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

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Full Text of Statement

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.

[1] See Attachment 1.

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 sixty (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.

[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.

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 governance 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]

[3] See Attachments 2 and 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 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.

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

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 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.[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 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.

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[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.

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 non-binding 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 "non-routine" 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 re-opening 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%. Today, approximately 36% of S&P 500 companies have separate chairs and CEOs; this is up from 22% in 2002. However, only 17% of S&P 1500 firms have chairs that can be qualified as independent and the incidence of independent chairs is concentrated on small and mid-cap 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.

[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*].

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 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.

[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.
[9] *Id*.

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%
Canada	Minimum of 5%
China	Minimum of 1%
Finland	Minimum of 10%
Germany	Minimum of 5% 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% of the company's share capital
Russia	Minimum of 2% of the voting stock
South Africa	Minimum of 5%
UK	Minimum of 5% 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% of companies researched provide such a vote)
- India
- Italy
- Poland
- Switzerland
- Taiwan
- UK[10]

[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.

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 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

Non-executive 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.

[11] *Chairing, supra* note 7, at 17.
[12] *Id*.

Conclusion

The Council is not the only group advocating corporate governance reforms. The Investors' Working Group, an independent task force co-sponsored 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]

[13] See Attachment 4.
[14] *Id*. at 22-23.

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.

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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

*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

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: 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: 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,

Jeff Mahoney

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AFL-CIO Pension Plan

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AFSCME Employees Pension Plan

Gail H. Stone
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Arkansas Public Employees Retirement System

David F. Stupar
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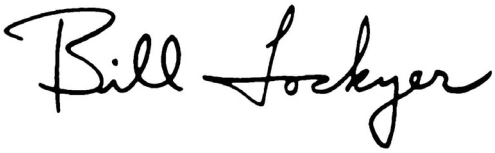
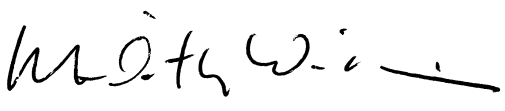
Eric B. Baggesen
Senior Investment Officer, Global Equity
California Public Employees' Retirement System

John Chiang
California State Controller

Jack Ehnes
Chief Executive Officer
California State Teachers' Retirement System

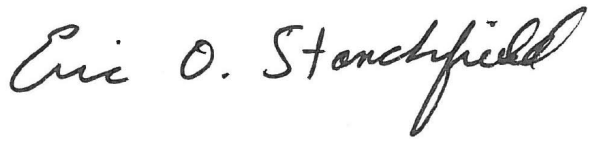


Bill Lockyer
California State Treasurer



Meredith Williams
Executive Director
Colorado Public Employees' Retirement Association

Denise L. Nappier
Connecticut State Treasurer
Connecticut Retirement Plans and Trust Funds



Eric O. Stanchfield
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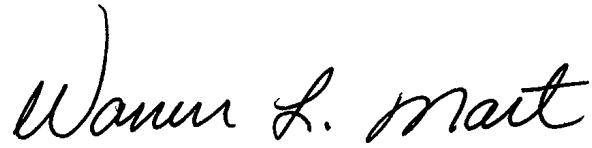
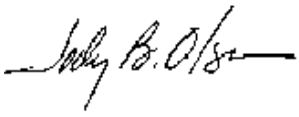
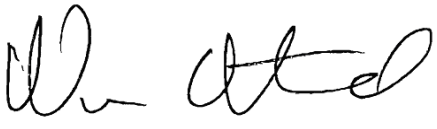
Ashbel C. Williams
Executive Director and Chief Investment Officer
Florida State Board of Administration



Warren L. Mart
Board Co-Chair, Union Trustee
IAM National Pension Fund



Jody B. Olson
Chairman
Public Employee Retirement System of Idaho

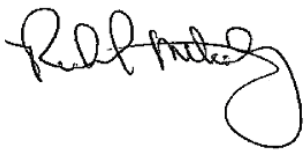


William R. Atwood
Executive Director
Illinois State Board of Investment

Dan M. Slack
Executive Director
State Universities Retirement System of Illinois

Michael Lostutter
Director
IUE-CWA Pension Fund & 401(k) Plan

Richard A. Bennett
Vice President
Lens Foundation for Corporate Excellence



Richard Metcalf
Director, Department of Corporate Affairs
LIUNA Staff and Affiliates Pension Fund

Moctesuma Esparza
Commissioner
Los Angeles City Employees' Retirement System

Gregg Rademacher
Chief Executive Officer
Los Angeles County Employees Retirement Association

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Retirement Plan Manager
Los Angeles Department of Water and Power

Michael A. Perez
General Manager
Los Angeles Fire and Police Pensions

Peter M. Leslie
Chair, Board of Trustees
Maine Public Employees Retirement System

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Executive Director
Maryland State Retirement Agency

Nancy K. Kopp
Maryland State Treasurer

Michael Travaglini
Executive Director
Massachusetts Pension Reserves Investment Management Board

William G. Clark
Director
New Jersey Division of Investment

Orin S. Kramer
Chair
New Jersey State Investment Council

Diane D'Alessandro
Executive Director
New York City Employees' Retirement System

William C. Thompson, Jr.
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Nelson Serrano
Executive Director
Teachers' Retirement System of the City of New York

Thomas P. DiNapoli
New York State Comptroller
New York State Common Retirement Fund

Thomas K. Lee
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Richard H. Moore
North Carolina State Treasurer
North Carolina Retirement Systems

William J. Estabrook
Executive Director
Ohio Police & Fire Pension Fund

Chris DeRose
Chief Executive Officer
Ohio Public Employees Retirement System

James R. Winfree
Executive Director
School Employees Retirement System of Ohio

Michael J. Nehf
Executive Director
State Teachers' Retirement System of Ohio

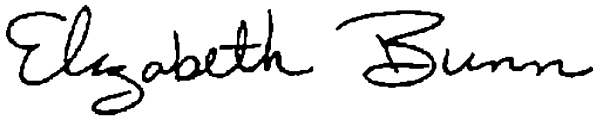
Jeffrey B. Clay
Executive Director
Pennsylvania Public School Employees' Retirement System

Leonard Knepp
Executive Director
Pennsylvania State Employees' Retirement System

Stephen Abrecht
Executive Director of Benefits
SEIU Master Trust

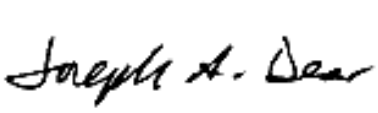
Kenneth Colombo
Fund Coordinator
Sheet Metal Workers' National Pension Fund

Eric Henry
Executive Director and Chief Investment Officer
Texas Municipal Retirement System

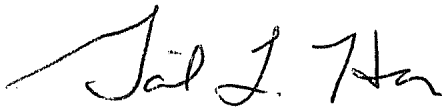


Elizabeth Bunn
Secretary-Treasurer, International Union, UAW
& Plan Administrator, Auto Workers
International Retirement Income Plan

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

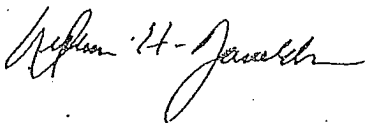
ABOUT THE INVESTORS' WORKING GROUP

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.



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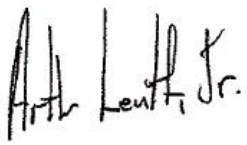

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OVERVIEW

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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