pressured by shareowners forced to spend tremendous amounts of time and money on company-by-company campaigns to advance majority voting.

To date, larger companies have been receptive to adopting majority voting standards. Plurality voting is the standard at less than a third of the companies in the S&P 500. However, plurality voting is still very common among the smaller companies included in the Russell 1000 and 3000 indices. Over half (54.5 percent) of the companies in the Russell 1000, and nearly three-quarters (74.9 percent) of the companies in the Russell 3000, still use a straight plurality voting standard for director

[3] *See* Attachments 2 and 3.

elections.[4] Statistics are not available for the thousands of additional companies not included in these indices; however, the Council believes most do not have majority voting standards.

Plurality voting is a fundamental flaw in the U.S. corporate governance system. It is time to move the default standard to majority voting. Given the failure by the States, particularly Delaware, to take the lead on this reform, the Council believes the time has come for the U.S. Congress to legislate this important and very basic shareowner right.

Shareowner Access to the Proxy

Nearly 70 years have passed since the Securities and Exchange Commission ("SEC" or "Commission") first considered whether shareowners should be able to include director candidates on management's proxy card. This reform, which has been studied and considered on and off for decades, is long overdue. Its adoption would be one of the most significant and important investor reforms by any regulatory or legislative body in decades. The Council applauds the SEC for its leadership on this important issue.

The financial crisis highlighted a longstanding concern—some directors are not doing the jobs expected by their employers, the shareowners. Compounding the problem is the fact that in too many cases the director nomination process is flawed, largely due to limitations imposed by companies and the securities laws.

Some boards are dominated by the CEO, who plays the key role in selecting and nominating directors. All-independent nominating committees ostensibly address this concern, but problems persist. Some companies don't have nominating committees, others won't accept shareowner nominations for directors, and Council members' sense is that shareowner-suggested candidates—whether or not submitted to all-independent nominating committees—are rarely given serious consideration.

Shareowners can now only ensure that their candidates get full consideration by launching an expensive and complicated proxy fight—an unworkable alternative for most investors, particularly fiduciaries who must determine whether the very significant costs of a proxy contest are in the best interests of plan participants and beneficiaries. While companies can freely tap company coffers to fund their campaigns for board-recommended candidates, shareowners must spend their own money to finance their efforts. And companies often erect various obstacles, including expensive litigation, to thwart investors running proxy fights for board seats.

The Council believes reasonable access to company proxy cards for long-term shareowners would address some of these problems. We believe such access would substantially contribute to the health of the U.S. corporate governance model and U.S. corporations by making boards more responsive to shareowners, more thoughtful about whom they nominate to serve as directors and more vigilant about their oversight responsibilities.

As such, Council members approved the following policy endorsing shareowner access to the proxy:

> Companies should provide access to management proxy materials for a long-term investor or group of long-term investors owning in aggregate at least three percent of a company's voting stock, to nominate less than a majority of the directors. Eligible investors must have owned the stock for at least 2 years. Company proxy materials and related mailings should provide equal space and equal treatment of nominations by qualifying investors.
>
> To allow for informed voting decisions, it is essential that investors have full and accurate information about access mechanism users and their director nominees. Therefore, shareowners nominating director candidates under an access mechanism should adhere to the same SEC rules governing disclosure requirements and prohibitions on false and misleading statements that currently apply to proxy contests for board seats.[5]

The Council is in the process of submitting a comment letter to the SEC on the Commission's outstanding proposal, Facilitating Shareholder Director Nominations.[6] While we have some suggested enhancements, the Council by and large is

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[4] Annalisa Barrett and Beth Young, "Majority Voting for Director Elections", *Directorship* 1 (Dec. 16, 2008), *http://www.directorship.com/contentmgr/showdetails.php/id/33732/page/1.*

[5] *See* Attachment 2, §3.2 Access to Proxy.

[6] 74 Fed. Reg. 29,024 (proposed June 18, 2009), *http://www.sec.gov/rules/proposed/2009/33-9046.pdf.*

very supportive of the proposal. We firmly believe that a Federal approach is far superior to a State-by-State system.

The Council believes Congress should support the SEC's efforts by affirming the Commission's authority to promulgate rules allowing shareowners to place their nominees for director on management's card. The Council believes the SEC has the authority to approve an access standard. However others disagree, and the Commission is likely to face unnecessary, costly and time-consuming litigation in response to a Commission-approved access mechanism. To ensure that owners of U.S. companies face no needless delays over the effective date of this critical reform, the Council recommends Congressional affirmation of the SEC's authority.

Of note, the Council believes access to the proxy complements majority voting for directors. Majority voting is a tool for shareowners to remove directors. Access is a tool for shareowners to elect directors.

Executive Compensation Reforms

As long-term investors with a significant stake in the U.S. capital markets, Council members have a vested interest in ensuring that U.S. companies attract, retain, and motivate the highest performing employees and executives. They are supportive of paying top executives well for superior performance.

However, the financial crisis has offered yet more examples of how investors are harmed when poorly structured executive pay packages waste shareowners' money, excessively dilute their ownership in portfolio companies, and create inappropriate incentives that reward poor performance or even damage a company's long-term performance. Inappropriate pay packages may also suggest a failure in the boardroom, since it is the job of the board of directors and the compensation committee to ensure that executive compensation programs are effective, reasonable, and rational with respect to critical factors such as company performance and industry considerations.

The Council believes executive compensation issues are best addressed by requiring companies to provide full, plain English disclosure of key quantitative and qualitative elements of executive pay, by ensuring that corporate boards can be held accountable for their executive pay decisions through majority voting and access mechanisms, by giving shareowners meaningful oversight of executive pay via nonbinding votes on compensation and by requiring disgorgement of ill-gotten gains pocketed by executives.

- *Advisory Vote on Compensation:* The Council believes an annual, advisory shareowner vote on executive compensation would efficiently and effectively provide boards with useful information about whether investors view the company's compensation practices to be in shareowners' best interests. Nonbinding shareowner votes on pay would serve as a direct referendum on the decisions of the compensation committee and would offer a more targeted way to signal shareowner discontent than withholding votes from committee members. They might also induce compensation committees to be more careful about doling out rich rewards, to avoid the embarrassment of shareowner rejection at the ballot box. In addition, compensation committees looking to actively rein in executive compensation could use the results of advisory shareowner votes to stand up to excessively demanding officers or compensation consultants. Of note, to ensure meaningful voting results, Federal legislation should mandate that annual advisory votes on compensation are a "nonroutine" matter for purposes of New York Stock Exchange Rule 452.
- *Independent Compensation Advisers:* Compensation consultants play a key role in the pay-setting process. The advice provided by these consultants may be biased as a result of conflicts of interest. Most firms that provide compensation consulting services also provide other kinds of services, such as benefits administration, human resources consulting, and actuarial services. Conflicts of interest contribute to a ratcheting up effect for executive pay and should thus be minimized and disclosed.
- *Stronger Clawback Provisions:* The Council believes a tough clawback policy is an essential element of a meaningful "pay for performance" philosophy. If executives are rewarded for "hitting their numbers"—and it turns out that they failed to do so—they should not profit. While Section 304 of the Sarbanes-Oxley Act gave additional authority to the SEC to recoup bonuses or other incentive-based compensation in certain circumstances, some observers have suggested this language is too narrow and perhaps unworkable. The Council does not advocate a reopening of the Sarbanes-Oxley Act, but it does recommend that Congress consider ways to cover cases where performance-based compensation may

be "unearned" in retrospect but not meet the high standard of "resulting from misconduct" required by Section 304.

- *Enhanced Disclosures:* Of primary concern to the Council is full and clear disclosure of executive pay. As U.S. Supreme Court Justice Louis Brandeis noted, "sunlight is the best disinfectant." Transparency of executive pay enables shareowners to evaluate the performance of the compensation committee and board in setting executive pay, to assess pay-for-performance links and to optimize their role of overseeing executive compensation through such means as proxy voting. The Council is very supportive of the SEC's continued efforts to enhance the disclosure of executive compensation, including its recent proposal to require disclosures about (1) how overall pay policies create incentives that can affect the company's risk and management of risk; (2) the grant date fair value of equity-based awards; and (3) remuneration to executive/director compensation consultants. We believe the disclosure regime in the U.S. would be substantially improved if companies would have to disclose the quantitative measures used to determine incentive pay. Such disclosure—which could be provided at the time the measures are established or at a future date, such as when the performance related to the award is measured—would eliminate a major impediment to the market's ability to analyze and understand executive compensation programs and to appropriately respond.

As indicated earlier in my testimony, the Council believes that a federally imposed standard for majority voting for directors and a SEC-approved access mechanism will be two of the most powerful tools for addressing executive pay excesses and abuses. Their absence in the U.S. corporate governance model effectively insulates directors from meaningful shareowner oversight. We believe enhancing director accountability via both mechanisms would help rein in excessive or poorly structured executive pay packages.

Independent Board Chair

The issue of whether the chair and CEO roles should be separated has long been debated in the U.S., where the roles are combined at most publicly traded companies. Interest in the issue renewed in recent years in the wake of Enron and other corporate scandals and, most recently, in response to the financial crisis.

The U.S. approach to the issue differs from other countries, particularly the U.K. and other European countries which have comply-or-disclose requirements regarding the separation of the roles and/or recommend it via nationally recognized best practices. According to the Millstein Center for Corporate Governance and Performance at the Yale School of Management:

> Up until the early 2000s, the percentage of the S&P 500 companies with combined roles remained barely unchanged in the previous 15 years, at 80 percent. Today, approximately 36 percent of S&P 500 companies have separate chairs and CEOs; this is up from 22 percent in 2002. However, only 17 percent of S&P 1500 firms have chairs that can be qualified as independent and the incidence of independent chairs is concentrated on small and midcap firms. This is in sharp contrast to the landscape of other countries.[7]

At the heart of the issue is whether the leadership of the board should differ from the leadership of the company. Clearly the roles are different, with management responsible for running the company and the board charged with overseeing management. The chair of the board is responsible for, among other things, presiding over and setting agendas for board meetings. The most significant concern over combining the roles is that strong CEOs could exert a dominant influence on the board and the board's agenda and thus weaken the board's oversight of management.

The Conference Board Commission on Public Trust and Private Enterprise discussed the issue in its post-Enron corporate governance report.[8] The Commission suggested three approaches—including naming an independent chair—for ensuring the appropriate balance of power between board and CEO functions, and it recommended that "each corporation give careful consideration, based on its particular

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[7] "Chairing the Board: The Case for Independent Leadership in Corporate North America" 17 (2009), *http://millstein.som.yale.edu/2009%2003%2030%20Chairing%20The%20Board.pdf* [hereinafter "Chairing"].

[8] The Conference Board, Commission on Public Trust and Private Enterprise 19 (Jan. 9, 2003),*http://www.conference-board.org/pdf_free/SR-03-04.pdf.*

circumstances, to separating the offices of the Chairman and Chief Executive Officer."[9]

The Council believes separating the chair/CEO positions appropriately reflects the differences in the roles, provides a better balance of power between the CEO and the board—particularly when the CEO dominates the board, and facilitates strong, independent board leadership/functioning.

What information exists about the potential impact of various approaches to improving corporate governance regulation?

Empirical evidence from companies in the U.S. and countries around the globe support the reforms recommended by the Council.

Majority Voting for Directors

Majority voting for directors is not an alien concept. It is standard practice in the United Kingdom, France, Germany, and other European nations. And as discussed, it is also in place at some U.S. companies. The experiences in these countries and in the U.S. indicate that majority voting is not harmful to the markets and does not result in dramatic and frequent changes to corporate boards.

Shareowner Access to the Proxy

Shareowner access to the proxy is a common right in countries around the globe. According to Glass Lewis, the shareowners of companies in the following countries are provided an access mechanism (Country/Requirement):

- Australia—Minimum of 5 percent
- Canada—Minimum of 5 percent
- China—Minimum of 1 percent
- Finland—Minimum of 10 percent
- Germany—Minimum of 5 percent of the issued share capital or shares representing at least €500,000 of the company's share capital
- India—Deposit of INR 500, refundable if the nominee is elected
- Italy—Minimum of 2.5 percent of the company's share capital
- Russia—Minimum of 2 percent of the voting stock
- South Africa—Minimum of 5 percent
- United Kingdom—Minimum of 5 percent or at least 100 shareowners each with shares worth a minimum of £100

In addition, a handful of U.S. companies—including Apria Healthcare and RiskMetrics—have voluntarily adopted access mechanisms. And Delaware recently revised its corporation code to allow corporate bylaws to require that a company's proxy include shareowner nominees for director along with management candidates. The experiences in these countries and in the U.S. indicate that proxy access is not harmful to the markets. Indeed these mechanisms have rarely been used by owners in these markets—powerful evidence that the existence of the mechanism may enhance board performance and board–shareowner communications.

Advisory Vote on Compensation

According to the CFA Institute Centre for Financial Market Integrity, the following countries have some form of shareowner vote on executive compensation:

- Australia
- France
- Germany (51 percent of companies researched provide such a vote)
- India
- Italy
- Poland
- Switzerland
- Taiwan
- United Kingdom[10]

Again, the experiences in these markets suggest that advisory votes on compensation are not harmful to the markets. And the fact that few compensation schemes

[9] *Id.*

[10] CFA Institute Centre for Financial Market Integrity, *Shareowner Rights Across the Markets: A Manual for Investors* (2009), *http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2009.n2.1.*

are voted down suggests that shareowners are careful stewards of their voting responsibilities and that advisory votes do not require dramatic "rearview mirror" adjustments to pay.

Independent Board Chair

Nonexecutive chairs are common in many countries outside the United States. Some 79 percent of companies in the United Kingdom's FTSE 350 index report that they have independent chairs.[11] Splitting the role of chair and CEO is the norm also in Australia, Belgium, Brazil, Canada, Germany, the Netherlands, Singapore, and South Africa.[12] Again, the experiences in these markets suggest that independent board chairs are not harmful to the markets.

Conclusion

The Council is not the only group advocating corporate governance reforms. The Investors' Working Group, an independent task force cosponsored by the Council and the CFA Institute Centre for Financial Market Integrity, issued July 15 a report recommending a set of reforms to put the U.S. financial regulatory system on sounder footing and make it more responsive to the needs of investors.[13] Noting that "investors need better tools to hold managers and directors accountable," its recommendations include six corporate governance reforms:

- In uncontested elections, directors should be elected by a majority of votes cast.
- Shareowners should have the right to place director nominees on the company's proxy.
- Boards of directors should be encouraged to separate the role of chair and CEO or explain why they have adopted another method to assure independent leadership of the board.
- Securities exchanges should adopt listing standards that require compensation advisers to corporate boards to be independent of management.
- Companies should give shareowners an annual, advisory vote on executive compensation.
- Federal clawback provisions on unearned executive pay should be strengthened.[14]

The Administration, legislators, and regulators have also recognized the need for corporate governance enhancements. The Council commends the SEC for its bold efforts to date, and it applauds the Obama administration and leaders on Capitol Hill for evaluating corporate governance issues and, in some cases, proposing formal reforms. Many of these proposals would address the key governance shortfalls identified by the Council.

Thank you, Mr. Chairman for inviting me to participate at this hearing. I look forward to the opportunity to respond to any questions.

Attachments

1. Council of Institutional Investors (Council) General Members
2. Council Corporate Governance Policies
3. Council Corporate Governance Reform Advocacy Letter (December 2008)
4. U.S. Financial Regulatory Reform: The Investors' Perspective, a Report by the Investors' Working Group

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[11] Chairing, *supra* note 7, at 17.
[12] *Id.*
[13] *See* Attachment 4.
[14] *Id.* at 22–23.

Testimony of
Ann Yerger
Executive Director
Council of Institutional Investors
before the
Subcommittee on Securities, Insurance, and Investment
of the
Committee on Banking, Housing, and Urban Affairs
July 29, 2009

Attachment 1

Council General Members

Council of Institutional Investors

General Members*

Last Updated: July 2009

AFL-CIO Pension Plan
AFSCME
Agilent Technologies Benefit Plans
Alameda County Employees' Retirement Association
American Federation of Teachers Pension Plan
Arkansas Public Employees Retirement System
BP America Master Trust for Employee Pension Plans
Bricklayers & Trowel Trades International Pension Fund
Building Trades United Pension Trust Fund Milwaukee and Vicinity
California Public Employees' Retirement System
California State Teachers' Retirement System
Campbells Soup Company Retirement & Pension Plans
Casey Family Programs
Central Laborers' Pension Fund
Central Pension Fund of the Operating Engineers
CERES Inc. Defined Contribution Retirement Plan & Tax Deferred Annuity
Chevron Master Pension Trust
Coca-Cola Retirement Plan
Colgate-Palmolive Employees' Retirement Income Plan
Colorado Fire & Police Pension Association
Communications Workers of America Pension Fund
Connecticut Retirement Plans and Trust Funds
Contra Costa County Employees' Retirement Association
CWA/ITU Negotiated Pension Plan
Delaware Public Employees' Retirement System
Detroit General Retirement System
District of Columbia Retirement Board
Eastern Illinois University Foundation
EMC Corporation
Employees' Retirement Fund of the City of Dallas
Evangelical Lutheran Church in America Board of Pensions
Fairfax County Educational Employees' Supplementary Retirement System
FedEx Corporation
Florida State Board of Administration
Gap Inc.
General Mills, Inc. Retirement Plan

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*General membership in the Council is open to any employee benefit plan, state or local agency officially charged with the investment of plan assets, or non-profit endowment funds and non-profit foundations. General Members participate in all meetings and seminars sponsored by the Council and are the only voting members of the Council. Annual dues are $1.30 per $1 million in fund assets, but no less than $3,000 and no more than $30,000.

Hartford Municipal Employees Retirement Fund
Hewlett-Packard Company Pension Plan
Houston Firefighters' Relief & Retirement Fund
HSBC
I.A.M. National Pension Fund
Idaho Public Employee Retirement System
Illinois State Board of Investment
Illinois Teachers' Retirement System
International Brotherhood of Electrical Workers' Pension Benefit Fund
International Union, UAW- Staff Retirement Income Plan
Iowa Municipal Fire & Police Retirement System
Iowa Public Employees' Retirement System
IUE-CWA Pension Fund
Jacksonville Police and Fire Pension Fund
Johnson & Johnson General Pension Trust
Kern County Employees' Retirement Association
KeyCorp Cash Balance Pension Plan
Laborers National Pension Fund
LIUNA Staff and Affiliates Pension Fund
Los Angeles City Employees' Retirement System
Los Angeles County Employees Retirement Association
Los Angeles Fire and Police Pension System
Los Angeles Water and Power Employees' Retirement Plan
Lucent Technologies Pension Plan
Maine Public Employees Retirement System
Marin County Employees' Retirement Association
Massachusetts Bay Transportation Authority Retirement Fund
Massachusetts Pension Reserves Investment Management Board
Microsoft Corporation Savings Plus 401(k) Plan
Milwaukee Employees' Retirement System
Minnesota State Board of Investment
Missouri Public School & Public Education Employee Retirement Systems
Missouri State Employees' Retirement System
Montgomery County Employees' Retirement System
Municipal Employees Retirement System of Michigan
Nathan Cummings Foundation
National Education Association Employee Retirement Plan
Navy-Marine Corps Relief Society
New Hampshire Retirement System
New Jersey Division of Investment
New York City Employees' Retirement System
New York City Pension Funds
New York City Teachers' Retirement System
New York State and Local Retirement System
New York State Teachers' Retirement System
North Carolina Retirement Systems
Ohio Police & Fire Pension Fund
Ohio Public Employees Retirement System
Orange County Employees Retirement System

Oregon Public Employees' Retirement System
Pennsylvania Public School Employees' Retirement System
Pennsylvania State Employees' Retirement System
Pfizer Retirement Annuity Plan
Pitney Bowes Pension Plan
Plumbers & Pipefitters National Pension Fund
Prudential Employee Savings Plan
Public Employees' Retirement Association of Colorado
Sacramento County Employees' Retirement System
San Diego City Employees' Retirement System
San Francisco City and County Employees' Retirement System
Santa Barbara County Employees' Retirement System
Sara Lee Corporation Salaried Pension Plan
Schering-Plough Employees' Savings Plan
School Employees Retirement System of Ohio
Sealed Air Corporation Retirement Plans
SEIU Pension Fund
Sheet Metal Workers' Local 19 Pension Plan
Sheet Metal Workers' National Pension Fund
Sonoma County Employees Retirement Association
South Carolina Retirement System
State of Wisconsin Investment Board
State Retirement and Pension System of Maryland
State Teachers' Retirement System of Ohio
State Universities Retirement System
Sunoco, Inc.
Target Corporate Pension Plan
Teamster Affiliates Pension Plan
Texas Municipal Retirement System
Texas Teacher Retirement System
Union Labor Life Insurance Co.
UNITE HERE Laundry & Dry Cleaning Workers Pension Fund
UNITE HERE National Retirement Fund
United Brotherhood Carpenters, Local Unions & Councils Pension Fund
United Food and Commercial Workers International Union Staff Trust Fund
United States Steel and Carnegie Pension Fund
UnitedHealth Group Incorporated Retirement Plans
Vermont Pension Investment Committee
Washington State Investment Board
West Virginia Investment Management Board
World Bank Staff Retirement Plan

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Attachment 2

Council Corporate Governance Policies

Council of Institutional Investors
The Voice of Corporate Governance

The Council of Institutional Investors
Corporate Governance Policies

CONTENTS:

1. Introduction
2. The Board of Directors
3. Shareowner Voting Rights
4. Shareowner Meetings
5. Executive Compensation
6. Director Compensation
7. Independent Director Definition

1. Introduction

1.1 Nature and Purpose of the Council's Corporate Governance Policies
1.2 Federal and State Law Compliance
1.3 Disclosed Governance Policies and Ethics Code
1.4 Accountability to Shareowners
1.5 Shareowner Participation
1.6 Business Practices and Corporate Citizenship
1.7 Governance Practices at Public and Private Companies
1.8 Reincorporation

1.1 **Nature and Purpose of the Council's Corporate Governance Policies**: Council policies are designed to provide guidelines that the Council has found to be appropriate in most situations. They bind neither members nor corporations.

1.2 **Federal and State Law Compliance**: The Council expects that corporations will comply with all applicable federal and state laws and regulations and stock exchange listing standards.

1.3 **Disclosed Governance Policies and Ethics Code**: The Council believes every company should have written, disclosed governance procedures and policies, an ethics code that applies to all employees and directors, and provisions for its strict enforcement. The Council posts its corporate governance policies on its Web site (www.cii.org); it hopes corporate boards will meet or exceed these standards and adopt similarly appropriate additional policies to best protect shareowners' interests.

1.4 **Accountability to Shareowners**: Corporate governance structures and practices should protect and enhance a company's accountability to its shareowners, and ensure that they are treated equally. An action should not be taken if its purpose is to reduce accountability to shareowners.

1.5 **Shareowner Participation**: Shareowners should have meaningful ability to participate in the major fundamental decisions that affect corporate viability, and meaningful opportunities to suggest or nominate director candidates and to suggest processes and criteria for director selection and evaluation.

1.6 **Business Practices and Corporate Citizenship**: The Council believes companies should adhere to responsible business practices and practice good corporate citizenship. Promotion, adoption and effective implementation of guidelines for the responsible conduct of business and business relationships are consistent with the fiduciary responsibility of protecting long-term investment interests.

1.7 **Governance Practices at Public and Private Companies**: Publicly traded companies, private companies and companies in the process of going public should practice good governance. General members of venture capital, buyout and other private equity funds should encourage companies in which they invest to adopt long-term corporate governance provisions that are consistent with the Council's policies.

1.8 **Reincorporation**: U.S. companies should not reincorporate to offshore locations where corporate governance structures are weaker, which reduces management accountability to shareowners.

2. The Board of Directors

2.1 Annual Election of Directors
2.2 Director Elections
2.3 Independent Board
2.4 Independent Chair/Lead Director
2.5 All-independent Board Committees
2.6 Board Accountability to Shareowners
2.7 Board/Director Succession Planning and Evaluation
2.8 CEO Succession Planning
2.9 "Continuing Directors"
2.10 Board Size and Service
2.11 Board Operations
2.12 Auditor Independence
2.13 Charitable and Political Contributions

2.1 **Annual Election of Directors**: All directors should be elected annually. Boards should not be classified (staggered).

2.2 **Director Elections**: To the extent permitted under state law, companies' charters and bylaws should provide that directors in uncontested elections are to be elected by a majority of the votes cast. In contested elections, plurality voting should apply. An election is contested when there are more director candidates than there are available board seats. In addition, boards should adopt a

policy asking all candidates for the board of directors, including incumbent directors and candidates nominated by shareowners, to tender conditional resignations in advance of any election, to take effect in the event that they fail to win majority support in uncontested elections. Should an incumbent director fail to achieve a majority of the votes cast in an uncontested election, the board should promptly determine whether to accept his or her resignation; if the board should decide not to accept the resignation, it should disclose that determination and the reasons for that action no less than 90 days after the date of the election. The policy should also provide that an incumbent director who fails to tender such a resignation will not be renominated for another term after his or her current term expires.

2.3 **Independent Board**: At least two-thirds of the directors should be independent; their seat on the board should be their only non-trivial professional, familial or financial connection to the corporation, its chairman, CEO or any other executive officer. The company should disclose information necessary for shareowners to determine whether directors qualify as independent. This information should include all of the company's financial or business relationships with and payments to directors and their families and all significant payments to companies, non-profits, foundations and other organizations where company directors serve as employees, officers or directors (*see Council definition of independent director, Section 7, below*).

2.4 **Independent Chair/Lead Director**: The board should be chaired by an independent director. The CEO and chair roles should only be combined in very limited circumstances; in these situations, the board should provide a written statement in the proxy materials discussing why the combined role is in the best interests of shareowners, and it should name a lead independent director who should have approval over information flow to the board, meeting agendas and meeting schedules to ensure a structure that provides an appropriate balance between the powers of the CEO and those of the independent directors.

Other roles of the lead independent director should include chairing meetings of non-management directors and of independent directors, presiding over board meetings in the absence of the chair, serving as the principle liaison between the independent directors and the chair and leading the board/director evaluation process. Given these additional responsibilities, the lead independent director should expect to devote a greater amount of time to board service than the other directors.

2.5 **All-independent Board Committees**: Companies should have audit, nominating and compensation committees, and all members of these committees should be independent. The board (not the CEO) should appoint the committee chairs and members. Committees should be able to select their own service providers. Some regularly scheduled committee meetings should be held with only the committee members (and, if appropriate, the committee's independent consultants) present. The process by which committee members and chairs are selected should be disclosed to shareowners.

2.6 **Board Accountability to Shareowners**

2.6a **Majority Shareowner Votes**: Boards should take actions recommended in shareowner proposals that receive a majority of votes cast for and against. If shareowner approval is required for the action, the board should seek a binding vote on the action at the next shareowner meeting.

2.6b **Interaction with Shareowners**: Directors should respond to communications from shareowners and should seek shareowner views on important governance, management and performance matters. To accomplish this goal, all companies should establish board-shareowner communications policies. Such policies should disclose the ground rules by which directors will meet with shareowners. The policies should also include detailed contact information for at least one independent director (but preferably for the

independent board chair and/or the independent lead director and the independent chairs of the audit, compensation and nominating committees). Companies should also establish mechanisms by which shareowners with non-trivial concerns can communicate directly with all directors. Policies requiring that all director communication go through a member of the management team should be avoided unless they are for record-keeping purposes. In such cases, procedures documenting receipt and delivery of the request to the board and its response must be maintained and made available to shareowners upon request. Directors should have access to all communications. Boards should determine whether outside counsel should be present at meetings with shareowners to monitor compliance with disclosure rules.

All directors should attend the annual shareowners' meetings and be available, when requested by the chair, to answer shareowner questions. During the annual general meeting, shareowners should have the right to ask questions, both orally and in writing. Directors should provide answers or discuss the matters raised, regardless of whether the questions were submitted in advance. While reasonable time limits for questions are acceptable, the board should not ignore a question because it comes from a shareowner who holds a smaller number of shares or who has not held those shares for a certain length of time.

2.7 Board/Director Succession Planning and Evaluation

2.7a **Board Succession Planning**: The board should implement and disclose a board succession plan that involves preparing for future board retirements, committee assignment rotations, committee chair nominations and overall implementation of the company's long-term business plan. Boards should establish clear procedures to encourage and consider board nomination suggestions from long-term shareowners. The board should respond positively to shareowner requests seeking to discuss incumbent and potential directors.

2.7b **Board Diversity**: The Council supports a diverse board. The Council believes a diverse board has benefits that can enhance corporate financial performance, particularly in today's global market place. Nominating committee charters, or equivalent, ought to reflect that boards should be diverse, including such considerations as background, experience, age, race, gender, ethnicity, and culture.

2.7c **Evaluation of Directors**: Boards should review their own performance periodically. That evaluation should include a review of the performance and qualifications of any director who received "against" votes from a significant number of shareowners or for whom a significant number of shareowners withheld votes.

2.7d **Board and Committee Meeting Attendance**: Absent compelling and stated reasons, directors who attend fewer than 75 percent of board and board-committee meetings for two consecutive years should not be renominated. Companies should disclose individual director attendance figures for board and committee meetings. Disclosure should distinguish between in-person and telephonic attendance. Excused absences should not be categorized as attendance.

2.8 **CEO Succession Planning**: The board should approve and maintain a detailed CEO succession plan and publicly disclose the essential features. An integral facet of management succession planning involves collaboration between the board and the current chief executive to develop the next generation of leaders from within the company's ranks. Boards therefore should: (1) make sure that broad leadership development programs are in place generally; and (2) carefully identify multiple candidates for the CEO role specifically, well before the position needs to be filled.

2.9 "Continuing Directors": Corporations should not adopt so-called "continuing director" provisions (also known as "dead-hand" or "no-hand" provisions, which are most commonly seen in connection with a potential change in control of the company) that allow board actions to be taken only by: (1) those continuing directors who were also in office when a specified event took place or (2) a combination of continuing directors plus new directors who are approved by such continuing directors.

2.10 Board Size and Service: Absent compelling, unusual circumstances, a board should have no fewer than five and no more than 15 members (not too small to maintain the needed expertise and independence, and not too large to function efficiently). Shareowners should be allowed to vote on any major change in board size.

Companies should establish and publish guidelines specifying on how many other boards their directors may serve. Absent unusual, specified circumstances, directors with full-time jobs should not serve on more than two other boards. Currently serving CEOs should not serve as a director of more than one other company, and then only if the CEO's own company is in the top half of its peer group. No other director should serve on more than five for-profit company boards.

2.11 Board Operations

2.11a Informed Directors: Directors should receive training from independent sources on their fiduciary responsibilities and liabilities. Directors have an affirmative obligation to become and remain independently familiar with company operations; they should not rely exclusively on information provided to them by the CEO to do their jobs. Directors should be provided meaningful information in a timely manner prior to board meetings and should be allowed reasonable access to management to discuss board issues.

2.11b Director Rights Regarding Board Agenda: Any director should be allowed to place items on the board's agenda.

2.11c Executive Sessions: The independent directors should hold regularly scheduled executive sessions without any of the management team or its staff present.

2.12 Auditor Independence

2.12a Audit Committee Responsibilities Regarding Outside Auditors: The audit committee should have the responsibility to hire, oversee and, if necessary, fire the company's outside auditor.

2.12b Competitive Bids: The audit committee should seek competitive bids for the external audit engagement at least every five years.

2.12c Non-audit Services: A company's external auditor should not perform any non-audit services for the company, except those, such as attest services, that are required by statute or regulation to be performed by a company's external auditor.

2.12d Audit Committee Charters: The proxy statement should include a copy of the audit committee charter and a statement by the audit committee that it has complied with the duties outlined in the charter.

2.12e Liability of Outside Auditors: Companies should not agree to limit the liability of outside auditors.

2.12f **Shareowner Votes on the Board's Choice of Outside Auditor**: Audit committee charters should provide for annual shareowner votes on the board's choice of independent, external auditor. Such provisions should state that if the board's selection fails to achieve the support of a majority of the for-and-against votes cast, the audit committee should: (1) take the shareowners' views into consideration and reconsider its choice of auditor and (2) solicit the views of major shareowners to determine why broad levels of shareowner support were not achieved.

2.12g **Disclosure of Reasons Behind Auditor Changes**: The audit committee should publicly provide to shareowners a plain-English explanation of the reasons for a change in the company's external auditors. At a minimum, this disclosure should be contained in the same Securities and Exchange Commission (SEC) filing that companies are required to submit within four days of an auditor change.

2.13 Charitable and Political Contributions

2.13a **Board Monitoring, Assessment and Approval**: The board of directors should monitor, assess and approve all charitable and political contributions (including trade association contributions) made by the company. The board should only approve contributions that are consistent with the interests of the company and its shareowners. The terms and conditions of such contributions should be clearly defined and approved by the board.

2.13b **Disclosure**: The board should develop and disclose publicly its guidelines for approving charitable and political contributions. The board should disclose on an annual basis the amounts and recipients of all monetary and non-monetary contributions made by the company during the prior fiscal year. Any expenditures earmarked for political or charitable activities that were provided to or through a third-party should be included in the report.

3. Shareowner Voting Rights

3.1 Right to Vote is Inviolate
3.2 Access to the Proxy
3.3 One Share, One Vote
3.4 Advance Notice, Holding Requirements and Other Provisions
3.5 Confidential Voting
3.6 Voting Requirements
3.7 Broker Votes
3.8 Bundled Voting

3.1 **Right to Vote is Inviolate**: A shareowners' right to vote is inviolate and should not be abridged.

3.2 **Access to the Proxy**: Companies should provide access to management proxy materials for a long-term investor or group of long-term investors owning in aggregate at least three percent of a company's voting stock, to nominate less than a majority of the directors. Eligible investors must have owned the stock for at least two years. Company proxy materials and related mailings should provide equal space and equal treatment of nominations by qualifying investors.

To allow for informed voting decisions, it is essential that investors have full and accurate information about access mechanism users and their director nominees. Therefore, shareowners nominating director candidates under an access mechanism should adhere to the same SEC rules governing disclosure requirements and prohibitions on false and misleading statements that currently apply to proxy contests for board seats.

3.3 **One Share, One Vote**: Each share of common stock should have one vote. Corporations should not have classes of common stock with disparate voting rights. Authorized, unissued common shares that have voting rights to be set by the board should not be issued with unequal voting rights without shareowner approval.

3.4 **Advance Notice, Holding Requirements and Other Provisions**: Advance notice bylaws, holding requirements, disclosure rules and any other company imposed regulations on the ability of shareowners to solicit proxies beyond those required by law should not be so onerous as to deny sufficient time or otherwise make it impractical for shareowners to submit nominations or proposals and distribute supporting proxy materials.

3.5 **Confidential Voting**: All proxy votes should be confidential, with ballots counted by independent tabulators. Confidentiality should be automatic, permanent and apply to all ballot items. Rules and practices concerning the casting, counting and verifying of shareowner votes should be clearly disclosed.

3.6 **Voting Requirements**: A majority vote of common shares outstanding should be sufficient to amend company bylaws or take other action that requires or receives a shareowner vote. Supermajority votes should not be required. A majority vote of common shares outstanding should be required to approve:

- Major corporate decisions concerning the sale or pledge of corporate assets that would have a material effect on shareowner value. Such a transaction will automatically be deemed to have a material effect if the value of the assets exceeds 10 percent of the assets of the company and its subsidiaries on a consolidated basis;

- The corporation's acquisition of five percent or more of its common shares at above-market prices other than by tender offer to all shareowners;

- Poison pills;

- Abridging or limiting the rights of common shares to: (1) vote on the election or removal of directors or the timing or length of their term of office or (2) nominate directors or propose other action to be voted on by shareowners or (3) call special meetings of shareowners or take action by written consent or change the procedure for fixing the record date for such action; and

- Issuing debt to a degree that would excessively leverage the company and imperil its long-term viability.

3.7 **Broker Votes**: Uninstructed broker votes and abstentions should be counted only for purposes of a quorum.

3.8 **Bundled Voting**: Shareowners should be allowed to vote on unrelated issues separately. Individual voting issues (particularly those amending a company's charter), bylaws or anti-takeover provisions should not be bundled.

4. Shareowner Meetings

4.1 Selection and Notification of Meeting Time and Location
4.2 Shareowner Rights to Call Special Meetings
4.3 Record Date and Ballot Item Disclosure
4.4 Timely Disclosure of Voting Results
4.5 Election Polls
4.6 Meeting Adjournment and Extension
4.7 Electronic Meetings
4.8 Director Attendance

4.1 Selection and Notification of Meeting Time and Location: Corporations should make shareowners' expense and convenience primary criteria when selecting the time and location of shareowner meetings. Appropriate notice of shareowner meetings, including notice concerning any change in meeting date, time, place or shareowner action, should be given to shareowners in a manner and within time frames that will ensure that shareowners have a reasonable opportunity to exercise their franchise.

4.2 Shareowner Rights to Call Special Meetings: Shareowners should have the right to call special meetings.

4.3 Record Date and Ballot Item Disclosure: To promote the ability of shareowners to make informed decisions regarding whether to recall loaned shares: (1) shareowner meeting record dates should be disclosed as far in advance of the record date as possible, and (2) proxy statements should be disclosed before the record date passes whenever possible.

4.4 Timely Disclosure of Voting Results: A company should broadly and publicly disclose in a timely manner the final results of votes cast at annual and special meetings of shareowners. The information should be available via Web site announcement, press release or 8-K filing as soon as results are tabulated and certified. With the exception of extenuating circumstances, this should be completed no later than one month after the meeting. Whenever possible, a preliminary vote tally should be announced at the annual or special meeting of shareowners itself.

4.5 Election Polls: Polls should remain open at shareowner meetings until all agenda items have been discussed and shareowners have had an opportunity to ask and receive answers to questions concerning them.

4.6 Meeting Adjournment and Extension: Companies should not adjourn a meeting for the purpose of soliciting more votes to enable management to prevail on a voting item. A meeting should only be extended for compelling reasons such as vote fraud, problems with the voting process or lack of a quorum.

4.7 Electronic Meetings: Companies should hold shareowner meetings by remote communication (so-called electronic or "cyber" meetings) only as a supplement to traditional in-person shareowner meetings, not as a substitute.

4.8 Director Attendance: As noted in Section 2, "The Board of Directors," all directors should attend the annual shareowners' meeting and be available, when requested by the chair, to respond directly to oral or written questions from shareowners.

5. Executive Compensation

5.1 Introduction
5.2 Advisory Shareowner Votes on Executive Pay
5.3 Gross-ups
5.4 Shareowner Approval of Equity-based Compensation Plans
5.5 Role of Compensation Committee
5.6 Salary
5.7 Annual Incentive Compensation
5.8 Long-term Incentive Compensation
5.9 Dilution
5.10 Stock Option Awards
5.11 Stock Awards/Units
5.12 Perquisites
5.13 Employment Contracts, Severance and Change-of-control Payments
5.14 Retirement Arrangements
5.15 Stock Ownership

5.1 **Introduction**: The Council believes that executive compensation is a critical and visible aspect of a company's governance. Pay decisions are one of the most direct ways for shareowners to assess the performance of the board. And they have a bottom line effect, not just in terms of dollar amounts, but also by formalizing performance goals for employees, signaling the market and affecting employee morale.

The Council endorses reasonable, appropriately structured pay-for-performance programs that reward executives for sustainable, superior performance over the long-term, consistent with a company's investment horizon. "Long-term" is generally considered to be five or more years for mature companies and at least three years for other companies. While the Council believes that executives should be well paid for superior performance, it also believes that executives should not be excessively paid. It is the job of the board of directors and the compensation committee specifically to ensure that executive compensation programs are effective, reasonable and rational with respect to critical factors such as company performance, industry considerations and compensation paid to other employees.

It is also the job of the compensation committee to ensure that elements of compensation packages are appropriately structured to enhance the company's short- and long-term strategic goals and to retain and motivate executives to achieve those strategic goals. Compensation programs should not be driven by competitive surveys, which have become excessive and subject to abuse. It is shareowners, not executives, whose money is at risk.

Since executive compensation must be tailored to meet unique company needs and situations, compensation programs must always be structured on a company-by-company basis. However, certain principles should apply to all companies.

5.2 **Advisory Shareowner Votes on Executive Pay**: All companies should provide annually for advisory shareowner votes on the compensation of senior executives.

5.3 **Gross-ups**: Senior executives should not receive gross-ups beyond those provided to all the company's employees.

5.4 **Shareowner Approval of Equity-based Compensation Plans**: Current listing standards require shareowner approval of equity-based compensation plans and material amendments to plans (with limited exceptions). The Council strongly supports this concept and advocates that companies adopt conservative interpretations of approval requirements when confronted with choices. (For example, this may include material amendments to the plan.)

5.5 **Role of Compensation Committee**: The compensation committee is responsible for structuring executive pay and evaluating executive performance within the context of the pay structure of the entire company, subject to approval of the board of directors. To best handle this role, compensation committees should adopt the following principles and practices:

5.5a **Committee Composition**: All members of the compensation committee should be independent. Committee membership should rotate periodically among the board's independent directors. Members should be or take responsibility to become knowledgeable about compensation and related issues. They should exercise due diligence and independent judgment in carrying out their committee responsibilities. They should represent diverse backgrounds and professional experiences.

5.5b **Executive Pay Philosophy**: The compensation philosophy should be clearly disclosed to shareowners in annual proxy statements. In developing, approving and monitoring the executive pay philosophy, the compensation committee should consider the full range of pay components, including structure of programs, desired mix of cash and equity awards, goals for distribution of awards throughout the company, the relationship of executive pay to the pay of other employees, use of employment contracts and policy regarding dilution.

5.5c **Oversight**: The compensation committee should vigorously oversee all aspects of executive compensation for a group composed of the CEO and other highly paid executives, as required by law, and any other highly paid employees, including executives of subsidiaries, special purpose entities and other affiliates, as determined by the compensation committee. The committee should ensure that the structure of employee compensation throughout the company is fair, non-discriminatory and forward-looking, and that it motivates, recruits and retains a workforce capable of meeting the company's strategic objectives. To perform its oversight duties, the committee should approve, comply with and fully disclose a charter detailing its responsibilities.

5.5d **Pay for Performance**: Compensation of the executive oversight group should be driven predominantly by performance. The compensation committee should establish performance measures for executive compensation that are agreed to ahead of time and publicly disclosed. Performance measures applicable to all performance-based awards (including annual and long-term incentive compensation) should reward superior performance—based predominantly on measures that drive long-term value creation—at minimum reasonable cost. Such measures should also reflect downside risk. The compensation committee should ensure that key performance metrics cannot be manipulated easily.

5.5e **Annual Approval and Review**: Each year, the compensation committee should review performance of individuals in the oversight group and approve any bonus, severance, equity-based award or extraordinary payment made to them. The committee should understand all components of executive compensation and annually review total compensation potentially payable to the oversight group under all possible scenarios, including death/disability, retirement, voluntary termination, termination with and without cause and changes of control. The committee should also ensure that the structure of pay at different levels (CEO and others in the oversight group, other executives and non-

executive employees) is fair and appropriate in the context of broader company policies and goals and fully justified and explained.

5.5f **Committee Accountability**: In addition to attending all annual and special shareowner meetings, committee members should be available to respond directly to questions about executive compensation; the chair of the committee should take the lead. In addition, the committee should regularly report on its activities to the independent directors of the board, who should review and ratify committee decisions. Committee members should take an active role in preparing the compensation committee report contained in the annual proxy materials, and be responsible for the contents of that report.

5.5g **Outside Advice**: The compensation committee should retain and fire outside experts, including consultants, legal advisers and any other advisers when it deems appropriate, including when negotiating contracts with executives. Individual compensation advisers and their firms should be independent of the client company, its executives and directors and should report solely to the compensation committee. The compensation committee should develop and disclose a formal policy on compensation adviser independence. In addition, the committee should annually disclose an assessment of its advisers' independence, along with a description of the nature and dollar amounts of services commissioned from the advisers and their firms by the client company's management. Companies should not agree to indemnify or limit the liability of compensation advisers or the advisers' firms.

5.5h **Clawbacks**: The compensation committee should develop and disclose a policy for reviewing unearned bonus and incentive payments that were awarded to executive officers owing to fraud, financial results that require restatement or some other cause. The policy should require recovery or cancellation of any unearned awards to the extent that it is feasible and practical to do so.

5.5i **Disclosure Practices**: The compensation committee is responsible for ensuring that all aspects of executive compensation are clearly, comprehensively and promptly disclosed, in plain English, in the annual proxy statement regardless of whether such disclosure is required by current rules and regulations. The compensation committee should disclose all information necessary for shareowners to understand how and how much executives are paid and how such pay fits within the overall pay structure of the company. It should provide annual proxy statement disclosure of the committee's compensation decisions with respect to salary, short-term incentive compensation, long-term incentive compensation and all other aspects of executive compensation, including the relative weights assigned to each component of total compensation.

The compensation committee should commit to provide full descriptions of the qualitative and quantitative performance measures and benchmarks used to determine compensation, including the weightings of each measure. At the beginning of a period, the compensation committee should calculate and disclose the maximum compensation payable if all performance-related targets are met. At the end of the performance cycle, the compensation committee should disclose actual targets and details on final payouts. Companies should provide forward-looking disclosure of performance targets whenever possible. Other recommended disclosures relevant to specific elements of executive compensation are detailed below.

5.5j **Benchmarking**: Benchmarking at median or higher levels is a primary contributor to escalating executive compensation. Although benchmarking can be a constructive tool for formulating executive compensation packages, it should not be relied on exclusively. If benchmarking is used, compensation committees should commit to annual disclosure of

the companies in peer groups used for benchmarking and/or other comparisons. If the peer group used for compensation purposes differs from that used to compare overall performance, such as the five-year stock return graph required in the annual proxy materials, the compensation committee should describe the differences between the groups and the rationale for choosing between them. In addition to disclosing names of companies used for benchmarking and comparisons, the compensation committee should disclose targets for each compensation element relative to the peer/benchmarking group and year-to-year changes in companies composing peer/benchmark groups.

5.6 Salary

5.6a **Salary Level**: Since salary is one of the few components of executive compensation that is not "at risk," it should be set at a level that yields the highest value for the company at least cost. In general, salary should be set to reflect responsibilities, tenure and past performance, and to be tax efficient—meaning no more than $1 million.

5.6b **Above-median Salary**: The compensation committee should publicly disclose its rationale for paying salaries above the median of the peer group.

5.7 **Annual Incentive Compensation**: Cash incentive compensation plans should be structured to align executive interests with company goals and objectives. They should also reasonably reward superior performance that meets or exceeds well-defined and clearly disclosed performance targets that reinforce long-term strategic goals that were written and approved by the board in advance of the performance cycle.

5.7a **Formula Plans**: The compensation committee should approve formulaic bonus plans containing specific qualitative and quantitative performance-based operational measures designed to reward executives for superior performance related to operational/strategic/other goals set by the board. Such awards should be capped at a reasonable maximum level. These caps should not be calculated as percentages of accounting or other financial measures (such as revenue, operating income or net profit), since these figures may change dramatically due to mergers, acquisitions and other non-performance-related strategic or accounting decisions.

5.7b **Targets**: When setting performance goals for "target" bonuses, the compensation committee should set performance levels below which no bonuses would be paid and above which bonuses would be capped.

5.7c **Changing Targets**: Except in extraordinary situations, the compensation committee should not "lower the bar" by changing performance targets in the middle of bonus cycles. If the committee decides that changes in performance targets are warranted in the middle of a performance cycle, it should disclose the reasons for the change and details of the initial targets and adjusted targets.

5.8 **Long-term Incentive Compensation**: Long-term incentive compensation, generally in the form of equity-based awards, can be structured to achieve a variety of long-term objectives, including retaining executives, aligning executives' financial interests with the interests of shareowners and rewarding the achievement of long-term specified strategic goals of the company and/or the superior performance of company stock.

But poorly structured awards permit excessive or abusive pay that is detrimental to the company and to shareowners. To maximize effectiveness and efficiency, compensation committees should carefully evaluate the costs and benefits of long-term incentive compensation, ensure that long-term compensation is appropriately structured and consider whether performance and incentive

objectives would be enhanced if awards were distributed throughout the company, not simply to top executives.

Companies may rely on a myriad of long-term incentive vehicles to achieve a variety of long-term objectives, including performance-based restricted stock/units, phantom shares, stock units and stock options. While the technical underpinnings of long-term incentive awards may differ, the following principles and practices apply to all long-term incentive compensation awards. And, as detailed below, certain policies are relevant to specific types of long-term incentive awards.

5.8a **Size of Awards**: Compensation committees should set appropriate limits on the size of long-term incentive awards granted to executives. So-called "mega-awards" or outsized awards should be avoided, except in extraordinary circumstances, because they can be disproportionate to performance.

5.8b **Vesting Requirements**: All long-term incentive awards should have meaningful performance periods and/or cliff vesting requirements that are consistent with the company's investment horizon but not less than three years, followed by pro rata vesting over at least two subsequent years for senior executives.

5.8c **Grant Timing**: Except in extraordinary circumstances, such as a permanent change in performance cycles, long-term incentive awards should be granted at the same time each year. Companies should not coordinate stock award grants with the release of material non-public information. The grants should occur whether recently publicized information is positive or negative, and stock options should never be backdated.

5.8d **Hedging**: Compensation committees should prohibit executives and directors from hedging (by buying puts and selling calls or employing other risk-minimizing techniques) equity-based awards granted as long-term incentive compensation or other stock holdings in the company. And they should strongly discourage other employees from hedging their holdings in company stock.

5.8e **Philosophy/Strategy**: Compensation committees should have a well-articulated philosophy and strategy for long-term incentive compensation that is fully and clearly disclosed in the annual proxy statement.

5.8f **Award Specifics**: Compensation committees should disclose the size, distribution, vesting requirements, other performance criteria and grant timing of each type of long-term incentive award granted to the executive oversight group. Compensation committees also should explain how each component contributes to the company's long-term performance objectives.

5.8g **Ownership Targets**: Compensation committees should disclose whether and how long-term incentive compensation may be used to satisfy meaningful stock ownership requirements. Disclosure should include any post-exercise holding periods or other requirements to ensure that long-term incentive compensation is used appropriately to meet ownership targets.

5.8h **Expiration Dates**: Compensation plans should have expiration dates and not be structured as "evergreen," rolling plans.

5.9 **Dilution**: Dilution measures how much the additional issuance of stock may reduce existing shareowners' stake in a company. Dilution is particularly relevant for long-term incentive compensation plans since these programs essentially issue stock at below-market prices to the

recipients. The potential dilution represented by long-term incentive compensation plans is a direct cost to shareowners.

Dilution from long-term incentive compensation plans may be evaluated using a variety of techniques including the reduction in earnings per share and voting power resulting from the increase in outstanding shares.

5.9a **Philosophy/Strategy**: Compensation committees should develop and disclose the philosophy regarding dilution including definition(s) of dilution, peer group comparisons and specific targets for annual awards and total potential dilution represented by equity compensation programs for the current year and expected for the subsequent four years.

5.9b **Stock Repurchase Programs**: Stock buyback decisions are a capital allocation decision and should not be driven solely for the purpose of minimizing dilution from equity-based compensation plans. The compensation committee should provide information about stock repurchase programs and the extent to which such programs are used to minimize the dilution of equity-based compensation plans.

5.9c **Tabular Disclosure**: The annual proxy statement should include a table detailing the overhang represented by unexercised options and shares available for award and a discussion of the impact of the awards on earnings per share.

5.10 **Stock Option Awards**: Stock options give holders the right, but not the obligation, to buy stock in the future. Options may be structured in a variety of ways. Some structures and policies are preferable because they more effectively ensure that executives are compensated for superior performance. Other structures and policies are inappropriate and should be prohibited.

5.10a **Performance Options**: Stock options should be: (1) indexed to peer groups or (2) premium-priced and/or (3) vest on achievement of specific performance targets that are based on challenging quantitative goals.

5.10b **Dividend Equivalents**: To ensure that executives are neutral between dividends and stock price appreciation, dividend equivalents should be granted with stock options, but distributed only upon exercise of the option.

5.10c **Discount Options**: Discount options should not be awarded.

5.10d **Reload Options**: Reload options should be prohibited.

5.10e **Option Repricing**: "Underwater" options should not be repriced or replaced (either with new options or other equity awards), unless approved by shareowners. Repricing programs, with shareowner approval, should exclude directors and executives, restart vesting periods and mandate value-for-value exchanges in which options are exchanged for a number of equivalently valued options/shares.

5.11 **Stock Awards/Units**: Stock awards/units and similar equity-based vehicles generally grant holders stock based on the attainment of performance goals and/or tenure requirements. These types of awards are more expensive to the company than options, since holders generally are not required to pay to receive the underlying stock, and therefore should be limited in size.

Stock awards should be linked to the attainment of specified performance goals and in some cases to additional time-vesting requirements. Stock awards should not be payable based solely on the attainment of tenure requirements.

5.12 Perquisites: Company perquisites blur the line between personal and business expenses. Executives, not companies, should be responsible for paying personal expenses—particularly those that average employees routinely shoulder, such as family and personal travel, financial planning, club memberships and other dues. The compensation committee should ensure that any perquisites are warranted and have a legitimate business purpose, and it should consider capping all perquisites at a *de minimis* level. Total perquisites should be described, disclosed and valued.

5.13 Employment Contracts, Severance and Change-of-control Payments: Various arrangements may be negotiated to outline terms and conditions for employment and to provide special payments following certain events, such as a termination of employment with/without cause and/or a change in control. The Council believes that these arrangements should be used on a limited basis.

5.13a Employment Contracts: Companies should only provide employment contracts to executives in limited circumstances, such as to provide modest, short-term employment security to a newly hired or recently promoted executive. Such contracts should have a specified termination date (not to exceed three years); contracts should not be "rolling" on an open-ended basis.

5.13b Severance Payments: Executives should not be entitled to severance payments in the event of termination for poor performance, resignation under pressure or failure to renew an employment contract. Company payments awarded upon death or disability should be limited to compensation already earned or vested.

5.13c Change-in-control Payments: Any provisions providing for compensation following a change-in-control event should be "double-triggered." That is, such provisions should stipulate that compensation is payable only: (1) after a control change actually takes place and (2) if a covered executive's job is terminated because of the control change.

5.13d Transparency: The compensation committee should fully and clearly describe the terms and conditions of employment contracts and any other agreements/arrangements covering the executive oversight group and reasons why the compensation committee believes the agreements are in the best interests of shareowners.

5.13e Timely Disclosure: New executive employment contracts or amendments to existing contracts should be immediately disclosed in 8-K filings and promptly disclosed in subsequent 10-Qs.

5.13f Shareowner Ratification: Shareowners should ratify all employment contracts, side letters or other agreements providing for severance, change-in-control or other special payments to executives exceeding 2.99 times average annual salary plus annual bonus for the previous three years.

5.14 Retirement Arrangements: Deferred compensation plans, supplemental executive retirement plans, retirement packages and other retirement arrangements for highly paid executives can result in hidden and excessive benefits. Special retirement arrangements—including those structured to permit employees whose compensation exceeds Internal Revenue Service (IRS) limits to fully participate in similar plans covering other employees—should be consistent with programs offered to the general workforce, and they should be reasonable.

5.14a Supplemental Executive Retirement Plans (SERPs): Supplemental plans should be an extension of the retirement program covering other employees. They should not include special provisions that are not offered under plans covering other employees, such as above-market interest rates and excess service credits. Payments such as stock and stock

options, annual/long-term bonuses and other compensation not awarded to other employees and/or not considered in the determination of retirement benefits payable to other employees should not be considered in calculating benefits payable under SERPs.

5.14b **Deferred Compensation Plans**: Investment alternatives offered under deferred compensation plans for executives should mirror those offered to employees in broad-based deferral plans. Above-market returns should not be applied to executive deferrals, nor should executives receive "sweeteners" for deferring cash payments into company stock.

5.14c **Post-retirement Exercise Periods**: Executives should be limited to three-year post-retirement exercise periods for stock option grants.

5.14d **Retirement Benefits**: Executives should not be entitled to special perquisites—such as apartments, automobiles, use of corporate aircraft, security, financial planning—and other benefits upon retirement. Executives are highly compensated employees who should be more than able to cover the costs of their retirement.

5.15 Stock Ownership

5.15a **Ownership Requirements**: Executives and directors should own, after a reasonable period of time, a meaningful position in the company's common stock. Executives should be required to own stock—excluding unexercised options and unvested stock awards—equal to a multiple of salary. The multiple should be scaled based on position, such as two times salary for lower-level executives and up to six times salary for the CEO.

5.15b **Stock Sales**: Executives should be required to sell stock through pre-announced 10b5-1 program sales or by providing a minimum 30-day advance notice of any stock sales. 10b5-1 program adoptions, amendments, terminations and transactions should be disclosed immediately, and boards of companies using 10b5-1 plans should: (1) adopt policies covering plan practices, (2) periodically monitor plan transactions and (3) ensure that company policies discuss plan use in the context of guidelines or requirements on equity hedging, holding and ownership.

5.15c **Post-retirement Holdings**: Executives should be required to continue to satisfy the minimum stock holding requirements for at least six months after leaving the company.

5.15d **Transparency**: Companies should disclose stock ownership requirements and whether any members of the executive oversight group are not in compliance.

6. Director Compensation

6.1 Introduction
6.2 Role of the Compensation Committee in Director Compensation
6.3 Retainer
6.4 Equity-based Compensation
6.5 Performance-based Compensation
6.6 Perquisites
6.7 Repricing and Exchange Programs

6.8 Employment Contracts, Severance and Change-of-control Payments
6.9 Retirement Arrangements
6.10 Disgorgement

6.1 **Introduction**: Given the vital importance of their responsibilities, non-employee directors should expect to devote significant time to their boardroom duties.

Policy issues related to director compensation are fundamentally different from executive compensation. Director compensation policies should accomplish the following goals: (1) attract highly qualified candidates, (2) retain highly qualified directors, (3) align directors' interests with those of the long-term owners of the corporation and (4) provide complete disclosure to shareowners regarding all components of director compensation including the philosophy behind the program and all forms of compensation.

To accomplish these goals, director compensation should consist solely of a combination of cash retainer and equity-based compensation. The cornerstone of director compensation programs should be alignment of interests through the attainment of significant equity holdings in the company meaningful to each individual director. The Council believes that equity obtained with an individual's own capital provides the best alignment of interests with other shareowners. However, compensation plans can provide supplemental means of obtaining long-term equity holdings through equity compensation, long-term holding requirements and ownership requirements.

Companies should have flexibility within certain broad policy parameters to design and implement director compensation plans that suit their unique circumstances. To support this flexibility, investors must have complete and clear disclosure of both the philosophy behind the compensation plan as well as the actual compensation awarded under the plan. Without full disclosure, it is difficult to earn investors' confidence and support for director and executive compensation plans.

Although non-employee director compensation is generally immaterial to a company's bottom line and small relative to executive pay, director compensation is an important piece of a company's governance. Because director pay is set by the board and has inherent conflicts of interest, care must be taken to ensure there is no appearance of impropriety. Companies should pay particular attention to managing these conflicts.

6.2 **Role of the Compensation Committee in Director Compensation**: The compensation committee (or alternative committee comprised solely of independent directors) is responsible for structuring director pay, subject to approval of all the independent directors, so that it is aligned with the long-term interests of shareowners. Because directors set their own compensation, the following practices should be emphasized:

6.2a **Total Compensation Review**: The compensation committee should understand and value each component of director compensation and annually review total compensation potentially payable to each director.

6.2b **Outside Advice**: Committees should have the ability to hire a compensation consultant for assistance on director compensation plans. In cases where the compensation committee does use a consultant, it should always retain an independent compensation consultant or other advisers it deems appropriate to assist with the evaluation of the structure and value of director compensation. A summary of the pay consultant's advice should be provided in the annual proxy statement in plain English. The compensation

committee should disclose all instances where the consultant is also retained by the committee to provide advice on executive compensation.

6.2c **Compensation Committee Report**: The annual director compensation disclosure included in the proxy materials should include a discussion of the philosophy for director pay and the processes for setting director pay levels. Reasons for changes in director pay programs should be explained in plain English. Peer group(s) used to compare director pay packages should be fully disclosed, along with differences, if any, from the peer group(s) used for executive pay purposes. While peer analysis can be valuable, peer-relative justification should not dominate the rationale for (higher) pay levels. Rather, compensation programs should be appropriate for the circumstances of the company. The report should disclose how many committee meetings involved discussions of director pay.

6.3 Retainer

6.3a **Amount of Annual Retainer**: The annual retainer should be the sole form of cash compensation paid to non-employee directors. Ideally, it should reflect an amount appropriate for a director's expected duties, including attending meetings, preparing for meetings/discussions and performing due diligence on sites/operations (which should include routine communications with a broad group of employees). In some combination, the retainer and the equity component also reflect the director's contribution from experience and leadership. Retainer amounts may be differentiated to recognize that certain non-employee directors—possibly including independent board chairs, independent lead directors, committee chairs or members of certain committees—are expected to spend more time on board duties than other directors.

6.3b **Meeting Attendance Fees**: Directors should not receive any meeting attendance fees since attending meetings is the most basic duty of a non-employee director.

6.3c **Director Attendance Policy**: The board should have a clearly defined attendance policy. If the committee imposes financial consequences (loss of a portion of the retainer or equity) for missing meetings as part of the director compensation program, this should be fully disclosed. Financial consequences for poor attendance, while perhaps appropriate in some circumstances, should not be considered in lieu of examining the attendance record, commitment (time spent on director duties) and contribution in any review of director performance and in re-nomination decisions.

6.4 **Equity-based Compensation**: Equity-based compensation can be an important component of director compensation. These tools are perhaps best suited to instill optimal long-term perspective and alignment of interests with shareowners. To accomplish this objective, director compensation should contain an ownership requirement or incentive and minimum holding period requirements.

6.4a **Vesting of Equity-based Awards**: To complement the annual retainer and align director-shareowner interests, non-employee directors should receive stock awards or stock-related awards such as phantom stock or share units. Equity-based compensation to non-employee directors should be fully vested on the grant date. This point is a marked difference to the Council's policy on executive compensation, which calls for performance-based vesting of equity-based awards. While views on this topic are mixed, the Council believes that the benefits of immediate vesting outweigh the complications. The main benefits are the immediate alignment of interests with shareowners and the fostering of independence and objectivity for the director.

6.4b **Ownership Requirements**: Ownership requirements should be at least three to five times annual compensation. However, some qualified director candidates may not have financial means to meet immediate ownership thresholds. For this reason, companies may set either a minimum threshold for ownership or offer an incentive to build ownership. This concept should be an integral component of the committee's disclosure related to the philosophy of director pay. It is appropriate to provide a reasonable period of time for directors to meet ownership requirements or guidelines.

6.4c **Holding Periods**: Separate from ownership requirements, the Council believes companies should adopt holding requirements for a significant majority of equity-based grants. Directors should be required to retain a significant portion (such as 80 percent) of equity grants until after they retire from the board. These policies should also prohibit the use of any transactions or arrangements that mitigate the risk or benefit of ownership to the director. Such transactions and arrangements inhibit the alignment of interests that equity compensation and ownership requirements provide.

6.4d **Mix of Cash and Equity-based Compensation**: Companies should have the flexibility to set and adjust the split between equity-based and cash compensation as appropriate for their circumstances. The rationale for the ratio used is an important element of disclosures related to the overall philosophy of director compensation and should be disclosed.

6.4e **Transparency**: The present value of equity awards paid to each director during the previous year and the philosophy and process used in determining director pay should be fully disclosed in the proxy statement.

6.4f **Shareowner Approval**: Current listing standards require shareowner approval of equity-based compensation plans and material amendments to plans (with limited exceptions). Companies should adopt conservative interpretations of approval requirements when confronted with choices.

6.5 **Performance-based Compensation**: While the Council is a strong advocate of performance-based concepts in executive compensation, we do not support performance measures in director compensation. Performance-based compensation for directors creates potential conflicts with the director's primary role as an independent representative of shareowners.

6.6 **Perquisites**: Directors should not receive perquisites other than those that are meeting-related, such as air-fare, hotel accommodations and modest travel/accident insurance. Health, life and other forms of insurance; matching grants to charities; financial planning; automobile allowances and other similar perquisites cross the line as benefits offered to employees. Charitable awards programs are an unnecessary benefit; directors interested in posthumous donations can do so on their own via estate planning. Infrequent token gifts of modest value are not considered perquisites.

6.7 **Repricing and Exchange Programs**: Under no circumstances should directors participate in or be eligible for repricing or exchange programs.

6.8 **Employment Contracts, Severance and Change-of-control Payments**: Non-employee directors should not be eligible to receive any change-in-control payments or severance arrangements.

6.9 **Retirement Arrangements**

6.9a **Retirement Benefits**: Since non-employee directors are elected representatives of shareowners and not company employees, they should not be offered retirement benefits, such as defined benefit plans or deferred stock awards, nor should they be entitled to special post-retirement perquisites.

6.9b **Deferred Compensation Plans**: Directors may defer cash pay via a deferred compensation plan for directors. However, such investment alternatives offered under deferred compensation plans for directors should mirror those offered to employees in broad-based deferral plans. Non-employee directors should not receive "sweeteners" for deferring cash payments into company stock.

6.10 **Disgorgement**: Directors should be required to repay compensation to the company in the event of malfeasance or a breach of fiduciary duty involving the director.

7. Independent Director Definition

7.1 Introduction
7.2 Basic Definition of an Independent Director
7.3 Guidelines for Assessing Director Independence

7.1 **Introduction**: A narrowly drawn definition of an independent director (coupled with a policy specifying that at least two-thirds of board members and all members of the audit, compensation and nominating committees should meet this standard) is in the corporation's and shareowners' financial interest because:

- Independence is critical to a properly functioning board;
- Certain clearly definable relationships pose a threat to a director's unqualified independence;
- The effect of a conflict of interest on an individual director is likely to be almost impossible to detect, either by shareowners or other board members; and
- While an across-the-board application of *any* definition to a large number of people will inevitably miscategorize a few of them, this risk is sufficiently small and is far outweighed by the significant benefits.

Independent directors do not invariably share a single set of qualities that are not shared by non-independent directors. Consequently no clear rule can unerringly describe and distinguish independent directors. However, the independence of the director depends on all relationships the director has, including relationships between directors, that may compromise the director's objectivity and loyalty to shareowners. Directors have an obligation to consider all relevant facts and circumstances to determine whether a director should be considered independent.

7.2 **Basic Definition of an Independent Director**: An independent director is someone whose only nontrivial professional, familial or financial connection to the corporation, its chairman, CEO or any other executive officer is his or her directorship. Stated most simply, an independent director is a person whose directorship constitutes his or her only connection to the corporation.

7.3 **Guidelines for Assessing Director Independence**: The notes that follow are supplied to give added clarity and guidance in interpreting the specified relationships. A director will not be considered independent if he or she:

7.3a Is, or in the past five years has been, or whose relative is, or in the past five years has been, employed by the corporation or employed by or a director of an affiliate;

NOTES: An "affiliate" relationship is established if one entity either alone or pursuant to an arrangement with one or more other persons, owns or has the power to vote more than 20 percent of the equity interest in another, unless some other person, either alone or pursuant to an arrangement with one or more other persons, owns or has the power to vote a greater percentage of the equity interest. For these purposes, joint venture partners and general partners meet the definition of an affiliate, and officers and employees of joint venture enterprises and general partners are considered affiliated. A subsidiary is an affiliate if it is at least 20 percent owned by the corporation.

Affiliates include predecessor companies. A "predecessor" is an entity that within the last five years was party to a "merger of equals" with the corporation or represented more than 50 percent of the corporation's sales or assets when such predecessor became part of the corporation.

"Relatives" include spouses, parents, children, step-children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, aunts, uncles, nieces, nephews and first cousins, and anyone sharing the director's home.

7.3b Is, or in the past five years has been, or whose relative is, or in the past five years has been, an employee, director or greater-than-20-percent owner of a firm that is one of the corporation's or its affiliate's paid advisers or consultants or that receives revenue of at least $50,000 for being a paid adviser or consultant to an executive officer of the corporation;

NOTES: Advisers or consultants include, but are not limited to, law firms, auditors, accountants, insurance companies and commercial/investment banks. For purposes of this definition, an individual serving "of counsel" to a firm will be considered an employee of that firm.

The term "executive officer" includes the chief executive, operating, financial, legal and accounting officers of a company. This includes the president, treasurer, secretary, controller and any vice-president who is in charge of a principal business unit, division or function (such as sales, administration or finance) or performs a major policymaking function for the corporation.

7.3c Is, or in the past five years has been, or whose relative is, or in the past five years has been, employed by or has had a five percent or greater ownership interest in a third-party that provides payments to or receives payments from the corporation and either: (i) such payments account for one percent of the third-party's or one percent of the corporation's consolidated gross revenues in any single fiscal year; or (ii) if the third-party is a debtor or creditor of the corporation and the amount owed exceeds one percent of the corporation's or third party's assets. Ownership means beneficial or record ownership, not custodial ownership;

7.3d Has, or in the past five years has had, or whose relative has paid or received more than $50,000 in the past five years under, a personal contract with the corporation, an executive officer or any affiliate of the corporation;

NOTES: Council members believe that even small personal contracts, no matter how formulated, can threaten a director's complete independence. This includes any

arrangement under which the director borrows or lends money to the corporation at rates better (for the director) than those available to normal customers—even if no other services from the director are specified in connection with this relationship;

7.3e Is, or in the past five years has been, or whose relative is, or in the past five years has been, an employee or director of a foundation, university or other non-profit organization that receives significant grants or endowments from the corporation, one of its affiliates or its executive officers or has been a *direct* beneficiary of *any* donations to such an organization;

NOTES: A "significant grant or endowment" is the lesser of $100,000 or one percent of total annual donations received by the organization.

7.3f Is, or in the past five years has been, or whose relative is, or in the past five years has been, part of an interlocking directorate in which the CEO or other employee of the corporation serves on the board of a third-party entity (for-profit or not-for-profit) employing the director or such relative;

7.3g Has a relative who is, or in the past five years has been, an employee, a director or a five percent or greater owner of a third-party entity that is a significant competitor of the corporation; or

7.3h Is a party to a voting trust, agreement or proxy giving his/her decision making power as a director to management except to the extent there is a fully disclosed and narrow voting arrangement such as those which are customary between venture capitalists and management regarding the venture capitalists' board seats.

The foregoing describes relationships between directors and the corporation. The Council also believes that it is important to discuss relationships between directors on the same board which may threaten either director's independence. A director's objectivity as to the best interests of the shareowners is of utmost importance and connections between directors outside the corporation may threaten such objectivity and promote inappropriate voting blocks. As a result, directors must evaluate all of their relationships with each other to determine whether the director is deemed independent. The board of directors shall investigate and evaluate such relationships using the care, skill, prudence and diligence that a prudent person acting in a like capacity would use.

(updated May 1, 2009)

Testimony of
Ann Yerger
Executive Director
Council of Institutional Investors
before the
Subcommittee on Securities, Insurance, and Investment
of the
Committee on Banking, Housing, and Urban Affairs
July 29, 2009

Attachment 3

Council Corporate Governance Reform Advocacy Letter
(December 2008)

COUNCIL OF INSTITUTIONAL INVESTORS

Suite 500 • 888 17th Street, NW • Washington, DC 20006 • (202) 822-0800 • Fax (202) 822-0801 • www.cii.org

December 2, 2008

The Honorable Jack Reed
Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, DC 20510

Re: Financial Markets Regulatory Reform Legislation

Dear Senator Reed:

On behalf of the Council of Institutional Investors and the undersigned member funds, I am writing to urge you to consider a number of key corporate governance improvements for inclusion in any financial markets regulatory reform legislation that may be pursued by the 111th Congress.

The Council is a nonprofit association of public, union and corporate pension funds with combined assets that exceed $3 trillion. Member funds are major long-term shareowners with a duty to protect the retirement assets of millions of American workers. The Council strives to educate its members and the public about good corporate governance, shareowner rights and related investment issues, and to advocate on our members' behalf.

As significant long-term investors, Council member funds have a deep, abiding interest in ensuring that the capital markets are on a sound footing. The global financial crisis has unmasked weaknesses in US regulation of the capital markets and has badly shaken trust in those markets. Simply put, the current crisis represents a massive failure of oversight. In order to restore trust and ensure that such a crisis never happens again, regulators and investors must be given the tools necessary to guarantee robust oversight and meaningful accountability of corporate managers and directors.

As Congress evaluates potential reforms, certain principles should be paramount: Oversight must include an independent and reliable regulator with a mandate of investor protection; and required disclosures of the issuers of securities must be robust, timely and meaningful. Above all, investor protection and enforcement of the rules must be vigorous.

Vigorous regulation focusing on investor protection cannot alone solve many of the issues that led to the current crisis, however. While crucial, such regulatory oversight is no replacement for shareowner driven market discipline. Only through the combination of effective regulation and strong investor oversight will trust be restored and future crises avoided. Investors need stronger tools to hold managers and boards accountable.

In our view, a number of key corporate governance reforms are essential to providing meaningful investor oversight of management and boards. Such measures would address many of the problems that led to the current crisis, and more importantly, empower shareowners to anticipate and address unforeseen future risks. Governance reforms must thus be part of any broader legislative effort to improve the effectiveness of the regulation of our financial markets.

More specifically, the governance improvements that the Council believes would have the greatest impact and, therefore, should be contained in any financial markets regulatory reform legislation include:

1. **Majority Voting for Directors:** Directors in uncontested elections should be elected by a majority of the votes cast.

2. **Shareowner Access to the Proxy:** A long-term investor or group of long-term investors should have access to management proxy materials to nominate directors.

3. **Broker Voting Restrictions:** Broker non-votes and abstentions should be counted only for purposes of a quorum.

4. **Independent Board Chair:** The board should be chaired by an independent director.

5. **Independent Compensation Advisers:** Compensation advisers and their firms should be independent of the client company, its executives and directors, and should report solely to the compensation committee.

6. **Advisory Shareowner Vote on Executive Pay:** All companies should provide annually for advisory shareowner votes on the compensation of senior executives.

7. **Stronger Clawback Provisions:** At a minimum, senior executives should be required to return unearned bonus and incentive payments that were awarded due to fraudulent activity or incorrectly stated financial results.

8. **Severance Pay Limitations:** Executives should not be entitled to severance payments in the event of termination for poor performance.

We look forward to working with you on this critical issue of reforming the regulation of the financial markets. To continue the dialogue, we plan on contacting your office in the near future to arrange for a mutually convenient date and time to meet with you and your staff in person to share views and discuss these matters in more detail. In the meantime, if you have any questions, please feel free to contact me at (202) 261-7081 or jeff@cii.org, or Council analyst Jonathan Urick at (202) 261-7096 or jonathan@cii.org.

Sincerely,

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Jeb Spaulding
Vermont State Treasurer
Vermont Pension Investment Committee

Joseph A. Dear
Executive Director
Washington State Investment Board

Gail L. Hanson
Deputy Executive Director
State of Wisconsin Investment Board

Testimony of
Ann Yerger
Executive Director
Council of Institutional Investors
before the
Subcommittee on Securities, Insurance, and Investment
of the
Committee on Banking, Housing, and Urban Affairs
July 29, 2009

Attachment 4

U.S. Financial Regulatory Reform: The Investors' Perspective
A Report by the Investors' Working Group

U.S. Financial Regulatory Reform:

The Investors Perspective

A Report by the Investors Working Group

An Independent Taskforce Sponsored by
CFA Institute Centre for Financial Market Integrity
and
Council of Institutional Investors

July 2009

U.S. Financial Regulatory Reform:

The Investors Perspective

A Report by the Investors Working Group

An Independent Taskforce Sponsored by
CFA Institute Centre for Financial Market Integrity
and
Council of Institutional Investors

July 2009

ABOUT THE INVESTORS WORKING GROUP

During the summer of 2008, the CFA Institute Centre for Financial Market Integrity and Council of Institutional Investors began exploring the idea of commissioning a study on financial regulatory reform. Both organizations were concerned that investor views were missing in the ongoing national debate about overhauling the U.S. system of financial regulation. The U.S. Treasury Department s -Blueprint for a Modernized Financial Regulatory Structure," released in March 2008, largely ignored investor considerations, focusing instead on making U.S. markets more globally -competitive" by reducing costs for public companies and financial institutions.

The result was the launch in February 2009 of the Investors Working Group (IWG). This independent, non-partisan panel was formed to provide an investor perspective on ways to improve the regulation of U.S. financial markets. The IWG worked collaboratively to seek agreement on the recommendations. This report fairly reflects the consensus views of the group on myriad reforms. However, not all IWG members agreed with every recommendation in the report.

Our report could not be more timely. Over the past year, the worst financial crisis since the Great Depression has brought markets to the brink of collapse, toppled iconic financial institutions and forced repeated government bailouts. The debacle has wiped out retirement savings for millions of Americans and crippled the economy. It also has changed fundamentally the terms of the debate about regulation. Calls to unshackle Wall Street and let markets police themselves no longer dominate. Instead, the focus of the discussion now is on making the U.S. system of regulation more comprehensive, effective and responsive to the needs of investors, consumers and the broader financial system.

This report offers an essential roadmap to that destination. It suggests practical, near-term improvements and longer-term, aspirational reforms, some of which may require further study. But all of our recommendations are guided by a profound commitment to restoring confidence in our markets by ensuring that regulation serves the needs of investors. Strong investor safeguards are a prerequisite for market stability and integrity and a vibrant U.S. financial system.

William H. Donaldson, CFA
Co-Chair,
Investors Working Group

Arthur Levitt, Jr.
Co-Chair,
Investors Working Group

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*Note: Affiliations are for identification purposes only. IWG members participated as individuals; the report reflects their own views and not those of organizations with which they are affiliated.

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The IWG also would like to thank the staff of the CFA Institute Centre for Financial Market Integrity (CFA Centre) and the Council of Institutional Investors (CII) for their assistance in keeping the project moving. The IWG would like to especially thank Don Marlais (CII) and Linda Rittenhouse (CFA Centre) for their hard work and dedication in managing this project. Other staffers who contributed to the report included Amy Borrus, Marie Brodmerkel, Justin Levis, Jeff Mahoney, Jonathan Urick and Ann Yerger at CII and Jim Allen, Patrick Finnegan, Debra Palmore and Kathy Valentine at CFA Centre.

OVERVIEW

The credit crisis has exposed the faulty underpinnings of the U.S. financial services sector. The fundamental flaws are glaring: gaps in oversight that let purveyors of abusive mortgages, complex over-the-counter (OTC) derivatives and convoluted securitized products run amok; woefully underfunded regulatory agencies; and super-sized financial institutions that are both too big to fail- and too labyrinthine to regulate or manage effectively. Too often, the complexities of the regulatory system and the institutions it is supposed to police benefit institutions, dealers and traders at the expense of investors and consumers.

Designing a more rational financial services sector will take time, thoughtful analysis and political will. The findings of the Financial Crisis Inquiry Commission, which is to report to the U.S. Congress on the origins of the market meltdown and measures to ensure that such catastrophes do not happen again, are critical to that effort. What is at stake—the integrity of the U.S. financial system—is too important to rush the review.

In the near term, there are critical, practical steps that the federal government can take to put the U.S. financial regulatory system on a sounder footing and make it more responsive to the needs of investors. The Obama Administration's regulatory reform plan, announced on June 17, 2009, is a start. The Investors' Working Group (IWG) supports many of these recommendations but advocates a bolder set of near-term measures to strengthen investor and consumer protections and check systemic risks that threaten the health of the financial system.

The IWG believes that the U.S. needs a process for dealing with threats to the broader financial system, but we also believe that bolstering investor and consumer protection is paramount. The lack of sufficient authority, resources and will on the part of regulators helped fuel the financial meltdown at least as much as the absence of systemic-risk oversight.

To address these shortcomings, reform in the near term should focus on:

Strengthening and reinvigorating existing federal agencies responsible for policing financial institutions and markets and protecting investors and consumers. To achieve this goal, the will to regulate must be restored. Light-touch federal regulation has met with disastrous results, as has starving agencies of needed resources. For example, the U.S. Securities and Exchange Commission's (SEC) funding has not kept pace with the explosive growth of the securities markets over the past two decades. Today, the agency monitors 30,000 entities, including more than 11,000 investment advisers, up 32 percent in only the last four years. Even so, in the three years from 2005 to 2007, the SEC's budgets were flat or declining.

Filling the gaps in the regulatory architecture and in authority over certain investment firms, institutions and products. For example, OTC derivatives contracts should be subject to comprehensive regulation; credit rating agencies should be subject to more meaningful oversight and greater accountability for their ratings; investment managers, including managers of hedge funds and private equity, should be required to register with the SEC; originators of asset"backed securities (ABS) should have some skin in the game"; and regulators should be given resolution authority, analogous to the Federal Deposit Insurance Corporation's (FDIC) authority for failed banks, to wind down or restructure troubled systemically significant non"banks.

Improving corporate governance. The financial crisis represents a massive breakdown in oversight at many levels, including at corporate boards. Investors need better tools to hold directors accountable so they will be motivated to challenge executives who pursue excessively risky strategies. Measures to make it easier for shareowners to nominate and elect directors are a good place to start.

Since the financial crisis erupted, fear that the failure of large financial institutions could have devastating repercussions throughout the U.S. financial system has prompted unprecedented government intervention in the markets and the private sector. Consequently, much of the debate about financial reform has focused on the need to monitor and address future systemic risks. The U.S. regulatory framework was not designed to monitor and respond to risks to the entire financial system posed by large, complex and interconnected institutions, practices and products.

The IWG believes that the appropriate way to address this immediate need is for Congress and the Administration to authorize the creation of an independent Systemic Risk Oversight Board (SROB). Ideally, the SROB would have the authority and highly skilled staff to 1) collect and analyze financial institutions' exposures, practices and products that could threaten the stability of the financial system and 2) recommend steps that existing regulators should take to reduce those risks.

This approach represents a middle ground between the systemic risk regulator advocated by the Administration and the college of cardinals" model of oversight by the heads of existing federal regulators that some leading lawmakers propose. The IWG views both approaches with skepticism. A council of regulators would have blurred lines of authority—ultimately no one would be in charge or accountable—and could be hamstrung by the usual jurisdictional disputes. The Administration's approach, which envisions the U.S. Federal Reserve Board as systemic risk regulator, has more serious drawbacks. The Fed has other, potentially competing responsibilities—from guiding monetary policy to managing the vast U.S. payments system. Its credibility has been tarnished by the easy credit policies it pursued and the lax regulatory oversight that let institutions ratchet higher their balance sheet leverage and amass huge concentrations of risky, complex securitized products. Other serious concerns stem from the Fed's regulatory failures—its refusal to police mortgage underwriting or to impose suitability standards on mortgage lenders—and the heavy influence that banks have on the Fed's governance.

The Systemic Risk Oversight Board s collection and analysis of data, with an eye on emerging systemic risks, would be informed by the Financial Crisis Inquiry Commission s parallel efforts to understand the root causes of the current crisis. The tandem investigations would help guide policymakers as they consider overall regulation of the financial services sector, including the eventual locus, scope and powers of a systemic risk regulator. Until then, the oversight board would monitor systemic threats and refer appropriate steps to existing regulatory agencies-the Treasury, the Fed and Congress.

While our report focuses on near-term needs, we recognize that there is a larger, long-term agenda. Restructuring the hodge-podge of financial regulators and key financial institutions is clearly an imperative, regardless of how politically arduous the task. Policymakers need to map out a path toward a more rational, less conflicted financial system. Steps they should consider include:

Designating a systemic risk regulator, with appropriate scope and powers. One option would be for the Systemic Risk Oversight Board to evolve into a full-fledged regulator.

Adopting new regulations for financial services that will prevent the sector from becoming dominated by a few giant and unwieldy institutions. New rules are needed to address and balance concerns about concentration and competitiveness.

Strengthening capital adequacy standards for all financial institutions. Too many financial institutions have weak capital underpinnings and excessive leverage.

Imposing careful constraints on proprietary trading at depository institutions and their holding companies. Proprietary trading creates potentially hazardous exposures and conflicts of interest, especially at institutions that operate with explicit or implicit government guarantees. Ultimately, banks should focus on their primary purposes, taking deposits and making loans.

Consolidating federal bank regulators and market regulators. Regulation of banks and other depository institutions may be streamlined through the appropriate consolidation of prudential regulators. Similarly, efficiencies may be obtained through the merger of the SEC and the Commodity Futures Trading Commission (CFTC).

Studying a federal role in the oversight of insurance companies. The current state-based regulation makes for patchwork supervision that has proven inadequate to the task.

The IWG believes that the goal of the longer-term effort should be a simpler yet more comprehensive regulatory net, stronger overseers and manageable, better-governed financial institutions that will not pose "too big to fail" threats. The new financial order that emerges must ensure appropriate safeguards for investors. Investors, in turn, must focus on sustainable, risk-adjusted performance, recognizing that pressing investment advisers and executives of portfolio companies for quick returns can spur out-on-a-limb behavior in pursuit of fast but often ephemeral profits.

The regulatory overhaul should not stop at the water s edge. Financial markets are increasingly global. U.S. financial institutions generate a growing share of their revenues and assets overseas. Washington policymakers must lead a fresh effort to forge international consensus on key elements of the regulation of global markets, players and products. U.S. leaders should also press for greater sharing of information among national regulators and harmonization of rules and practices. In contrast to other recent global initiatives, however, the focus should be on *raising* standards, not weakening them.

This report is intended to ensure that policymakers fully consider and reflect on making regulatory changes that serve investors, consumers and the broader financial system. A balance is needed among many interests. In particular, building a U.S. financial system that correctly balances efficiency, global competitiveness, and investor and consumer protection is enormously challenging. It is also an opportunity, however, to put the U.S. financial system on a firmer, more rational footing and ensure that it serves the needs of investors. Strong investor protections are integral to restoring trust, stability and vibrancy to U.S. financial markets. The IWG believes this plan of action is the best way forward toward that goal.

OUTLINE OF RECOMMENDATIONS

I. INVESTOR AND CONSUMER PROTECTIONS

A. Strengthening Existing Federal Regulators

- Congress and the Administration should nurture and protect regulators commitment to fully exercising their authority.
- Regulators should have enhanced independence through stable, long-term funding that meets their needs.
- Regulators should acquire deeper knowledge and expertise.

B. Closing the Gaps for Products, Players and Gatekeepers

OTC Derivatives

- Standardized derivatives should trade on regulated exchanges and clear centrally.
- OTC trading in derivatives should be strictly limited and subject to robust federal regulation.
- The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) should improve accounting for derivatives.
- The SEC and the CFTC should have primary regulatory responsibility for derivatives trading.
- The United States should lead a global effort to strengthen and harmonize derivatives regulation.

Securitized Products

- New accounting standards for off-balance-sheet transactions and securitizations should be implemented without delay and efforts to weaken the accounting in those areas should be resisted.
- Sponsors should fully disclose their maximum potential loss arising from their continuing exposure to off-balance-sheet asset-backed securities.
- The SEC should require sponsors of asset-backed securities to improve the timeliness and quality of disclosures to investors in these instruments and other structured products.
- ABS sponsors should be required to retain a meaningful residual interest in their securitized products.

Hedge Funds, Private Equity and Investment Companies, Advisers and Brokers

- All investment managers of funds available to U.S. investors should be required to register with the SEC as investment advisers and be subject to oversight.
- Existing investment management regulations should be reviewed to ensure they are appropriate for the variety of funds and advisers subject to their jurisdiction.
- Investment managers should have to make regular disclosures to regulators on a real-time basis, and to their investors and the market on a delayed basis.

Hedge Funds, Private Equity and Investment Companies, Advisers and Brokers (cont.)

- Investment advisers and brokers who provide investment advice to customers should adhere to fiduciary standards. Their compensation practices should be reformed, and their disclosures should be improved.
- Institutional investors including pension funds, hedge funds and private equity firms should make timely, public disclosures about their proxy voting guidelines, proxy votes cast, investment guidelines, and members of their governing bodies and report annually on holdings and performance.

Non-Bank Financial Institutions

- Congress should give regulators resolution authority, analogous to the Federal Deposit Insurance Corporation's authority for failed banks, to wind down or restructure troubled, systemically significant non'banks.

Mortgage Originators

- Congress should create a new agency to regulate consumer financial products, including mortgages.
- Banks and other mortgage originators should comply with minimum underwriting standards, including documentation and verification requirements.
- Mortgage regulators should develop suitability standards and require lenders to comply with them.
- Mortgage originators should be required to retain a meaningful residual interest in all loans and outstanding credit lines.

Nationally Recognized Statistical Rating Organizations (NRSROs)

- Congress and the Administration should consider ways to encourage alternatives to the predominant issuer'pays NRSRO business model.
- Congress and the Administration should bolster the SEC's position as a strong, independent overseer of NRSROs.
- NRSROs should be required to manage and disclose conflicts of interest.
- NRSROs should be held to a higher standard of accountability.
- Reliance on NRSRO ratings should be greatly reduced by statutory and regulatory amendments. Market participants should reduce their dependence on ratings in making investment decisions.

C. Corporate Governance

- In uncontested elections, directors should be elected by a majority of votes cast.
- Shareowners should have the right to place director nominees on the company's proxy.
- Boards of directors should be encouraged to separate the role of chair and CEO or explain why they have adopted another method to assure independent leadership of the board.
- Securities exchanges should adopt listing standards that require compensation advisers to corporate boards to be independent of management.
- Companies should give shareowners an annual, advisory vote on executive compensation.
- Federal clawback provisions on unearned executive pay should be strengthened.

II. Systemic Risk Oversight Board

- Congress should create an independent governmental Systemic Risk Oversight Board.
- The board s budget should ensure its independence from the firms it examines.
- All board members should be full"time and independent of government agencies and financial institutions.
- The board should have a dedicated, highly skilled staff.
- The board should have the authority to gather all information it deems relevant to systemic risk.
- The board should report to regulators any findings that require prompt action to relieve systemic pressures and should make periodic reports to Congress and the public on the status of systemic risks.
- The board should strive to offer regulators unbiased, substantive recommendations on appropriate action.
- Regulators should have latitude to implement the oversight board s recommendations on a "comply or explain" basis.

I. Investor and Consumer Protections

The Investors Working Group believes that strengthening existing regulatory agencies, closing gaps in the regulatory structure, enhancing consumer and investor protections and improving corporate governance are the most important steps Congress and the Obama Administration can take to restore the integrity of the financial system and the stability of financial markets.

Background

When the financial meltdown began, regulators for the most part had enough information and should have recognized the signs but did not, or could not, stop the downward spiral. One reason is that regulators lacked the requisite will, resources and expertise. Another is that the web of regulatory supervision that covers the U.S. financial services industry is riddled with holes. Some are intentional. For example, the OTC derivatives market has been expressly exempted from virtually all federal oversight. But even in regulated parts of the markets, the oversight fabric is not knit tightly enough.

A. Strengthening Existing Federal Regulators

While the IWG acknowledges that regulatory failures were a major contributing cause of the financial debacle, we believe that the right solution is to reinforce, rather than abandon, the existing regulatory framework.

Above all, regulators must be committed to promoting policies that are good for consumers, investors and the financial markets. Although the will to regulate cannot be legislated, Congress can encourage vigorous regulation through general oversight and its specific role in providing advice and consent regarding nominees to lead financial regulatory agencies. Structural and financial changes can also help strengthen regulatory agencies by making them more independent of the industries they supervise and allowing them to hire staff with deep knowledge of complex products and rapid financial innovation. Consolidating agencies as appropriate can help bolster and streamline financial regulation so long as mergers are crafted with a keen understanding of the differences between existing regulators and the markets and institutions they supervise.

Background

Since 1980, a dramatic shift in the financial regulatory system has occurred. Vigorous governmental oversight was abandoned as regulators placed their faith in the ability of markets to self-police and self-correct. Even as the credit crisis unfolded in early 2008, the prevailing view in the industry and among many agency chiefs and government leaders was that too much regulation, rather than too little, was eroding the competitiveness of U.S. markets.

The IWG believes that this view is misguided. The financial crisis has revealed that insufficient and ineffective oversight, not over-regulation, paved the way to financial turmoil.

Beyond a misplaced faith in markets, regulators lacked the will, knowledge and resources to flexibly respond to rapid financial innovation and market expansion. Poor funding and a lack of independence allowed an anti-regulatory ideology to permeate regulatory agencies. The Congressional appropriations process helped to undermine robust oversight. Fearful of political budgetary retaliation, agencies grew reluctant to exercise their authority fully in certain areas. It is no coincidence that these pockets of poor oversight proved to be sources of great risk.

Specific Recommendations

1. Congress and the Administration should nurture and protect regulators commitment to fully exercising their authority. Congress and the Administration should amend statutory language establishing various financial regulators to prominently include provisions requiring that the President consider potential appointees determination to exercise vigorous oversight and their commitment to the regulatory mission. Congress should be vigilant in exercising its general supervisory authority and thoughtfully carry out its obligation to provide advice and consent to ensure that nominees possess the resolve to regulate effectively.

The President, Congress and agency leaders must work to foster a culture of regulatory professionalism that rewards high-quality work and instills a community of purpose. Such a culture is rooted in steadfast devotion to vigorous oversight and enforcement. Regulators should be encouraged to exercise the greatest supervision where the need is greatest, including over the most complex and rapidly expanding institutions, products and markets. Resistance to regulation in these often highly lucrative areas is likely to be intense. Staff should be rewarded for asking tough questions, pursuing difficult cases and thinking outside the bounds of conventional wisdom. A healthy tension and skepticism between regulators and those they oversee should be promoted as a hallmark of exemplary regulation.

2. Regulators should have enhanced independence through stable, long-term funding that meets their needs. All federal financial regulators should have the resources and independence to fulfill their mission effectively without political interference or dependence on the firms they oversee. The IWG encourages Congress and the Administration to consider ways to develop mechanisms for stable, long-term funding. To ensure that funding keeps pace with rapid market changes and financial innovation, Congress, the Administration and regulators should periodically reevaluate the resources each agency needs to fulfill its mission. To the extent possible, agencies should have funding flexibility to respond to these changes on their own.

3. Regulators should acquire deeper knowledge and expertise. The speed with which financial products and services have proliferated and grown more complex has outpaced regulators ability to monitor the financial waterfront. Staffing levels failed to keep pace with the growing work load, and many agencies lack staff with the necessary expertise to grapple with emerging issues. Political appointees and senior civil service staff should have a wide range of financial backgrounds. Compensation should be sufficient to attract top-notch talent. In addition, continuing education and training should be dramatically expanded and officially mandated to help regulators keep pace with innovation. Although we recognize that the -revolving door" between regulatory agencies and the private sector can lead to abuse, we believe that both the public sector and the private sector can benefit from people with experience in both. In particular, agencies should explore ways of recruiting individuals from the private sector to improve the regulators ability to understand and keep up with complex financial and market innovations. And those who have served in regulatory agencies can assist market players in understanding the perspective of regulators and the need for regulations.

B. Closing the Gaps for Products, Players and Gatekeepers

The nation s regulatory umbrella should be comprehensive. Specifically, it should be broadened to cover important financial products, players and gatekeepers that lack meaningful oversight. Critical gaps that urgently need attention include OTC derivatives, securitized products, investment managers, mortgage finance companies and credit rating agencies.

OTC Derivatives

All standardized (and standardizable) derivative contracts currently traded over the counter should be required to be traded on regulated exchanges and cleared through regulated clearinghouses. Any continuing OTC derivatives trading should be limited strictly to truly customized contracts between highly sophisticated parties, at least one of which requires a customized contract in order to hedge business risk. What remains of the OTC derivatives market should be subject to a robust federal regulatory regime, including reporting, capital and margin requirements.

Background

OTC derivatives generally are bilateral contracts between sophisticated parties. They include interest rate swaps, foreign exchange contracts, equity swaps, commodity swaps and the now-infamous credit default swaps (CDS), along with other types of swaps, contracts and options. It is widely acknowledged that OTC derivatives contracts, and particularly CDS, played a significant role in the current financial crisis. For December 2008, the Bank for International Settlements reported a notional amount outstanding of $592 trillion and a gross market value outstanding of $34 trillion for global OTC derivatives. This enormous financial market was exempted from virtually all federal oversight and regulation by the Commodity Futures Modernization Act of 2000 (CFMA).

Although OTC derivatives have been justified as vehicles for managing financial risk, they have also spread and multiplied risk throughout the economy in the current crisis, causing great financial harm. Warren Buffett has dubbed them financial weapons of mass destruction." Problems plaguing the market include lack of transparency and price discovery, excessive leverage, rampant speculation and lack of adequate prudential controls.

Specific Recommendations

1. Standardized derivatives should trade on regulated exchanges and clear centrally. Congress and the Administration should enact legislation overturning the exemptive provisions of the CFMA and requiring standardized (and standardizable) derivatives contracts to be traded on regulated derivatives exchanges and cleared through regulated derivatives clearing operations. Legal requirements based on those established in the Commodity Exchange Act for designated contract markets and derivatives clearing operations should apply to such trading and clearing. These requirements would allow effective government oversight and enforcement efforts, ensure price discovery, openness and transparency, reduce leverage and speculation and limit counterparty risk. Although requiring central clearing alone would mitigate counterparty risk, it would not provide the essential price discovery, transparency and regulatory oversight provided by exchange trading.

2. OTC trading in derivatives should be strictly limited and subject to robust federal regulation. An OTC market is necessarily much less transparent and much more difficult to regulate than an exchange market. If trading OTC derivatives is permitted to continue, such trading should be strictly limited to truly customized contracts between highly sophisticated parties, at least one of which requires such a customized contract in order to hedge business risk. Congress and the Administration should enact legislation limiting the eligibility requirement for OTC derivatives trades to highly sophisticated and knowledgeable parties and requiring that at least one party to each OTC contract should certify and be prepared to demonstrate that it is entering into the contract to hedge an actual business risk. This limitation to trading on the OTC market would permit entities to continue to hedge actual business risks but would reduce the current pervasive speculation in the market.

A federal regulatory regime is needed for any continuing OTC market. OTC derivatives dealers should be required to register, maintain records and report transaction prices and volumes to the federal regulator. They should be subject to adequate capital requirements and business conduct standards, including requirements to disclose contract terms and risks to their customers. All OTC trades should be subject to federally imposed margin requirements, and all large market participants should be subject to capital requirements. In addition, transaction prices and volumes of OTC derivatives should be publicly reported on a timely basis.

All market participants should be subject to federal fraud and manipulation prohibitions, recordkeeping and reporting requirements, and position limits if imposed by the federal regulator. The regulator should have broad powers to oversee the market and all its participants, including powers to require additional reporting and inspection of records and to order positions to be eliminated or reduced. Federal legal prohibitions should be enacted to prohibit the use of OTC derivatives to misrepresent financial condition or to avoid federal laws.

3. The FASB and IASB should improve accounting for derivatives. A thorough and comprehensive review of accounting rules related to derivative instruments is needed. The goals of this review should be to ensure consistent reporting about these instruments and to ensure full disclosure for the benefit of investors, counterparties and regulators. To make informed decisions, investors and those entering into counterparty relationships need information about these positions.

4. The SEC and the CFTC should have primary regulatory responsibility for derivatives trading. Currently, the SEC and the CFTC each have regulatory responsibilities for certain portions of derivatives trading, depending on the nature of the derivatives product and/or the type of exchange on which it is traded. Those agencies have the experience and sophistication to oversee derivatives markets and should act as the primary regulators of both exchange trading and any continuing OTC market. It is important that federal standards for derivatives trading be comprehensive and consistent and that agency jurisdiction over such trading be clearly delineated. For this reason, the SEC and the CFTC must agree on appropriate regulatory standards and on their respective regulatory responsibilities, and the terms of such agreement should be enacted into law.

5. The United States should lead a global effort to strengthen and harmonize derivatives regulation. Because the OTC derivatives market is global, U.S. financial regulators should work with foreign authorities to strengthen and harmonize standards for derivatives regulation internationally and to enhance international cooperation in enforcement and information sharing.

Securitized Products

Investors have had a difficult time understanding securitized instruments because of the lack of information about them and the confusing manner in which this information is reported, both to the shareowners of the issuing company (or sponsor), and to investors in these often complex products. This opacity stems in part from securitized products absence from sponsors balance sheets. Moreover, securitized products are sold before investors have access to a comprehensive and accurate prospectus.

The IWG believes that accounting standards setters should improve the quality, appropriateness and transparency of reporting related to off-balance-sheet transactions and securitizations by sponsoring institutions. The SEC should develop new rules for the sale of asset backed securities that give investors in these products a reasonable opportunity to review disclosures before making a decision to invest. Sponsors of ABS and structured products should have to retain a meaningful interest in the underlying assets they securitize. Lastly, while the status of government-sponsored enterprises (GSEs) is currently in limbo, the IWG believes the GSEs or their successor enterprises should be subject to the same securities regulations that apply to all other sponsors when they issue ABS.

Background

Beginning in the 1980s, banks and other lenders began repackaging mortgage loans and other predictable cash flows into asset-backed securities. Some $3 trillion were outstanding by year-end 2008.

Both investors in these securities and the shareowners of their sponsoring organizations lack crucial information needed to judge their true risk. The off-balance-sheet accounting treatment of securitizations masks from shareowners of the sponsoring company the potential costs of deterioration in the quality of the assets underlying the instruments. Consequently, shareowners of a sponsoring company may not appreciate the impact on the company of deterioration in the quality of the underlying loans. In addition, the off-balance-sheet treatment allows the sponsor to reduce the amount of capital supporting the underlying loans by as much as 90 percent. Significant capital shortfalls can thus occur when a sponsor chooses to support these securitizations (whether according to or beyond the terms of the securitization) by bringing them back onto its balance sheet.

Beyond poor accounting and disclosures by the sponsors of securitized products, institutions that invest directly in these securities have been ill-served by existing disclosures. In particular, investors often have to decide whether to invest in an ABS issuance based not upon a detailed prospectus but rather on a basic term sheet with limited information. Although these investors could choose not to invest under such terms, doing so would lock them out of many ABS transactions. Institutions feared that this lockout would be inconsistent with their fiduciary duty to find the best investments for their clients. Investing before reviewing a prospectus, however, limits the ability of investors to perform adequate due diligence.

Accounting and disclosure problems were even more severe at the GSEs. As government-chartered corporations, the GSEs were able to operate as major sponsors of mortgage-backed securities, even though they were not subject to the same regulations as other participants. As recent events have shown, an implicit government guarantee does not protect investors from systemic failure. Consequently, investors need to have relevant information that will help them review, analyze and make reasoned and informed investment decisions about securities and firms that might be affected by the financial performance and condition of GSEs. Although the GSEs future is uncertain at this time, the IWG believes that they or their successors should have to adhere to the same regulations as other securities issuers.

Notwithstanding the serious lack of crucial information about securitized products, the IWG recognizes that investors need to be more diligent. Some investors effectively outsourced their investment due diligence to third parties, such as credit rating agencies, without fully understanding the nature of the collateral underlying the bonds, the purpose of the rating or the rating agency s conflicts of interest that may have colored its ratings. Investors must pay more attention to these details, which are critical to understanding the risks and opportunities of ABS investments.

Specific Recommendations

1. New accounting standards for off-balance-sheet transactions and securitizations should be implemented without delay and efforts to weaken the accounting in those areas should be resisted. The IWG applauds the recent action by the FASB finalizing accounting standards that limit exemptions for consolidating off-balance-sheet entities and require more information about securitization transactions. Efforts to water down or delay the implementation of those new requirements should be vigorously resisted.

2. Sponsors should fully disclose their maximum potential loss arising from their continuing exposure to off-balance-sheet asset-backed securities. Sponsoring companies with off-balance-sheet exposure to ABS that they sponsored and/or are servicing should be required to provide full disclosure about how these exposures could affect shareowners if the firm returns the related assets and liabilities to their balance sheets. More transparent disclosure would permit investors to better understand the amount and type of loans that sponsors are originating and the amount of leverage they could create. The disclosure would also provide investors with information about ongoing changes in loan quality and underwriting standards and the potential risks those changes may create in the future. In particular, such disclosure also should describe how those actions could affect the sponsoring firm s capital and liquidity positions, earnings and future business prospects if the firm repurchases the loans onto its balance sheet.

3. The SEC should require sponsors of asset-backed securities to improve the timeliness and quality of disclosures to investors in these instruments and other structured products. Current rules allowing sponsors to issue asset-backed securities via shelf registration provide for woefully inadequate disclosures to potential investors in these products. Because each ABS offering involves a new and unique security, the IWG does not believe the SEC should allow such issuances to be eligible for its normal shelf-registration procedures. Instead, the SEC should develop a regulatory regime for such asset-backed securities that would require issuers to make prospectuses available for potential investors in advance of their purchasing decisions. These prospectuses should disclose important information about the securities, including the terms of the offering, information about the sponsor, the issuer and the trust, and details about the collateral supporting the securities. Such new rules would give investors critical information they need to perform due diligence on offerings prior to investing. It would also create better opportunities for due diligence by the underwriters of such securities, thus adding additional levels of oversight of the quality and appropriateness of structured offerings.

4. ABS sponsors should be required to retain a meaningful residual interest in their securitized products. Having -skin in the game" would make sponsors more thoughtful about the quality of the assets they securitize. Sponsors should have to retain a meaningful residual interest in ABS offerings. Hedging these retained exposures should be prohibited.

Hedge Funds, Private Equity and Investment Companies, Advisers and Brokers

All investment managers of funds available to U.S. investors should be required to register with the SEC as investment advisers so that they are subject to federal scrutiny. All registered fund managers should have to make periodic disclosures to regulators about the current positions of their funds, and should make regular, delayed public disclosures of their funds positions to help their investors and other market participants understand the associated risks. Regulators should conduct a full review of rules governing investment managers and their funds to ensure that they adequately address the different types of investment vehicles and practices subject to those rules. In order to improve the quality of advice provided to retail investors and to protect them from abusive practices, the SEC should be empowered to reform compensation practices that create unacceptable conflicts of interest, improve pre-sale disclosures, and subject all those who provide personalized investment advice, including broker-dealers, to a fiduciary duty.

Regulators should also be empowered to oversee new participants and products as they emerge and have adequate resources for timely and careful examinations.

Background

Many hedge funds, funds of hedge funds and private equity funds operate within the shadow" financial system of unregulated non"bank financial entities. These funds and their managers have been exempt from regulation because of a combination of factors related to the number and relative sophistication of investors they serve and the size of assets under management.

Unencumbered by leverage limits, compliance examinations or full disclosure requirements, many hedge funds and private equity funds operate under the radar. Their ability to take on enormous leverage, in particular, enables them to hold huge positions that can imperil the broader market. If market trends move against a hedge fund or a private equity fund and it is forced to liquidate at fire"sale prices, prime brokers, banks and other counterparties could be subject to significant losses. Even market participants who have no direct dealings with the fund could be battered by the resulting plunge in asset prices and liquidity squeeze. Registration would afford a degree of transparency and oversight for these systemically important market players. It would at least ensure disclosure of basic information about the managers and funds and make them eligible for examination by the SEC.

Oversight of the intermediaries that investors rely on in making investment decisions has failed to keep pace with dramatic changes in the industry. These changes include the development and rapid growth of the financial planning profession and changes in the full"service brokerage business model to one that is, or is portrayed as being, largely advisory in nature. Nevertheless, a series of decisions by regulators over the years allowed brokerages to call their sales representatives financial advisers," offer extensive personalized investment advice and market their services based on the advice offered, all without regulating them as advisers.

As a result, investors are forced to choose among financial intermediaries who offer services that appear the same to unsophisticated eyes, but who are subject to very different standards of conduct and legal obligations to the client. Most significantly, investment advisers are required to act in their clients' best interest and disclose all material information, including information about conflicts of interest, whereas brokers are subject to the less rigorous suitability standard and do not have to provide the same extensive disclosures.

Meanwhile, although investors are encouraged to place their trust in financial advisers," compensation practices in the industry are riddled with conflicts of interest that may encourage sales of products that are not in clients' best interests. The disclosures that investors are supposed to rely on in making investment decisions are often inadequate and overly complex and typically arrive after the sale–long past the point when they could have been useful to investors in analyzing their investment options.

As innovation produces new institutions, products and practices, federal regulators must be able to bring them under their jurisdiction, too. One important lesson of the recent crisis is that as financial products and services proliferate and become more complex, they often fall through the regulatory cracks. Extending the scope of examinations will require additional funding for regulators and ultimately result in more effective regulation.

Specific Recommendations

1. All investment managers of funds available to U.S. investors should be required to register with the SEC as investment advisers and be subject to oversight. All investment advisers and brokers offering investment advice should have to meet uniform registration requirements, regardless of the amount of assets under management, the type of product they offer or the sophistication of investors they serve. Exemptions from registration should not be permitted, although smaller advisory firms should continue to be overseen by state regulators.

2. Existing investment management regulations should be reviewed to ensure they are appropriate for the variety of funds and advisers subject to their jurisdiction. The frequency and extent of regulatory examinations should be determined by the nature and size of the firm. The exam process should be augmented by independent third-party reviews and reporting. Regulators should be empowered to extend their jurisdictional reach to cover emerging participants and products.

3. Investment managers should have to make regular disclosures to regulators on a real-time basis and to their investors and the market on a delayed basis. Because of the potential systemic risks associated with investment managers, and their interconnections with other systemically important financial institutions, the IWG believes that all investment managers should have to disclose their positions to regulators on a confidential but real-time basis. This would allow regulators to recognize large and growing exposures and take steps to limit their impact.

The IWG also believes that hedge funds and other private pools of capital should make regular but delayed public disclosures about their positions. Delayed disclosure would provide investors a window on the fund manager s investment strategies while preventing other investors from -front-running" those game plans. It would also give the market at large an understanding of the degree of risk inherent in the investment strategies. In light of new trading techniques and products available, regulators should reexamine how often investment companies are required to report their holdings to investors and the market.

4. Investment advisers and brokers who provide investment advice to customers should have to adhere to fiduciary standards. Their compensation practices should be reformed and their disclosures improved. All investment professionals, including broker-dealers who provide personalized investment advice, should be subject to a fiduciary duty to act in their clients best interests and to disclose material information. Compensation practices that encourage investment professionals to make recommendations that are not in their clients best interests should be reformed. Disclosures should also be improved to ensure that investors receive pre-engagement disclosure to aid them in selecting an investment professional and clear, plain English, pre-sale

disclosure of key information about recommended investments. This would provide an added level of protection to both retail and institutional clients.

5. Institutional investors including pension funds, hedge funds and private equity firms should make timely public disclosures about their proxy voting guidelines, proxy votes cast, investment guidelines, and members of their governing bodies and report annually on holdings and performance. Investors who champion best disclosure practices at portfolio companies have a responsibility to play by similar rules. Best disclosure practices for institutional investors would foster transparency and accountability throughout the capital markets, thus enhancing confidence in the markets. They would also strengthen fiduciary ties between fund beneficiaries and trustees and guard against misuse of fund assets and abuses of the power inherent in large pools of capital. Specifically, institutional investors should make timely, public disclosures about their proxy voting guidelines, proxy votes cast, investment guidelines, members of their governing bodies and report annually on holdings and performance.

Non-Bank Financial Institutions

Congress should enact legislation granting appropriate regulators resolution authority for faltering non-bank financial institutions. Such authority should include explicit powers to seize, wind down and restructure troubled institutions deemed too big to fail.- The IWG generally supports the Administration's proposal for this new authority but does not take a position on where it should be vested and how it should be implemented.

Background

In the 1930s, chaotic and costly bank failures motivated Congress and President Roosevelt to empower federal regulators to seize and wind down, in an orderly fashion, illiquid and insolvent banks. The financial crisis of 2008 included, in particular, a run on several large firms operating in the non-bank financial system. No mechanism existed, however, to deal with the failure of large, complex, interconnected non-bank institutions, such as Bear Stearns, Lehman Brothers or American International Group (AIG). As a result, federal bailouts were ad hoc and inconsistent, fueling further market chaos that threatened the entire financial system.

Specific Recommendation

Congress should give regulators resolution authority, analogous to the FDIC-s authority for failed banks, to wind down or restructure troubled, systemically significant non-banks. Banks are no longer the primary systemically significant players in our financial system. The disorderly failure of large, interconnected investment banks, insurers and other institutions could also trigger cascading failures throughout the financial system. A carefully designed resolution regime for large non-banks would provide much needed market stability by ensuring that the essential functions of failed institutions continue relatively uninterrupted. Consideration also should be given to expanded use of the Bankruptcy Code. An orderly liquidation or restructuring would also help minimize the cost to taxpayers over the long run.

Mortgage Originators

All banks and other mortgage lenders should be required to meet minimum underwriting standards. They should also adhere to baseline standards for documenting and verifying a borrower s ability to repay and for ensuring that loans and credit lines they issue are appropriate for particular borrowers. A new consumer product oversight agency could help ensure that mortgage lenders adhere to such standards and requirements. Mortgage lenders should be required to retain a meaningful residual interest in all loans and credit lines they originate.

Background

Over the past 20 years, the link between mortgage underwriting and origination and retention of the risk of repayment has become increasingly attenuated. Although mortgage bankers and brokers, as well as some bank loan officers, have always been paid on the basis of the size of the loan and its characteristics, it has become common for brokers and others to be paid more for loans with higher interest rates or other characteristics (such as prepayment penalties) that in fact make it harder for borrowers to repay. The practice encouraged steering borrowers to loans for which they were not qualified and falsifying income and other data so borrowers could get loans they could not afford. Lenders that quickly sold loans to packagers of securitized products had little or no interest in the borrowers ability to repay. Ultimately, investors who purchased mortgage-backed securities shouldered the credit risk.

The lack of meaningful federal oversight of consumer credit product providers exacerbated the off-loading of risk to investors. Without minimum standards and oversight applied consistently to all mortgage lenders, many of the largest mortgage originators -regulated" themselves—and competition drove down standards. The consequences were disastrous for borrowers, lenders, communities and the economy as a whole.

Specific Recommendations

1. Congress should create a new agency to regulate consumer financial products, including mortgages. The financial crisis has demonstrated that mortgage originators cannot exercise necessary market self-discipline and that current regulatory structures, where they exist, have failed to provide appropriate protection for both consumers and investors. The IWG supports the Administration s call for a new federal agency to regulate consumer financial products and payment systems. The agency should have broad rulemaking, oversight and enforcement authority.

2. Banks and other mortgage originators should comply with minimum underwriting standards, including documentation and verification requirements. Mortgage originators will make more responsible lending decisions if they face minimum underwriting standards that are subject to review by federal and state regulators. These standards should be based on a realistic appraisal of the borrower s ability to repay the debt, taking into account any features that would increase the payments in the future. Such standards should also require mortgage originators to obtain and verify key financial information from all borrowers and to obtain and retain evidence that the borrower has seen and agreed with this information before a loan is closed. Federal and state

regulators should monitor all mortgage originators for compliance with these practices. These changes should reduce the race to the bottom" that characterized the last decade.

3. Mortgage regulators should develop suitability standards and require lenders to comply with them. This will help ensure that mortgage companies consider carefully whether a particular credit product is appropriate for a particular borrower. Innovative features in mortgage products can help certain borrowers. But these should be tailored to each borrower's needs and ability to repay, and originators should be required to offer consumers the best possible mortgage rates, fees and terms for which they qualify.

4. Mortgage originators should be required to retain a meaningful residual interest in all loans and outstanding credit lines. Having skin in the game" would make lenders more thoughtful about the credit"worthiness of potential borrowers. Mortgage lenders should be required to retain a meaningful interest in all loans and outstanding credit lines they generate. Federal and state regulators should be empowered to determine the minimum holding period and related terms and conditions. Lenders should be prohibited from hedging these exposures.

Nationally Recognized Statistical Rating Organizations

The failure of Nationally Recognized Statistical Ratings Organizations to alert investors to the risks of many structured products underscores the need for significant change in the regulation of credit rating agencies. Congress should grant the SEC greater authority to scrutinize NRSROs. Congress and the Administration should consider steps to encourage alternatives to the predominant, issuer"pays NRSRO business model. Congress also should eliminate the safe harbor in Section 11 of the Securities Act of 1933 that shields rating agencies from liability for due diligence failures. And to deter investors from relying too heavily on rating agencies, lawmakers and regulators should remove or diminish provisions in laws and regulations that designate minimum NRSRO ratings for specific kinds of investments.

Background

Credit ratings issued by NRSROs are widely embedded in federal and state laws, regulations and private contracts. Ratings determine the net capital requirements of financial institutions globally under the Basel II capital accords. They also dictate the primary types of investment securities that money market funds and pension funds may hold. Partly as a result, many institutional investors have come to rely on credit rating agencies as a basic investment screen, a problem that is exacerbated by the lack of adequate disclosures in the sale of asset"backed securities.

Despite the semi"official status of NRSROs as financial gatekeepers, the rating agencies face minimal federal scrutiny. The Credit Rating Agency Reform Act of 2006 did not much alter that light"touch" oversight. Although it standardized the process for NRSRO registration and gave the SEC new oversight powers, those powers were limited. It also expressly ruled out any private right of action against an NRSRO.

The central role that rating agencies played in the financial crisis makes such limited oversight untenable. The leading NRSROs Fitch Ratings, Moody's Investors Service and Standard & Poor's Ratings Services maintained high investment'grade ratings on many troubled financial institutions until they were on the brink of failure or collapse. And well into the credit crisis, NRSROs maintained triple'A ratings on complex structured financial instruments despite the poor and deteriorating the quality of the sub'prime assets underlying those securities.

The conflicted issuer'pays model of many NRSROs contributed to their poor track record. Most NRSROs are paid by companies and securitizers whose debt they rate. With their profitability dependent on the rapidly growing business of rating structured finance products, rating agencies appear to have been all too willing to assign the high ratings that originators and underwriters demanded. Questions about the quality of their ratings continued to rise in recent years even as they rated more and more complicated instruments.

But credit rating agencies' statutory exemption from liability also keeps NRSROs from having to answer for their shoddy performance and poorly managed conflicts of interest. Credit rating agencies have long maintained that their ratings are merely opinions that should be afforded the same protection as the opinions of newspapers and other publishers. Judicial rulings have tended to support their claim to protected status.

To be sure, some investors relied too heavily on NRSRO ratings, ignoring warning signs such as the rating agencies' notorious failure to downgrade ratings on Enron and other troubled companies until they were on the brink of bankruptcy. And some investors ignored or failed to comprehend the fundamental differences between ratings on structured securities and ratings on traditional debt instruments.

Statutory and regulatory reliance on ratings encourages investors to put more faith in the rating agencies than they should. If the rating agencies cannot dramatically improve their rating performance, they should be weaned from such official seals of approval. At the very least, legal references to ratings should make clear that reliance on them does not satisfy the requirement that investors perform appropriate due diligence to determine the appropriateness of the investments. In other words, ratings should be seen not as a seal of approval for certain investments but as defining the investments that should not be considered for a particular purpose.

The IWG recognizes that it is not practical to abolish the concept of NRSROs and erase references to NRSRO ratings in laws and regulations, at least not with one stroke. Mandates to use ratings are embedded in many financial rules. The more practical course for the near term is to reform credit rating agency regulation and to work toward reducing or removing references to credit ratings in laws and regulations.

Specific Recommendations

1. Congress and the Administration should consider ways to encourage alternatives to the predominant issuer-pays NRSRO business model. In addition, the fees earned by the NRSROs should vest over a period of time equal to the average duration of the bonds. Fees should vest based on the performance of the original ratings and changes to those ratings over time relative to the credit performance of the bonds. Credit rating agencies that continue to operate under the issuer-pays model should be subject to the strictest regulation.

2. Congress and the Administration should bolster the SEC s position as a strong, independent overseer of NRSROs. The SEC s authority to regulate rating agency practices, disclosures and conflicts of interest should be expanded and strengthened. The SEC should also be empowered to coordinate the reduction of reliance on ratings.

3. NRSROs should be required to manage and disclose conflicts of interest. As an immediate step, NRSROs should be required to create an executive-level compliance officer position. More complete, prominent and consistent disclosures of conflicts of interest are also needed. And credit raters should disclose the name of any client that generates more than 10 percent of the firm s revenues.

4. NRSROs should be held to a higher standard of accountability. Congress should eliminate the effective exemption from liability provided to credit rating agencies under Section 11 of the Securities Act of 1933 for ratings paid for by the issuer or offering participants. This change would make rating agencies more diligent about the ratings process and, ultimately, more accountable for sloppy performance.

NRSROs should not rate products for which they lack sufficient information and expertise to assess. Credit rating agencies should only rate instruments for which they have adequate information and should be legally vulnerable if they do otherwise. This would effectively limit their ability to offer ratings for certain products. For example, rating agencies should be restricted from rating any product that has a structure dependent on market pricing. They should not be permitted to rate any product where they cannot disclose the specifics of the underlying assets. Credit rating agencies should be restricted from taking the metrics and methodology for one class of investment to rate another class without compelling evidence of comparability.

5. Reliance on NRSRO ratings should be greatly reduced by statutory and regulatory amendments. Market participants should reduce their dependence on ratings in making investment decisions. Many statutes and rules that require certain investors to hold only securities with specific ratings encouraged some investors to rely too heavily on credit ratings. Eliminating these safe harbors over time, or clarifying that reliance on the rating does not satisfy due diligence obligations, would force investors to seek additional and alternative assessments of credit risk.

C. Corporate Governance

Investors need better tools to hold managers and directors accountable for their actions. Improved corporate governance requirements would also help restore trust in the integrity of U.S. financial markets. In particular, shareowners ability to hold an advisory vote on the compensation of senior executives, as well as their ability to nominate and elect directors, must be enhanced. Board independence should also be strengthened.

Background

The global financial crisis represents a massive failure of oversight. Vigorous regulation alone cannot address all of the abuses that paved the way to financial disaster. Shareowner"driven market discipline is also critical. Too many CEOs pursued excessively risky strategies or investments that bankrupted their companies or weakened them financially for years to come. Boards were often complacent, failing to challenge or rein in reckless senior executives who threw caution to the wind. And too many boards approved executive compensation plans that rewarded excessive risk" taking.

But shareowners currently have few ways to hold directors feet to the fire. The primary role of shareowners is to elect and remove directors, but major roadblocks bar the way. Federal proxy rules prohibit shareowners from placing the names of their own director candidates on proxy cards. Shareowners who want to run their own candidates for board seats must mount costly full"blown election contests. Another wrinkle in the proxy voting system is that relatively few U.S. companies have adopted majority voting for directors. Most elect directors using the plurality standard, by which shareowners may vote for, but not against, a nominee. If they oppose a particular nominee, they may only withhold their votes. As a consequence, a nominee only needs one "for" vote to be elected and unseating a director is virtually impossible.

Poorly structured pay plans that rewarded short"term but unsustainable performance encouraged CEOs to pursue risky strategies that hobbled one financial institution after another and tarnished the credibility of U.S. financial markets. To remedy this situation, stronger governance checks on runaway pay are needed.

Specific Recommendations

1. In uncontested elections, directors should be elected by a majority of votes cast. At many U.S. public companies, directors in uncontested elections are elected by a plurality of votes cast. An uncontested election occurs when the number of director candidates equals the number of available board seats. Plurality voting in uncontested situations results in "rubber stamp" elections. Majority voting in uncontested elections ensures that shareowners votes count and makes directors more accountable to shareowners. Plurality voting for *contested* elections should be allowed because investors have a more meaningful choice in those elections.

2. Shareowners should have the right to place director nominees on the company s proxy. In the United States, unlike most of Europe, the only way that shareowners can run their own candidates is by waging a full-blown election contest, printing and mailing their own proxy cards to shareowners. For most investors, that is onerous and prohibitively expensive. A measured right of access would invigorate board elections and make boards more responsive to shareowners, more thoughtful about whom they nominate to serve as directors and more vigilant in their oversight of companies. Federal securities laws should be amended to affirm the SEC s authority to promulgate rules allowing shareowners to place their nominees for directors on the company s proxy card.

3. Boards of directors should determine whether the chair and CEO roles should be separated or whether some other method, such as lead director, should be used to provide independent board oversight or leadership when required. Boards of directors should be encouraged to separate the roles of chair and CEO or explain why they have adopted another method to assure independent leadership of the board.

4. Exchanges should adopt listing standards that require compensation advisers to corporate boards to be independent of management. Compensation consultants play a key role in the pay-setting process. But conflicts of interest may lead them to offer biased advice. Most firms that provide compensation consulting services to boards also provide other kinds of services to management, such as benefits administration, human resources consulting and actuarial services. These other services can be far more lucrative than advising compensation committees. Conflicts of interest contribute to a ratcheting-up effect for executive pay. They should be minimized and disclosed.

5. Companies should give shareowners an annual advisory vote on executive compensation. Nonbinding shareowner votes on pay would make board compensation committees more careful about doling out rich rewards to underperforming CEOs, and thus would avoid the embarrassment of shareowner rejection at the ballot box. So-called - say on pay" votes would open up dialogue between boards and shareowners about pay concerns.

6. Federal clawback provisions on unearned executive pay should be strengthened. Clawback policies discourage executives from taking questionable actions that temporarily lift share prices but ultimately result in financial restatements. Senior executives should be required to return unearned bonus and incentive payments that were awarded as a result of fraudulent activity, incorrectly stated financial results or some other cause. The Sarbanes-Oxley Act of 2002 required boards to go after unearned CEO income, but the Act s language is too narrow. It applies only in cases where misconduct is proven—which occurs rarely because most cases result in settlements where charges are neither admitted nor denied—and only covers CEO and CFO compensation. Many courts, moreover, have refused to allow this provision to be enforced via private rights of action.

II. Systemic Risk Oversight Board

The Investors Working Group believes there is an immediate need to monitor and respond to risks to the entire financial system posed by large, complex, interconnected institutions, practices and products and supports the creation of an independent Systemic Risk Oversight Board to supplement, not supplant, the functions of existing federal financial regulators. The mission of the board should include collecting and analyzing the risk exposure of bank and non-bank financial institutions, as well as those institutions practices and products that could threaten the stability of the financial system and the broader U.S. economy; reporting on those risks and any other systemic vulnerabilities; and recommending steps regulators should take to reduce those risks.

The Systemic Risk Oversight Board would fill an immediate void on systemic issues, and its future would be shaped by the findings of the Financial Crisis Inquiry Commission.

Background

The current U.S. system of financial regulation was not designed to monitor and respond to risks to the entire financial system posed by the interconnectedness of complex institutions, practices and products. To properly address the range of significant threats to the broader financial system, we need better and more coordinated information about a wide range of exposures. Mechanisms to identify and assess information on rapidly expanding markets and products also are critical.

Many factors contributed to the financial crisis, including excessive leverage, lax mortgage underwriting standards and a weak understanding of the risk profiles of complex securitized products. Just as devastating, however, was the absence of any oversight mechanism to track and sound early warnings about the extent to which financial institutions had taken on excessive leverage or held dangerously large concentrations of specific securities.

Individual exposures and the interconnections between institutions with significant exposures were misunderstood or not recognized and, in many cases, hidden from view. AIG was widely recognized as the king of credit-default swaps. But few appreciated that AIG s activities in the CDS market could not just produce catastrophic losses for the company; they imperiled dozens of AIG s counterparties too. The failure to count and connect the dots applied to highly regulated entities as well as those, such as hedge funds and private equity firms, which were lightly or not at all supervised. Even now, regulators world-wide are still sorting out the number and interrelations of many structured financial instruments.

One clear lesson of the financial crisis is the need for an ongoing effort to aggregate and analyze relevant risk exposure information across firms, securities instruments and markets. This oversight must keep up with financial innovation and be able to coordinate with regulators outside the United States. And it must suggest corrective steps before particular risks grow big or concentrated enough to threaten entire markets or economic sectors.

By taking a panoramic view, a Systemic Risk Oversight Board would be quicker to recognize emerging threats than would regulators that tend to focus more narrowly on the safety and soundness of individual institutions or on conduct that harms consumers and investors. In particular, the board would be able to identify practices designed to escape regulatory attention and other efforts by firms or individuals to exploit the cracks between various agencies jurisdictions.

Much of the discussion surrounding systemic risk oversight has focused on two alternative approaches. One is to set up a strong systemic regulator in the more traditional sense: an agency with statutory authority that permits it to analyze and take direct action to contain or defuse emerging systemic risks before they wreak havoc. The other approach envisions a hybrid advisory council that would be a research- and information-sharing body with formal regulatory powers to address systemic imbalances. This -college of cardinals," as Senator Mark Warner (D-VA) has dubbed it, would have regulatory and enforcement authority and perhaps consist of the heads of key financial regulators.

The IWG believes both of these approaches have major drawbacks. First, the Administration and others in favor of a macro regulator with expansive, plenary authority over systemic risk regulation envision the Federal Reserve playing that role. But that would vest far too much authority in an agency whose credibility has been damaged by its own part in the financial cataclysm. The Fed s easy credit policies, pursued with the aim of stimulating the economy, enabled financial firms to lever up to sky-high levels and amass large concentrations of risky complex securitized products. The potential for conflict between monetary policy, the Fed s primary responsibility, and systemic oversight also argues against making the Fed the systemic risk regulator.

The Federal Reserve s existing duties are daunting enough. Besides crafting monetary policy, the Fed also supervises bank holding companies and the U.S. activities of foreign-owned banks and manages the vast U.S. payments system. Regulating systemic risk would heap too much responsibility on the Fed s already-full plate. Finally, the Federal Reserve s tendency to favor secrecy over public disclosure could undermine transparency and crucial consumer and investor protections.

The IWG also is concerned about systemic oversight via a coordinating council of existing financial regulators. Such a council would add a layer of regulatory bureaucracy without closing the gaps that regulators currently have in skills, experience and authority needed to track systemic risk comprehensively.

The IWG believes that a Systemic Risk Oversight Board would strike an appropriate balance between the two models. We advocate immediate creation of an independent board vested with broad powers to examine information from both bank and non-bank financial institutions and their regulators. The board would also have the authority to make recommendations to the appropriate regulators about how to address potential systemic threats. Regulators would either have to comply or justify an alternative course of action. In this way, existing regulators would still have the primary role in addressing systemic risk but could not ignore the board s findings or advice.

The long-term approach to systemic risk issues and the role of the Systemic Risk Oversight Board should hinge on the results of the Financial Crisis Inquiry Commission. One option would be for the Systemic Risk Oversight Board to evolve into a full-fledged regulator, if that is what policymakers determine is best.

Specific Recommendations

1. Congress should create an independent governmental Systemic Risk Oversight Board. To function efficiently, the board should consist of a chair and no more than four other members. All should be presidential appointees confirmed by the U.S. Senate. The board would be accountable primarily to Congress.

2. The board s budget should ensure its independence from the firms it examines. Funding should be adequate and sustainable to attract and retain highly competent board members and staff. Appropriate funding options include an industry assessment fee similar to that of the Public Company Accounting Oversight Board (PCAOB).

3. All board members should be full-time and independent of government agencies and financial institutions. Members should possess broad financial market knowledge and expertise. Collectively, the members should have backgrounds in investment practice, risk management and modeling, market operations, financial engineering and structured products, investment analysis, counterparty matters and forensic accounting.

4. The board should have a dedicated, highly skilled staff. Staffers should have a range of key skills and experiences and work exclusively for the board. They should be experts who understand the components and complexities of systemic risk and how to fully examine critical interconnections between firms and markets. To attract and retain top-notch individuals, staff and board member salaries should be commensurate with those of the PCAOB.

5. The board should have the authority to gather all information it deems relevant to systemic risk. The IWG believes that federal regulators do not currently have the full scope and depth of information they need to understand systemic risks in the U.S. financial system, much less the behavior of those risks in the context of global markets. For the Systemic Risk Oversight Board to have that capability, it should develop a timely way to identify a broad range of threats emanating from institutions, markets, practices, financial instruments and emerging products. Therefore, the board should have the legal authority to gather all the financial information it deems necessary to assess systemic vulnerabilities.

Defining such threats is not a static process. Systemic risks do not lurk only in systemically significant institutions. Highly concentrated market segments or critical financial instruments can threaten the health of the financial system. Risk may be baked into regulation in ways that are not well understood. For example, the financial crisis has revealed the danger to the markets of rules that make credit rating agencies gatekeepers for issuing debt without ensuring that they are independent and accountable for the accuracy of their ratings.

The board would need to develop appropriate procedures for determining which entities to examine and what information to review. It would need a degree of flexibility so that its focus and examinations could adjust to shifts in market conditions. The board and staff should be able to use their professional judgment to determine the scope of analysis for financial institutions, products or practices. The board should also have the authority to hire consultants and other experts as needed.

6. The board should report to regulators any findings that require prompt action to relieve systemic pressures and should make periodic reports to Congress and the public on the status of systemic risks. If appropriate, the board would also report its findings to specific companies and other institutions. The board should take steps to mitigate any severe market reactions or disruptions that could occur as a result of its reports. How the board reports its activities and findings should take into consideration the confidential nature of much of the information it will gather and the potential for market mayhem if information is not dealt with properly.

The board should also provide comprehensive, periodic reports on the state of systemic risks to all relevant regulators and Congress or committees designated by Congress as well as the public. As appropriate, the board should consult with systemic risk overseers outside the United States. The board should consult with regulators and Congress about the nature of any information it releases publicly.

7. The board should strive to offer regulators unbiased, substantive recommendations on appropriate action. As an independent monitor, the board should identify firms and markets that are at risk before significant damage is done. This might entail identifying exposures, modeling potential solutions and communicating those recommendations fully and clearly to regulators. Regulators should determine whether and how to implement the board s recommendations. Where appropriate, the board should coordinate its recommendations with those of overseas systemic risk overseers.

8. Regulators should have latitude to implement the oversight board s recommendations on a "comply or explain" basis. Regulators are generally better positioned to understand the operational and practical implications of a proposed regulatory action, and a regulator may believe that it would be appropriate to refine or modify a recommendation of the board. For this reason, the IWG does not believe that the Systemic Risk Oversight Board should have regulatory authority or other powers to force a regulator to implement a recommendation.

Instead, the recommendations would shift the onus of systemic risk mitigation onto regulators, by requiring them either to 1) adopt and implement the recommendation(s) as suggested, 2) refine and modify the recommendations as they deem necessary, or 3) reject them and take no further action or follow another course. In the case of options 2 or 3 above, the regulator would provide the board a detailed explanation of its response. This should include a discussion of any alternative approach to address the systemic risk the board identified. The regulator should also address any concerns or issues that could emerge if its alternative approach is not consistent with the coordinated response of other regulators. If the board is not satisfied with the regulator s response, it should communicate its concerns to the President and appropriate Congressional authorities.

ABOUT THE SPONSORING ORGANIZATIONS

About the CFA Institute Centre for Financial Market Integrity

The CFA Institute Centre for Financial Market Integrity develops timely, practical solutions to global capital market issues, while advancing investors interests by promoting the highest standards of ethics and professionalism within the investment community worldwide. It builds upon the 40-year history of standards and advocacy work of CFA Institute, especially its Code of Ethics and Standards of Professional Conduct for the investment profession, which were first established in the 1960s. In 2007, the CFA Institute Centre published *Self'Regulation in Today's Securities Markets: Outdated System or Work in Progress?*, a report that explored the failure of the current system of self-regulation to keep pace with the dramatic evolution of the global economy.

About the Council of Institutional Investors

The Council of Institutional Investors is a nonprofit association of public, union and corporate pension funds with combined assets exceeding $3 trillion. Member funds are major long-term shareowners with a duty to protect the retirement assets of millions of American workers. The Council strives to educate its members, policymakers and the public about good corporate governance, shareowner rights and related investment issues, and to advocate on our members' behalf. Corporate governance involves the structure of relationships between shareowners, directors and managers of a company. Good corporate governance is a system of checks and balances that fosters transparency, responsibility, accountability and market integrity.

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PREPARED STATEMENT OF JOHN J. CASTELLANI

PRESIDENT, BUSINESS ROUNDTABLE

JULY 29, 2009

Introduction

Business Roundtable (*www.businessroundtable.org*) is an association of chief executive officers of leading U.S. companies with more than $5 trillion in annual revenues and nearly 10 million employees. Member companies comprise nearly a third of the total value of the U.S. stock markets and pay nearly half of all corporate income taxes paid to the Federal Government. Annually, they return $133 billion in dividends to shareholders and the economy. Business Roundtable companies give more than $7 billion a year in combined charitable contributions, representing nearly 60 percent of total corporate giving. They are technology innovation leaders, with $70 billion in annual research and development spending—more than a third of the total private R&D spending in the United States.

We appreciate the opportunity to participate in this hearing on "Protecting Shareholders and Restoring Public Confidence by Improving Corporate Governance." Business Roundtable has long been at the forefront of efforts to improve corporate governance. We have been issuing "best practices" statements in this area for three decades, including Principles of Corporate Governance (November 2005), The Nominating Process and Corporate Governance Committees: Principles and Commentary (April 2004), Guidelines for Shareholder–Director Communications (May 2005), and Executive Compensation: Principles and Commentary (January 2007) (attached as Exhibits I through IV). More recently, Business Roundtable became a signatory to Long-Term Value Creation: Guiding Principles for Corporations and Investors, also known as The Aspen Principles, a set of principles drafted in response to concerns about the corrosiveness that short-term pressures exert on companies. The signatories to The Aspen Principles are a group of business organizations, institutional investors and labor unions, including the AFL–CIO, Council of Institutional Investors, and TIAA–CREF, who are committed to encouraging and implementing best corporate governance practices and long-term management and value-creation strategies. In addition, Business Roundtable recently published its Principles for Responding to the Financial Markets Crisis (2009) (attached as Exhibit V), and many of our suggestions have been reflected in the Administration's proposal to reform the financial regulatory system.

At the outset, we must respectfully take issue with the premise that corporate governance was a significant cause of the current financial crisis.[1] It likely stemmed from a variety of complex financial factors, including major failures of a regulatory system, over-leveraged financial markets and a real estate bubble.[2] But even experts disagree about the crisis's origins.[3] Notably, with the support of Business Roundtable, Congress recently established the Financial Crisis Inquiry Commission to investigate the causes of the crisis.[4]

Because the recently established Financial Crisis Inquiry Commission is just starting its work, any attempt to make policy in response to those purported causes would seem premature. In fact, a legitimate concern is that many of the proposals currently being suggested could even exacerbate factors that may have contributed to the crisis. For example, commentators have asserted that the emphasis of certain institutional investors on short-term gains at the expense of long-term, sustainable growth played a role in the crisis.[5] Some of the current corporate governance proposals, including a universal "say-on-pay" right and the Securities and Exchange Commission's recent proposal for a mandatory process access regime, may actually exacerbate the emphasis on short-term gains. One large institutional investor, the New Jersey State Investment Council, recently expressed this concern, stating that, "we do not want a regime where the primary effect is to empower corporate raiders

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[1] *See* Lawrence Mitchell, "Protect Industry From Predatory Speculators", *Financial Times,* July 8, 2009. Professor Mitchell, a George Washington University law professor, argues that it is "hyperbolic" to suggest that inattentive boards had anything significant to do with the current recession.

[2] *See* Robert G. Wilmers, "Where the Crisis Came From", *The Washington Post,* July 27, 2009.

[3] Ben S. Bernanke, "Four Questions About the Financial Crisis" (Apr. 14, 2009), available at *http://www.federalreserve.gov/newsevents/speech/bernanke20090414a.htm.*

[4] Stephen Labton, "A Panel Is Named To Examine Causes of the Economic Crisis", *N.Y. Times,* July 16, 2009, at B3.

[5] *See* Lawrence Mitchell, "Protect Industry From Predatory Speculators", *Financial Times,* July 8, 2009.

with a short-term focus."[6] Thus, we must be cautious that in our zeal to address the financial crisis, we do not jeopardize companies' ability to create the jobs, products, services and benefits that improve the economic well-being of all Americans.

Moreover, the problems giving rise to the financial crisis occurred at a specific group of companies in the financial services industry. Having the Federal Government impose a universal one-size-fits-all corporate governance regime on all public companies based on the experience at a small subset of companies could undermine the stability of boards of directors and place corporations under even greater pressure for short-term performance.

We also cannot ignore the sweeping transformation in corporate governance practices in the past 6 years, many of which have been adopted voluntarily by corporations, sometimes in response to shareholder requests. Similarly, State corporate law has been the bedrock upon which the modern business corporation has been created and it remains the appropriate and most effective source for law as it applies to corporate governance. It has been responsive to developments in corporate governance, most recently to majority voting for directors, proxy access, and proxy contest reimbursement. Further, the SEC plays an active role in seeing that shareholders receive the information they need to make informed voting decisions, and, in this regard, recently has issued a number of proposals designed to provide shareholders with additional corporate governance information.

Recent Developments in Corporate Governance

The past few years have seen a sea change in corporate governance through a combination of legislation, rule making by the SEC and the securities markets and voluntary action by companies. As long-time advocates for improved corporate governance, Business Roundtable has supported and helped effect many of these changes while simultaneously working to ensure that they provide necessary operational flexibility and avoid unintended negative consequences.

Board Independence

In the past several years, public companies have taken a number of steps to enhance board independence. First, there has been a significant increase in the number of independent directors serving on boards. A 2008 Business Roundtable Survey of member companies (attached as Exhibit VI) indicated that at least 90 percent of our member companies' boards are at least 80 percent independent. According to the RiskMetrics Group 2009 Board Practices, average board independence at S&P 1,500 companies increased from 69 percent in 2003 to 78 percent in 2008. According to the same study, in 2008, 85 percent of S&P 1,500 companies, and 91 percent of S&P 500 companies, had boards that were at least two-thirds independent.

Second, directors increasingly meet in regular "executive sessions" outside the presence of management and 75 percent of our member companies hold executive sessions at every meeting, compared to 55 percent in 2003. Moreover, the NYSE listing standards require a nonmanagement director to preside over these executive sessions and require companies to disclose in their proxy materials how interested parties may communicate directly with the presiding director or the nonmanagement directors as a group.

Third, there has been a steady increase in the number of companies that have appointed a separate chairman of the board. According to the RiskMetrics Group 2009 Board Practices survey, from 2003 to 2008, the number of S&P 1,500 companies with separate chairmen of the board increased from 30 percent to 46 percent. Moreover, many companies without an independent chair have appointed a lead or presiding director in order to provide for independent board leadership. A 2007 Business Roundtable survey of member companies indicated that 91 percent of companies have an independent chairman or an independent lead or presiding director, up from 55 percent in 2003. According to the 2008 Spencer Stuart Board Index, by mid-2008, 95 percent of S&P 500 companies had a lead or presiding director, up from 36 percent in 2003. Lead directors' duties are often similar to those of an independent chairman and include: presiding at all meetings of the board at which the chairman is not present, including executive sessions of the independent directors; serving as liaison between the chairman and independent directors; approving information sent to the board; approving meeting agendas for the board; approving meeting schedules to assure that there is sufficient time for discussion of all agenda items; having authority to call meetings of the independent directors; being available for consultation and direct communication with major shareholders; and serving as interim leadership in the event of an emergency succession situation. Many

[6] Letter from Orin S. Kramer, Chair, New Jersey State Investment Council to Mary Schapiro, Chairman, Securities and Exchange Commission re: comments on File S7-10-09 (July 9, 2009).

companies provide information about their board leadership structures in their corporate governance guidelines, their proxy statements or both, and the SEC recently has proposed to require disclosure about a company's leadership structure and why that structure is appropriate for the company.

Finally, various organizations are focusing on voluntary steps that companies can take to enhance independent board leadership. In the spring of 2009, the National Association of Corporate Directors, with the support of Business Roundtable, issued a set of Key Agreed Principles To Strengthen Corporate Governance for U.S. Publicly Traded Companies. One "key agreed principle" states that boards should have independent leadership, either through an independent chairman or a lead/presiding director, as determined by the independent directors. The principles further recommend that boards evaluate their independent leadership annually. In March 2009, the Chairman's Forum, an organization of nonexecutive chairmen of U.S. and Canadian public companies, issued a policy briefing calling on companies to appoint an independent chairman upon the succession of any combined chairman/CEO. The policy briefing recognizes, however, that particular circumstances may warrant a different leadership structure and recommends, in these instances, that companies explain to shareholders why combining the positions of chairman and CEO represents a superior approach.

Majority Voting and Annual Elections

Companies also have taken steps to enhance accountability through the adoption of majority voting standards for the election of directors and the establishment of annual elections for directors. Historically, most U.S. public companies have used a plurality voting standard in director elections. Under plurality voting, the director nominees for available board seats who receive the highest number of "For" votes are elected. In a typical annual election, the number of nominees equals the number of available Board seats, so if at least one share is voted "For" the election or reelection of a nominee, the nominee will gain or retain a seat on the Board. Accordingly, director nominees in uncontested elections are assured election. Under a majority voting regime, a candidate must receive a majority of votes cast in order to retain his or her board seat. Majority voting thus increases shareholder influence and encourages greater board accountability.

In 2004, several labor unions and other shareholder groups began to broadly advocate that companies adopt a majority vote standard in uncontested director elections, in order to demonstrate directors' accountability to shareholders. Companies and shareholders alike recognized the merits of a majority voting standard and this corporate governance enhancement was quickly adopted by many companies. According to our 2008 Survey of Corporate Governance Trends, 75 percent of our member companies have adopted some form of majority voting for directors. According to the leading study on majority voting, as of October 2008, more than 70 percent of S&P 500 companies had adopted some form of majority voting, as compared with only 16 percent in 2006,[7] and mid- and small-cap companies increasingly are adopting majority voting as well.[8]

A growing number of companies have moved to annual director elections too. According to the RiskMetrics Group 2009 Board Practices survey, 64 percent of S&P 500 companies held annual director elections in 2008 as compared to only 44 percent in 2004. Likewise, 50 percent of S&P 1,500 companies held annual director elections in 2008, and the number of S&P 1,500 companies with classified boards had decreased to 50 percent in 2008 from 61 percent in 2004. The decrease in the prevalence of classified boards is reflected across mid- and small-cap companies as well.[9] However, as discussed below, there are reasons why some companies believe it is in the best interests of their shareholders to retain their classified boards.

One Size Does Not Fit All

While Business Roundtable consistently has worked toward enhancing corporate governance practices, we strongly believe that with respect to many of these practices a "one-size-fits-all" approach simply will not work. Companies vary tremendously in their size, shareholder base, centralization and other factors that can change over time. Attempting to shoehorn all companies, whether it is a Fortune 50 company or a small company with a single significant shareholder, into the same

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[7] Melissa Klein Aguilar, "Shareholder Voice Getting Louder, Stronger", *Compliance Week* (Oct. 21, 2008) available at *http://www.complianceweek.com/article/5113/shareholder-voices-getting-louder-stronger* (quoting Claudia Allen, author of *Study of Majority Voting in Director Elections*).

[8] *See* Claudia H. Allen, *Study of Majority Voting in Director Elections* (Feb. 5, 2007) available at *http://www.ngelaw.com/files/upload/majoritystudy111207.pdf.*

[9] *See* RiskMetrics Group, *Board Practices: The Structure of Boards of Directors at S&P 1,500 Companies* (2008).

corporate governance regime deprives companies and their shareholders of choices about the practices that will enable them to operate their businesses in a way that most effectively creates the jobs, products, services, and benefits that improve the economic well-being of all Americans. In this regard, corporate governance initiatives intended to improve corporate functioning and protect shareholders can actually end up harming companies and the interests of the shareholders they were meant to protect. This realization has been echoed by others including the New Jersey Investment Council, which oversees the New Jersey $63 billion public pension system. The Council recently stated in a letter to SEC Chairman Mary Schapiro that it is "troubled by the proliferation of rigid prescriptive responses. which are costly, time-consuming, unresponsive to the individual fact settings surrounding specific companies and industries, and which may correlate only randomly with the creation of shareholder value." [10]

For instance, despite the increasing trend of annual director elections, some companies have concluded that it is in the best interest of their shareholders to retain a classified board. In this regard, some economic studies have found that a classified board can enhance a board's ability to negotiate the best results for shareholders in a potential takeover situation by giving the incumbent directors additional opportunity to evaluate the adequacy and fairness of any takeover proposal, negotiate on behalf of all shareholders and weigh alternative methods of maximizing shareholder value. [11] In addition, classified boards can have other advantages, including greater continuity, institutional memory and stability, thereby permitting directors to take a longer-term view with respect to corporate strategy and shareholder value. Some recent proposed legislation, however, would deprive boards of directors and shareholders of this choice. [12]

Likewise, Business Roundtable believes that it is critical for boards of directors to have independent board leadership, but a single method of providing that leadership is not appropriate for all companies at all times. While some companies have separated the position of chairman of the board and chief executive officer, others have voluntarily established lead independent or presiding directors. This illustrates the need for, and advantages of, an individualized approach and demonstrates that a universally mandated approach is neither necessary nor desirable. [13] It would, in fact, deprive boards of directors, and indeed shareholders, of the flexibility to establish the leadership structure that they believe will best equip their companies to govern themselves most effectively for long-term growth and value creation.

State Law Is the Bedrock for Effective Corporate Governance

Historically, for more than 200 years, State corporations statutes have been the primary source of corporate law and have enabled thoughtful and effective corporate governance policies and practices to be developed. In large part, this stems from the flexibility and responsiveness of State corporate law in responding to evolving circumstances. In this regard, State corporate law is described as "enabling" because it generally gives corporations flexibility to structure their governance operations in a manner appropriate to the conduct of their business. It also preserves a role for private ordering and shareholder choice by permitting shareholder proposed bylaws to address corporate governance issues.

Where a corporation and its shareholders determine that a particular governance structure—such as a majority voting regime—is appropriate, enabling statutes permit, but do not mandate, its adoption. And when changes in State corporate law are determined to be necessary, such as to facilitate changes to a majority voting standard, States responded by amending their statutes. For example, Delaware amended its corporate law to provide that, if shareholders approve a bylaw amendment providing for a majority vote standard in the election of directors, a company's board of directors may not amend or repeal the shareholder-approved bylaw. [14] Other States have also amended their corporations statutes to address majority vot-

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[10] Letter from Orin S. Kramer, Chair, New Jersey State Investment Council to Mary Schapiro, Chairman, Securities and Exchange Commission re: comments on File S7-10-09 (July 9, 2009).

[11] *See,, e.g.,* M. Sinan Goktan, *et al.,* "Corporate Governance and Takeover Gains" (Working Paper 2008) available at *http://www.fma.org/Texas/Papers/corpgov_takeovergains_fma2008.pdf;* Lucian A. Bebchuk, *et al.,* "The Powerful Antitakeover Force of Staggered Boards: Theory", Evidence and Policy, 54 *Stanford L. Rev.* 887–951 (2002).

[12] *See* Shareholder Bill of Rights Act of 2009 S. 1074, 111th Cong. §3 (2009).

[13] *See* Shareholder Bill of Rights Act of 2009 S. 1074, 111th Cong. §5 (2009) and Shareholder Empowerment Act of 2009 H.R. 2861, 111th Cong. §2 (2009).

[14] Delaware General Corporations Law §216 (2009).

ing as well, including California, Nevada, North Dakota, Ohio, Utah, and others.[15] In addition, the American Bar Association approved amendments to the Model Business Corporation Act, which 30 States have adopted, permitting a company's board or shareholders to adopt majority voting in director elections through bylaw amendments rather than through a more cumbersome process.[16]

Most recently, in April of this year, Delaware amended its corporate law to clarify the ability of companies and their shareholders to adopt proxy access bylaws, as well as bylaws providing for the reimbursement of expenses incurred by a shareholder in connection with the solicitation of proxies for the election of directors.[17] New Section 112 of the Delaware General Corporation Law permits a company to amend its bylaws to provide that shareholders may include in the company's proxy materials shareholder nominees for director positions. The bylaws may condition the obligation to include shareholder nominees on the satisfaction of eligibility requirements and/or compliance with procedures set forth in the bylaws. New Section 113 permits shareholders to adopt bylaws that require the company to reimburse expenses incurred by a shareholder in connection with the solicitation of proxies for the election of directors. The American Bar Association is considering similar amendments to the Model Business Corporation Act.[18] Like the majority voting enabling legislation described above, these reforms will allow companies and their shareholders to determine whether the costs of proxy access and proxy reimbursement outweigh the benefits for a particular company.

In contrast to the enabling approach of State corporate law, some recently proposed Federal legislation in response to the financial crisis, the Shareholder Bill of Rights Act of 2009[19] and the Shareholder Empowerment Act of 2009,[20] would mandate specific board structures. Such Federal Government intrusion into corporate governance matters would be largely unprecedented as the Federal Government's role in corporate governance traditionally has been limited. The Sarbanes-Oxley Act of 2002 did not change the role of the States as the primary source of corporate law; rather, it was a rare instance of Federal action in the area of corporate governance.

Shareholders Have Effective Means of Influencing Corporate Governance

Under the existing corporate governance framework, shareholders have the ability to make their views known to the companies in which they invest through a variety of methods. First, many companies provide means for shareholders to communicate with the board about various matters, including recommendations for director candidates and the director election process in general. In this regard, in 2003 the SEC adopted rules requiring enhanced disclosure about companies' procedures for shareholder communication with the board and for shareholders' recommendations of director candidates.[21] In addition, companies listed on the New York Stock Exchange must have publicized mechanisms for interested parties, including shareholders, to make their concerns known to the company's nonmanagement directors.[22] The SEC's 2008 rules regarding electronic shareholder forums also provided additional mechanisms for communications between the board and shareholders.[23] According to a 2008 survey, board members or members of management of nearly 45 percent of surveyed S&P 500 companies reached out to shareholders proactively.[24]

Second, shareholders can submit proposals to be included in company proxy materials. These proposals have been an avenue for shareholders to express their views with respect to various corporate governance matters. For example, the CEO of Bank of America stepped down as chairman of the board this year after a majority of shareholders approved a binding bylaw amendment requiring an independent

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[15] *See* California Corporations Code §708.5 (2009); Nevada General Corporation Law §330 (2009); North Dakota Century Code §10-35-09 (2009); Ohio General Corporation Law §1701.55 (2009); and Utah Revised Business Corporation Act §728 (2009).

[16] Model Business Corporation Act §10.22 (2006).

[17] Delaware General Corporation Law §§112 and 113.

[18] *See* Press Release, American Bar Association Section of Business Law, "Corporate Laws Committee to Address Current Corporate Governance Issues" (Apr. 29, 2009).

[19] *See* Shareholder Bill of Rights Act of 2009 S. 1074, 111th Cong. §5 (2009).

[20] *See* Shareholder Empowerment Act of 2009 H.R. 2861, 111th Cong. §2 (2009).

[21] Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors, Release No. 33-8340, 68 Fed. Reg. 69,204 (Dec. 11, 2003).

[22] NYSE Listed Company Manual §303A.03.

[23] Electronic Shareholder Forums, Release No. 34-57172, 73 Fed. Reg. 4450 (Jan. 25, 2008). *See* also Jaclyn Jaeger, "The Rise of Online Shareholder Activism", *Compliance Week* (Mar. 11, 2008), available at *http://www.complianceweek.com/article/4007/the-rise-of-online-shareholder-activism* (providing examples of successful online shareholder activism).

[24] Spencer Stuart Board Index at 28 (2008), available at *http://content.spencerstuart.com/sswebsite/pdf/lib/SSBI-2006.pdf.*

chair for the company's board.[25] In addition, predatory shareholder proposals can engender dialogue between companies and shareholder proponents about corporate governance issues.[26] In this regard, an advisory vote on compensation has been implemented at several companies that received shareholder proposals on this topic.[27] Moreover, as advocates of such votes have suggested that it is a way to enhance communication between shareholders and their companies about executive compensation, many companies have responded by employing other methods to accomplish this goal. These include holding meetings with their large shareholders to discuss governance issues, as well as using surveys, blogs, webcasts and other forms of electronic communication for the same purpose.[28]

Third, the proliferation of "vote no" campaigns in recent years has provided shareholders with another method of making their views known and effecting change in board composition. In these low-cost, organized campaigns, shareholder activists encourage other shareholders to withhold votes from or vote against certain directors. Although "vote no" campaigns do not have a legally binding effect where the targeted company uses a plurality voting regime in an uncontested election, evidence indicates that such campaigns are nonetheless successful in producing corporate governance reform.[29] For example, following a 2008 "vote no" campaign at Washington Mutual in which several shareholder groups called for shareholders to withhold votes from certain directors, the finance committee chairman stepped down upon receiving 49.9 percent withheld votes.[30] In addition, a recent study of "vote no" campaigns found that targeted companies experienced improved post-campaign operating performance and increased rates of forced CEO turnover, suggesting that "vote no" campaigns are effective.[31] At companies that have adopted majority voting in director elections, "vote no" campaigns are likely to have an even greater impact.

Fourth, the existing framework allows shareholders to make their views known through nominating their own director candidates and engaging in election contests. In fact, they have done so recently at companies including Yahoo! Inc. and Target Corporation. "Short slate" proxy contests in which dissidents seek board representation but not full board control, have been very successful in recent years. According to a recent study conducted by the Investor Responsibility Research Center Institute, during a 4-year period, short slate proxy contest dissidents were able to gain representation at approximately 75 percent of the companies they targeted.[32] Significantly, in the majority of these cases, dissidents found it unnecessary to pursue the contest to a shareholder vote; instead, they gained board seats through settlement agreements with the target companies.[33] Clearly the threat of proxy contests, to say nothing of the contests themselves, is an effective mechanism for shareholder nomination of directors. Moreover, the SEC adopted "e-proxy" rules in 2007 that permit companies and others soliciting proxies from shareholders to deliver proxy materials electronically, which has streamlined the proxy solicitation process and

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[25] Dan Fitzpatrick and Marshall Eckblad, "Lewis Ousted as BofA Chairman", *Wall St. J.,* Apr. 30, 2009, at A1.

[26] Edward Iwata, "Boardrooms Open Up to Investors' Input", *USA Today,* Sept. 7, 2009, available at *http://www.usatoday.com/money/companies/management/2007-09-06-shareholders-fight_N.htm.*

[27] Thus far, in 2009, shareholders have submitted shareholder proposals to over 100 individual companies requesting an advisory vote on executive compensation. In response to previous years' shareholder proposals, many companies are providing shareholders with such a vote, including Aflac Incorporated, H&R Block, Inc., Jackson Hewitt Tax Service, Inc., Littlefield Corporation, RiskMetrics Group, Inc. and Zale Corporation. At least 25 other companies including Intel Corporation, Motorola, Inc. and Verizon Communications, Inc. have agreed to hold an annual advisory vote voluntarily or in response to their shareholders' concerns.

[28] A 2007 Business Roundtable survey of member companies indicated that in 2007, board members of 28 percent of companies met with shareholders. Another survey indicates that in 2008, board members or members of management of nearly 45 percent of S&P 500 companies reached out to shareholders proactively. Other companies have established e-mail links on their Web site for investors to provide feedback to the compensation committee. And in April 2009, Schering-Plough Corp. submitted a survey to its shareholders to obtain their views on a variety of compensation issues.

[29] *See* Joseph A. Grundfest, "'Just Vote No': A Minimalist Strategy for Dealing With Barbarians Inside the Gates", 45 *Stan. L. Rev. 857 (1993).*

[30] RiskMetrics Group 2008 Post-Season Report, at 10 (October 2008).

[31] Diane Del Guercio, *et al.,* "Do Boards Pay Attention When Institutional Investor Activists 'Just Vote No'?", *Journal of Financial Economics,* Oct. 2008.

[32] Chris Cernich, *et al.,* "Investor Responsibility Research Center Institute, Effectiveness of Hybrid Boards", at 4 (May 2009), available at *http://www.irrcinstitute.org/pdf/IRRC_05_09_EffectiveHybridBoards.pdf.*

[33] *Id.* at 4, 13 (noting that 76 percent of dissidents gaining representation were able to do so through settlement).

greatly reduced the costs of printing and mailing proxy materials.[34] All of this has made it easier and less costly for shareholders to nominate directors themselves.

Finally, increasing numbers of companies have been amending their governing documents to allow shareholders to call special meetings of shareholders or, for companies that already allow shareholders to call meetings, to lower the thresholds required to call those meetings. Currently 45 percent of S&P 500 and 46 percent of S&P 1,500 companies[35] permit their shareholders to call special meetings, the majority of which require either 25 percent or a majority of the outstanding shares to call a special meeting. Beginning in 2007, shareholder proponents began submitting a large number of shareholder proposals requesting that 10 percent–20 percent of outstanding shares be able to call special meetings. The number of such proposals has increased dramatically since 2007 and these proposals have been receiving high votes.[36]

Clearly, there currently are numerous and potent methods that shareholders can use to see that their voices are heard and their views made known to the companies in which they invest. Accordingly, proposals to increase shareholder rights must be considered in the context of existing shareholder leverage and the manner in which shareholders vote their shares. In this regard, the extensive reliance of many institutional investors on the recommendations of the proxy advisory services must be considered. Unfortunately, these services often do not engage in company-by-company analysis when making their recommendations, applying a one-size-fits-all approach to important corporate governance decisions at individual companies.

The SEC Is Addressing Corporate Governance Matters

While, as noted above, State corporate law is central to corporate governance, the SEC plays a role in assuring that shareholders receive the information they need to make informed voting decisions, including about corporate governance matters. In this regard, earlier this month, the SEC proposed several rule changes intended to provide shareholders with additional disclosure concerning individual director experience and qualifications, board leadership structure and oversight of risk management, compensation practices and potential conflicts of interest with compensation consultants and compensation matters.

The proposed amendment relating to individual directors would require companies to provide disclosure about (1) the experience, qualifications, attributes and skills of directors and director nominees that qualify them to serve as a director and as a member of each committee on which they serve, (2) all public company directorships held by directors and director nominees during the past 5 years, as opposed to just current directorships (as required under the current rules), and (3) the involvement of directors, director nominees and executive officers in legal proceedings during the prior 10 years.

With regard to board leadership, the proposal would require disclosure about a company's board leadership structure and why the structure is appropriate for the company. The proposed disclosure would need to include a discussion of whether the company separates or combines the roles of the chairman and chief executive officer, whether the company has a lead independent director, and the board's role in the company's risk-management process and the effects, if any, that this role has on the company's board leadership structure.

Finally, the proposal relating to compensation consultant disclosures would require enhanced disclosure of potential conflicts of interest involving compensation consultants that provide advice to the board or compensation committee regarding executive or director compensation and also provide other services to the company. Specifically, this disclosure would need to include a discussion of (1) any other services that the compensation consultant or its affiliates provide to the company and the fees paid for such services, (2) the aggregate fees paid for advising on executive and director compensation, (3) whether the consultant was engaged for these other services by or on the recommendation of management, and (4) whether the board or compensation committee approved these other services.

We believe that this disclosure approach to matters relating to board leadership and risk oversight is far superior to the one-size-fits-all approach in proposed legislation that would mandate the separation of the chairman and CEO position and

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[34] Internet Availability of Proxy Materials, Exchange Act Release No. 34-55146, 17 Fed. Reg. 240, 249 and 274 (March 30, 2007).

[35] Data provided by SharkRepellent.net (S&P 500) and RiskMetrics Group, Inc. (S&P 1,500) as of June 2009.

[36] Based on data from RiskMetrics Group, Inc. as of July, in 2009, shareholders have submitted special meeting shareholder proposals to 74 individual companies. The average support for these votes has been 52.3 percent, and 26 companies have received majority votes in support of the proposal.

require all public companies—no matter what size of industry—to establish a risk committee of the board.[37] Companies and their shareholders should have the choice to determine the structures that will best enable them to grow and prosper.

In addition to the corporate governance disclosure enhancements described above, the SEC also approved an amendment to NYSE Rule 452, which will prohibit brokers from voting uninstructed shares in director elections.[38] This rule amendment, which will be effective for annual meetings after January 1, 2010, is likely to have a considerable impact on the director election process, particularly for companies that have adopted a majority voting standard.

Another significant recent SEC action is the proposal to amend the proxy rules to permit shareholders to nominate directors in a company's proxy materials. If adopted, the proposed rules would establish a Federal proxy access right and permit proxy access shareholder proposals. The Federal process right would permit a shareholder or group of shareholders to nominate one or more directors and have those nominees included in a company's proxy materials contingent on the shareholder or group beneficially owning a certain percentage of the company's voting shares (which varies depending on a company's size) for at least 1 year prior to submitting the nomination. Shareholders meeting the proposal's requirements would be allowed to have their proposed nominees (up to 25 percent of the board) included in the company's proxy statement, on a first-come first-served basis.

In contrast to our support for the SEC's disclosure proposals, we believe that the proposed Federal proxy access right could result in serious, harmful consequences, as well as being beyond the SEC's authority to adopt. First, widespread shareholder access to company proxy materials will promote a short-term focus and encourage the election of "special interest" directors who will disrupt boardroom dynamics and jeopardize long-term shareholder value. Second, the proposed rules will enhance the influence of proxy advisory firms and institutional investors, which may use the rules as leverage for advancing special interest causes and promoting policies to encourage short-term gains in stock price. Third, the increased likelihood of divisive and time-consuming annual election contests could deter qualified directors from serving on corporate boards. Fourth, shareholder-nominated directors could impede a company's ability to satisfy board composition requirements. Finally, serious questions have been raised about the ability of the current proxy voting system to handle the increasing number of proxy contests that would result from the implementation of the proxy access proposal. While the Commission's proposing release touches upon some of these issues, it fails to seriously address them. We currently are preparing a comment letter to the SEC on these proposals which will expand upon our concerns.

Conclusion

Business Roundtable is committed to enhanced corporate governance practices that enable U.S. companies to compete globally, create jobs and generate long-term economic growth. We are concerned, however, that in a rush to respond to the financial crisis, Congress, and the SEC, are considering hastily prepared and universally applicable legislation and regulation that will exacerbate some of the factors that led to the crisis. In particular, an advisory vote on compensation and proxy access could well increase the pressure on short-term performance to the detriment of long-term value creation. The flexible approaches of State corporate law, SEC disclosure and shareholder and company choice that have produced the engine of economic growth that is the American corporation should not be ignored.

Attachments

Exhibit I—Principles of Corporate Governance (November 2005)

Exhibit II—The Nominating Process and Corporate Governance Committees: Principles and Commentary (April 2004)

Exhibit III—Guidelines for Shareholder–Director Communications (May 2005)

Exhibit IV—Executive Compensation: Principles and Commentary (January 2007)

Exhibit V—Principles for Responding to the Financial Markets Crisis (2009)

Exhibit VI—2008 Business Roundtable Survey

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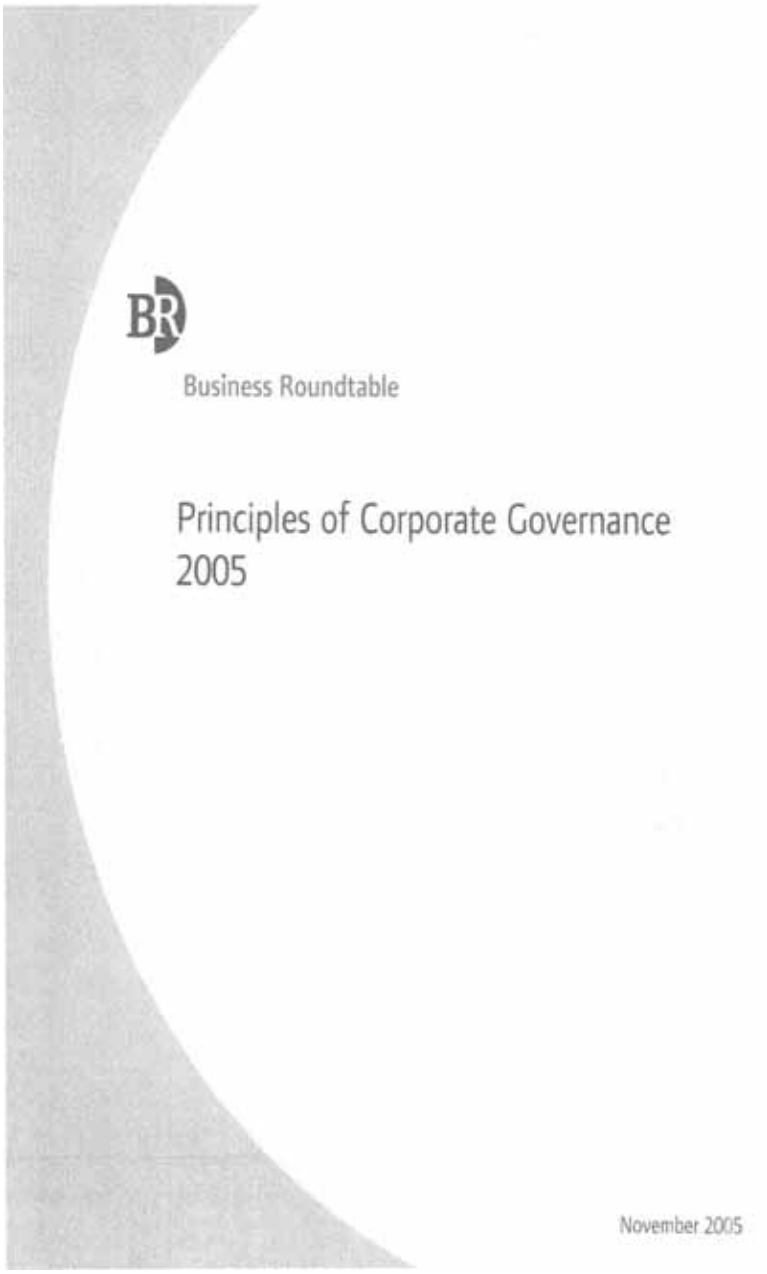
[37] *See* Shareholder Bill of Rights Act of 2009 S. 1074, 111th Cong. §5 (2009) and Shareholder Empowerment Act of 2009 H.R. 2861, 111th Cong. §2 (2009).

[38] Note that this amendment moots part of section 2 of the Shareholder Empowerment Act of 2009. See Shareholder Empowerment Act of 2009 H.R. 2861, 111th Cong. §2 (2009) which would require that a broker not be allowed to vote securities on an uncontested election to the board of directors of an issuer to the extent that the beneficial owner of those securities has not provided specific instructions to the broker.

EXHIBIT I

PRINCIPLES OF CORPORATE GOVERNANCE (NOVEMBER 2005)



Business Roundtable

Business Roundtable (www.businessroundtable.org) is an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees and $4 trillion in annual revenues. The chief executives are committed to advocating public policies that foster vigorous economic growth and a dynamic global economy.

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Principles of Corporate Governance 2005

A White Paper by Business Roundtable | November 2005

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Foreword and Introduction

Business Roundtable is recognized as an authoritative voice on matters affecting American business corporations and, as such, has a keen interest in corporate governance. Business Roundtable is an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees and $4 trillion in annual revenues. The chief executives are committed to advocating public policies that foster vigorous economic growth, a dynamic global economy, and the well-trained and productive U.S. workforce essential for future competitiveness.

Since May 2002, when Business Roundtable issued its *Principles of Corporate Governance*, U.S. public corporations have witnessed fundamental and accelerated changes in the area of corporate governance, beginning with the passage of the Sarbanes-Oxley Act of 2002 and continuing with the adoption of strengthened listing standards by the securities markets. We note that many of the best practices recommended in the principles are now embedded in the Sarbanes-Oxley Act and in securities market listing standards.

Following the publication of *Principles of Corporate Governance* (May 2002), Business Roundtable issued *Executive Compensation: Principles and Commentary* (November 2003), *The Nominating Process and Corporate Governance Committees: Principles and Commentary* (April 2004), and *Guidelines for Shareholder-Director Communications* (May 2005). Other publications from Business Roundtable that have addressed corporate governance include *Statement on Corporate Governance* (September 1997), *Executive Compensation/Share Ownership* (March 1992), *Corporate Governance and American Competitiveness* (March 1990), *Statement on Corporate Responsibility* (October 1981), and *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation* (January 1978).

Business Roundtable continues to believe, as we noted in *Principles of Corporate Governance* (2002), that the United States has the best corporate governance, financial reporting and securities markets systems in the world. These systems work because of the adoption of best practices by public companies within a framework of laws and regulations.

Given the fundamental nature of the changes that have occurred during the past several years in the framework of laws and regulations related to corporate governance, as well as in best practices, Business Roundtable believes it is appropriate, once again, to restate our guiding principles of corporate governance. Although applicable legal requirements and securities market listing standards establish minimum requirements, these principles, we believe, should help guide the ongoing advancement of corporate governance practices and, thus, advance the ability of public corporations to compete, create jobs and generate economic growth.

Business Roundtable supports the following guiding principles:

First, the paramount duty of the board of directors of a public corporation is to select a chief executive officer and to oversee the CEO and senior management in the competent and ethical operation of the corporation on a day-to-day basis.

Second, it is the responsibility of management to operate the corporation in an effective and ethical manner to produce value for shareholders. Senior management is expected to know how the corporation earns its income and what risks the corporation is undertaking in the course of carrying out its business. The CEO and board of directors should set a "tone at the top" that establishes a culture of legal compliance and integrity. Management and directors should never put personal interests ahead of or in conflict with the interests of the corporation.

Third, it is the responsibility of management, under the oversight of the audit committee and the board, to produce financial statements that fairly present the financial condition and results of operations of the corporation and to make the timely disclosures investors need to assess the financial and business soundness and risks of the corporation.

Fourth, it is the responsibility of the board, through its audit committee, to engage an independent accounting firm to audit the financial statements prepared by management, issue an opinion that those statements are fairly stated in accordance with Generally Accepted Accounting Principles and oversee the corporation's relationship with the outside auditor.

Fifth, it is the responsibility of the board, through its corporate governance committee, to play a leadership role in shaping the corporate governance of the corporation. The corporate governance committee also should select and recommend to the board qualified director candidates for election by the corporation's shareholders.

Sixth, it is the responsibility of the board, through its compensation committee, to adopt and oversee the implementation of compensation policies, establish goals for performance-based compensation, and determine the compensation of the CEO and senior management.

Seventh, it is the responsibility of the board to respond appropriately to shareholders' concerns.

Eighth, it is the responsibility of the corporation to deal with its employees, customers, suppliers and other constituencies in a fair and equitable manner.

These responsibilities and others are critical to the functioning of the modern public corporation and the integrity of the public markets. No law or regulation alone can be a substitute for the voluntary adherence to these principles by corporate directors and management.

Business Roundtable continues to believe that corporate governance should be enhanced through conscientious and forward-looking action by a business community that focuses on generating long-term shareholder value with the highest degree of integrity.

The principles discussed here are intended to assist corporate management and boards of directors in their individual efforts to implement best practices of corporate governance, as well as to serve as guideposts for the public dialogue on evolving governance standards.

I. Key Corporate Actors

Effective corporate governance requires a clear understanding of the respective roles of the board and senior management and of their relationships with others in the corporate structure. The relationships of the board and management with shareholders should be characterized by candor; their relationships with employees should be characterized by fairness; their relationships with the communities in which they operate should be characterized by good citizenship; and their relationships with government should be characterized by a commitment to compliance.

The board of directors has the important role of overseeing management performance on behalf of shareholders. Its primary duties are to select and oversee a well-qualified and ethical chief executive officer who, with senior management, runs the corporation on a daily basis and to monitor management's performance and adherence to corporate and ethical standards. Effective corporate directors are diligent monitors, but not managers, of business operations.

Senior management, led by the CEO, is responsible for running the day-to-day operations of the corporation and properly informing the board of the status of these operations. Management's responsibilities include strategic planning, risk management and financial reporting.

Shareholders are not involved in the day-to-day management of corporate operations but have the right to elect representatives (directors) to look out for their interests and to receive the information they need to make investment and voting decisions. The board should be responsive to communications from shareholders and should address issues of concern to shareholders.

Effective corporate governance requires a proactive, focused state of mind on the part of directors, the CEO and senior management, all of whom must be committed to business success through the maintenance of the highest standards of responsibility and ethics. Although there are a number of legal and regulatory requirements that must be met, good governance is far more than a "check-the box" list of minimum board and management policies and duties. Even the most

thoughtful and well-drafted policies and procedures are destined to fail if directors and management are not committed to enforcing them in practice. A good corporate governance structure is a working system for principled goal setting, effective decision making, and appropriate monitoring of compliance and performance. Through this vibrant and responsive structure, the CEO, the senior management team and the board of directors can interact effectively and respond quickly and appropriately to changing circumstances, within a framework of solid corporate values, to provide enduring value to the shareholders who invest in the enterprise.

II. The Roles of the Board of Directors and Management

An effective system of corporate governance provides the framework within which the board and management address their respective responsibilities.

The Board of Directors

- The business of a corporation is managed under the direction of the corporation's board. The board delegates to the CEO — and through the CEO to other senior management — the authority and responsibility for managing the everyday affairs of the corporation. Directors monitor management on behalf of the corporation's shareholders.

- Making decisions regarding the selection, compensation and evaluation of a well-qualified and ethical CEO is the single most important function of the board. The board also appoints or approves other members of the senior management team.

- Directors bring to the corporation a range of experience, knowledge and judgment. Directors should not represent the interests of particular constituencies.

- Effective directors maintain an attitude of constructive skepticism; they ask incisive, probing questions and require accurate, honest answers; they act with integrity and diligence; and they demonstrate a commitment to the corporation, its business plans and long-term shareholder value.

- In performing its oversight function, the board is entitled to rely on the advice, reports and opinions of management, counsel, auditors and expert advisers. The board should assess the qualifications of those it relies on and hold managers and advisers accountable. The board should ask questions and obtain answers about the processes used by managers and the corporation's advisers to reach their decisions and recommendations, as well as about the substance of the advice and reports received by the board. When appropriate, the board and its committees should seek independent advice.

- Given the board's oversight role, shareholders and other constituencies can reasonably expect that directors will exercise vigorous and diligent oversight of a corporation's affairs. However, they should not expect the board to micromanage the corporation's business by performing or duplicating the tasks of the CEO and senior management team.

- The board's oversight function carries with it a number of specific responsibilities in addition to that of selecting and overseeing the CEO. These responsibilities include:

  - *Planning for management development and succession.* The board should oversee the corporation's plans for developing senior management personnel and plan for CEO and senior management succession. When appropriate, the board should replace the CEO or other members of senior management.

  - *Understanding, reviewing and monitoring the implementation of the corporation's strategic plans.* The board has responsibility for overseeing and understanding the corporation's strategic plans from their inception through their development and execution by management. Once the board reviews a strategic plan, it should regularly monitor implementation of the plan to determine whether it is being implemented effectively and whether changes are needed. The board also should ensure that the corporation's incentive compensation program is aligned with the corporation's strategic plan.

  - *Understanding and approving annual operating plans and budgets.* The board is responsible for understanding, approving and overseeing the corporation's annual operating plans and for reviewing the annual budgets presented by management. The board should monitor implementation of the annual plans to assess whether they are being implemented effectively and within the limits of approved budgets.

  - *Focusing on the integrity and clarity of the corporation's financial statements and financial reporting.* The board, assisted by its audit committee, should be satisfied that the financial statements and other disclosures prepared by management accurately present the corpora-

tion's financial condition and results of operations to shareholders and that they do so in an understandable manner. To achieve accuracy and clarity, the board, through its audit committee, should have an understanding of the corporation's financial statements, including why the accounting principles critical to the corporation's business were chosen, what key judgments and estimates were made by management, and how the choice of principles and the making of these judgments and estimates affect the reported financial results of the corporation.

- *Advising management on significant issues facing the corporation.* Directors can offer management a wealth of experience and a wide range of perspectives. They provide advice and counsel to management in formal board and committee meetings, and they are available for informal consultation with the CEO and senior management.

- *Reviewing and approving significant corporate actions.* As required by state corporate law, the board reviews and approves specific corporate actions, such as the election of executive officers, the declaration of dividends and (as appropriate) the implementation of major transactions. The board and senior management should have a clear understanding of what level or types of decisions require specific board approval.

- *Reviewing management's plans for business resiliency.* As part of its oversight function, the board should designate senior management who will be responsible for business resiliency. The board should periodically review management's plans to address this issue. Business resiliency can include such items as business risk assessment and management, business continuity, physical and cyber security, and emergency communications.

- *Nominating directors and committee members and overseeing effective corporate governance.* It is the responsibility of the board, through its corporate governance committee, to nominate directors and committee members and oversee the composition, independence, structure, practices and evaluation of the board and its committees.

- *Overseeing legal and ethical compliance.* The board should set a "tone at the top" that establishes the corporation's commitment to integrity and legal compliance. The board should oversee the corporation's compliance program relating to legal and ethical conduct. In this regard, the board should be knowledgeable about the corporation's compliance program and should be satisfied that the program is effective in preventing and deterring violations. The board should pay particular attention to conflicts of interest, including related party transactions.

The CEO and Management

- It is the responsibility of the CEO and senior management, under the CEO's direction, to operate the corporation in an effective and ethical manner. As part of its operational responsibility, senior management is charged with:

  - *Operating the corporation.* The CEO and senior management run the corporation's day-to-day business operations. With a thorough understanding of how the corporation operates and earns its income, they carry out the corporation's strategic objectives within the annual operating plans and budgets, which are reviewed and approved by the board. In making decisions about the corporation's business operations, the CEO considers the long-term interests of the corporation and its shareholders and necessarily relies on the input and advice of others, including senior management and outside advisers. The CEO keeps the board apprised of significant developments regarding the corporation's business operations.

  - *Strategic planning.* The CEO and senior management generally take the lead in strategic planning. They identify and develop strategic plans for the corporation; present those plans to the board; implement the plans once board review is completed; and recommend and carry out changes to the plans as necessary.

- *Annual operating plans and budgets.* With the corporation's overall strategic plans in mind, senior management develops annual operating plans and budgets for the corporation and presents the plans and budgets to the board. Once the board has reviewed and approved the plans and budgets, the management team implements the annual operating plans and budgets.

- *Selecting qualified management, and establishing an effective organizational structure.* Senior management is responsible for selecting qualified management and implementing an organizational structure that is efficient and appropriate for the corporation's particular circumstances.

- *Identifying and managing risks.* Senior management identifies and manages the risks that the corporation undertakes in the course of carrying out its business. It also manages the corporation's overall risk profile.

- *Accurate and transparent financial reporting and disclosures.* Senior management is responsible for the integrity of the corporation's financial reporting system and the accurate and timely preparation of the corporation's financial statements and related disclosures in accordance with Generally Accepted Accounting Principles and in compliance with applicable laws and regulations. It is senior management's responsibility — under the direction of the CEO and the corporation's principal financial officer — to establish, maintain and periodically evaluate the corporation's internal controls over financial reporting and the corporation's disclosure controls and procedures. In accordance with applicable law and regulations, the CEO and the corporation's principal financial officer also are responsible for certifying the accuracy and completeness of the corporation's financial statements and the effectiveness of the corporation's internal and disclosure controls.

- The CEO and senior management are responsible for operating the corporation in an ethical manner. They should never put individual, personal interests before those of the corporation or its shareholders. Business Roundtable believes that when carrying out this function, corporations should have:

  - *A CEO of integrity.* The CEO should be a person of integrity who takes responsibility for the corporation adhering to the highest ethical standards.

  - *A strong, ethical "tone at the top."* The CEO and senior management should set a "tone at the top" that establishes a culture of legal compliance and integrity communicated to personnel at all levels of the corporation.

  - *An effective compliance program.* Senior management should take responsibility for implementing and managing an effective compliance program relating to legal and ethical conduct. As part of its compliance program, a corporation should have a code of conduct with effective reporting and enforcement mechanisms. Employees should have a means of seeking guidance and alerting management and the board about potential or actual misconduct without fear of retribution, and violations of the code should be addressed promptly and effectively.

III. How the Board Performs Its Oversight Function

Publicly owned corporations employ diverse approaches to board structure and operations within the parameters of applicable legal requirements and securities market listing standards. Although no one structure is right for every corporation, Business Roundtable believes that the corporate governance "best practices" set forth in the following sections provide an effective approach for corporations to follow.

Board Composition and Leadership

- Boards of directors of large, publicly owned corporations vary in size from industry to industry and from corporation to corporation. In determining board size, directors should consider the nature, size and complexity of the corporation as well as its stage of development. The experiences of many Business Roundtable members suggest that smaller boards often are more cohesive and work more effectively than larger boards.

- Business Roundtable believes that having directors with relevant business and industry experience is beneficial to the board as a whole. Directors with this experience can provide a useful perspective on significant risks and competitive advantages and an understanding of the challenges facing the business. A diversity of backgrounds and experience, consistent with the corporation's needs, also is important to the overall composition of the board. Because the corporation's need for particular backgrounds and experience may change over time, the board should monitor the mix of skills and experience that directors bring to the board against established board membership criteria to assess, at each stage in the life of the corporation, whether the board has the necessary tools to perform its oversight function effectively.

- The board of a publicly owned corporation should have a substantial degree of independence from management. Board independence depends not only on directors' individual relationships but also on the board's overall attitude toward management. Providing objective independent judgment is at the core of the board's oversight function, and the board's composition should reflect this principle.

- A substantial majority of directors of the board of a publicly owned corporation should be independent, both in fact and appearance, as determined by the board. In accordance with the listing standards of the major securities markets, the board should make an affirmative determination as to the independence of each director annually and should have a process in place for making these determinations.

  - *Definition of "independence."* An independent director should not have any relationships with the corporation or its management — whether business, employment, charitable or personal — that may impair, or appear to impair, the director's ability to exercise independent judgment. The listing standards of the major securities markets define "independence" and enumerate specific relationships (such as employment with the corporation or its outside auditor) that preclude a director from being considered independent.

  - *Assessing independence.* The board should approve standards for determining directors' independence, taking into account the requirements of the federal securities laws, securities market listing standards, and the views of institutional investors and other relevant groups. These standards should be set forth in the corporation's corporate governance principles. When considering whether a director is independent, the board should consider not only whether the director has any of the relationships covered by the board's independence standards but also whether the director has any other relationships, either directly or indirectly, with the corporation, senior management or other board members that could affect the director's actual or perceived independence.

- *Relationships with not-for-profit organizations.* The board's director independence standards should include standards for assessing directors' relationships with not-for-profit organizations that receive support from the corporation. In applying these standards, the board should take into account the size of the corporation's contributions and the nature of directors' relationships to the recipient organizations. Independence issues are most likely to arise when a director is an employee of the not-for-profit organization and when a substantial portion of the organization's funding comes from the corporation. It also may be appropriate to consider contributions from a corporation's foundation to organizations with which a director is affiliated.

- Most American corporations have been well served by a structure in which the CEO also serves as chairman of the board. The CEO serves as a bridge between management and the board, ensuring that both act with a common purpose. The decision concerning whether the CEO also should serve as chairman of the board often is part of the succession planning process, and the board should make that decision in light of the corporation's facts and circumstances.

- Although no one structure is right for every corporation, it is critical that the board has independent leadership. Some boards have found it useful to separate the roles of CEO and chairman of the board. Alternatively, there is a growing trend for boards to appoint a "lead" or "presiding" director. A lead director generally advises on board meeting schedules and agendas, chairs executive sessions of the board, oversees the flow of information to the board, and serves as a liaison between the independent directors and the CEO. The lead director also may play a key role in overseeing performance evaluations of the CEO and the board, be available for communication with shareholders, and lead the board in crisis situations.

- Still other boards have designated an independent director to preside over the executive sessions of a board's independent or nonmanagement directors that are required by securities market listing standards. Depending on the corporation, the so-called presiding director also may perform some or all of the other functions performed by the lead director.

Board Organization

- Virtually all boards of directors of large, publicly owned corporations operate using committees to assist them. A committee structure permits the board to address key areas in more depth than may be possible in a full board meeting.

- Decisions about committee membership and chairs should be made by the full board based on recommendations from the corporate governance committee. Consideration should be given to whether periodic rotation of committee memberships and chairs would provide fresh perspectives and enhance directors' familiarity with different aspects of the corporation's business, consistent with applicable listing standards.

- Committees should apprise the full board of their activities on a regular basis. Processes should be developed and monitored for keeping the board informed through oral or written reports. For example, some corporations provide minutes of committee meetings to all members of the board.

- Business Roundtable believes that the functions generally performed by the audit, compensation and corporate governance committees are central to effective corporate governance. The listing standards of the major securities markets require corporations to have an audit committee that performs specific functions, and many corporations also are required to have committees that oversee executive compensation, director nominations and corporate governance matters. Business Roundtable does not believe that a particular committee structure is essential for all corporations. What is important is that key issues are addressed effectively by the independent members of the board. Thus, the references below to the functions performed by particular committees are not intended to preclude corporations from allocating these functions differently, consistent with applicable listing standards.

- Additional committees, such as finance or risk management committees, also may be used. Some corporations find it useful to establish committees to examine special problems or opportunities in greater depth than would otherwise be feasible.

- The responsibilities of each committee and the qualifications required for committee membership should be clearly defined and set out in a written charter that is approved by the board and publicly available. Each committee should review its charter annually and recommend changes to the board as appropriate.

- A more detailed discussion of particular committee functions appears in Business Roundtable's *Executive Compensation: Principles and Commentary* (November 2003) and *The Nominating Process and Corporate Governance Committees: Principles and Commentary* (April 2004).

Audit Committee

- Every publicly owned corporation should have an audit committee of at least three members, who should all be independent directors.

- Audit committees typically consist of three to five members. The listing standards of the major securities markets require that all members of the audit committee qualify as independent directors under applicable listing standards, subject to limited exceptions, and that they meet additional, heightened independence criteria.

- Audit committee members should meet minimum financial literacy standards, as required by the listing standards of the major securities markets, and at least one member of the audit committee should be an audit committee financial expert, as determined by the board in accordance with regulations of the Securities and Exchange Commission. Just as important is the ability of audit committee members, as with all directors, to understand the corporation's business and risk profile and to apply their business experience and judgment with an independent and critical eye to the issues for which the committee is responsible.

- With the significant responsibilities imposed on audit committees under applicable law, regulations and listing standards, consideration should be given to whether it is appropriate to limit the number of public company audit committees on which a corporation's audit committee members may

serve. Some boards have adopted policies that audit committee members may not serve on the audit committees of more than three public corporations, in accordance with applicable securities market listing standards. Policies may permit exceptions to this limit when the corporation's board determines that the simultaneous service would not affect an individual's ability to serve effectively on the corporation's audit committee.

- The audit committee is responsible for supervising the corporation's relationship with its outside auditor. In performing this responsibility, the primary functions of the audit committee include:

  - *Retaining the auditor and approving in advance the terms of the annual audit engagement.* The selection of the outside auditor should involve an annual due diligence process in which the audit committee reviews the qualifications, work product, independence and reputation of the outside auditor and the performance of key members of the audit team. The committee should be mindful of the schedule, mandated by applicable law and regulations, for rotating the engagement and concurring partners and should begin the process of reviewing new partners sufficiently in advance of required rotations. The audit committee also should consider periodically whether it is appropriate for the corporation to change its outside auditor. The audit committee should base its decisions about selecting and possibly changing the outside auditor on its assessment of what is likely to lead to more effective audits. In retaining the auditor, the audit committee should oversee the process of negotiating the annual audit engagement letter and should scrutinize the terms of the engagement carefully.

  - *Overseeing the independence of the outside auditor.* The audit committee should maintain an ongoing, open dialogue with the outside auditor about independence issues. The committee should consider its overall approach to using the outside auditor as a service provider and identify those services, beyond the annual audit engagement, that the outside auditor can provide to the corporation consistent with applicable law and regulations and with maintaining independence. In pre-approving all non-audit services to be provided by the outside auditor, as required

by applicable law and regulations, the audit committee should decide whether to adopt a pre-approval policy or approve services on an engagement-by-engagement basis.

- The audit committee also is responsible for overseeing the corporation's financial reporting process. The audit committee should review and discuss the corporation's annual financial statements with management and the outside auditor and should review the corporation's quarterly financial statements and related earnings press releases prior to issuance. As part of its reviews, the audit committee should review and discuss with management and the outside auditor the corporation's critical accounting policies, the quality of accounting judgments and estimates made by management, and any material written communications between the outside auditor and management.

- The audit committee should understand and be familiar with the corporation's system of internal controls over financial reporting and its disclosure controls and procedures, including the processes for producing the certifications required of the CEO and principal financial officer, and the audit committee should be comfortable that the corporation has appropriate controls in place. On a periodic basis, the committee should review with both the internal and outside auditors, as well as with management, the corporation's procedures for maintaining and evaluating the effectiveness of these systems. The committee should be promptly notified of any significant deficiencies or material weaknesses in internal controls and kept informed about the steps and timetable for correcting them.

- Unless the full board or another committee does so, the audit committee should oversee the corporation's program that addresses compliance with ethical and legal standards and important corporate policies, including the corporation's code of conduct and the mechanisms it has in place for employees to report compliance issues. In accordance with applicable legal requirements, the audit committee should establish procedures for receiving and handling complaints and concerns related to accounting, internal accounting controls and auditing issues, and the committee should evaluate these procedures periodically and revise them as appropriate. The audit

committee should be briefed regularly on the status of outstanding compliance issues, including concerns submitted through the committee's procedures for handling accounting and related concerns, and it should receive prompt notification of any significant compliance issues.

- The audit committee should understand the corporation's risk profile and oversee its risk assessment and risk management practices.

- The audit committee should oversee the corporation's internal audit function, including reviewing the scope of the internal audit plan, reports submitted by the internal audit staff and management's response, and the appointment and replacement of the senior internal auditing executive.

- The audit committee should implement a policy covering the hiring of personnel who previously worked for the corporation's outside auditor. At a minimum, this policy should incorporate the "cooling off" period mandated by applicable law and regulations.

- Audit committee meetings should be held frequently enough to allow the committee to monitor the corporation's financial reporting appropriately. Meetings should be scheduled with enough time to permit and encourage active discussions with management and the internal and outside auditors. The audit committee should meet privately with each of the internal and outside auditors and management on a regular basis, and in any event at least quarterly, and communicate with them between meetings as necessary. The audit committee also should hold private sessions with the corporation's chief legal officer on a regular basis to facilitate the communication of concerns regarding legal compliance matters and significant legal contingencies. The audit committee also may determine that it is appropriate to hold private sessions with other parties, such as outside counsel, from time to time.

Corporate Governance Committee

- Every publicly owned corporation should have a committee composed solely of independent directors that addresses director nominations and corporate governance matters.

- The corporate governance committee (often combined with or referred to as a nominating committee) should have at least three members and should be composed solely of independent directors.

- The corporate governance committee recommends director nominees to the full board and the corporation's shareholders; oversees the composition, structure, operation and evaluation of the board and its committees; and plays a leadership role in shaping the corporate governance of the corporation. Depending on how the board has allocated responsibilities among its committees, the corporate governance committee also may oversee the compensation of the board if the compensation committee does not do so, or the two committees may share oversight responsibility for this area.

- In performing the core function of recommending nominees to the board, the corporate governance committee should establish criteria for board and committee membership and recommend these criteria to the board for approval. Based on these criteria, the committee should identify director candidates, review their qualifications and any potential conflicts with the corporation's interests, and recommend candidates to the board. The committee also should assess the contributions of current directors in connection with their renomination.

- In identifying director candidates, the corporate governance committee should take a proactive approach by soliciting ideas for potential candidates from a variety of sources. The committee should have the authority to retain search firms as appropriate to assist it in identifying candidates and should develop a process for considering shareholder recommendations for board nominees. Although it is appropriate for the CEO to meet with board candidates, the final responsibility for selecting director nominees should rest with the corporate governance committee and the board.

- The corporate governance committee should monitor and safeguard the independence of the board. An important function of a corporate governance committee, related to its core function of recommending nominees to the board, is to see that a substantial majority of the directors on the board meet appropriate standards of independence that are consistent with securities market listing standards and to see that these directors are independent in both fact and appearance. The corporate governance committee should develop and recommend standards of independence to the board, assess the independence of directors in light of these standards, and make recommendations to the board regarding determinations of director independence. In addition, the committee should be notified promptly of any change in a director's circumstances that may affect the director's independence.

- The corporate governance committee also recommends directors for appointment to committees of the board. The committee should periodically review the board's committee structure and annually recommend candidates for membership on the board's committees. The committee should see that the key board committees, including the audit, compensation and corporation governance committees, are composed of directors who meet applicable independence and qualification standards.

- The corporate governance committee should oversee the effective functioning of the board. The committee should review the board's policies relating to meeting schedules and agendas and the corporation's processes for providing information to the board. The corporate governance committee should assess the reporting channels through which the board receives information and see that the board obtains appropriately detailed information in a timely fashion.

- The corporate governance committee should develop and recommend to the board a set of corporate governance principles, review them annually, and recommend changes to the board as appropriate. The corporation's corporate governance principles should be publicly available and should address, at a minimum, board leadership, qualifications for directors (including independence standards), director responsibilities, the structure

and functioning of board committees, board access to management and advisers, director compensation, director orientation and continuing education, board evaluations, and management succession.

- The corporate governance committee should oversee the evaluation of the board and its committees. Specifics concerning the evaluation process are discussed under "Board and Committee Evaluation."

Compensation Committee

- Every publicly owned corporation should have a committee composed solely of independent directors that addresses compensation issues.
- The compensation committee should have at least three members and should be composed solely of independent directors. All committee members should have sufficient knowledge of executive compensation and related issues to perform their duties effectively.
- The compensation committee's responsibilities include overseeing the corporation's overall compensation structure, policies and programs; establishing or recommending to the board performance goals and objectives for the CEO and other members of senior management; and establishing or recommending to the independent directors compensation for the CEO and senior management. The compensation committee should see that the corporation's compensation policies reflect the core principle of pay for performance and should establish meaningful goals for performance-based compensation.
- The compensation committee should have the authority to retain compensation consultants, counsel and other advisers to provide the committee with independent advice.
- The compensation committee should understand all aspects of an executive's compensation package and should review and understand the maximum pay-out due under multiple scenarios (such as retirement, termination with or without cause, and severance in connection with business combinations or the sale of a business).

- The compensation committee should require senior management to build and maintain significant continuing equity investment in the corporation. The committee should establish requirements that senior management acquire and hold a meaningful amount of the corporation's stock. The committee also should consider whether to require senior management to hold for a period of time a specified amount of stock earned through incentive-based awards.

- In addition to reviewing and setting compensation for senior management, the compensation committee should look more broadly at the overall compensation structure of the enterprise to determine that it establishes appropriate incentives for management and employees at all levels. The committee should consider carefully and understand the incentives created by different forms of compensation. Incentives should further the corporation's long-term strategic plan and be consistent with the culture of the corporation and the overall goal of enhancing enduring shareholder value.

- Executive compensation should directly link the interests of senior management, both individually and as a team, to the long-term interests of shareholders. It should include significant performance-based criteria related to long-term shareholder value and should reflect upside potential and downside risk.

- The compensation committee should consider whether the benefits and perquisites provided to senior management are proportional to the contributions made by management.

- The compensation committee should oversee the corporation's disclosures with respect to executive compensation. In particular, the committee should use the compensation committee report included in the corporation's annual proxy statement to provide shareholders with meaningful and understandable information about the corporation's executive compensation practices.

Board Operations

- Serving on a board requires significant time and attention on the part of directors. Directors must participate in board meetings, review relevant materials, serve on board committees, and prepare for meetings and discussions with management. They must spend the time needed and meet as frequently as necessary to properly discharge their responsibilities. The appropriate number of hours to be spent by a director on his or her duties and the frequency and length of board meetings depend largely on the complexity of the corporation and its operations. Longer meetings may permit directors to explore key issues in depth, whereas shorter but more frequent meetings may help directors stay up-to-date on emerging corporate trends and business and regulatory developments. When arranging a meeting schedule for the board, each corporation should consider the nature and complexity of its operations and transactions, as well as its business and regulatory environment.

- Directors should receive incentives to focus on long-term shareholder value. Including equity as part of directors' compensation helps align the interests of directors with those of the corporation's shareholders. Accordingly, a meaningful portion of a director's compensation should be in the form of long-term equity. In this regard, corporations increasingly are providing the long-term equity component of directors' compensation in the form of restricted stock, rather than stock options, to better align directors' interests with those of shareholders. Corporations should establish a requirement that directors acquire a meaningful amount of the corporation's stock and hold that stock for as long as they remain on the board.

- Business Roundtable does not endorse a specific limitation on the number of directorships an individual may hold. However, service on too many boards can interfere with an individual's ability to satisfy his or her responsibilities, either as a member of senior management or as a director. Before accepting an additional board position, a director should consider whether the acceptance of a new directorship will compromise the ability to perform present responsibilities. It also is good practice for directors to notify the chair of the corporate governance committee for each board on which

they serve before accepting a seat on the board of another corporation. Some corporations require the prior approval of the corporate governance committee. Similarly, the corporation should establish a process to review senior management service on other boards prior to acceptance.

- The board's independent or nonmanagement directors should have the opportunity to meet regularly in executive session, outside the presence of the CEO and any other management directors, in accordance with applicable listing standards.
  - Time for an executive session should be placed on the agenda for every regularly scheduled board meeting.
  - To maximize the effectiveness of executive sessions, there should be follow-up with the CEO and other appropriate members of senior management.
- Many board responsibilities may be delegated to committees to permit directors to address key areas in more depth. Regardless of whether the board grants plenary power to its committees with respect to particular issues or prefers to take recommendations from its committees, committees should keep the full board informed of their activities. Corporations benefit greatly from the collective wisdom of the entire board acting as a deliberative body, and the interaction between committees and the full board should reflect this principle.
- The board's agenda must be carefully planned yet flexible enough to accommodate emergencies and unexpected developments. The chairman of the board should work with the lead director (when the corporation has one) in setting the agenda and should be responsive to individual directors' requests to add items to the agenda and open to suggestions for improving the agenda. It is important that the agenda and meeting schedule permit adequate time for discussion and a healthy give-and-take between board members and management.
- Board agendas should be structured to allow time for open discussion. Board members should have full access to senior management.

- The board must have accurate, complete information to do its job; the quality of information received by the board directly affects its ability to perform its oversight function effectively. Directors should receive and review information from a variety of sources, including management, board committees, outside experts, auditor presentations, and analyst and media reports. The board should be provided with information before board and committee meetings, with sufficient time to review and reflect on key issues and to request supplemental information as necessary.

- Corporations should have an orientation process for new directors that is designed to familiarize them with the corporation's business, industry and corporate governance practices. Common practices include briefings from senior management, on-site visits to the corporation's facilities, informal meetings with other directors and written materials. Corporations also should encourage directors to take advantage of educational opportunities on an ongoing basis to enable them to better perform their duties and to keep informed about developments in areas such as the corporation's industry, corporate governance and director responsibilities.

- Where appropriate, boards and board committees should seek advice from outside advisers independent of management with respect to matters within their responsibility. For example, there may be technical aspects of the corporation's business — such as risk assessment and risk management — or conflict of interest situations for which the board or a committee determines that additional expert advice would be useful. Similarly, many compensation committees engage their own compensation consultants. The board and its committees should have the authority to select and retain advisers and approve the terms of their retention and fees.

Management Development and Succession

- Long-term planning for CEO and senior management development and succession is one of the board's most important functions. The board, its corporate governance committee or another committee of independent directors should identify and regularly update the qualities and characteristics necessary for an effective CEO. With these principles in mind, the

board or committee should periodically monitor and review the development and progression of potential internal candidates against these standards.

- Emergency succession planning also is critical. Working with the CEO, the board or committee should see that plans are in place for contingencies such as the departure, death or disability of the CEO or other members of senior management to facilitate the transition to both interim and longer-term leadership in the event of an untimely vacancy.

- Under the oversight of an independent committee or the lead director, the board should annually review the performance of the CEO and participate with the CEO in the evaluation of members of senior management. All nonmanagement members of the board should participate with the CEO in senior management evaluations. The results of the CEO's evaluation should be promptly communicated to the CEO in executive session by representatives of the independent directors and used by the compensation committee or board in determining the CEO's compensation.

Board and Committee Evaluation

- The board should have an effective mechanism for evaluating performance on a continuing basis. Meaningful board evaluation requires an assessment of the effectiveness of the full board, the operations of board committees and the contributions of individual directors.

  - For some companies, securities market listing standards now require that the board and its audit, compensation and corporate governance committees conduct annual evaluations. Regardless of whether an evaluation is required, the performance of the full board should be evaluated annually, as should the performance of its committees. The board should use the annual self-evaluation to assess whether it is following the procedures necessary to function effectively. Each board committee should conduct an annual self-evaluation to assess its effectiveness, and the results of this evaluation should be reported to the full board.

- The board should have a process for evaluating whether the individuals sitting on the board bring the skills and expertise appropriate for the corporation and how they work as a group. Board positions should not be regarded as permanent. Directors should serve only so long as they add value to the board, and a director's ability to continue to contribute to the board should be examined by the corporate governance committee each time the director is considered for renomination.

- Planning for the departure of directors and the designation of new board members is essential. The board should plan ahead for changes in membership, and it should have written criteria for director candidates that should be re-evaluated periodically. The board also should establish procedures for the retirement or replacement of board members. These procedures may, for example, include a mandatory retirement age, a term limit and/or a requirement that directors who change their primary employment tender a board resignation, providing an opportunity for the governance committee to consider the desirability of their continued service on the board.

IV. Relationships with Shareholders and Other Constituencies

Corporations are often said to have obligations to shareholders and other constituencies, including employees, the communities in which they do business and government, but these obligations are best viewed as part of the paramount duty to optimize long-term shareholder value. Business Roundtable believes that shareholder value is enhanced when a corporation treats its employees well, serves its customers well, fosters good relationships with suppliers, maintains an effective compliance program and strong corporate governance practices, and has a reputation for civic responsibility.

Shareholders and Investors

- Corporations have a responsibility to communicate effectively and candidly with shareholders. The goal of shareholder communications should be to help shareholders understand the business, risk profile, financial condition and operating performance of the corporation and the board's corporate governance practices.

- Corporations communicate with investors and other constituencies not only in proxy statements, annual and other reports, and formal shareholder meetings, but in many other ways as well. All of these communications should provide consistency, clarity and candor.

- Corporations should have effective procedures for shareholders to communicate with the board and for directors to respond to shareholder concerns. The board, or an independent committee such as the corporate governance committee, should establish, oversee and regularly review and update these procedures as appropriate.

  - The board should respond in a timely manner to substantive communications from shareholders, and when appropriate, directors should meet with shareholders regarding issues of concern.

- A corporation's procedures for shareholder communications and its governance practices should be readily available to shareholders. Information about the board's structure and operations, committee composition and responsibilities, corporate governance principles, and codes of ethics should be widely disseminated to shareholders.

- The board should be notified of shareholder proposals, and the board or its corporate governance committee should oversee the corporation's response to these proposals.

- Directors should attend the corporation's annual meeting of shareholders, and the corporation should have a policy requiring attendance absent unusual circumstances. Time at the annual meeting should be set aside for shareholders to submit questions and for management or directors to respond to those questions.

- The board should seriously consider issues raised by shareholder proposals that receive substantial support and should communicate its response to proposals to the shareholder-proponents and to all shareholders.

- The board should respond appropriately when a director nominee receives a significant "withhold" or "against" vote with respect to his or her election to the board. The corporate governance committee should assess the reasons for the vote and recommend to the board the action to be taken with respect to the vote, which should be communicated to the corporation's shareholders.

- In planning communications with shareholders and investors, corporations should consider:

  - *Candor.* Directors and management should never mislead or misinform shareholders about the corporation's operations or financial condition.

  - *Need for timely disclosure.* In an age of instant communication, corporations increasingly are disclosing significant information closer to the time when it arises and becomes available. Business Roundtable supports prompt disclosure of significant developments.

- *Use of technology.* Technology makes communicating quicker, easier and less expensive. Corporations should take advantage of technological advances to enhance the dissemination of information to shareholders and employees.

- *Ultimate goal of shareholder communications.* Whatever the substance of the communication, the corporation's ultimate goal should be to furnish information that is honest, intelligible, meaningful, timely and broadly disseminated and that gives investors a realistic picture of the corporation's financial condition and results of operations through the eyes of management.

Employees

- It is in a corporation's best interest to treat employees fairly and equitably.

- Corporations should have in place policies and practices that provide employees with compensation, including benefits, that is appropriate given the nature of the corporation's business and employees' job responsibilities and geographic locations.

- When corporations offer retirement, health care, insurance and other benefit plans, employees should be fully informed of the terms of those plans.

- Corporations should have in place and publicize mechanisms for employees to seek guidance and to alert management and the board about potential or actual misconduct without fear of retribution.

- Corporations should communicate honestly with their employees about corporate operations and financial performance.

Communities

- Corporations have obligations to be good citizens of the local, national and international communities in which they do business. Failure to meet these obligations can result in damage to the corporation, both in immediate economic terms and in longer-term reputational value.

- A corporation should be a good citizen and contribute to the communities in which it operates by making charitable contributions and encouraging its directors, managers and employees to form relationships with those communities. A corporation also should be active in promoting awareness of health, safety and environmental issues, including any issues that relate to the specific types of business in which the corporation is engaged.

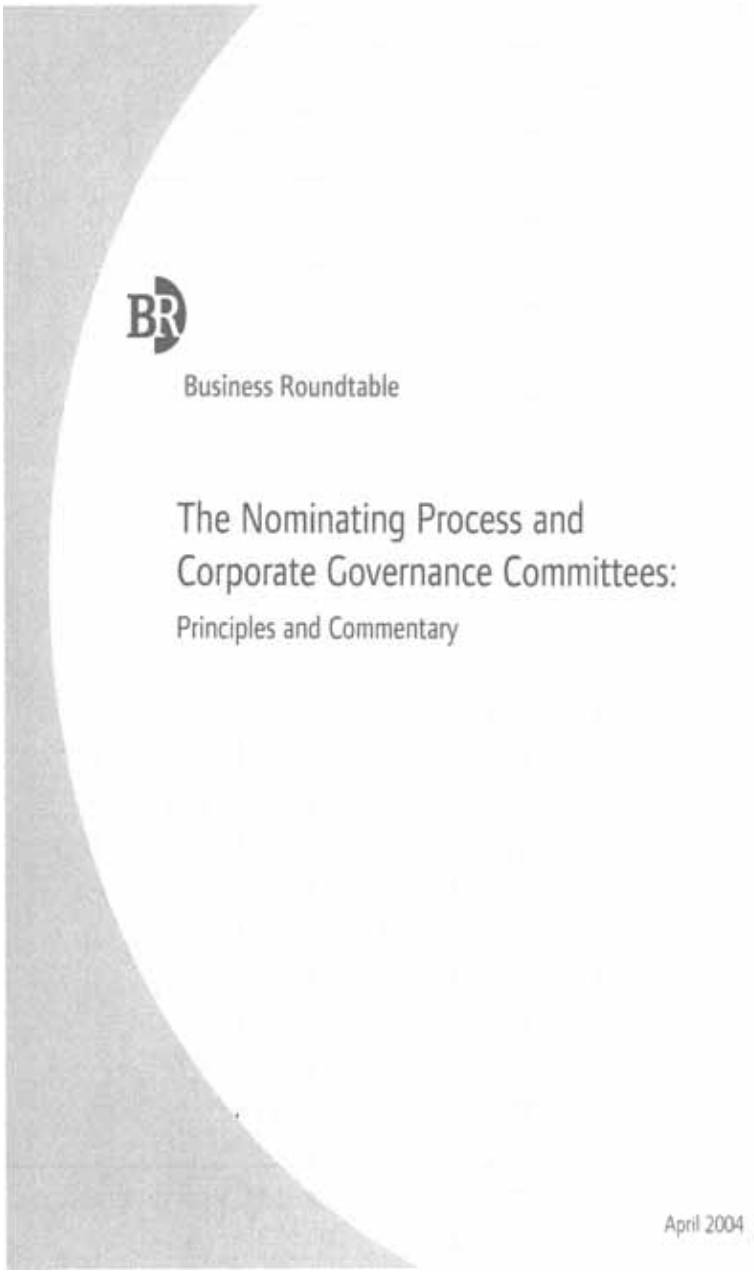
Government

- Corporations, like all citizens, must act within the law. The penalties for serious violations of law can be extremely severe, even life-threatening, for corporations. Compliance is not only appropriate — it is essential. Management should take reasonable steps to develop, implement and maintain an effective legal compliance program, and the board should be knowledgeable about and oversee the program, including periodically reviewing the program to gain reasonable assurance that it is effective in deterring and preventing misconduct.

- Corporations have an important perspective to contribute to the public policy dialogue and should be actively involved in discussions about the development, enactment and revision of the laws and regulations that affect their businesses and the communities in which they operate and their employees reside.

EXHIBIT II

THE NOMINATING PROCESS AND CORPORATE GOVERNANCE COMMITTEES: PRINCIPLES AND COMMENTARY (APRIL 2004)



Business Roundtable

Business Roundtable is an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees in the United States and $3.7 trillion in annual revenues. The chief executives are committed to advocating public policies that foster vigorous economic growth, a dynamic global economy, and a well-trained and productive U.S. workforce essential for future competitiveness.

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The Nominating Process and Corporate Governance Committees:

Principles and Commentary

A White Paper from Business Roundtable | April 2004

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The Nominating Process and Corporate Governance Committees: Principles

1. *The corporate governance committee, which should be composed entirely of independent directors, should play a leadership role in shaping a company's corporate governance and overseeing the composition, structure, operation and evaluation of the board and its committees.*

2. *The corporate governance committee should take responsibility for assuring that a substantial majority of the board meets appropriate standards of independence developed by the committee and approved by the board.*

3. *The corporate governance committee should develop and recommend to the board a set of corporate governance principles, which the corporation should make publicly available.*

4. *Director candidates should be identified, evaluated and recommended to the board by the corporate governance committee. The corporate governance committee should consider director candidates recommended by stockholders, as well as suggestions from directors, management and other sources.*

5. *The corporate governance committee should have an established process for evaluating the independence, contributions and effectiveness of incumbent directors when deciding whether to recommend those directors for re-nomination.*

6. *The corporate governance committee should be responsible for establishing and overseeing procedures for stockholder communications with directors if the full board or another committee does not do so.*

7. *The corporate governance committee should assist the board in planning for CEO and senior management development and succession if another committee of independent directors does not do so.*

Introduction

Business Roundtable is recognized as an authoritative voice on matters affecting American business corporations and, as such, has a keen interest in improving corporate governance practices. Business Roundtable is an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees in the United States and $3.7 trillion in annual revenues. The chief executives are committed to advocating public policies that foster vigorous economic growth, a dynamic global economy, and a well-trained and productive U.S. workforce essential for future competitiveness.

Every publicly owned corporation should have an independent board committee that addresses director nominations and corporate governance issues. An effective corporate governance committee (often combined with, or referred to as, a nominating committee) is central to the functioning of the board. Traditionally, the corporate governance committee's role was to recommend director candidates to the board and the corporation's stockholders. Over the past decade, however, the committee's role has expanded so that today at many corporations it plays a leadership role in shaping corporate governance and overseeing the composition, structure, operation, compensation and evaluation of the board and its committees.

Business Roundtable has developed seven principles to serve as best practices for the nominating process and corporate governance committees. These principles are discussed in more detail in the commentary that follows. While the commentary illustrates ways to implement the principles, other approaches may be appropriate given the circumstances of an individual corporation.

It is critical to have independent director oversight of board nominations and operations. However, references in the principles and commentary to the corporate governance committee are not intended to preclude corporations from allocating responsibility for particular matters to a different committee, to the

independent directors as a group or to the full board. (For example, although the principles suggest that the corporate governance committee should assist the board in planning for CEO and senior management succession, at some corporations the compensation committee is charged with this responsibility.) What is important is that key corporate governance issues are addressed effectively by the independent members of the board.

Commentary on Principles

1. *The corporate governance committee, which should be composed entirely of independent directors, should play a leadership role in shaping a company's corporate governance and overseeing the composition, structure, operation and evaluation of the board and its committees.*

- Members of the corporate governance committee should be independent in both fact and appearance, as determined by the board. They should have the ability to exercise independent judgment free from any relationship or influence that could compromise their ability to approach nominating and governance issues decisively and independently.

- The responsibilities of the corporate governance committee should be set out in a written committee charter that is made publicly available to stockholders and other interested parties.

- The committee's responsibilities should include identifying, evaluating and recommending director candidates to the board; establishing criteria for board and board committee membership; overseeing the evaluation of the board; developing and recommending to the board for public release a set of corporate governance principles; providing direction and oversight for director orientation and continuing education programs; overseeing procedures for stockholder communications with the board; and assisting the board and the CEO in planning for CEO and senior management development and succession (or seeing that another committee or the full board addresses these issues).

- The corporate governance committee should review the board's committee structure and recommend candidates for membership on the board's committees. As the corporation's circumstances change, it may be appropriate for the committee to recommend that the board add or dissolve board committees (other than those required by law, regulation or listing standards).

- In recommending committee membership, the corporate governance committee should focus on the strengths that different directors bring to the committees and the needs of the committees.

- It is the corporate governance committee's responsibility to see that key board committees, including the audit, compensation and nominating-corporate governance committees, are composed of directors who meet applicable independence and qualification standards.

- When evaluating potential committee chairs, the corporate governance committee should consider each candidate's leadership abilities, as well as his or her expertise and availability.

- The corporate governance committee, along with the full board, should consider whether periodic rotation of committee membership and chairs would provide fresh perspectives and enhance directors' familiarity with different aspects of the corporation's business.

- The corporate governance committee should be responsible for overseeing the effective functioning of the board. The committee should review the board's policies relating to meeting schedules, meeting agendas and the participation of management at board and committee meetings.

  - The committee should evaluate the quality and timeliness of information received by the board and the manner in which it is provided. The board should receive from management in a timely manner appropriately detailed information, and directors should request additional information as necessary.

  - The board also should be provided with information from sources outside the corporation, including analyst and press reports (both positive and negative) relating to the corporation, management, the industry and corporate governance issues.

  - The board should have an opportunity to meet with members of management on a regular basis in order to assess their capabilities and to stay apprised of issues facing the company and its industry.

- The corporate governance committee should oversee evaluation of board and board committees performance and individual director contributions.
  - The performance of the full board should be evaluated at least annually. Companies conduct board evaluations in a variety of ways, including discussions led by the board chair or the chair of the corporate governance committee, annual board self-evaluation questionnaires and the use of third parties.
  - The committee and the board should assess how directors work as a group and with the CEO and whether changes in the composition of the board or key committees would better serve the corporation's interests.
  - Evaluation of the board involves a candid assessment of the board's strengths and weaknesses. The committee should report to the board on any weaknesses identified through the evaluation process and, together with the board, should develop and implement plans to address those weaknesses.
  - The corporate governance committee should conduct its own committee self-evaluation and should assist other board committees with their self-evaluations.
  - Individual directors' contributions should be evaluated in connection with the re-nomination process, as discussed below.
- The corporate governance committee should establish procedures for the retirement or replacement of board members. Such procedures may include a mandatory retirement age or term limits. In addition, directors who change primary employment should notify the chair of the corporate governance committee so that the committee may determine whether the director's continued service on the board is appropriate.
- The corporate governance committee should ask directors and the most senior executive officers to notify the corporate governance committee chair before accepting a position on another for-profit company's board.

- The corporate governance committee, if the compensation committee does not do so, should review and recommend changes to the corporation's director compensation policies.
  - A meaningful portion of a director's compensation should be in the form of long-term equity.
  - The committee should consider establishing a requirement that, for as long as directors remain on the board, they hold a meaningful amount of company stock.
  - The committee should review the compensation provided to the lead or presiding director (if one has been designated) and key committee chairs to determine whether supplemental compensation, reflecting their additional responsibilities and time commitment, would be appropriate.

2. *The corporate governance committee should take responsibility for assuring that a substantial majority of the board meets appropriate standards of independence developed by the committee and approved by the board.*

- The corporate governance committee should monitor and safeguard the independence of the board and should see that a substantial majority of directors are independent in both fact and appearance, as determined by the board.
- The committee should develop and recommend to the board standards for determining directors' independence, taking into account the requirements of the federal securities laws and applicable securities markets and the views of institutional investors and other relevant groups.
- An independent director should not have relationships with the corporation or its management — whether business, employment, charitable or personal — that could impair his or her ability to exercise independent judgment.

- The committee should have a rigorous screening process to uncover any conflicts of interest or other relationships affecting independence. Director questionnaires are a useful part of this process. The committee also should review information from other sources as necessary.

3. *The corporate governance committee should develop and recommend to the board a set of corporate governance principles, which the corporation should make publicly available.*

- The corporate governance committee should develop, recommend to the board and update as necessary a set of corporate governance principles.

- The corporate governance principles of a public corporation should address, at a minimum, board leadership, qualifications for directors (including independence standards), director responsibilities, the structure and functioning of board committees, the board's access to management and independent advisers, director compensation, director orientation and continuing education, board evaluations, and management succession.

- The corporate governance principles should be made publicly available to the corporation's stockholders and other interested parties.

- The corporate governance committee should conduct regular reviews of corporate governance trends and best practices and should recommend changes to the principles and board practices as appropriate.

4. *Director candidates should be identified, evaluated and recommended to the board by the corporate governance committee. The corporate governance committee should consider director candidates recommended by stockholders, as well as suggestions from directors, management and other sources.*

- A core function of the corporate governance committee is selecting and recommending to the board qualified director candidates for election by the corporation's stockholders. To perform this responsibility properly, the committee should prepare and recommend to the board written criteria for director candidates. Over time, the committee should evaluate whether changes to the board's criteria are appropriate.

- In developing criteria and evaluating individual candidates for nomination, the corporate governance committee should consider the background and expertise of existing board members and the specific needs of the board.

- The composition of the board should reflect a mix of talents, experience, expertise and perspectives appropriate to the corporation's circumstances and strategic challenges, and the corporate governance committee should plan ahead for changes in board composition.

- The committee should consider candidates from a range of backgrounds. Diversity in gender, age, race and perspective all are appropriate considerations. In recent years, corporations have drawn directors from a variety of sources, including the public sector, educational and charitable institutions, and senior management in addition to current and former CEOs.

- Important criteria for directors include integrity, candor, good judgment, commitment and willingness to consider matters before the board with objectivity and impartiality. In addition, the committee should consider whether candidates have the requisite knowledge, skills and experience to understand the business of the corporation. A candidate's prior success as a manager or director of another corporation or significant enterprise also may be relevant.

- The board's membership criteria should be disclosed to the corporation's stockholders and included in its corporate governance principles. As the board's needs change, the corporate governance committee should update its criteria for membership.

- Many corporate governance committees use executive search firms to assist them in identifying and recruiting qualified board candidates. Any such outside firm should be retained by, and report directly to, the corporate governance committee.

- The corporate governance committee should encourage stockholder suggestions regarding board composition and should consider director candidates recommended by stockholders.

- The corporation should disclose publicly how and when stockholders may recommend director candidates to the corporate governance committee for consideration and should indicate the information that must be provided so that those candidates can be considered by the committee. The corporation should update this information as necessary.

- The committee should evaluate stockholder candidates for director using the same criteria it uses to evaluate candidates recommended by other sources.

- The committee should consider the candidate's ability to act in the best interests of the corporation and all of its stockholders.

- The committee should communicate with any stockholder who recommends a candidate to the committee, informing him or her of the receipt and status of the recommendation and the committee's determination regarding the candidate.

▸ Although it is appropriate for the CEO to meet with board candidates, final responsibility for selecting director nominees should rest with the corporate governance committee and the board.

5. *The corporate governance committee should have an established process for evaluating the independence, contributions and effectiveness of incumbent directors when deciding whether to recommend those directors for re-nomination.*

▸ Board positions should not be regarded as permanent. Directors should serve only so long as they add value to the board and act in the best interests of stockholders. The corporate governance committee should have a rigorous process for evaluating whether incumbent directors continue to have the appropriate skills and experience to contribute to the board.

- In assessing a director's contributions, the following should be considered: his or her attendance, preparation and active participation at board and committee meetings; input from the CEO; the board's criteria for membership; and current needs for particular background and expertise.

- The committee should evaluate a director's availability and commitment going forward.

- Corporate governance committees use a variety of means to assess directors' contributions, including discussions led by the board chair or the chair of the corporate governance committee, confidential self-evaluations or peer evaluations.

6. *The corporate governance committee should be responsible for establishing and overseeing procedures for stockholder communications with directors if the full board or another committee does not do so.*

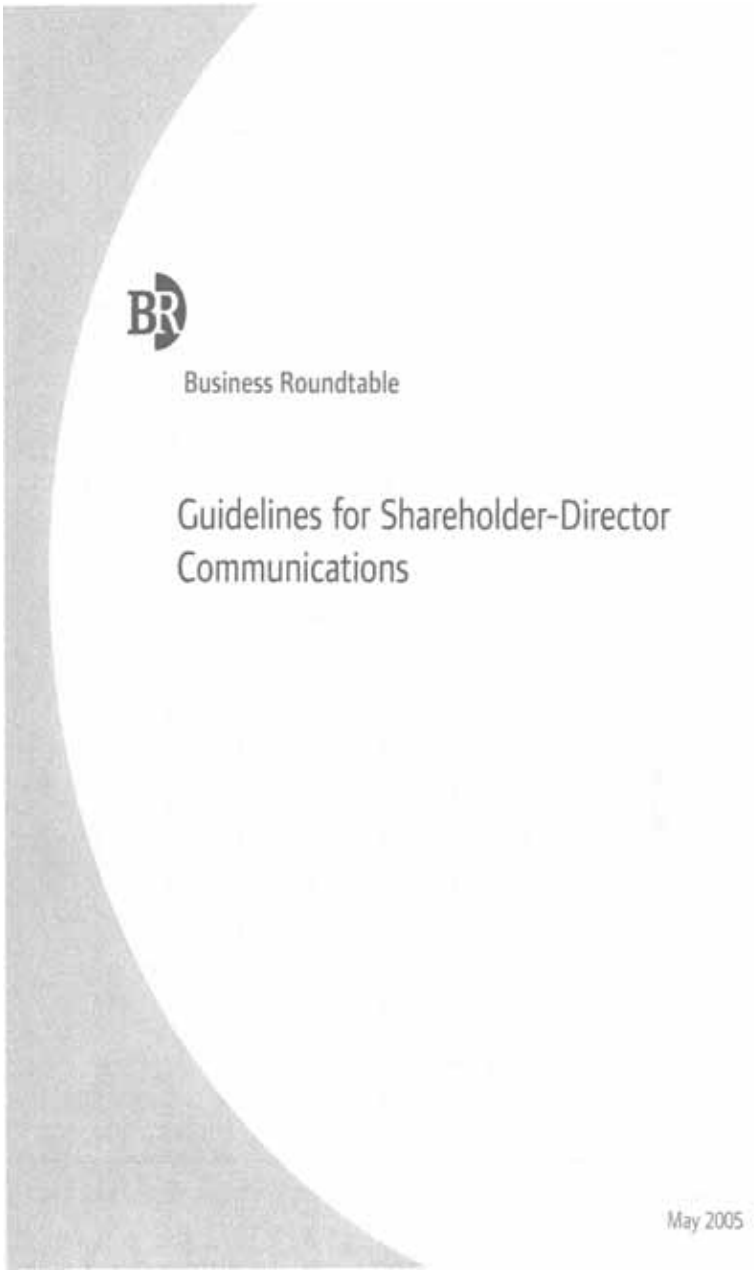
- Every publicly owned corporation should have effective and meaningful procedures for stockholders to communicate with the board and for directors to respond to stockholder concerns.
  - Such procedures may include a mailing address, telephone number or electronic-mail address for stockholders to register concerns or questions with the board as a whole, the independent directors or key committee chairs.
  - The board, the corporate governance committee or members of management should consider meeting with stockholders regarding issues of concern.
  - The corporate governance committee, another committee or the full board should oversee the corporation's response to proposals submitted by stockholders. It may be appropriate for members of the board to meet with stockholders regarding specific proposals. In addition, the corporation should communicate its response to stockholder proposals that receive a majority vote.
- Directors should attend the corporation's annual meeting of stockholders and have a process for responding to stockholder questions concerning the corporation. At the annual meeting, committee chairs may wish to make presentations on certain issues.

7. *The corporate governance committee should assist the board in planning for CEO and senior management development and succession if another committee of independent directors does not do so.*

- Long-term planning for CEO and senior management development and succession is one of the board's most important functions. The corporate governance committee should assist the board in identifying and regularly updating the qualities necessary for an effective CEO of the corporation.
  - The board or the committee should monitor the development and progression of potential internal candidates using these standards.
  - The board or the committee should review with the CEO what is being done to prepare potential candidates for succession.
- Emergency succession planning is equally critical. Working with the CEO, the board should assure that the corporation has a plan to deal with unexpected events, such as the sudden departure, death or disability of the CEO or other senior managers.

EXHIBIT III

GUIDELINES FOR SHAREHOLDER-DIRECTOR COMMUNICATIONS (MAY 2005)



Business Roundtable

Business Roundtable (www.businessroundtable.org) is an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees and $4 trillion in annual revenues. The chief executives are committed to advocating public policies that foster vigorous economic growth and a dynamic global economy.

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Guidelines for Shareholder-Director Communications

A White Paper from Business Roundtable | May 2005

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Guidelines for Shareholder-Director Communications

1. *Every publicly owned corporation should have effective procedures for shareholders to communicate with the board and for directors to respond to shareholders' concerns.*
2. *A corporation's relationship with its shareholders should be characterized by candor. All communications with shareholders should be consistent, clear and candid.*
3. *A corporation's procedures for shareholder-director communications, and its corporate governance practices generally, should be readily available to shareholders.*
4. *The board should be notified of all proposals submitted by shareholders, and the board or its corporate governance committee should oversee the corporation's response to shareholders' proposals.*
5. *Directors should attend the corporation's annual meeting of shareholders and should respond, or ensure that management responds, to appropriate shareholder questions concerning the corporation.*

Introduction

Business Roundtable is recognized as an authoritative voice on matters affecting American business corporations and, as such, has a keen interest in improving corporate governance practices. Business Roundtable is an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees and $4 trillion in annual revenues. The members of Business Roundtable have demonstrated their commitment to advocating public policies that foster vigorous economic growth, a dynamic global economy, and the well-trained and productive U.S. workforce essential for future competitiveness.

Congress, the U.S. Securities and Exchange Commission (SEC), and the national securities markets recently adopted reforms to strengthen shareholder-director communications and enhance related disclosures. The business community strongly supports these reforms, and corporations have explored new ways to implement them. To assist in this effort, Business Roundtable has developed five guidelines to serve as best practices for shareholder-director communications.

Laws and regulations cannot substitute for simple business sense and common courtesy — qualities that mandate fair, respectful treatment of shareholders and their views. It is with these qualities in mind that we developed the guidelines and commentary in this report.

Commentary on Guidelines

1. *Every publicly owned corporation should have effective procedures for shareholders to communicate with the board and for directors to respond to shareholders' concerns.*

- The board, or one of its independent committees, should establish and oversee procedures for shareholder communications with directors.
  - These procedures may include a variety of communication methods, such as mail, telephone, electronic mail and face-to-face meetings with members of the board.
  - Although communications with shareholders as a group generally are management's responsibility, directors may initiate contact with shareholders when appropriate, generally with notification to management.
  - Shareholders should have a mechanism to be able to register concerns or questions with the full board, the independent directors as a group or the chairs of key board committees. Complaints related to accounting, internal controls or auditing matters should be handled pursuant to procedures established by the audit committee.
  - In addition, if the board has a lead or presiding director, shareholders also should be able to communicate with that person.
- When appropriate, directors should meet with shareholders regarding issues of concern. At the same time, it should be made clear that the board values diversity of thought and that the views of one director are not necessarily the views of the board.
  - Meetings with directors should be reserved for shareholders with serious concerns about significant company policies.
  - When appropriate, such meetings can include informal discussions with one or more directors or more formal meetings with the full board or a board committee.

- The board should decide when management will be invited to attend meetings between shareholders and directors and what role management will play.

- The board should specifically designate a member of management (such as the corporate secretary, the head of investor relations or the general counsel) to collect, organize and review communications from shareholders, unless all such communications are sent directly to the board. Any such procedure should be approved and overseen by the independent directors or a committee of independent directors.

  - The board's designee should report to the board or an independent committee of the board at least quarterly on the number and nature of communications received from shareholders and should convey shareholders' requests to meet with directors. When a communication is deemed to be urgent or to require immediate action, the designee should, as outlined in the above procedure, notify the board or the appropriate committee chair as soon as possible so that an appropriate response can be made.

  - The designee should forward to the board all substantive communications, including letters, telephone inquiries, electronic mail and comments on the corporation's proxy cards.

  - Nonsubstantive communications, such as solicitations, advertisements, spam and mass mailings, as well as communications that are unduly hostile, threatening, unlawful or similarly inappropriate, may be excluded. Any communication that is excluded (other than junk mail and spam) should be made available to the nonmanagement directors upon request and should be referenced in the communications report delivered to the board.

  - Records of all substantive communications from shareholders should be retained by the corporation for a reasonable period of time.

- The board should respond in a timely manner to substantive communications from shareholders. As set forth in the approved procedure for dealing with shareholder communications, directors may designate a member of management to respond on behalf of the corporation.

- In developing policies for shareholder-director communications, the corporation should be aware of legal restrictions, including the SEC's Regulation Fair Disclosure (FD), that bar selective disclosure of material, nonpublic information.

  - Regulation FD should not stand in the way of shareholders sharing their concerns or meeting with directors. However, directors should be careful not to disclose material, nonpublic information to individual shareholders or groups of shareholders.

  - Directors should consult management or legal counsel to assist with Regulation FD compliance.

- The board should regularly update and review its communications procedures, including benchmarking the corporation's policies against corporate governance best practices and the practices of peer companies, as appropriate.

2. *A corporation's relationship with its shareholders should be characterized by candor. All communications with shareholders should be consistent, clear and candid.*

- When directors and management communicate with shareholders, they should do so candidly. They should never mislead or misinform shareholders.

- The goal of communications with shareholders should be to help shareholders understand the corporation's business and the board's decisionmaking process.

3. *A corporation's procedures for shareholder-director communications, and its corporate governance practices generally, should be readily available to shareholders.*

   - Clear disclosure of corporate governance information provides a foundation for effective shareholder-director communications procedures. Information about the board's structure and operations, committee composition and responsibilities, corporate governance principles, and codes of ethics should be readily accessible to shareholders.

   - Disclosure regarding procedures for shareholder-director communications should be transparent, accessible and understandable. It may include contact information (such as a mailing address, telephone number or electronic mail address) for the board, the independent directors as a group and key committee chairs. It also should provide information on how to contact the lead or presiding director, if one has been designated.

4. *The board should be notified of all proposals submitted by shareholders, and the board or its corporate governance committee should oversee the corporation's response to shareholders' proposals.*

   - Management should report periodically to the board or its corporate governance committee on the number, substance and status of proposals submitted by shareholders for inclusion in the corporation's proxy statement.

   - Management also should report to the board or the corporate governance committee on communications from shareholders indicating that a proposal will be submitted if certain steps are not taken by the corporation. In many cases, management, under the oversight of the board or an independent board committee, may be able to resolve shareholders' concerns outside the formal proxy process.

   - The corporation generally should encourage a dialogue with the proponents of shareholders' proposals. Management and the directors, as appropriate, should be available to speak or meet with proponents to discuss their concerns.

- The board should consider seriously the issues raised by shareholders' proposals that receive significant support and should communicate its response to such proposals to the proponents and all shareholders.

5. *Directors should attend the corporation's annual meeting of shareholders and should respond, or ensure that management responds, to appropriate shareholder questions concerning the corporation.*

- The corporation should have a policy in place stating that all directors are expected to attend the annual meeting of shareholders, absent unusual circumstances.

- At the annual meeting, committee chairs may wish to make presentations or comment on certain issues.

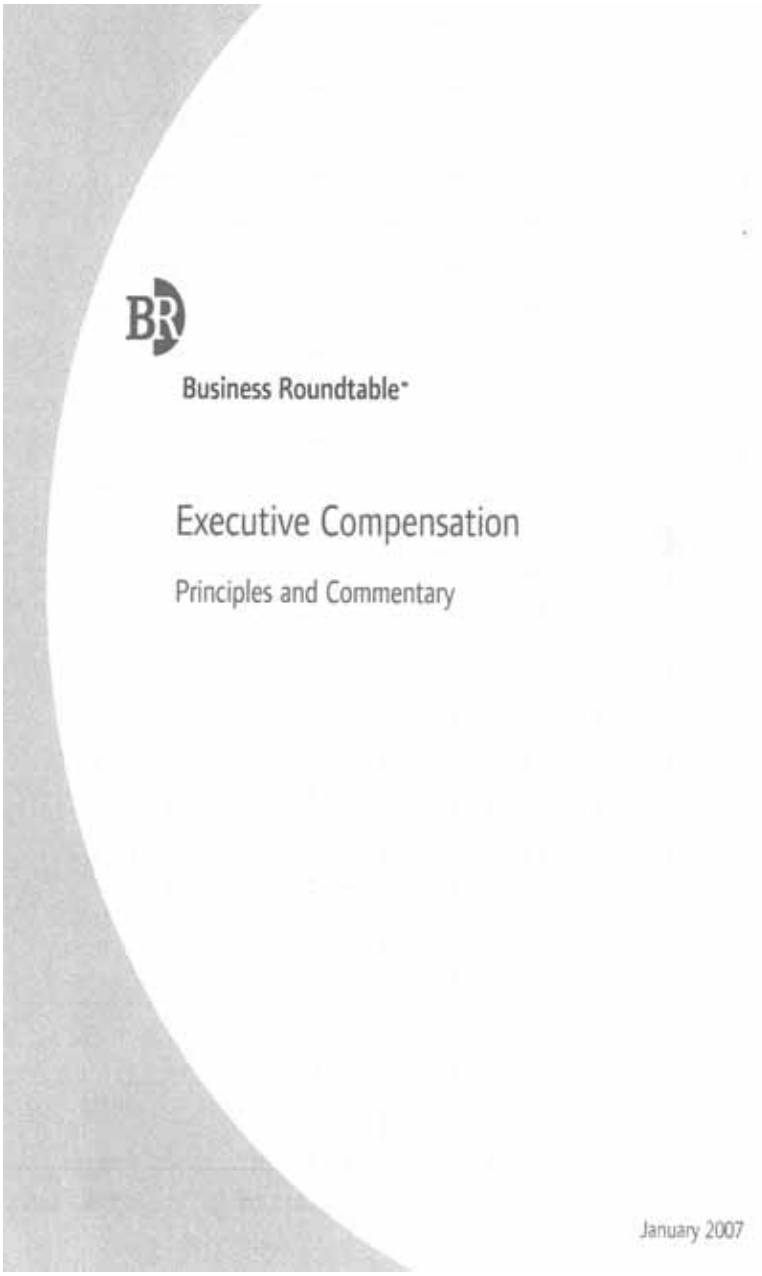
- The corporation should have a process for responding to shareholder questions submitted before, during and after the annual meeting.

  - This process may include management or directors, as appropriate, answering questions in person at the meeting; responding to shareholders by mail, telephone or electronic mail; or scheduling individual meetings with shareholders.

  - The corporation should set aside time at the annual meeting for shareholders to submit questions and for management or directors to respond.

EXHIBIT IV

EXECUTIVE COMPENSATION: PRINCIPLES AND COMMENTARY (JANUARY 2007)



Business Roundtable™

Business Roundtable (www.businessroundtable.org) is an association of chief executive officers of leading U.S. companies with $4.5 trillion in annual revenues and more than 10 million employees. Member companies comprise nearly a third of the total value of the U.S. stock market and represent over 40 percent of all corporate income taxes paid to the federal government. Collectively, they returned more than $112 billion in dividends to shareholders and the economy in 2005.

Roundtable companies give more than $7 billion a year in combined charitable contributions, representing nearly 60 percent of total corporate giving. They are technology innovation leaders, with $90 billion in annual research and development spending — nearly half of the total private R&D spending in the U.S.

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Executive Compensation

Principles and Commentary

A White Paper from Business Roundtable | January 2007

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Principles of Executive Compensation

1. *Executive compensation should be closely aligned with the long-term interests of shareholders and with corporate goals and strategies. It should include significant performance-based criteria related to long-term shareholder value and should reflect upside potential and downside risk.*

2. *Compensation of the CEO and other top executives should be determined entirely by independent directors, either as a compensation committee or together with the other independent directors based on the committee's recommendations.*

3. *The compensation committee should understand all aspects of executive compensation and should review the maximum payout and all benefits under executive compensation arrangements. The compensation committee should understand the maximum payout and consequences under multiple scenarios, including retirement, termination with or without cause, and severance in connection with business combinations or sale of the business.*

4. *The compensation committee should require executives to build and maintain significant continuing equity investment in the corporation.*

5. *The compensation committee should have independent, experienced expertise available to provide advice on executive compensation arrangements and plans. The compensation committee should oversee consultants to ensure that they do not have conflicts that would limit their ability to provide independent advice.*

6. *The compensation committee should oversee its corporation's executive compensation programs to see that they are in compliance with applicable laws and regulations and aligned with best practices.*

7. *Corporations should provide complete, accurate, understandable and timely disclosure to shareholders concerning all elements of executive compensation and the factors underlying executive compensation policies and decisions.*

Introduction

Business Roundtable, an association of CEOs of 160 leading corporations, is committed to policies and actions that stimulate economic growth and foster investor confidence and public trust in businesses. Roundtable CEOs take seriously their responsibilities to improve corporate governance and promote the highest standards of accountability and ethical behavior.

Business Roundtable CEOs lead companies with more than $4.5 trillion in annual revenues and more than 10 million employees. Member companies comprise nearly a third of the total value of the U.S. stock market, collectively returned more than $110 billion in dividends to shareholders and the economy in 2005, and represent nearly a third of all corporate income taxes paid to the federal government. The CEOs advocate public policies that encourage economic growth in the United States and across the world and have been leaders in developing the well-trained and productive U.S. workforce essential for future competitiveness.

For the past three decades, compensation has played an increasingly significant role in attracting, retaining and motivating executive officers and employees at all levels. In March 1992, when Business Roundtable released *Executive Compensation/Share Ownership*, we noted the intense interest in compensation paid to corporate executives. The stock market boom of the late 1990s and the corporate failures in the early part of this decade have heightened the focus on executive compensation. Moreover, there has been a growing concern among investors and the public that pay has not always been commensurate with performance, with a perception that some executives have reaped substantial financial rewards even at times of declining stock prices and large losses to employees and shareholders. Roundtable CEOs share that concern and believe that executive compensation should be clearly linked to company performance.

Since the publication of our executive compensation principles, there has been continuing scrutiny of executive compensation and developments relating to compensation committees. Major securities markets have adopted listing standards that require compensation committees' or independent directors' oversight of executive compensation, along with prescribed minimum responsibilities for compensation committees.

Given the ongoing development of best practices in executive compensation, Business Roundtable is updating our principles of executive compensation. In addition, the Roundtable urges all corporations to make their compensation policies and practices as responsible and transparent as possible.

Compensation should serve the objectives of a corporation's business. Accordingly, the structure and components of an appropriate executive compensation program will vary widely among corporations due to such factors as a corporation's size, industry, competitive challenges and culture. Nevertheless, the executive compensation program of every publicly owned corporation should adhere to two fundamental characteristics. First, it should reflect the core principle of pay for results. Although this concept is not new, it means that a corporation's executive compensation program not only rewards success, but also incorporates a meaningful element of risk. Additionally, it should reflect the performance of the corporation, not just the stock market in general. Second, the executive compensation program of every publicly traded corporation should be established and overseen by a committee comprised solely of independent directors who, among other things, set the goals and objectives for executive compensation and determine whether those goals and objectives have been achieved. In doing so, compensation committees should be aware of all aspects of their corporation's executive compensation and see that the compensation arrangements are in the best interests of shareholders.

Building on these characteristics as a foundation, Business Roundtable has developed seven interrelated principles to serve as best practices for the design, implementation and oversight of executive compensation programs at publicly held corporations.

We urge all corporations and their compensation committees to consider these practices as they develop and implement executive compensation arrangements.

Commentary on Executive Compensation Principles

1. *Executive compensation should be closely aligned with the long-term interests of shareholders and with corporate goals and strategies. It should include significant performance-based criteria related to long-term shareholder value and should reflect upside potential and downside risk.*

- Compensation is a primary tool for attracting and retaining the highly qualified individuals necessary for a corporation to succeed in a competitive world economy. The board of directors is responsible for adopting and overseeing the implementation of compensation policies that support the corporation's ability to compete successfully in the marketplace.

- Executive compensation should directly link the interests of executive officers, both individually and as a team, to the long-term interests of shareholders. Equity-based compensation can be effective in accomplishing this objective. Establishing a meaningful link between executive officer and shareholder interests requires careful consideration of the incentives created by different forms of compensation.

- Compensation committees and boards of directors should establish meaningful goals for performance-based compensation; payment should be tied to the achievement of those goals. A failure to meet performance goals should reduce or eliminate payments.

- Once performance goals have been established, corporations should adhere to them. A corporation should not adjust previously established targets or reprice options prior to the end of a performance measurement period or the options' term simply because it appears that results for that period or term may fall short of the goals.

- In setting performance goals, corporations should look beyond short-term market value changes and focus on metrics related to long-term shareholder value creation. Compensation plans should further both the near-term objectives and the corporation's long-term strategy, and they should be consistent with the culture of the corporation and the overall goal of enhancing sustainable shareholder value. They should avoid windfalls due solely to general stock market performance.

- In setting performance measures, consideration should be given to a variety of performance metrics, both qualitative and quantitative. These metrics should not be tied solely to the corporation's short-term stock price. Examples of quantitative metrics that may be used include such items as cash and debt management, cost containment, dividends and earnings per share, labor relations, margins, market share, mergers and acquisitions, return on equity, revenue and profit growth, sale of assets, stock price, and significant reorganizations. Qualitative metrics include such items as community relations, crisis response, customer satisfaction, employee development and relations, ethics and a culture of integrity, leadership, legal compliance, product quality, succession planning, and workforce diversity. In addition, consideration of performance relative to peer groups as well as absolute performance may be appropriate measures.

- Performance-based incentives should reflect both business and individual accomplishments. Incentives should be tied not only to the corporation's operating results, but also to the executive's distinctive leadership in managing the corporation effectively and ethically, which creates long-term value for shareholders.

- A meaningful portion of executive compensation should be performance based, thereby incorporating a greater element of downside risk into compensation arrangements. This can be accomplished, for example, by linking the granting or vesting of equity compensation to the achievement of meaningful performance targets, including a meaningful vesting period. Performance-based or performance-vested stock options, performance share units, or stock appreciation rights that are payable in the corporation's stock or cash — only if targets are met — put equity-based compensation "at risk" and link pay to performance.

- Restricted stock can be an alternative or supplement to stock options and other equity-based compensation. Although restricted stock can be an appropriate and effective retention device, it also can be more effective as a long-term incentive if it is paid or vests based on the achievement of specified performance targets.

- Performance-based incentives often will measure accomplishments over several years. For example, in a year when the corporation experiences declining financial results, the CEO may receive performance-based

compensation keyed to a previously established multiyear target. Similarly, gains realized from option exercises and stock sales in a given year may be the result of options granted over many years and several years' appreciation in the underlying stock. Corporations should take steps to enhance investor understanding of the relationship between pay and performance by providing meaningful disclosure about this relationship in the corporation's Compensation Discussion and Analysis (CD&A).

2. *Compensation of the CEO and other top executives should be determined entirely by independent directors, either as a compensation committee or together with the other independent directors based on the committee's recommendations.*

- Directors who sit on a compensation committee should be independent in both fact and appearance. Committee members should have, and be perceived to have, the ability to exercise independent judgment free from any relationship or influence that could appear to compromise their ability to approach compensation issues decisively and independently.

- In recommending directors to serve on the compensation committee, the corporate governance/nominating committee should consider the following:

  - A diversity of professional backgrounds is important to the effective functioning of a compensation committee.

  - Periodic rotation of members and the chair can bring fresh perspectives to the compensation committee.

  - All members of the committee should have sufficient knowledge of executive compensation and related issues to perform their responsibilities effectively. In-depth orientation should be provided to new committee members, and all committee members should be encouraged to participate in continuing education programs related to executive compensation.

- The particular duties and responsibilities that are delegated to the compensation committee will depend on the corporation and should be set forth in the committee's written charter. At a minimum, the duties and responsibilities of the compensation committee should include:

  - Overseeing the corporation's overall compensation structure, policies and programs;

- Reviewing and approving corporate goals and objectives relating to executive compensation;
- Evaluating executive officers' performance in light of those goals and objectives;
- Determining and approving (either as a committee or together with the other independent directors) executive officers' compensation level based on this evaluation; and
- Setting or making recommendations to the board with respect to executive compensation and compensation plans.

- The compensation committee should play an integral role in the preparation of the CD&A to be included in a corporation's proxy statement or annual report, and it should see that the CD&A effectively explains the material aspects of the corporation's compensation objectives and the factors underlying executive compensation decisions. The compensation committee also must indicate in its committee report whether it has reviewed and discussed the CD&A with management and recommended to the board that the CD&A be included in the corporation's proxy statement or annual report.

- The compensation committee should perform an annual evaluation of its performance and review the adequacy of the committee's charter. In light of this review, the compensation committee should consider appropriate changes in its practices and recommend any necessary changes in its charter to the board.

- Corporations should consider having compensation committee chairs speak for the corporation on executive compensation matters and be available at annual meetings to address executive compensation.

3. *The compensation committee should understand all aspects of executive compensation and should review the maximum payout and all benefits under executive compensation arrangements. The compensation committee should understand the maximum payout and consequences under multiple scenarios, including retirement, termination with or without cause, and severance in connection with business combinations or sale of the business.*

- The compensation committee should fully understand all the benefits and consequences to the executive and the costs to the corporation of the compensation arrangement under various circumstances, including under a

range of economic results and severance scenarios. The committee should understand how the various elements of cash and noncash compensation, including benefits, deferred compensation arrangements and supplemental retirement benefits, are allocated and work together. In addition, the committee should understand the accounting and tax aspects of different types of arrangements. Executive compensation arrangements should not be unduly complex.

- The compensation committee should be aware of all elements of the compensation of each executive officer; there should be no surprises. This may be facilitated by the use of tally sheets, which should include all forms of compensation.

- In structuring a compensation arrangement, consideration should be given to whether the amount and mix of compensation is reasonable, appropriate and fair in light of the roles, responsibilities and performance of the individual, the corporation's circumstances and overall compensation structure, and the need to attract and retain high-quality executive officers.

- The committee should consider building into executive compensation agreements the right to review and consider changes at appropriate time intervals. When a compensation arrangement is modified, the committee should assess and understand how the change will affect the overall compensation of an executive officer.

- Particular attention should be paid to severance arrangements and to all benefits provided to executive officers in connection with termination of employment. Corporations should review such arrangements on a regular basis. They should not offer excessive severance packages that reward executives who have not met performance goals and objectives during the term of their employment. Employment contracts, if any, should clearly articulate the consequences of termination and the circumstances in which an executive can be terminated for cause.

4. *The compensation committee should require executives to build and maintain significant continuing equity investment in the corporation.*

- The compensation committee should establish requirements that executive officers and members of the board of directors acquire and hold a meaningful amount of the corporation's stock to align executive and director interests with the interests of shareholders.

- Stock retention requirements can foster a long-term stake in the corporation among executive officers. The compensation committee should require that executive officers hold a specified amount of the stock for a period of time until they meet the corporation's stock ownership guidelines or until they leave the corporation.

- To minimize questions and possible concerns about the propriety of particular stock trades, corporations should make available to executive officers and directors prearranged trading plans to the extent they determine to sell some portion of their stock. When executive officers and directors enter into such trading plans, they should be disclosed.

5. *The compensation committee should have independent, experienced expertise available to provide advice on executive compensation arrangements and plans. The compensation committee should oversee consultants to ensure that they do not have conflicts that would limit their ability to provide independent advice.*

- The compensation committee should have the authority to retain compensation consultants, counsel and other outside experts in compensation matters to provide the committee with independent advice for performing its responsibilities. Nevertheless, decisions with respect to executive compensation are the ultimate responsibility of the compensation committee and the the board.

- The compensation committee should retain and oversee any compensation consultants hired to assist with executive compensation matters, approve the terms of their retention and fees, and evaluate their performance. In doing so, the committee should consider any other work that the consultants may perform for the corporation and whether such work has any impact on the advice provided to the compensation committee. The compensation committee should consider whether it should preapprove any other work the consultant does for the corporation.

- The compensation committee should use information from a variety of sources in determining compensation levels. The committee should resist an over-reliance on surveys and other statistical analyses in determining compensation levels. Although such information can be used as a tool, company-specific factors should be given significant weight in determining

executive compensation. In addition, the compensation committee should carefully examine the composition of any peer groups used in considering executive compensation and consider, among other things, the performance of the other corporations included in the peer group.

- The compensation committee should retain independent counsel that reports directly to the committee to assist in negotiation of the CEO contract and benefits and to assist the committee in addressing its other responsibilities as appropriate.

6. *The compensation committee should oversee its corporation's executive compensation programs to see that they are in compliance with applicable laws and regulations and aligned with best practices.*

- The compensation committee should assess whether executive compensation programs are consistent with the corporation's goals and strategies.

- The compensation committee should review on an ongoing basis its policies and practices with respect to the granting of stock options and other forms of equity compensation to see that they are in accord with state corporate law, Securities and Exchange Commission (SEC) rules, accounting standards, Internal Revenue Service regulations, and any other applicable requirements. The committee should be sensitive to the timing of such grants (e.g., no "back dating") and maintain consistent practices.

- Corporations should consider adopting policies and/or provisions in compensation plans or agreements that permit them to seek the return of bonuses and equity compensation from executive officers in the event of a financial restatement or fraud resulting from an executive's misconduct or fraudulent activity.

- The compensation committee should carefully examine executive perquisites and determine whether they are appropriate and in the interest of shareholders. If not, the corporation should not bear the cost of personal expenses.

- Benefits granted to executive officers should not be safeguarded to a greater extent than regular employee benefits.

- Corporations should be sensitive to the appearance of executive compensation practices, and special attention should be given to such controversial practices as:

- Tax gross-ups and supplemental retirement plans beyond those provided to other employees and
- Preferential investment or above-market interest for deferred compensation.

7. *Corporations should provide complete, accurate, understandable and timely disclosure to shareholders concerning all elements of executive compensation and the factors underlying executive compensation policies and decisions.*

- Disclosure about executive compensation should be transparent and understandable to shareholders and in plain English. Corporations should disclose the terms of executive officer employment arrangements when they are entered into or materially changed. Disclosure about a corporation's executive compensation arrangements, as a whole, should address not only the form and amount of executive compensation (including projections of future benefits), but also the interaction of the different elements of compensation, the economic impact of the compensation (such as any dilution resulting from stock options) on the corporation and its shareholders, the material factors underlying compensation policies and decisions, why specific elements of compensation were awarded, and the relationship of executive compensation to corporate goals and strategy.
- Corporations also should disclose the criteria used in performance-based awards to executives and the measurement methods used to determine whether those criteria have been met, unless disclosure of the criteria involves the disclosure of trade secrets or confidential information that could cause competitive harm.
- As required by SEC rules, the CD&A included in the proxy statement or annual report should provide shareholders an explanation of all material elements of compensation for executive officers. The CD&A should include information explaining the objectives of the compensation program, what the compensation program is designed to award, and how each element fits into the corporation's overall compensation objectives and affects other elements.
- Corporations should use the CD&A to provide shareholders with meaningful and understandable disclosure about their executive compensation philosophy, policies and practices; the factors that the compensation committee and the board consider in making compensation decisions; and the relationship between executive compensation and corporate performance.

EXHIBIT V

PRINCIPLES FOR RESPONDING TO THE FINANCIAL MARKETS CRISIS (2009)

Business Roundtable Principles for Responding to the Financial Markets Crisis

Background

Business Roundtable is an association of chief executive officers of leading U.S. companies with more than $5 trillion in annual revenues and nearly 10 million employees. Business Roundtable believes the basic interests of business closely parallel the interests of American workers, who are directly linked to companies as consumers, employees, shareholders and suppliers. In their roles as CEOs, Business Roundtable members are responsible for the jobs, products, services and benefits that affect the economic well-being of all Americans.

Business Roundtable has worked with the prior and current administrations and with Congress to put in place programs and other initiatives to help America emerge from the current recession. Our highest priority is and has been to grow the U.S. economy and produce jobs, so that all Americans can enjoy better lives. To that end, Business Roundtable supported passage of the Emergency Economic Stabilization Act and a targeted economic stimulus package. We also support robust and thoughtful financial services regulatory reform; reform that supports the principle of economic and job growth in America.

Business Roundtable approaches financial services regulatory reform from a user perspective. Most of our members, while not financial services companies, work with and rely upon such companies to finance our activities, to insure against risk, to grow and expand. We understand the importance of functioning financial markets because we rely on them literally every day and could not provide jobs, products, and services without them.

Modernizing our financial services regulatory reform system is not just an issue for corporations. More than half of American households are invested - directly or indirectly - in our financial markets through stocks, retirement plans and mutual funds. Virtually every American household uses credit for mortgages and for auto and student loans. Companies large and small that are unrelated to the financial sector are seeing an adverse impact on their businesses from the current financial crisis. In developing a more modern, strong, financial services regulatory structure, it is important to bear in mind what needs fixing – and what does not.

Even as the Administration and Congress turn to the task of enacting financial services regulatory reform, they must take further steps in the short term to fix our financial markets. Liquidity and credit problems continue to affect businesses throughout our economy and, while both this and the previous Administration have established programs that have helped with respect to particular types of issues or particular businesses, many problems remain and many companies continue to need more access to credit.

For example, on October 7, 2008, in response to the disruption in the commercial paper market, the Board of Governors of the Federal Reserve System (FRB) announced the creation of a Commercial Paper Funding Facility (CPFF), established by the New York Federal Reserve Bank to purchase commercial paper. The facility was, and remains, limited to commercial paper rated A-1/P-1/F-1 ("Tier 1" commercial paper). The establishment of this facility helped to restore

liquidity to the Tier 1 commercial paper market as interest rates fell dramatically and short-term funds again became available at low-interest rates to Tier 1 issuers. At the same time, the Tier 1 CPFF hurt A-2/P-2/F-2 ("Tier 2") issuers as the market appeared to penalize these companies for not having access to the government backstop.

This disruption in the commercial paper market – and associated cost increases and uncertainty – hurt business activity, affected companies' ability to retain and hire workers, and sharply curtailed financing provided to suppliers, dealers and customers. The inability to secure short-term financing sends tremors throughout the economy by forcing companies to postpone capital expenditures indefinitely and by disrupting supply chains and affecting production. This unnecessarily harms the manufacturers and businesses that rely on those outlays to create new jobs and retain existing workers.

While the commercial paper market has improved since last fall, it remains a challenge for many companies to gain access at reasonable rates and terms. Yet the CPFF has not been expanded.

Likewise, the federal government can and should do more to incentivize lending to small and medium-sized businesses. One possibility is to use Troubled Asset Relief Program repayments to help guarantee loans to such businesses.

This and the previous Administration deserve credit for developing programs designed to jump-start the credit markets. However, Business Roundtable believes that the federal government should do everything practicable to restore market liquidity to normal levels.

Principles for Responding to the Financial Markets Crisis

What follows is a set of principles for, in the short term, restoring a healthy flow of credit throughout our economy and, in the longer term, enacting financial services regulatory reform that can help our economy sustain economic and job growth.

- Restoring Credit Flow
    - The federal government should do more to assist with the severe short term liquidity and credit problems that continue to fuel the financial markets crisis. Further consideration should be given to expanding programs to additional companies or assets where assistance is particularly needed and the federal government should seek more creative ways to limit taxpayer risk.
    - Conditions placed on participation in such government programs should not be moving targets. Businesses and the millions of Americans who rely on them for jobs and invest in them should know at the outset what requirements apply to program participants.
    - Greater transparency is needed of the process for exiting government programs. Uncertainty over exit requirements limits participation in programs and diminishes the assistance they provide to businesses and the economy.
    - The federal government should make it clear that these programs are temporary and should develop plans to provide for a smooth transition once the economy recovers and these programs are no longer needed. Permanent programs could

Business Roundtable

lead to market distortions and mispriced credit detrimental to the interests of well-run companies.

- Process for Reform
  - The current financial crisis calls for financial services regulatory reform, and the most important principle for reform is not to get it done quickly but to get it done right. The potential consequences of getting it wrong are enormous; far more so than the consequences of taking more time to draft legislation that is better conceived and more likely to help the economy grow long term.
  - The bipartisan, independent commission created by Congress should look carefully at what happened *and* make recommendations on how to fix the system. A more developed factual record would lay a deeper foundation for reform and likely lead to a better, consensus-driven and more politically-resilient product.

- Systemic Risk
  - An appropriate entity or council should be tasked with working to prevent a future crisis from occurring while preserving an environment conducive to economic growth and job creation.
  - The systemic risk regulator should emphasize transparency, not restrictions.
  - The systemic risk regulator should not be layered on top of the existing regulatory structure and, indeed, systemically significant institutions should be regulated on a consistent and consolidated basis. Bifurcated regulation of systemically significant activities can increase systemic risk by creating potential regulatory gaps and inconsistencies.
  - The systemic risk regulator should have the authority to regulate derivative products and instruments as well as to address mortgage risk.
  - The systemic risk regulator should avoid identifying systemically significant institutions, the failure of which would cause unacceptable harm to our economy and instead focus on activities that could cause unacceptable harm to our economy. The systemic risk regulator should treat differently a company's efforts to finance its own products and technologies and activities surrounding the creation and trading of complex derivative instruments.

- Resolution Authority
  - The federal government should have a process in place to help guide systemically significant institutions (SSIs) quickly and successfully through critical periods, during times of financial crisis, and to resolve them in an orderly manner if necessary. The process should not duplicate or interfere with existing resolution mechanisms for non-SSIs.
  - Resolution authority parameters should be carefully drawn so that the legitimate expectations and interests of creditors (which are often pension or other retirement funds) and other stakeholders are respected. Without appropriate safeguards on the exercise of resolution authority, the cost of financing could increase as investors and creditors price in the future risk of having their rights limited or cancelled.

- The new system should, to the extent possible, be based on the Bankruptcy Code with divergence only as necessary to create a more streamlined process to protect the interests of taxpayers and the economy.

- Corporate Governance
  - The primacy of state corporation law should be respected. Moreover, a corporation should be governed by its board of directors in compliance with such law even where the federal government has invested in the company.
  - Corporate boards should be allowed to establish appropriate compensation policies. The federal government's role in the manner in which compensation is set should be temporary and limited to companies in which the government has taken an equity stake with taxpayer dollars.
  - In order to better ensure the long-term viability of companies to create and protect jobs, shareholders should be given more and better information about – and consideration should be given to providing additional authority to regulate – activist investors seeking to influence a company's policies.

- Derivatives
  - OTC derivatives dealers and systemically significant market participants should be subject to a strong regulatory and supervisory regime.
  - Centralized clearing of standardized, liquid OTC derivatives between dealers should be required in order to bring additional transparency to a large portion of the derivatives market providing key information on pricing, volume, and risk.
  - Care must be taken not to destroy the specialized derivatives market by mandating clearing or exchange trading. As Secretary Geithner has testified, the Administration's proposal is designed "to preserve the capacity for the more specialized tailored products which our system relies on to manage risk effectively."

- Securities
  - Companies should disclose their risk management and oversight practices and key performance indicators to the extent that such disclosure does not infringe upon the need to protect competition and sensitive information.
  - In 2007, the SEC eliminated the short sale uptick rule, which had been in place for decades. An appropriate form of the uptick rule should be reinstated, and there should be greater transparency of short selling activity.

- Accounting
  - Accounting standards should not be set through legislation. The Financial Accounting Standards Board should be permitted to continue to use its process of standard setting through a public comment and hearing process coupled with additional staff guidance on particular interpretative questions being raised under the guidance.

- Prudential Regulation

- Explore consolidation of prudential regulatory functions to create more effective regulation and prevent forum-shopping and competitive non-regulation.
- Consider combining SEC and CFTC.
- Avoid duplicative regulation of financial products through the creation of a "financial products protection agency" or other means. Regulatory gaps should be filled as needed but without creating an additional layer of bureaucracy or overlapping or overly-intrusive authorities.

- Global Approach
  - Key regulatory policies should be coordinated throughout the international community to ensure more consistent and predictable supervision and regulation.

- Credit Rating Agencies
  - New regulations pertaining to credit rating agencies must be considered with an eye toward international consistency and preserving the analytical independence of credit ratings agencies from government proscriptions. A regulatory system should mandate registration for credit rating agencies and require greater transparency about their management of conflicts of interest and the processes and procedures for analyzing creditworthiness. Setting these types of requirements, coupled with accountability to regulatory authorities through a system of fines, penalties, and sanctions, will help restore confidence in the credit rating industry and foster increased competition, while affording ratings agencies the flexibility to address market innovation going forward.
  - Credit rating agencies should disclose and apply ratings processes, methodologies, benchmarks, standards and metrics in a consistent manner that is appropriate to the particular class of securities.

- Insurance
  - Congress should consider an appropriate federal role in the regulation of insurance that could assist in meeting the goals of financial modernization and address international matters related to insurance.

EXHIBIT VI

2008 BUSINESS ROUNDTABLE SURVEY

Business Roundtable

2008 CORPORATE GOVERNANCE SURVEY

BOARD OF DIRECTORS

1) Do you have:

a)	a separate chairman who is independent	☐	since 200__
b)	a separate chairman who is not independent	☐	since 200__
c)	a presiding/lead director whose primary function is to chair executive sessions	☐	since 200__
d)	a presiding/lead director who chairs executive sessions and performs additional functions	☐	since 200__
e)	none of the above	☐	

2) How often do your non-management (or independent) directors meet in Executive Session each year?

		2007	2008 (expected)
a)	never	☐	☐
b)	once or twice	☐	☐
c)	three-four times but not at every regular Board meeting	☐	☐
d)	at every regular Board meeting	☐	☐

3) Do the Audit, Compensation and Nominating/Governance Committees meet in Executive Session each year (check all that apply)?

a)	no, committees do not meet in Executive Session	☐
b)	yes (Audit)	☐
b)	yes (Compensation)	☐
d)	yes (Nominating/Governance)	☐

e) if yes, how often do Executive Sessions occur:

	Audit	Comp.	Nom./ Gov.
once or twice	☐	☐	☐
three-four times but not at every regular committee meeting	☐	☐	☐
at every regular committee meeting	☐	☐	☐

4) Do you perform formal individual director evaluations?

	2007	2008 (expected)
a) no	☐	☐
b) yes	☐	☐
c) if yes, indicate which apply:		
self evaluation	☐	☐
peer evaluation	☐	☐
one-on-one discussion/interview	☐	☐
other – please explain below:	☐	☐

_____

_____

_____

5) What percentage of the Board is independent, excluding the CEO, under applicable listing standards?

	2007	2008 (expected)
a) less than 60%	☐	☐
b) 61-80%	☐	☐
c) 81-99%	☐	☐
d) 100%	☐	☐

6) How many other public company boards of directors does your CEO serve on?

a) none	☐
b) one	☐
c) two	☐
d) three	☐
e) four or more	☐

7) How long has your CEO been in his/her position?

_____ (years/months)

8) Has one or more members of the Board met with a group of shareholders during the past year?

a) no	☐
b) yes	☐

9) Has one or more members of the Board met with individual shareholders during the past year?
   a) no ☐
   b) yes ☐

10) If one or more members of the Board met with individual shareholders during the past year, did the meeting occur in connection with the shareholder's submission of a shareholder proposal?
   a) no – please explain below: ☐
   b) yes ☐

_____

_____

_____

11) If one or more members of the Board met with individuals shareholder during the past year, were company personnel present?
   a) no ☐
   b) such communications have not occurred ☐
   c) yes ☐
   d) if yes, indicate who is typically present (check all that apply):

   the CEO ☐
   the General Counsel ☐
   the Corporate Secretary or another designated corporate governance officer ☐
   investor relations personnel ☐

12) Have you adopted some form of "Majority Voting" for directors (check all that apply)?
   a) no ☐
   b) yes, we have adopted a director resignation policy ☐
   c) yes, we have amended our charter or bylaws to provide for a majority voting standard ☐
   d) actively considering doing so in the future ☐

13) How many shareholder proposals did you receive during the 2008 proxy season?
   a) none ☐
   b) one ☐
   c) two ☐
   d) three ☐
   e) four or more – please provide number below: ☐

_____

14) If you received at least one shareholder proposal during the 2008 proxy season, how many shareholder proposals were included in your proxy statement?

a) none ☐
b) one ☐
c) two ☐
d) three ☐
e) four or more – please provide number below: ☐

_____

15) If you received at least one shareholder proposal during the 2008 proxy season, did the proposal(s) address (check all that apply):

a) "Say-on-Pay" ☐
b) director elections ("Majority Voting") ☐
c) independent chairman ☐
d) social responsibility issues ☐

16) Has the Nominating/Governance Committee received any shareholder recommendations for Board nominees in the past year?

a) no ☐
b) do not know ☐
c) yes (self-nomination) ☐
d) yes (nomination of another individual) ☐

if yes, indicate the approximate amount of company stock owned by the shareholder:

_____

EXECUTIVE COMPENSATION PRACTICES

17) Has the Compensation Committee adjusted the performance element of senior executive compensation in the past year?

a) no ☐
b) do not know ☐
c) yes ☐
if yes, indicate whether the performance element was adjusted to include:

more short-term performance goals ☐
more long-term performance goals ☐

18) Is the CEO's compensation:

a) approved by the Compensation Committee ☐
b) approved by the Compensation Committee after discussion/consultation at the Board level ☐
c) approved by the Compensation Committee and ratified at the Board level ☐
d) recommended by the Compensation Committee for approval by the independent directors ☐
e) recommended by the Compensation Committee for approval by the Board (except the CEO) ☐
f) other – please describe: ☐

_____

_____

_____

19) Has the Board or Compensation Committee adopted a "clawback" policy or provision allowing the company to seek recovery of compensation paid to executives in the case of financial restatements?

a) no ☐
b) yes ☐
c) do not know ☐

COSTS OF SOX

20) Did the annual costs your company incurred in connection with the internal control requirements of SOX decrease in light of the SEC's interpretive guidance and the PCAOB's Auditing Standard No. 5?

a) no, costs remained about the same ☐
b) no, costs increased ☐
c) yes, costs decreased moderately ☐
d) yes, costs decreased significantly ☐
e) do not know ☐

OTHER BOARD PRACTICES

21) Has your Board considered or adopted any other corporate governance practices that you would like to share?

_____

_____

_____

COMMENTS

_____

_____

_____

_____

_____

_____

RESPONDENT INFORMATION

Name: _____

Title: _____

Company: _____

Telephone: _____

Email _____

Send completed survey by **October 8, 2008,** to LaShawn Taylor by fax at (202) 466-3509 or by mail at Business Roundtable, 1717 Rhode Island Avenue, NW, Suite 800, Washington, DC 20036.

PREPARED STATEMENT OF J.W. VERRET

ASSISTANT PROFESSOR OF LAW, GEORGE MASON UNIVERSITY SCHOOL OF LAW

JULY 29, 2009

The Misdirection of Current Corporate Governance Proposals

Chairman Reed, Ranking Member Bunning, and distinguished Members of the Subcommittee, it is a privilege to testify in this forum today.

My name is J.W. Verret, and I am an Assistant Professor of Law at George Mason Law School, a Senior Scholar at the Mercatus Center at George Mason University and a member of the Mercatus Center Financial Markets Working Group. I also direct the Corporate Federalism Initiative, a network of scholars dedicated to studying the intersection of State and Federal authority in corporate governance.

I will begin by addressing proxy access and executive compensation rules under consideration and close with a list of contributing causes for the present crisis.

I am concerned that some of the corporate governance proposals recently advanced impede shareholder voice in corporate elections. This is because they leave no room for investors to design corporate governance structures appropriate for their particular circumstances.

Rather than expanding shareholder choice, these reforms actually stand in the way of shareholder choice. Most importantly, they do not permit a majority of shareholders to reject the Federal approach.

The Director of the United Brotherhood of Carpenters said it best, "we think less is more, fewer votes and less often would allow us to put more resources toward intelligent analysis." The Brotherhood of Carpenters opposes the current proposal out of concern about compliance costs. The proposals at issue today ignore their concerns, as well as concerns of many other investors.

Consider why one might limit shareholders from choosing an alternative means of shareholder access. It can only be because a majority of the shareholders at many companies might reject the Federal approach if given the opportunity.

Not all shareholders share similar goals. Public Pension Funds run by State elected officials and Union Pension Funds are among the most vocal proponents of shareholder power. Main street investors deserve the right to determine whether they want the politics of Unions and State Pension funds to take place in their 401(k)s.

The current proposals also envision more disclosure about compensation consultants. Such a discussion would be incomplete without mentioning conflicts faced by proxy advisory firms. Proxy advisory firms advise institutional investors on how to vote. Current proposals have failed to address this issue. The political clout enjoyed by these firms is evidenced by the fact that the CAO of RiskMetrics, the dominant firm in the industry, was recently hired as special advisor to the SEC Chairman.

To close the executive compensation issue, I will note that if executive compensation were to blame for the present crisis, we would see significant difference between compensation policies at those financial companies that recently returned their TARP money and those needing additional capital. We do not.

Many of the current proposals also seek to undermine, and take legislative credit for, efforts currently underway at the State level and in negotiations between investors and boards. This is true for proxy access, the subject of recent rule making at the State level, and it is true for Federal proposals on staggered boards, majority voting, and independent Chairmen.

The Sarbanes-Oxley Act passed in 2002 and was an unprecedented shift in corporate governance designed to prevent poor management practices. Between 2002 and 2008, the managerial decisions that led to the current crisis were in full swing. I won't argue that Sarbanes-Oxley caused the crisis, but this suggests that corporate governance reform does a poor job of preventing crisis.

And yet, the financial crisis of 2008 must have a cause. I salute this Committee's determination to uncover it, but challenge whether corporate governance is the culprit. Let me suggest six alternative contributing factors for this Committee to investigate:

i. The moral hazard problems created by the prospect of Government bailout;

ii. The market distortions caused by subsidization of the housing market through Fannie Mae, Freddie Mac, and Federal tax policy;

iii. Regulatory failure by the banking regulators and the SEC in setting appropriate risk-based capital reserve requirements for investment and commercial banks;

iv. Short-term thinking on Wall Street fed by institutional investor fixation on firms making, and meeting, quarterly earnings predictions;

v. A failure of credit-rating agencies to provide meaningful analysis, caused by an oligopoly in that market supported by regulation;

vi. Excessive write downs in asset values under mark-to-market accounting, demanded by accounting firms who refused to sign off on balance sheets out of concern about exposure to excessive securities litigation risk.

Corporate governance is the foundation of American capital markets. If this Committee tinkers with the American corporate governance system merely for the appearance of change, it risks irreparable damage to that foundation.

I thank you for the opportunity to testify, and I look forward to answering your questions.

PREPARED STATEMENT OF RICHARD C. FERLAUTO

DIRECTOR OF CORPORATE GOVERNANCE AND PENSION INVESTMENT,
AMERICAN FEDERATION OF STATE, COUNTY, AND MUNICIPAL EMPLOYEES

JULY 29, 2009

Good Afternoon, Chairman Reed and Members of the Subcommittee. My name is Richard Ferlauto, Director of Corporate Governance and Investment Policy at the American Federation of State, County, and Municipal Employees. AFSCME is the largest union in the AFL–CIO with 1.6 million members who work in the public service. Our members have their retirement assets invested through public retirement systems with more than one trillion dollars in assets. They depend on the earnings of these systems to support their benefits in retirement. Large public pension system investments in the public markets are diversified, largely owning the market, and heavily indexed, which operate with time horizons of 20 years or more to match the benefit obligations they have to their plan participants. Indeed, public pension systems are the foundation of patient capital investment in this economy, which seeks long-term shareholder value creation.

AFSCME places strong emphasis on improving corporate governance through direct company engagement, regulation, and legislation as a way to achieve long-term shareholder value. As an active shareowner, we have been a leading advocate for a shareholder advisory vote on CEO compensation and shareholder proxy access to nominate directors on company proxy materials.

I am also chairman of ShareOwners.org, a new nonprofit, nonpartisan social network designed to give a voice to retailers or individuals who rarely have opportunities to communicate with regulators, policy makers, and the companies in which they are invested.

We urge the Committee to create better protections for the average American investor in the financial marketplace. The severe losses suffered by tens of millions of Americans in their portfolios, 401(k)s, mutual funds, and traditional pension plans all point to the need for a new emphasis on shareowner rights and meaningful regulation in order to ensure the financial security of American families.

America has tried going down the road of financial deregulation and reduced corporate accountability. That path has proven to be a dead end that is now imperiling the financial well-being of millions of long-term shareowners. Unfortunately, shareholders in America's corporations—who actually should more correctly be thought of as "shareowners"—have limited options today when it comes to protecting themselves from weak and ineffectual boards dominated by management, misinformation peddled as fact, accounting manipulation, and other abuses.

Under the disastrous sway of deregulation and lack of accountability, corporate boards and executives either caused or allowed corporations to undertake unreasonable risks in the pursuit of short-term financial goals that were devoid of real economic substance or any long-term benefits. In most cases, it is long-term shareowners—not the deregulators and the speculators—that are paying the price for the breakdown in the system.

According to a recent scientific survey that the Opinion Research Corporation conducted for ShareOwners.org of 1,256 U.S. investors, "American investors clearly want to see tough action taken soon by Congress to reform how our financial markets work and also to clean up abuses on Wall Street. Support for such action is strong across all groups by age, income, educational achievement and political affiliation. It is particularly noteworthy that such a high percentage of investors (34 percent) would use a term as strong as 'angry' to describe their views about the need for such action. And, even though they are not angry, the additional nearly half of other investors (45 percent) who want to see strong clean-up action taken sends an unmistakable message to policy makers. This is particularly true when you look at

that data alongside the finding that nearly 6 out of 10 investors (57 percent) said that strong Federal action would help to restore their lost confidence in the fairness of the markets." The full survey from ShareOwners.org is attached as an addendum to this testimony [*Ed. note:* not included, please see *http://www.shareowners.org/profiles/blogs/read-all-about-it*], but I would like to point out the following findings:

- More than four out of five American investors (83 percent) agree that "shareholders should be permitted to be actively involved in CEO pay and other important issues that may bear on the long-term value of a company to their retirement portfolio or other fund."
- More than four out of five investors (82 percent) agree that "shareholders should have the ability to nominate and elect directors of their own choosing to the boards of the companies they own." Only 16 percent of Americans say that "shareholders should NOT be able to propose directors to sit on the boards of the companies they own."
- Nearly nine out of 10 investors (87 percent) say that "investors who lose their retirement savings due to fraud and abuse should have the right to go to court if necessary to recover those funds." Only one in 10 American investors think that "investor lawsuits clog up the courts and make it more expensive for companies to run their businesses."
- The number one reason for loss of investor confidence in the markets: "overpaid CEOs and/or unresponsive management and boards" at (81 percent).

It is time for America to get back on the road of prudent financial regulatory oversight and increased corporate accountability. We urge you to recognize the devastating impact that a lack of appropriate regulation and accountability has had on our economy. In order to restore the confidence of investors in our capital markets, it is now necessary to take the following steps:

I. Strengthen the regulation of the markets. Key reforms needed to protect the interests of shareowners include the following:

- Beef up the Securities and Exchange Commission (SEC). Congress should assess the funding needs of the SEC and 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 order to protect and advocate for investors. Among other priorities, the SEC should impose requirements for the disclosure of long and short positions, enhance disclosures for private equity firms bidding for public companies, and require both the registration of hedge fund advisors with the Commission as investment advisors and additional disclosures of the underlying hedge fund. Following the request of the Administration, the SEC should be given additional authority to create a full-fledged fiduciary standard for broker dealers, so that the interests of clients who purchase investment products comes before the self interest of the broker. The SEC Division of Enforcement should be unshackled to prosecute criminal violations of the Federal securities laws where the Department of Justice declines to bring an action.
- Clear the way for forfeiture of compensation and bonuses earned by management in a deceptive fashion. Legislation should be adopted to allow for the "clawing back" 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 shareowners are victimized by crippling losses. The outrageous bonuses at AIG, Morgan Stanley, and other banks responsible for our financial meltdown were not deserved and should not be allowed to stand. 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.
- Strengthen State-level shareowner rights. Corporation structures and charters are regulated under State law. The corporate law in most States has not clarified the rights, responsibilities and powers of shareholders and directors or ways that they should communicate outside of annual general meetings. If regulation to strengthen shareholder rights does not occur at the Federal level, it will be up to the States to move forward. State corporate law should require proxy access, majority voting and the reimbursement of solicitation expenses in a board challenge. We would encourage robust competition among States for corporate charters based on a race to the top for improved shareowner rights. If necessary, Federal law should be changed to allow for shareholders to call a special meeting to reincorporate in another State by majority vote, in order

to avoid being shackled by the corporate State laws that put the interests of management ahead of shareowners.

- Protect whistleblowers and confidential sources who expose financial fraud and other corporate misconduct. 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. Legislation is needed to clearly state that the corporate whistleblowers and other confidential informants will be protected when they step forward.

II. Increase the accountability of boards and corporate executives. Key reforms needed to protect the interests of shareowners include the following:

- Allow shareowners to vote on the pay of CEOs and other top executives. Corporate compensation policies that encourage short-term risk-taking at the expense of long-term corporate health and reward executives regardless of corporate performance have contributed to our current economic crisis. Shareowners 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. The recently enacted stimulus bill requires all companies receiving TARP bail-out funds, nearly 400 companies, to include a "say-on-pay" vote at their 2009 annual meetings and at future annual meetings as long as they hold TARP funds. It is now time for Congress to implement Treasury Secretary Geithner's plan for compensation reform by passing "say-on-pay" legislation for all companies and to make it permanent as the center piece of needed reforms to encourage executive accountability.

  A key item to making the advisory vote meaningful will be not to permit brokers to cast votes on management sponsored executive compensation proposals as was recently done by the SEC in support of changes to NYSE Rule 452 in board elections. Stockbrokers who hold shares in their own name for their client investors have no real economic interest in the underlying corporation but can cast votes on routine items on the proxy. These pay votes are not routine items and should not be treated as such by investors, issuers or the regulators and we do not believe would be the intent of Congress if they give authorization to the SEC to require advisory votes on pay. Brokers almost universally vote for management's nominees and proposals and, in effect, interfere with shareowner supervision of the corporations they own.

- Empower shareowners to more easily nominate directors for election on corporate boards through proxy access. The process for nominating directors at American corporations is dominated today 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. The result is that corporate directors often are selected based on their allegiance to the policies of the incumbent board, instead of their responsiveness to shareowner concerns. Unless they can afford to launch an expensive independent proxy solicitation, shareowners have little or no say in selecting the directors who are supposed to represent their interests. The solution is to enable shareowners, under certain circumstances, to require corporate boards to include information about candidates nominated by shareowners in the company's proxy materials.

  We are very encouraged that the SEC is in the process of rule making on the issue but this is such an important right that we believe that it should not become a political football for future commissions. There needs to be long-term consistency in securities law and the Exchange Act is the appropriate place to clearly codify the authority that the Commission has to require the disclosure of nominees running for board seats. And to further enunciate that access to the proxy is fundamental to free and fair elections for directors.

- Require majority election of all members of corporate boards at American companies. Corporate directors are the elected representatives of shareowners who are responsible for overseeing management. Under the default rule applicable to virtually every corporation in the United States, however, corporate directors can be elected with just a single affirmative vote, even if that director's can-

didacy is opposed by the overwhelming majority of shareowners. While a few corporations have adopted policies that would require a director to receive support of the majority of shareowners in order to be elected, most corporations—particularly those not in the S&P 500—have not. True majority voting should be mandatory in every uncontested director election at all publicly traded corporations.

- Split the roles of chairman of the board and CEO in any company. (1) receiving Federal taxpayer funds, or (2) operating under Federal financial regulations. It already is the practice in most of the world to divide these two key positions so that an independent chairman can serve as a check on potential CEO abuses. Separation of the CEO and board chair roles helps to ensure good board governance and fosters independent oversight to protect the long-term interests of private shareowners, pension funds and institutional investors. A strong independent chair can help to address legitimate concerns raised by shareowners in a company. Splitting these roles and then requiring a prior shareowner vote to reintegrate them would be in the best interests of investors.
- Allow shareowners to call special meetings. Shareowners should be allowed to call a special meeting. Shareowners who own 5 percent or more of the stock of a company should be permitted, as they are in other countries, to call for a special meeting of all shareowners. They also should be given the right to call for a vote on reincorporation when management and corporate boards unduly use State laws detrimental to shareowner interests to entrench themselves further.

III. Improve financial transparency. Key reforms needed to protect the interests of shareowners include the following:

- Crackdown on corporate disclosure abuses that are used to manipulate stock prices. Shareowners in securities fraud cases have always had the burden of proving that defendants' fraud caused the shareowners' losses. When corporate wrongdoers lie to shareowners 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. Defendants should not be allowed to escape accountability to their shareowners for fraudulent conduct simply by cleverly timing the release of information affecting a company's stock price.
- Improve corporate disclosures so that shareowners can better understand long-term risks. To rebuild shareowner confidence regulators should emphasize transparency by creating more mechanisms for comprehensive corporate disclosure. The SEC should devote particular attention to the adequacy of disclosures concerning such key factors as credit risk, financial opacity, energy and climate risk and those reflecting the financial challenges to the economy as identified by the transition team and the new Administration. The SEC should develop internal expertise on issues such as environmental, social, and governance factors that pose material financial risks to corporations and shareowners, and also to require disclosure of these types of risks.
- Protect U.S. shareowners by promoting new international accounting standards. Our current financial crisis extends far beyond the borders of the U.S. and has affected financial markets and investors across the globe. Part of the problem has been a race to the bottom in favor of a more flexible international accounting standard that would decrease disclosure protection for the average investor. The current crisis makes a compelling case for why we need to slow down the movement toward the use of international accounting standards that could provide another back door route to financial deregulation and further erode confidence in corporate book keeping. A slower time frame is necessary to protect shareowners and allow the Administration to reach out to other governments that share a commitment to high accounting and transparency standards.

IV. Protect the legal rights of defrauded shareowners. Key reforms needed to protect the rights of shareowners include the following:

- Preserve the right of investors to go to court to seek justice. 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. 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. The ability of shareowners to take civil actions against market wrong-

doers provides an effective adjunct to securities law enforcement and serves as a strong deterrent to fraud and abuse. Shareowners should have the right to access Federal courts individually or as a member of a class action.

- Ensure that those who play a role in committing frauds bear their share of the cost for cleaning up the mess. What is known as 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 effectively have 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 shareowners and the economy. Most recently, in the subprime 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 subprime debt instruments in order to generate more business from the junk marketers. The immunity from private liability that these culpable third parties currently enjoy should be eliminated.
- Allow State courts to help protect investor rights. The previous decade saw the greatest shift in governmental authority away from the States and to the Federal Government in our history. The effect 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 subprime mortgage lending that are now at the heart of our economic crisis. Indeed, State attorneys general were blocked from prosecuting subprime lenders who violated State laws. The integrity of State law should be restored and both State officials and shareowners should be allowed to pursue remedies available under State law. Federal policy should make clear that State law exists coextensively with Federal regulations, except where State law directly contradicts Federal law.

In conclusion, I would like to thank the Chairman for the opportunity to testify today. Rebuilding investor confidence in the market depends upon thoughtful policy making that expands investor rights and authorizes the SEC to strengthen its advocacy role on behalf of all Americans' financial security. I would be pleased to answer any questions.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM MEREDITH B. CROSS

Q.1. There has been a lot of talk about giving shareholders a vote on pay packages, but little discussion of the details. If we were to require such a vote, what specifically should be voted on, and how often?

A.1. As you noted, this topic has been widely discussed, and a number of issues have been raised. One issue relates to what precisely the shareholders would vote on if given a vote. Shareholders could cast a nonbinding vote on the compensation of executives, as disclosed pursuant to the Commission's compensation disclosure rules. This is what Section 111(e) of the Emergency Economic Stabilization Act of 2008 requires for TARP recipients. Alternatively, shareholders could be asked to cast a nonbinding vote on the company's compensation philosophy, policies and procedures, as described in the Compensation Discussion and Analysis. As you note, another issue to consider would be the frequency of any such vote, which some have suggested either be annually or once every 2–3 years. While these are just a few of the many issues that would need to be considered with regard to shareholder advisory votes on pay, the Commission has not expressed a view about this topic.

As you may know, the Commission recently proposed rules to implement the "say-on-pay" requirement in Section 111(e) of the Emergency Economic Stabilization Act of 2008. The proposed rule would require TARP recipients to provide a separate shareholder vote to approve the compensation of the company's executives in proxies solicited during the period in which any obligation arising from Federal assistance provided under the TARP remains outstanding. In the proposing release, the Commission requested comment about whether the proposed rule should include more specific requirements regarding the manner in which TARP recipients should present the shareholder vote on executive compensation. Any information received in response to that request for comment will be instructive for the proposed rule for TARP companies.

Q.2. How do we make sure boards can be an effective check on management?

A.2. The recent market crisis has led many to raise serious questions and concerns about the accountability and responsiveness of companies and boards of directors, including questions about whether boards are exercising appropriate oversight of management. State corporate law and stock exchange listing standards play an important role in addressing this question. As for the Commission, in recent months, it has worked diligently to address those questions and concerns. As Chairman Schapiro has said, one of the most effective means of providing accountability is to give shareholders a meaningful opportunity to exercise the rights they have under State law to nominate directors. The Commission's proposed rules to facilitate the ability of shareholders to exercise their rights to nominate directors would provide shareholders a greater opportunity to hold directors accountable. The possibility that shareholders may take advantage of the rules, if adopted, may encourage directors to take a more active role in the oversight of management.

The Chairman also has stated that shareholders should also be informed about how compensation structures and practices drive an executive's risk-taking. In an effort to improve the information provided to shareholders on this topic, the Commission recently proposed rules to require greater disclosure about how a company and its board manage risks, particularly in the context of setting and overseeing compensation. Requiring companies to provide enhanced disclosure in proxy statements about the relationship of a company's overall compensation policies to risk would enable shareholders to make more informed investment and voting decisions.

Q.3. How do we make sure boards and management know what is going on inside the large firms they are supposedly running?

A.3. The Chairman believes that directors must be sufficiently independent of management so that they will ask the difficult questions; directors also must be skilled enough to know what questions need to be asked. A qualified and independent board is the best means of ensuring that management is fully engaged. While the Commission generally does not prescribe these governance rules, the Commission's disclosure rules are designed to provide investors—who elect directors—with information about director independence and qualifications.

Q.4. Is a better approach to making sure boards and management understand what is going on inside their companies to shrink the size and scope of the companies?

A.4. I can assure you that the Commission understands the concerns raised, in light of the recent turmoil in our markets, about board and management oversight of companies; however, determinations regarding the appropriate size and scope of companies is probably best left to markets and shareholders. While we will continue to consider ways that we can enhance our disclosure rules to provide meaningful additional information to investors, we know that Congress is also taking steps to address corporate governance reforms. We look forward to working with you as you move forward, and lending our expertise where appropriate.

Q.5. For proxy access, how large of a block of shareholders should have to request that the item be included?

A.5. The Commission recently proposed changes to the proxy rules to facilitate shareholder director nominations, which is often referred to as "proxy access." Proposed Rule 14a-11 under the Exchange Act would require, under certain circumstances, a company to include shareholder nominees for director in the company's proxy materials. Under the proposed rule, a nominating shareholder or group would be eligible to have a nominee included in a company's proxy materials if the nominating shareholder or group beneficially owns, as of the date of the shareholder notice regarding the nomination, a certain percentage of the company's securities entitled to be voted on the election of directors, which range from 1 percent to 5 percent depending on the size of the company. The proposal would require a nominating shareholder to have held the securities for at least 1 year. The staff will consider carefully the comments submitted regarding ownership thresholds and other re-

quirements when making a recommendation to the Commission as to the appropriate threshold for any final rule adopted.

Q.6. What are issues that shareholders should have an opt out or opt in vote on?

A.6. The idea of an opt in or opt out vote has been discussed regarding a number of governance proposals. With respect to our pending proposal to facilitate shareholder director nominations, the Commission requested comment about whether or not shareholders should be able to vote to opt out of the proposed mechanism for shareholder director nominations, or vote to choose a different mechanism to nominate directors. We are currently considering the responses to our request for comment on this issue, which reflect a wide range of views.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM JOHN C. COATES IV

Q.1. There has been a lot of talk about giving shareholders a vote on pay packages, but little discussion of the details. If we were to require such a vote, what specifically should be voted on, and how often?

A.1. I would suggest following the U.K. model, as in S. 1074: The shareholder advisory vote would be on the disclosure of compensation to top executives as disclosed in the annual proxy statement, as required by current SEC rules on compensation disclosure and analysis, which calls for a specific report on executive compensation.

Q.2. How do we make sure boards can be an effective check on management?

A.2. Making boards effective checks on management is one of the central goals of corporate governance—and as I emphasized in my testimony, much uncertainty persists about how to best achieve that goal, even among academic specialists who generally agree on both that goal and how to study progress toward that goal. In general, making sure that shareholders have sufficient information and tools to nominate and elect effective board members is a key first step. A second is to make sure that boards themselves have effective access to information (see answer to Question 3 below). A third is to make sure that boards themselves have the incentives and resources to take action when needed. Each of the steps I favor—"say-on-pay"; making a split chairman/CEO split a default rule for large operating companies, subject to opt out by shareholders; and shareholder access of the kind proposed by the SEC (subject to modifications that were suggested by a number of professors at the Harvard Law and Business Schools, including myself, available here: *http://blogs.law.harvard.edu/corpgov/files/2009/08/hbs_hls-letter-to-sec_0946.pdf*—would be helpful steps, as they would represent what are likely to be modest improvements that do not impose irrevocable mandatory rules or high costs on most companies. Still, it should be recognized that ideal corporate governance is not likely to ever be fully achieved, but is something that must be continually pursued.

Q.3. How do we make sure boards and management know what is going on inside the large firms they are supposedly running?

A.3. As firms grow in size in complexity, it may not be a practical goal to expect boards or even top management to always know everything is going on inside the firms they run, any more than it is practical for officials in the U.S. Government to know everything that is going on inside the organization they oversee. What is important is enable shareholders most effectively to choose and over time modify a system of governance that provides both them and boards with ready access to information about their companies, and with the right incentives and tools to focus on the most important activities their companies undertake, and the most important risks their companies face. What has been disheartening about the recent crisis is that well-regarded boards at prominent financial companies did not seem to be aware of some of the largest risks that their companies faced. This may suggest that there may be natural limits to the size and complexity of an organization that can be safely managed by fallible humans. But if that is true, it would be better, in my view, to let investors provide the feedback to boards about that fact, as they raise the cost of capital for increased growth, or use their rights as investors to control their companies, than for such limits to be pursued directly as a matter of public policy, as some have suggested (other than pursuant to existing antitrust policy, which limits the concentration of any given industry, and thus the size of firms operating in those industries).

Q.4. Is a better approach to making sure boards and management understand what is going on inside their companies to shrink the size and scope of the companies?

A.4. See answer to Question 3.

Q.5. For proxy access, how large of a block of shareholders should have to request that the item be included?

A.5. See *http://blogs.law.harvard.edu/corpgov/files/2009/08/hbs_hls-letter-to-sec_0946.pdf,* where others and I suggest a limit of 5–10 percent. However, as noted in my testimony, I do not believe that this kind of detail in implementing proxy access is something that should be done in legislation—but rather, through SEC rule-making. The most important thing the Congress can and should do on proxy access is to affirm in clear terms that the SEC has the authority to adopt rules in this area, and perhaps to mandate that the SEC revisit its rules after some period of time, and/or report on the effects of proxy access, perhaps with a statutory opt out right for shareholders that do not want their companies to be subject to such rules.

Q.6. What are issues that shareholders should have an opt out or opt in vote on?

A.6. Nearly all rules of internal governance at public companies should be subject to an opt out or an opt in by shareholders. The only exceptions would be (a) where there is some nonshareholder constituency that might be directly affected by the decision to opt out, (b) where the rules concern disclosure—which is the predicate for investors to exercise their powers (including the power to opt out of default governance provisions), or (c) where the rule is de-

signed to protect minority shareholders from majority or control shareholders, as opposed to insure that managers serve the interests of all shareholders. In general, I favor opt outs where the evidence suggests that the rule in question is beneficial for most companies, as with "say-on-pay" advisory shareholder votes, or where the difficulty (legal and/or financial) of opt ins is sufficiently high that shareholders have a difficult time acting collectively to change the governance rules at their companies, as with proxy access (where a combination of costs and legal obstacles—such as past decisions of the SEC itself—have long stymied efforts by shareholders to implement their own rules requiring proxy access). I favor opt ins where the rule is either best for a minority of companies, or where evidence does not support any particular rule as the best for most companies, as long as the ability of shareholders to pursue their own governance systems have not been effectively blocked by costs or legal impediments.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER FROM JOHN C. COATES IV

Q.1. Professor, in your testimony you support the idea of a Government-mandated shareholder vote on compensation or a "say-on-pay." You sight the "improved link between executive pay and corporate performance in the U.K." after its adoption there even though only five companies in England have lost shareholder votes on executive pay this year. Does it occur to you that this "say-on-pay" model no longer works? The vast majority of shares in the U.S. aren't held by an average investor sitting at home. If it is true that shares are primarily held by mutual funds and the ownership of the stock is a derivative instrument. How does a Government-mandated "say-on-pay" vote get the participation that the 23 companies in the U.S., who have already offered "say-on-pay" votes on their own, not get?

A.1. The fact that few U.K. firms have lost "say-on-pay" votes is not a sign of "say-on-pay's" ineffectiveness. It only takes a few high-profile losses for incumbent managers to get the message. That is what the evidence suggests has happened in the U.K. As I noted in my testimony, the best evidence suggests that "say-on-pay" tightened the link between pay design and performance, and that many firms improved their pay practices both before and after "say-on-pay" votes, including votes that were technically "won" because they received bare majorities in favor.

You are right that most stock is now held by institutions, and only indirectly by individuals. Institutions such as mutual funds, however, owe a responsibility to their investors to use their voting power responsibly, and generally do so, in my view. In effect, institutional investors are representative bodies, as is the Senate. If institutional investors use their "say-on-pay" vote powers irresponsibly, they will be disciplined by market forces in many instances, and where markets do not effectively control institutional investors, there may need to be regulation or reform of those institutions through the political process—as may be the case, for example, with public pension funds. But potential problems with institutional shareholders have nothing to do with "say-on-pay"—if there

are problems with institutions, they also extend to ordinary voting rights that they already possess, to vote for and against mergers, for example.

Finally, you ask why not continue to shareholders of companies effectively opt in to "say-on-pay," as a small number of companies have done, rather than mandate "say-on-pay" for all companies? To be clear, I believe that any "say-on-pay" rule should permit shareholders to opt out of the rule, and I would expect shareholders at some companies to do so. The rule is thus not a "mandate" in the sense of uniformly mandatory. Thus, the difference between the *status quo* and the rule I would support boils down to whether one thinks that most (not all) companies would be better off with "say-on-pay." As my testimony suggests, the best evidence is that "say-on-pay" advisory votes—which, after all, are only advisory, and have no binding effect on companies—improve pay practices generally, and thus would be good for most public companies. What the adoption of "say-on-pay" would achieve is to speed up the process of reform, and to eliminate the costs associated with shareholder efforts to adopt the rules that a small but growing number of companies have already adopted. Those costs are substantial—to wage a proxy contest to pressure managers to adopt "say-on-pay" rules requires expensive lawyers and regulatory filings, all paid for by shareholders, while incumbent managers use company (*i.e.,* shareholder) funds to oppose those efforts, even (at times) when managers know or expect most shareholders support the rules.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM ANN YERGER

Q.1. There has been a lot of talk about giving shareholders a vote on pay packages, but little discussion of the details. If we were to require such a vote, what specifically should be voted on, and how often?

A.1. There is broad agreement among Council members on the inherent value of an advisory shareowner vote on executive compensation as a feedback mechanism and dialogue tool, but opinions differ on the frequency and type of votes. Many investors, such as the AFSCME Employees Pension Plan, favor one vote every year on the pay of the "named executive officers (NEOs) set forth in the proxy statement's Summary Compensation Table (the "SCT") and the accompanying narrative disclosure of material factors provided to understand the SCT (but not the Compensation Discussion and Analysis)."

Annual, advisory shareowner votes on executive compensation are required in Australia, Sweden, and the United Kingdom. In fact, U.K. regulations requiring such votes went into effect in 2002, and are held on "remuneration reports" covering both the quantitative and qualitative aspects of executive compensation, including the nature of and rationale for performance conditions tied to incentive payouts. "Say-on-pay" votes in the U.K. have resulted in "better disclosure, better and more dialogue between shareholders and companies, and more thought put into remuneration policy by directors," according to David Paterson, research director of U.K.-based Research, Recommendations and Electronic Voting, a proxy

advisory service. British drugmaker GlaxoSmithKline (GSK) is a case in point. In 2003, 51 percent of GSK shareowners protested the CEO's golden parachute package by either voting against or abstaining from voting on the company's remuneration report. Stunned, the GSK board held talks with shareowners and the next year reduced the length of executive contracts and set new performance targets, muting investor criticism. Other U.K. companies got the message and now routinely seek investor input on compensation policies.

The annual-vote aspect of the AFSCME resolution and the U.K. vote aligns with the Council's own policy on the subject, which reads, "All companies should provide annually for advisory shareowner votes on the compensation of senior executives." As mentioned in the background material to the Council's policy, an annual vote would allow shareowners to provide regular, timely feedback on the board's recent executive pay decisions. And annual votes would allow companies and their shareowners to gauge the trend in support for pay decisions. So we do specify that the "say-on-pay" vote should be annual and should be on senior executive compensation. But our policy gives boards the flexibility to determine exactly what disclosures should be covered by the vote (*i.e.,* the Summary Compensation Table by itself *vs.* the SCT plus accompanying qualitative disclosures in the CD&A).

This was discussed in the background statement to our "say-on-pay" policy: "While the push by investors for shareowner votes on pay has made significant headway in a short time, thoughts are still evolving on how best to implement the reform. Therefore, the Council's draft updated policy endorses the concept of advisory shareowner votes on executive compensation, but stops short of dictating the precise contents of such a vote."

Q.2. How do we make sure boards can be an effective check on management?

A.2. As noted by renowned corporate governance expert Nell Minow, "Boards of directors are like subatomic particles. They behave differently when they are observed." The Council of Institutional Investors believes boards would be a more effective check on management if an overwhelming number of directors are independent of management and if shareowners could hold directors accountable for their performance. As a result, the Council strongly supports mechanisms—including majority voting for directors, advisory votes on executive compensation and access to the proxy—that empower shareowners to truly exercise their rights to elect and remove directors.

We believe federalization of these standards is appropriate and indeed essential to the investing public. While the Council appreciates that 50 governors, and likely many other self-interested parties, oppose federalization of these basic rights, the Council believes their opposition would be overwhelmed by the support of the millions of U.S. citizens and investors who have suffered profound losses from the many market disruptions that have occurred in recent years, including the dot-com bubble, the corporate scandals of the early part of this decade, and most recently, the financial crisis.

Q.3. How do we make sure boards and management know what is going on inside the large firms they are supposedly running?

A.3. Robust, timely public disclosures are essential for providing outside parties insights into the performance of boards and management of large and small companies.

Since audited financial statements are a primary sources of information available to guide and monitor investment decisions, tough audit standards and strong accounting standards are critical to ensuring that financial-related disclosures are of the highest quality.

Auditors, financial analysts, credit-rating agencies and other financial "gatekeepers" play a vital role in ensuring the integrity and stability of the capital markets. They provide investors with timely, critical information they need, but often cannot verify, to make informed investment decisions. With vast access to management and material nonpublic information, financial gatekeepers have an inordinate impact on public confidence in the markets. They also exert great influence over the ability of corporations to raise capital and the investment options of many institutional investors. Given their power, the Council of Institutional Investors believes financial gatekeepers should be transparent in their methodology and avoid or tightly manage conflicts of interest. Robust oversight and genuine accountability to investors are also imperative. Regulators should remain vigilant and work to close gaps in oversight. Continued reforms are needed to ensure that the pillars of transparency, independence, oversight and accountability are solidly in place.

Q.4. Is a better approach to making sure boards and management understand what is going on inside their companies to shrink the size and scope of the companies?

A.4. The Council of Institutional Investors has no formal position on this issue. Regarding entities that may pose a systemic risk to the financial system at large or the economy at large, an independent task force, the Investors' Working Group (IWG), cosponsored by the CFA Institute Centre for Financial Integrity and the Council of Institutional Investors, recommended that policy makers consider the following:

- Designating a systemic risk regulator, with appropriate scope and powers.
- Adopting new regulations for financial services that will prevent the sector from becoming dominated by a few giant and unwieldy institutions. New rules are needed to address and balance concerns about concentration and competitiveness.
- Strengthening capital adequacy standards for all financial institutions. Too many financial institutions have weak capital underpinnings and excessive leverage.
- Imposing careful constraints on proprietary trading at depository institutions and their holding companies. Proprietary trading creates potentially hazardous exposures and conflicts of interest, especially at institutions that operate with explicit or implicit Government guarantees. Ultimately, banks should focus on their primary purposes, taking deposits and making loans.

- Consolidating Federal bank regulators and market regulators. Regulation of banks and other depository institutions may be streamlined through the appropriate consolidation of prudential regulators. Similarly, efficiencies may be obtained through the merger of the SEC and the Commodity Futures Trading Commission (CFTC).
- Studying a Federal role in the oversight of insurance companies.

IWG members strongly believed that all firms should be able to fail. As a result, it recommended that "Congress should give regulators resolution authority, analogous to the Federal Deposit Insurance Corporation's authority for failed banks, to wind down or restructure troubled, systemically significant nonbanks."

Q.5. For proxy access, how large of a block of shareholders should have to request that the item be included?

A.5. The Council endorses the following policy regarding shareowner access to the proxy:

Companies should provide access to management proxy materials for a long-term investor or group of long-term investors owning in aggregate at least 3 percent of a company's voting stock, to nominate less than a majority of the directors. Eligible investors must have owned the stock for at least 2 years. Company proxy materials and related mailings should provide equal space and equal treatment of nominations by qualifying investors.

To allow for informed voting decisions, it is essential that investors have full and accurate information about access mechanism users and their director nominees. Therefore, shareowners nominating director candidates under an access mechanism should adhere to the same SEC rules governing disclosure requirements and prohibitions on false and misleading statements that currently apply to proxy contests for board seats.

Q.6. What are issues that shareholders should have an opt out or opt in vote on?

A.6. The Council has no position on opt in/opt out votes for shareowners. Council policies state that "shareowners should have meaningful ability to participate in the major fundamental decisions that affect corporate viability, and meaningful opportunities to suggest or nominate director candidates and to suggest processes and criteria for director selection and evaluation."

In addition, the Council believes a majority vote of common shares outstanding should be sufficient to amend company bylaws or take other action that requires or receives a shareowner vote. Supermajority votes should not be required. A majority vote of common shares outstanding should be required to approve:

- Major corporate decisions concerning the sale or pledge of corporate assets that would have a material effect on shareowner value. Such a transaction will automatically be deemed to have a material effect if the value of the assets exceeds 10 percent of the assets of the company and its subsidiaries on a consolidated basis;

- The corporation's acquisition of 5 percent or more of its common shares at above-market prices other than by tender offer to all shareowners;
- Poison pills;
- Abridging or limiting the rights of common shares to: (1) vote on the election or removal of directors or the timing or length of their term of office or (2) nominate directors or propose other action to be voted on by shareowners or (3) call special meetings of shareowners or take action by written consent or change the procedure for fixing the record date for such action; and
- Issuing debt to a degree that would excessively leverage the company and imperil its long-term viability.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER FROM ANN YERGER

Q.1. One of the proposals you support, which is supported by the Administration, is to allow advisory shareowner votes on executive pay. How would a Government-mandated "say-on-pay" vote have prevented the current financial turmoil? How would a government mandated "say-on-pay" vote prevent future financial turmoil when, according to the American Federation of State, County, and Municipal Employees, 23 companies have allowed "say-on-pay" provisions to proceed to a vote and shareholders have yet to vote down a single executive pay plan in the U.S.?

A.1. The Council believes annual advisory shareowner votes on executive compensation would efficiently and effectively provide boards with useful information about whether investors view the company's compensation practices to be in shareowners' best interests. Nonbinding shareowner votes on pay would serve as a direct referendum on the decisions of the compensation committee and would offer a more targeted way to signal shareowner discontent than withholding votes from committee members.

While advisory votes might not have prevented the current financial crisis nor might they prevent future financial turmoil, they might induce compensation committees to be more careful about doling out rich rewards, to avoid the embarrassment of shareowner rejection at the ballot box. In addition, compensation committees looking to actively rein in executive compensation could use the results of advisory shareowner votes to stand up to excessively demanding officers or compensation consultants.

Historically, early "volunteers" for corporate governance reforms tend to be companies with the best practices and hence, nothing to fear from the reforms. As a result, I am not surprised that shareowners supported the compensation proposals of the 23 companies identified by AFSCME. Of the thousands of other public companies, I expect some would find that their owners do not support their compensation programs, and that this vote will provide meaningful information to board and compensation committees.

In addition to the 23 companies identified by AFSCME, hundreds of financial firms receiving aid under the U.S. Troubled Assets Relief Program (TARP) were required to put their executive pay pack-

ages to an advisory shareowner vote. And while some received large "no" votes, "on average 88.6 percent of votes cast at 237 firms that have disclosed results were in favor of management, according to an analysis by David G. Wilson, a securities lawyer at Waller Lansden Dortch & Davis who focuses on corporate governance matters," according to a September 26, 2009, article in *The Washington Post*. While some might attribute the high support votes to a failure of the advisory vote concept, others might attribute the support levels to the pay restrictions imposed on these firms by the U.S. Department of Treasury and the 2009 Economic Stimulus Act.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM JOHN J. CASTELLANI

Q.1. Professor Coates raised an interesting idea in his written testimony. Rather than forcing a structure on all companies, he suggests an opt out vote by shareholders every few years for some governance proposals. That idea could be applied to proxy access and advisory vote procedures as well instead of the Government deciding what the rules will be. I want to know what you think of that approach, of a mandatory opt in or opt out vote every few years to decide certain matters. Please also comment on whether such a vote should be an opt in or opt out vote.

A.1. Business Roundtable believes that shareholders and companies should have the ability to make choices about the governance practices that are most appropriate for their circumstances. However, we do not believe that an "opt in" or "opt out" vote on different governance practices is necessary. Shareholders already have the ability to communicate their views on whether to adopt particular practices. They can do this through the shareholder proposal process as well as procedures that companies have implemented for shareholders to communicate with the board as a whole and with particular directors. For example, shareholders who believe an advisory vote is necessary at their company can submit shareholder proposals requesting such a vote. If other shareholders agree, they can vote in favor of these proposals, and several companies have implemented advisory votes after proposals on this subject received significant shareholder support. Other companies have taken different approaches to obtaining shareholder views on executive compensation, such as holding meetings with their large shareholders or obtaining shareholder feedback through procedures that allow shareholders to communicate with the board.

If Congress considers an "opt in" or "opt out" vote, we believe that an "opt in" vote would be preferable. An "opt in" vote would require shareholders to take the affirmative step of voting "for" a specific governance practice before a company adopts it, which in turn, would provide a more accurate indication that a critical mass of shareholders favors the practice.

Q.2. There has been a lot of talk about giving shareholders a vote on pay packages, but little discussion of the details. If we were to require such a vote, what specifically should be voted on, and how often?

A.2. If Congress requires an advisory vote on executive compensation, Business Roundtable believes that it should give companies flexibility to structure the vote based on their individual compensation programs and packages. There are a number of approaches companies could use, and that companies have taken to date, to seek input on executive compensation through an advisory vote. For example, companies could ask shareholders to vote on: (a) the executive compensation tables in the annual proxy statement; (b) the company's compensation philosophy and procedures as described in the Compensation Discussion and Analysis section of the proxy statement; and/or (c) particular aspects of a company's compensation program, such as post-retirement benefits or long-term incentive plans. In addition, there are different approaches companies could take with respect to the frequency of advisory votes. Although many have suggested an annual vote, other practices are likely to emerge. For example, the United Brotherhood of Carpenters Pension Fund has proposed that companies hold advisory votes once every 3 years. Accordingly, Business Roundtable does not believe that a "one-size-fits-all" Federal legislative approach to advisory votes on executive compensation is appropriate.

As an alternative to allowing companies and shareholders to determine the specifics of advisory votes, Business Roundtable believes that Congress should give the Securities and Exchange Commission (SEC) authority to adopt rules addressing matters such as the frequency of the vote requirement, its applicability to particular businesses or types of businesses, and the matter(s) to be voted on. This administrative flexibility would allow the SEC to tailor the application of voting requirements based on a range of factors and to make changes over time. For example, the SEC proposed rules in July 2009 to help implement the advisory vote requirement in the Emergency Economic Stabilization Act of 2008 applicable to companies receiving funds under the Troubled Asset Relief Program. As the SEC noted in proposing these rules, their purpose is to provide clarity about how to comply with the advisory vote requirement while at the same time affording companies adequate flexibility in making relevant disclosures about the vote.

Q.3. How do we make sure boards can be an effective check on management?

A.3. Business Roundtable believes that an engaged and diligent board of directors is the most effective mechanism for overseeing management. One of the guiding principles in our Principles of Corporate Governance (2005) states that "the paramount duty of the board of directors is to select a chief executive officer and to oversee the CEO and senior management in the competent and ethical operation of the corporation on a day-to-day basis."

We believe that the best way to provide for effective board oversight is to continue to foster the long tradition of addressing corporate governance matters at the State level through private ordering by shareholders, boards and companies acting within the framework established by State corporate law. In this regard, the corporate governance landscape has undergone a sea change over the past 6 years. Many of the corporate governance practices implemented during this time—such as greater independent board lead-

ership and majority voting in director elections—have occurred as a result of voluntary reforms adopted by companies and their shareholders under the auspices of enabling State corporate law provisions, rather than through legislative or regulatory fiat. Moreover, under State corporate law, directors have fiduciary duties requiring them to act in good faith, in the corporation's best interests, and to exercise appropriate diligence in overseeing the management of the corporation, making decisions and taking other actions. In this regard, there are consequences under State corporate law, as well as the Federal securities laws, for directors who fail to perform their responsibilities.

Q.4. How do we make sure boards and management know what is going on inside the large firms they are supposedly running?

A.4. Business Roundtable believes that the most effective way for a company's board and management to remain informed is for the company to have effective processes for communicating complete, accurate, and timely information to the attention of the board and management. Information flow between the board and senior management is critical, and well-functioning boards foster an environment that promotes candor and encourages management to bring potential issues to the board early so that there are "no surprises." Moreover, as we recommend in our Principles of Corporate Governance (2005), a company's nominating/governance committee should assess the reporting channels through which the board receives information and see that the board obtains appropriately detailed information in a timely fashion. In situations where specialized expertise would be useful, the board and its committees should seek advice from outside advisors who are independent of the company's management. In addition, it is senior management's responsibility—under the direction of the CEO and CFO—to establish, maintain and periodically evaluate the corporation's: (a) internal controls (controls designed to provide reasonable assurance about the reliability of the company's financial information) and (b) disclosure controls (controls designed to see that a company records, processes and reports information required in SEC filings in a timely manner). In accordance with applicable law and regulations, the CEO and CFO also are responsible for certifying the accuracy and completeness of the financial statements and the effectiveness of the company's internal controls and disclosure controls.

Q.5. Is a better approach to making sure boards and management understand what is going on inside their companies to shrink the size and scope of the companies?

A.5. Business Roundtable does not believe that this is a better approach, nor is it consistent with the traditional U.S. approach to encouraging a vibrant private sector. Well-structured and well-governed companies have the ability to deal with the size and scope of their businesses because they have solid information flow between the board and management and they maintain effective internal controls.

Q.6. For proxy access, how large of a block of shareholders should have to request that the item be included?

A.6. Business Roundtable believes that a Federal proxy access right is unnecessary and would have serious adverse consequences, including promoting an unhealthy emphasis on short-termism at the expense of long-term value creation, facilitating the election of "special interest" directors, increasing the frequency of contested elections and discouraging qualified directors from serving on corporate boards. Therefore, we do not support a Federal proxy access right. If Congress moves forward in this area, Business Roundtable believes that proxy access should be available only to holders of a significant, long-term interest in a company. Accordingly, we believe that the stock ownership threshold for individual shareholders seeking to place nominees on company proxy statements should be 5 percent of a company's outstanding voting stock and that the threshold for shareholders aggregating their shares should be 10 percent. In either case, a "net long" ownership position—that is, full voting and investment power with respect to the shares in question—should be required.

In addition, we believe that proxy access should be available only to shareholders who have demonstrated a commitment to a company and its business. Accordingly, we believe that shareholders should have to satisfy the relevant stock ownership threshold for a period of at least 2 years before they can nominate a director for inclusion in the company's proxy statement. Any shorter holding period would allow shareholders with a short-term focus to nominate directors who, if elected, would be responsible for the creation of long-term shareholder value. In addition, we believe that shareholders should have to continue to satisfy the relevant ownership threshold not just through the annual meeting at which their nominees are elected, but for the duration of the nominees' service on the board or at least through the term for which they nominated the director.

Q.7. What are issues that shareholders should have an opt out or opt in vote on?

A.7. As discussed above in the answer to Question 1, we do not believe that an "opt in" or "opt out" vote on different governance practices is necessary because shareholders already have the ability to communicate their views on whether to adopt particular practices. As an alternative to this approach, Business Roundtable supports enhanced disclosure about companies' corporate governance practices. For example, the SEC recently proposed rules that would require annual proxy disclosure about a company's leadership structure and why the company believes it is the best structure for the company, including discussion about whether the company combines or separates the roles of chairman of the board and CEO and whether the company has a lead independent director. Similarly, Business Roundtable would support a "comply or explain" approach, which some non-U.S. markets already follow, that would require companies to disclose whether they have adopted specific governance practices, and if not, why not. Either of these alternatives would allow companies and shareholders flexibility in determining the practices that are most appropriate for them, provide transparency to shareholders and avoid a "one-size-fits-all" approach.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM J.W. VERRET

Q.1. Professor Coates raised an interesting idea in his written testimony. Rather than forcing a structure on all companies, he suggests an opt out vote by shareholders every few years for some governance proposals. That idea could be applied to proxy access and advisory vote procedures as well instead of the Government deciding what the rules will be. I want to know what you think of that approach, of a mandatory opt in or opt out vote every few years to decide certain matters. Please also comment on whether such a vote should be an opt in or opt out vote.

A.1. Answer not received by time of publication.

Q.2. There has been a lot of talk about giving shareholders a vote on pay packages, but little discussion of the details. If we were to require such a vote, what specifically should be voted on, and how often?

A.2. Answer not received by time of publication.

Q.3. Are States responding to concerns about corporate governance issues with changes to their own laws? Is there really a need to federalize business laws?

A.3. Answer not received by time of publication.

Q.4. How do we make sure boards can be an effective check on management?

A.4. Answer not received by time of publication.

Q.5. How do we make sure boards and management know what is going on inside the large firms they are supposedly running?

A.5. Answer not received by time of publication.

Q.6. Is a better approach to making sure boards and management understand what is going on inside their companies to shrink the size and scope of the companies?

A.6. Answer not received by time of publication.

Q.7. For proxy access, how large of a block of shareholders should have to request that the item be included?

A.7. Answer not received by time of publication.

Q.8. What are issues that shareholders should have an opt out or opt in vote on?

A.8. Answer not received by time of publication.

Q.9. Please provide any comments you may have on the proposed Shareholders Bill of Rights Act, S. 1074, or otherproposed legislation.

A.9. Answer not received by time of publication.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER FROM J.W. VERRET

Q.1. Professor, in your testimony you suggest alternative contributing factors for the Committee to investigate to determine the "culprit" of the financial crisis. The first factor you suggest to investigate is the moral hazard problems created by the prospect of

the Government bailout. Do you think that moral hazard problem is stronger cause of the than corporate pay structure? Do you think the distortions to the housing market cause by Fannie Mae and Freddie Mac played a larger role in causing the financial crisis of 2008 than how a company pays its CEO?

A.1. Answer not received by time of publication.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM RICHARD C. FERLAUTO

Q.1. Professor Coates raised an interesting idea in his written testimony. Rather than forcing a structure on all companies, he suggests an opt out vote by shareholders every few years for some governance proposals. That idea could be applied to proxy access and advisory vote procedures as well instead of the Government deciding what the rules will be. I want to know what you think of that approach, of a mandatory opt in or opt out vote every few years to decide certain matters. Please also comment on whether such a vote should be an opt in or opt out vote.

A.1. The proxy access procedure that has been proposed by the SEC aims to remove regulatory barriers to shareholders' exercise of their existing rights to nominate director candidates. It facilitates shareholders' use of their nomination rights by recognizing that in the modern system of proxy voting, the proxy statement itself is the forum that used to occur at the shareholder meeting. Accordingly, the proxy access procedure is a disclosure measure, rather than a new substantive right. [1]

For that reason, I don't believe it would be appropriate for companies to opt in or opt out of the proxy access procedure. In the same way that companies are not permitted to opt out of the application of the SEC's shareholder proposal rule or the executive compensation disclosure requirements, they should not be allowed to opt out of the proxy access procedure.

Of course, a company should be able to provide its shareholders with a more shareholder-friendly form of access procedure than that established by the SEC's proposed rule. For example, a company could provide that holders of a lower percentage of outstanding shares are entitled to invoke the proxy access procedure, or it could allow nominating shareholders to include longer supporting statements than the SEC's rules contemplate.

The shareholder advisory vote on executive compensation does not primarily address disclosure, and thus stands on different footing. My main concern about a regime in which "say-on-pay" would not apply to companies for some period of time is that it imposes significant delay on the process of obtaining shareholder voice, should shareholders believe that such voice is needed to safeguard shareholder value.

For instance, one could imagine a regime that would provide for a vote of one kind or another every 3 years. At a company without

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[1] I acknowledge that there are some who argue that section 14(a) of the Exchange Act does not authorize the Commission to propose a proxy access procedure. Although I believe that the Commission's authority is clear in this regard, an explicit legislative grant of authority would be useful in order to avoid unnecessary litigation and provide some measure of stability in this area.

"say-on-pay" where performance begins to suffer shortly before the scheduled vote, but it does not become apparent that the pay-performance relationship has been severed until shortly after the vote, shareholders might have to wait almost 3 years to vote in favor of applying or reinstating "say-on-pay." As Bob Pozen, formerly of Fidelity, stated in criticizing the triggering requirements of the SEC's 2003 proposed proxy access procedure, "two years is an eternity in this game."[2]

In any event, the collective action problem facing shareholders, which has been exhaustively analyzed in the academic literature, argues in favor of an opt out procedure rather than an opt in procedure. The weight given to management's recommendations on proxy issues—the opt in or opt out proposal would be a management proposal, presumably—the well-documented expense and difficulty attendant to shareholder communication and the vote-boosting effect of the New York Stock Exchange's "broker-may-vote" rule on management proposals all argue in favor of making applicability of a governance feature the default, and requiring management to convince shareholders that the company is so well-governed that the governance feature would not be value enhancing.

Q.2. There has been a lot of talk about giving shareholders a vote on pay packages, but little discussion of the details. If we were to require such a vote, what specifically should be voted on, and how often?

A.2. As proposed in H.R. 3269, the Corporate and Financial Institution Compensation Fairness Act of 2009, shareholders should be given the opportunity to vote on "the compensation of executives as disclosed pursuant to the Commission's compensation disclosure rules for named executive officers (which disclosure shall include the compensation committee report, the compensation discussion and analysis, the compensation tables, and any related materials, to the extent required by such rules)." This vote should occur annually.

Q.3. How do we make sure boards can be an effective check on management?

A.3. Many factors have an impact on board effectiveness, including the skills, qualifications, and experience of directors; the independence and vitality of the board's leadership; and the quality of the information and advice provided to the board. However, the single most important factor determining whether the board can and will effectively oversee management is whether board members feel they work for the shareholders. If shareholders do not have a meaningful role in nominating and electing directors, they will not engage in robust monitoring. As Relational Investors' Ralph Whitworth has said, "you dance with who brought you."[3] Accordingly, measures such as proxy access that enable shareholders to more fully exercise their State-law right to nominate directors would be very useful in improving board effectiveness.

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[2] *See* "The Debate on Shareholder Access to the Ballot, Part I" (transcript of symposium at Harvard Law School in October 2003), at 46 (available at *http://www.law.harvard.edu/programs/olin_center/corporate_governance/papers/03.bebchuk.debate-1.pdf*).

[3] *See, id.* at 41.

Q.4. How do we make sure boards and management know what is going on inside the large firms they are supposedly running?

A.4. Keeping boards and managements informed enough to do their jobs well requires different strategies. Members of management are employees of the company and devote themselves full-time to its management. The right reporting and information structures to ensure that senior managers are aware of what is happening will vary tremendously from one company to another, depending on the nature of the company's business, the geographical reach of its operations and other factors. As a result, it is not possible to prescribe a single structure that works well for all companies.

Boards of directors, by contrast, are composed primarily of people from outside the company and they meet to work on company business only periodically. Many board members have demanding day jobs; those who do not are often members of multiple boards or engage in philanthropic or other pursuits that take significant time and attention. Accordingly, information must be collected and synthesized before presentation to the board, in order to use directors' time efficiently.

It is important that a company's senior management not have a monopoly on the flow of information to the board; if it does, the board functions more as a rubber stamp than as an effective monitor and resource. Independent board leadership is the best way to ensure that directors have access to all the information they need to do their jobs well. An independent board chairman sets the agenda and provides relevant information to directors; he or she will include material furnished by members of senior management but will also be able to provide outside perspectives. Where the chairman is also the CEO, by contrast, his or her perspective will dominate and outside information is less likely to be provided to board members.

Q.5. Is a better approach to making sure boards and management understand what is going on inside their companies to shrink the size and scope of the companies?

A.5. It is possible that a company's operations may become too large, varied, and dispersed for adequate monitoring to be cost-effective. In the vast majority of cases, however, I believe that the mechanisms discussed in response to Questions 3 and 4 will address the problem of ensuring robust oversight.

Q.6. For proxy access, how large of a block of shareholders should have to request that the item be included?

A.6. The thresholds proposed by the SEC in its current rule making strike the right balance between ensuring that the access procedure is available only to shareholders with a substantial stake in the company and fulfilling the objective of removing obstacles to the exercise of shareholders' State-law director nomination rights.

Q.7. What are issues that shareholders should have an opt out or opt in vote on?

A.7. I do not favor, in the first instance, an opt in or opt out regime for the governance reforms discussed at the hearing. As discussed in the answer to Question 1, an opt in or opt out process is not appropriate for disclosure measures. For other reforms, my support of

an opt out regime would depend on how often the vote was held and whether shareholders could quickly trigger an earlier vote if circumstances warranted.