United States House of Representatives

Committee on Financial Services

Hearing on Compensation Structure and Systemic Risk

June 11, 2009

2128 Rayburn House Office Building

Testimony of Lynn E. Turner

Thank you Chairman Frank and Ranking member Bauchus for the opportunity to provide you my views on compensation and risk management, both of which are somewhat intertwined. I applaud the leadership of the Committee and its members for soliciting input on these important issues which played a role in the financial crisis.

Compensation and risk management are certainly not new topics. People have always wanted to know if they were making as much or more than their peers, from the day they graduated and started working. Human behavior is such that people all too often judge one another, right or wrongly, by the size of their home, the car they drive, and the material wealth they have accumulated. Accordingly, it comes as no surprise that people have often been willing to take greater risks when greater rewards could be had. And when those rewards are large, and can come quick and fast and make one financially secure for life as often they do on Wall Street, people have been willing to engage in greater risks to the individual, the business and even the capital markets.

With that in mind, my views on compensation and risk are also based on past experience as:

- A chief financial officer in an international high technology manufacturing company where I was involved with establishing compensation arrangements and terms.
- A board member of both large and small public companies.
- As a trustee for two institutional investors who invest in public companies, including financial institutions. As a trustee I chair a board committee that oversees proxy voting on such issues as compensation committee members and compensation arrangements.
- The managing director of research for several years at the proxy and financial research advisory firm, Glass Lewis.
- Chief accountant for the Securities and Exchange Commission.
- A former partner in an international accounting firm where I did audits of financial institutions, and advised businesses on compensation arrangements and Wall Street firms on new financial products.

Currently I am a senior advisor and managing director for LECG, a global expert services and consulting firm, with more than 750 experts and professionals in 31 offices around the world, providing independent expert testimony, original authoritative studies, and strategic advisory and financial advisory services. However, the views I express today represent my own personal perspective on the issues and do not necessarily represent those of the other organizations I am associated with.

Background

The U.S capital markets have been an important contributor to the growth of the American economy and business. They serve to gather available capital from retail and institutional investors who are looking for investment returns greater than they can achieve otherwise, and allocate this capital to companies. Companies receiving this capital in turn use it to invest in research, jobs, plant and equipment in a way that will provide investors with the returns they seek.

Capital markets attract capital when investors believe they can trust them with their money. The markets must demonstrate with confidence that they can be trusted by investors. Critical to establishing trust and confidence among investors is:

- A market perceived as being **fair** to all, with no particular participant receiving an upper hand or ability to wrongly manipulate the market to their advantage, at cost to others. Independence and avoidance of financial conflicts which would influence one's behavior is important in ensuring a market is perceived by investors as being fair.

- **Transparency** in the market such that investors receive the necessary financial information about the markets operations including execution and pricing, the companies with whom capital is being invested, the existence of any potential conflicts and the regulators who are assigned the task of protecting investors and consumers. High quality financial information that is considered to be the life blood of any capital market. Investors must have the financial information necessary to make an informed decision as to where they will allocate their capital so as to maximize their investment returns. If misleading, incomplete or untimely information is provided, investors will likely make misinformed decisions, allocating capital to where returns will be sub-optimal, and ultimately leading investors to seek other markets where higher returns can be achieved. Since there is only a finite amount of capital available, when through manipulation or deception companies get capital, they in turn deny access to that capital by deserving companies.

- To provide investors with confidence that the information they receive is full and fair disclosure, and not unbalanced, as well as to assist market participants in complying with laws and regulations, the markets require **independent** and unbiased gatekeepers such as independent auditors who verify numbers and disclosures, credit rating agencies who can unlock access to capital markets for companies and analysts who provide investment analysis. The markets and participants also require professionals such as attorneys who assist, prepare and/or review corporate filings in their capacity as experts to ensure compliance with laws and regulations.

- There needs to be **accountability** for those who take the public's money, and those responsible for ensuring the integrity of the market. This includes company executives whose companies receive and put the investors money to use, corporate boards who as the elected representatives of investors oversee management, those responsibility for performing due diligence on the transactions on behalf of the investors including determining if the investment is suitable for them, and gatekeepers such as accountants and credit rating agencies.

- **Regulators** who fulfill their responsibility to act as investor's advocate, and legislators who give them the tools they need to do so. This includes laws and regulations that are written to ensure orderly and fair, transparent markets and in doing so, provide the necessary protections to all market participants including investors.

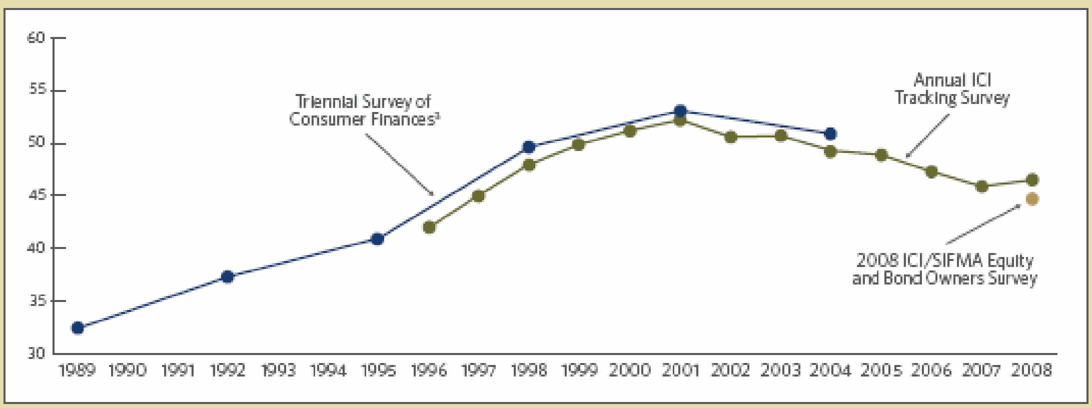
- Effective and timely **enforcement** of the laws, rules and regulations. Without strict enforcement, those who are law abiding capital market participants are disadvantaged by those who are not, and the laws, rules and regulations become meaningless. Investors then begin to lose their trust and confidence in the markets and look for safer things to invest in.

Currently today, there are approximately 90 million Americans, in 47 percent of the American households invested in the capital markets.[1] The number of Americans, and extent to which they invest, ramped up significantly during the 1990's as the chart below illustrates. This was driven by Americans setting aside money for their future retirement in self-directed pension plans, such as 401-K defined contribution accounts.

FIGURE 1.2

EQUITIES ARE THE DRIVING FORCE IN OVERALL OWNERSHIP RATES

OWNERSHIP OF EQUITIES[1] ACROSS THREE SURVEYS; PERCENTAGE OF U.S. HOUSEHOLDS



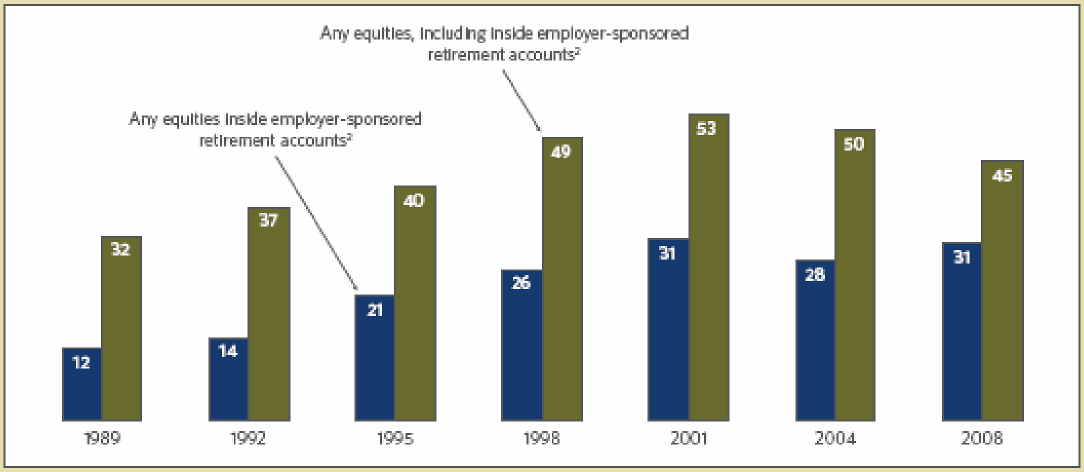
[1]Equities include individual stocks, stock mutual funds, hybrid mutual funds, exchange-traded funds, and variable annuities.
[2]Note that the fraction of households owning equities in the 2004 SCF is reported in this figure, even though the overall bond and equity ownership rate is not reported for 2004 in Figure 1.1. This is because the SCF questionnaire was changed between 2001 and 2004, and it is no longer possible to discern bond owners from households owning interest-bearing assets.
Sources: Investment Company Institute Annual Mutual Fund Shareholder Tracking Surveys, 2008 ICI/SIFMA Equity and Bond Owners Survey, and Federal Reserve Board Survey of Consumer Finances

[1] Equity and Bond Ownership in America, 2008. Investment Company Institute and Securities Industry and Financial Markets Association.

FIGURE 1.4

EQUITY OWNERSHIP THROUGH RETIREMENT ACCOUNTS FUELED OVERALL GROWTH BETWEEN 1989 AND 2008

OWNERSHIP OF EQUITIES,[1] PERCENTAGE OF U.S. HOUSEHOLDS



[1]*Equities include individual stocks, stock mutual funds, hybrid mutual funds, exchange-traded funds, and variable annuities.*
[2]*Employer-sponsored retirement plans include DC plans (such as 401(k), 403(b), or 457 plans) and employer-sponsored IRAs (SEP IRAs, SAR-SEP IRAs, and SIMPLE IRAs).*
Sources: ICI tabulations of Federal Reserve Board Survey of Consumer Finances 1989–2004 and 2008 ICI/SIFMA Equity and Bond Owners Survey

However, the trends in investing were negatively impacted during this decade, when corporate scandals such Enron and World Com, the Wall Street analyst scandal, and mutual fund improprieties such as market timing and late trading were exposed. Each of these scandals contributed to investors' loss of trust and confidence in the markets. However, the Dow Jones Industrial Average was able to climb from a low of 7,938.79 on October 1, 2002 in the midst of the corporate scandals to over 14,000 in 2007. Some attribute this change and rise to in part, the enactment of the Sarbanes-Oxley Act of 2002 and the restored confidence it gave some investors.

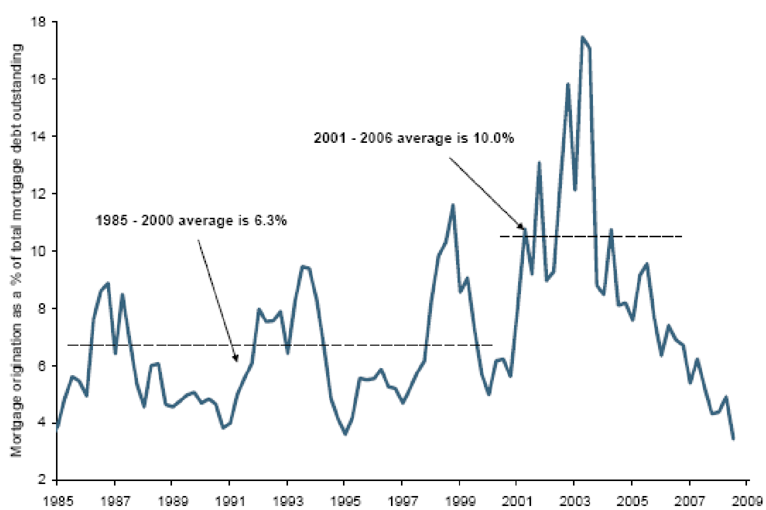
Nonetheless, with that loss of trust from one scandal after another this decade, the percentage of American households investing in the equity markets began to ebb and decline as the chart below illustrates. Unfortunately, when the supply of capital diminishes, it can drive up the cost of available capital, and make it more difficult for businesses to access the capital they need for research, jobs and investments. When combined with system-wide deleveraging and tightening of credit, the economic impact is potentially devastating.

A February 2009 Harris Poll in February found that those surveyed believed Wall Street provided more benefit than harm as it provides the money needed by business. (Actually much of the money comes from American investors, not Wall Street.) However, those surveyed expressed a great distrust of Wall Street. The survey found "Those who think "most people on Wall Street would be willing to break the law if they believed that they could make a lot of money and get away with it" are up to 71%. The highest number previously was 64% in 1996." Those who believe that "in general people on Wall Street are as honest and moral as other people" have fallen to 26% from 41% last year. The previous low was 35% in 2000, 2002 and 2003 during the dot.com market bust and corporate and Wall Street analyst scandals. And finally, "Those surveyed also indicated that those who believe that "most successful people on Wall Street deserve to make the kind of money they earn" have fallen to 30%, compared to 40% last year. The lowest number previously was 36% in 2002."

Compensation for Undue Risks

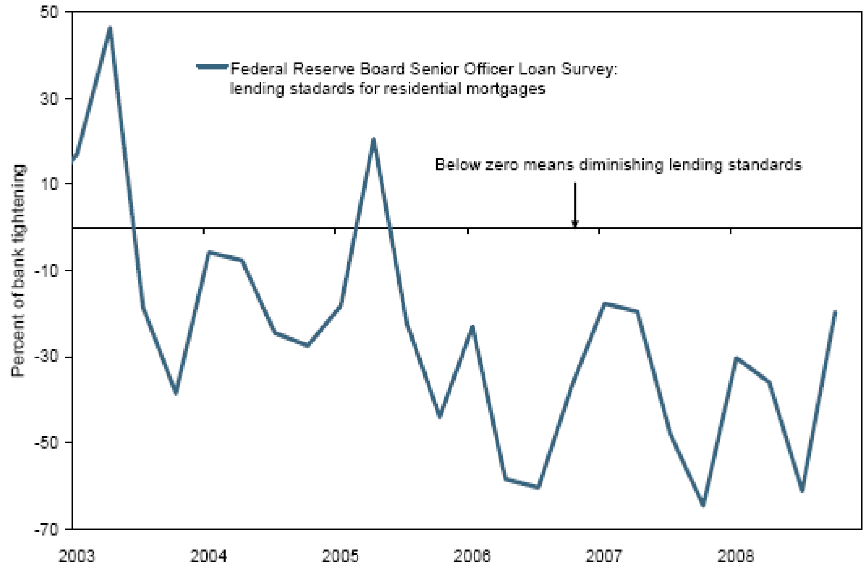
The blame for the financial crisis rests first and foremost with those who originated unsound loans, including mortgage brokers, mortgage lenders and bankers. The individuals and institutions involved, originated loans that were predatory in nature and not likely to be repaid in ever increasing numbers in the late 1990's and the 2000's. Sub prime loans were made by the millions, including loans that have often been referred to as No Doc loans, Liar's Loans, or Ninja (no income, no job, no assets) loans. Despite Congress having provided banking regulators authority to set lending standards for banks, as well as standards for what quality of assets they can hold the banking regulators failed to act. The chart below illustrates how as home owners took on ever increasing amounts of debt, risks to retail and institutional investors in these loans, the capital markets, the financial system and ultimately taxpayers and American workers rose quickly.

Exhibit 11: Mortgage origination surged – mortgage origination as a percentage of total mortgage debt outstanding



Source: Mortgage Bankers Association, Federal Reserve Board, Goldman Sachs Global Investment Research.

Exhibit 12: The surge in capital inflows eroded lending standards

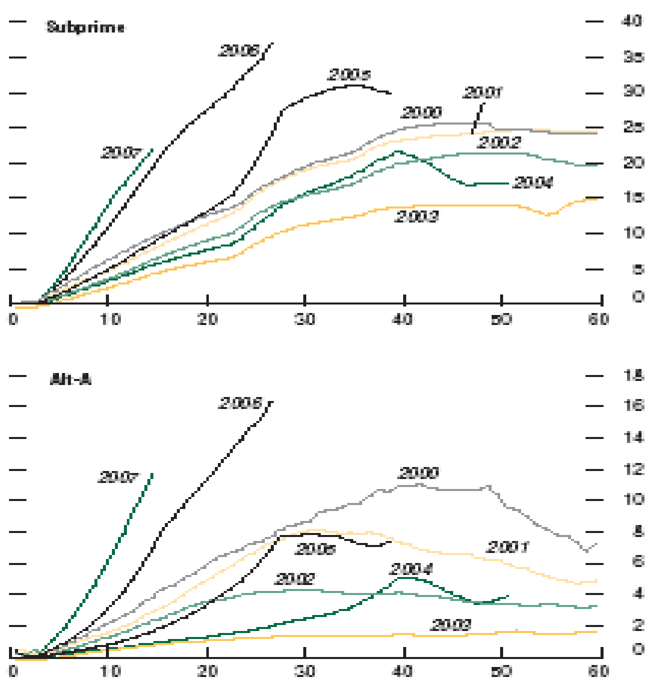


Source: Federal Reserve Board, Goldman Sachs Global Investment Research.

Securitizations of loans, including sub prime loans was also on the rise.

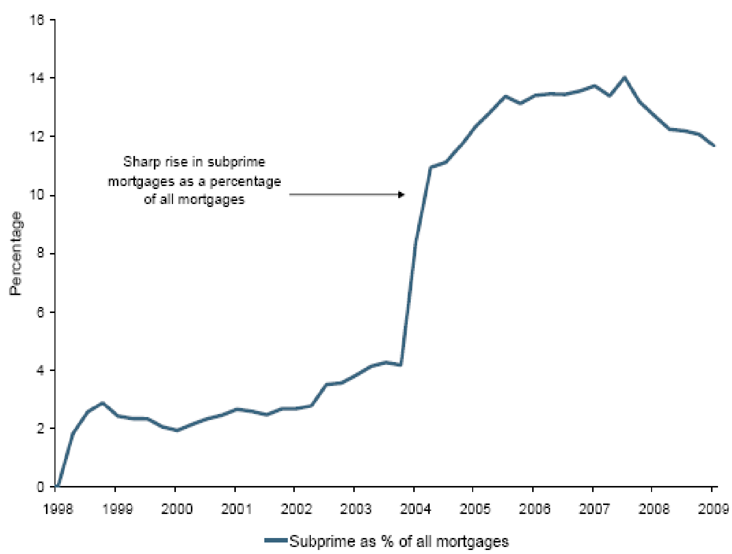
By 2006, the mortgage lending markets had become a train wreck waiting to happen. As noted in the charts below from the International Monetary Fund (IMF), loans originated in 2006 went into default almost as quickly as they were being made.

Figure 1.8. U.S. Mortgage Delinquencies by Vintage Year
(60+ day delinquencies, in percent of original balance)



As the volume of questionable mortgage loans increased, both in terms of loan amount and number of loans, housing advocates and others warned that many of the loans were unsustainable and would lead to as significant rise in foreclosure rates. The bank managements, boards of directors, and regulators ignored these earnings and failed to act on the increasing risks these loans introduced into the financial system. The mortgage loans, including home equity loans, significantly increased the levels of debt taken on by home owners. And the problems with the most problematic loans – the sub prime loans – rose exponentially.

Exhibit 13: The percentage of subprime mortgages soared to record levels



Source: Mortgage Bankers Association, Goldman Sachs Global Investment Research.

Unfortunately, the financial system lacked the transparency, risk management or financial incentives necessary to ensure there would be self discipline in the capital markets with respect to lending activities. Despite a request from the SEC to the accounting standard setters in 1998, the standard setters had failed to pass new standards providing greater transparency with respect to loans which are almost always the largest asset on the balance sheets of banks. In 2000, The Working Group on Public Disclosure, established in April of 2000 by the Board of Governors of the Federal Reserve System, issued a report to banking and securities regulators that largely went unheeded. That report recommended banks and other financial institutions disclose market risks on a quarterly basis including current credit exposures and risks based on internal credit ratings, insight into key concentrations of risks such as sub prime loans, and how well market risk models actually performed.

A Failure to Properly Manage Risks

Risk management was also lax or nonexistent both within financial institutions and at the federal regulatory agencies. It was clearly the responsibility of the federal financial market regulators to identify risks and take responsible actions within their authority to manage and mitigate those risks. As a former SEC senior official, I think a federal regulator who said their job did not involve identifying and addressing risks is a regulator who should be fired.

The SEC's risk management office established by Chairman Donaldson in the wake of the mutual fund scandals, had largely been dismantled in subsequent years with only one remaining employee by February of 2008. The Office of the Comptroller of the Currency (OCC) had two risk offices, that were combined into one in 2006. Although the OCC, Federal Reserve, Office of Thrift Supervision (OTS), and Federal Depository Insurance Corporation (FDIC) all had field examiners in banks they regulated, the banking regulators failed to identify and/or failed to manage the risks that were growing with each passing day. And certainly the regulator of Fannie and Freddie was very cognizant of the risks those two institutions were engaging in as they greatly expanded their portfolios and exposure to risks, and yet failed to take responsible actions to stem the risks.

When Merrill Lynch removed their CEO in 2007, they announced they would be hiring a risk officer for what was one of the largest financial institutions in the world. The lack of an effective risk officer in this institution with adequate authority was emblematic of problems throughout the industry. In Merrill's case it was later found to contribute to losses that first forced the company to find a buyer and ultimately, caused the buyer to need government aid as a result of those losses.

By the end of 2007, the sub prime crisis had exploded. Merrill Lynch and other firms took billions in write downs. Merrill's CEO would leave in October of 2007 followed by the Citigroup CEO the following month. CEO's of AIG and Wachovia would also be pushed out. All of these institutions would take tens of billions in writedowns and ultimately need billions in investment from the U.S. taxpayer to survive.

Pay for Nonperformance – The Wrong Financial Incentives

A key problem with compensation among executives is that the compensation is not negotiated directly between management and the investors. Rather an intermediary, the board compensation committee, who often has close ties to management but not investors, negotiates the pay package on behalf of investors. Too often that results in compensation based on what other executives are paid. It is not linked to the actual performance of the company versus its competitors, nor to the total shareholder returns that are generated.

This process is exacerbated among Wall Street firms that have tended to pay lower base salaries and very large bonuses. The annual large bonuses have resulted from volume selling of products that were very damaging to the markets and investors without consideration to the long term impact they could have on corporate profits. As a result, bonuses were often paid in profitable years for business activities that in later years destroyed some of these firms. Unfortunately, there needs to be much closer alignment between compensation and long term performance, through the reduced percentage of pay that is given through annual bonuses, greater use of restricted stock, and the ability to claw back excessive compensation when it has been earned through deceptive or fraudulent means.

The public does properly perceive compensation among financial firms to be excessive. Merrill's CEO retained more than $161 million after he was ousted on top of the $70 million he took home during his four-year tenure. The bulk of the exit pay was linked to previously earned benefits and stock since his departure was deemed a retirement; he did not receive any severance pay. Citigroup's CEO collected $110 million while presiding over the evaporation of roughly $64 billion in market value. He left with an exit package worth $68 million, including $29.5 million in accumulated stock, a $1.7 million pension, an office and assistant, and a car and a driver. Citigroup's board also awarded him a cash bonus for 2007 worth about $10 million, largely based on his performance in 2006 when the bank's results were better. Mr. Mozilo, the CEO of Countrywide Financial which was forced into a sale to Bank of America (BofA), took home more than $410 million since becoming chief executive in 1999, including several stock sales made under an automatic plan while the company was buying back shares.[2] Unfortunately, the boards of these companies were either unable or unwilling to clawback this compensation as a result of

[2] Chiefs' Pay Under Fire at Capital. New York Times, March 8, 2008. Jenny Anderson.

the destruction of these companies and the huge losses suffered by their investors due to a lack of performance.

According to the Wall Street Journal on May 2, 2009, "From 2006 through 2008, the 10 largest financial companies in the U.S. awarded their chief executives a cumulative total of more than $560 million in cash, stock and options. Those firms -- some of which are no longer among the 10 biggest -- have lost a total of nearly $1 trillion in market value since the end of 2006."[3] That means CEO's of companies who stock performance was miserable were taking out over half a billion in compensation. No wonder investors and the American public are livid with them.

On January 17, 2007, Bloomberg reported that Wall Street's five biggest firms paid a record $39 billion in bonuses for 2007. In that year the firms shed 25 percent of their equity value, said they were eliminating at least 6,200 jobs and three of the companies suffered the worst quarterly losses in their history and shareholders lost more than $80 billion.

Goldman Sachs Group Inc., Morgan Stanley, Merrill Lynch & Co., Lehman Brothers Holdings Inc. and Bear Stearns Cos. together awarded $65.6 billion in compensation and benefits last year to 186,000 employees. The year-end bonuses, at 60 percent of the total, exceeded the *$36 billion* distributed in 2006 when the industry reported all-time high profits. The industry's bonuses were larger than the gross domestic products of Sri Lanka, Lebanon or Bulgaria, and the average bonus of $219,198 was more than four times higher than the median U.S. household income in 2006, according to data compiled by the U.S. Census Bureau.[4] And these bonuses were paid out in part due to earnings made from sub prime lending, securitizations and derivative products that would prove to be the "financial weapons of mass destruction" Warren Buffet had forewarned of.

Chief executives at the nation's largest corporations earned less in total compensation in 2008 than in 2007, according to an analysis of the pay data of companies in the Standard & Poor's 500 index. The analysis is based on 2009 proxy statements filed through March 31. Average total compensation for the CEOs declined 6 percent from $11.07 million in 2007 to $10.4 million in 2008. Similarly, median income for these CEOs declined from $8.6 million in 2007 to $7.7 million in 2008.[5] This compares to the median pay for the full-time workers who have kept their jobs rose 4 percent to $37,544 in 2008, from $36,140 the previous year, according to the federal Bureau of Labor Statistics.[6]

But even as the economy slumped and 5.1 million Americans lost their jobs, the median salary for CEOs of 200 large companies increased 4.5 percent to $1.08 million, according

[3] CEOs Need to Bring Investors Along for the Ride with Them. Wall Street Journal, May 2, 2009.
[4] Wall Street Bonuses Hit Record $39 Billion for 2007. Bloomberg News, January 17, 2008, Christine Harper. See http://www.bloomberg.com/apps/news?pid=20601087&sid=aPXU4y.z8E9o&refer=home
[5] Preliminary data from The Corporate Library is based on 218 proxy statements filed through March 31, 2009.
[6] "Who Moved My Bonus? Executive Pay Makes a U-Turn," The New York Times, April 5, 2009.

to a survey by The Wall Street Journal.[7] And despite the public outcry over private jets and other executive perks, companies kept plying executives with generous freebies. CEO perks went up, on average, 12.5 percent in 2008 to $336,248—or nine times the median salary of a full-time worker.[8]

"When push comes to shove, companies didn't make as many changes to these programs last year as shareholders would like," according to David Wise, a senior consultant at the Hay Group, which compiled the survey for The Wall Street Journal.[9]

That is not to say all executives are overpaid. I have seen many executives who provided their investors with above average returns in exchange for reasonable compensation. And some executives such as Lloyd Blankfein at Goldman Sachs and Jeffrey Immelt at GE have advocated very beneficial changes in compensation schemes that members of Congress and the business community should give due consideration to. Care should be taken to ensure not all business executives are painted with the same broad brush.

In foreign countries such as the United Kingdom, the Netherlands and Australia, the owners of public companies – the investors – are given a right to vote on executive compensation. But it is a basic fundamental right that shareholders here in the United States have been denied during a period in which executive compensation, especially as compared to the compensation of Main Street Americans, has risen exponentially.

Unaccountable Boards of Directors

With Americans increasing their investment in stocks of public companies, they have become increasingly dependent on their elected representatives to oversee the management of companies working on their behalf. This includes being dependent upon the compensation committees of boards of directors for establishing reasonable levels of compensation based on the performance of the management team and the company given full consideration to the environment that company operates in. Yet the corporate governance system in the U.S. currently only allows investors to vote for a director, or

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[7] "CEO Pay Sinks Along With Profits," The Wall Street Journal, April 3, 2009.
[8] Preliminary data from The Corporate Library is based on 218 proxy statements filed through March 31, 2009.
[9] "CEO Pay Sinks Along With Profits," The Wall Street Journal, April 3, 2009.

abstain from voting. Investors are not given the opportunity to vote against investors. Investors in countries such as the U.K., Canada, Australia, Germany, Japan, South Africa, Finland, Indonesia, Russia, Italy and India all provide investors some form of nominating directors when they hold a sufficient ownership in the company ranging from a nominal amount to up to 10%.

"Proxy Access" is a term used to describe a procedure by which directors nominated by shareholders would be identified in proxy statements published by corporations and listed on the corporation's proxy card for election by the shareholders.

The process by which directors at U.S. corporations are elected long has been criticized by investors both here and abroad. Incumbent directors, by controlling the nomination process and deciding who to place on the corporation's ballot for consideration by the shareholders, essentially have maintained control over corporate boards and have been resistant to meaningful change in the boardroom. In addition, because the nomination process has been controlled by incumbent directors, director candidates largely have been viewed as being more responsive to their fellow directors, upon whom they depend for appointment to the board, than to the shareholders who they are supposed to represent.

Under the existing regime, shareholders have no meaningful ability to influence the nomination process by corporate boards, and financing an independent solicitation for the election of an alternative candidate or slate of candidates can be prohibitively expensive. Indeed, the expense of proxy solicitation generally dissuades investors from financing independent campaigns for directors unless part of a larger goal to acquire control over the company. Thus, the existing regime prevents shareholders from directly influencing the board of directors through the election of independent candidates.

"Proxy access" long has been considered the "holy grail" for shareholders. If implemented, it would provide shareholders with a low-cost method of nominating director candidates and the expense of soliciting proxies for such candidates would be shared by all shareholders. As a result, shareholders have been advocating for "proxy access" for decades. In 1976, the SEC considered adopting a mandatory "proxy access" rule, but declined to do so.

Even in the absence of an SEC rule requiring "proxy access," corporations are not legally precluded from voluntarily adopting proxy access policies, and can have bylaws making proxy access a requirement at a particular corporation. Thus, beginning in the mid-1980's, shareholders began to submit proposals to specific corporations urging the adoption of "proxy access" policies and/or bylaws. Initially, the SEC's Division of Corporation Finance permitted such proposals to be submitted to shareholders. In approximately 1998, however, the Division began permitting companies to exclude such proposals under the "election exclusion" of SEC Rule 14a-8(i)(8). Between 1998 and 2002, the SEC generally barred "proxy access" proposals. Also during this period, activist shareholders increased their use of the shareholder proposal mechanism of Rule 14a-8, and sought to introduce proxy access proposals with increasing frequency. In 2002, the SEC proposed the adoption of a formal rule that would have made proxy access mandatory for all publicly traded corporations. In response to intense lobbying efforts by corporate interests, the SEC did not take any action on the proposed rule.

In 2006, the United States Court of Appeals for the Second Circuit held that under the existing proxy solicitation rules, corporations were *not* permitted to exclude shareholder proposals advocating the adoption of bylaws that would install proxy access regimes at individual corporations. *AFSCME Employees Pension Plan v. American International Group*, 462 F.3d 121 (2nd Cir. 2006). In other words, the Second Circuit ruled that shareholders were empowered under the existing proxy rules to submit proposals advocating the adoption of proxy access bylaws, yet the SEC's Division of Corporation Finance had wrongfully been depriving shareholders of that right for nearly a decade. Although the SEC had declined to participate in that litigation, the SEC's response to the Second Circuit's decision was immediate – it promised to amend the proxy rules to "provide uniformity." In the summer of 2007, the SEC published two competing proposed rules. The first rule would have permitted shareholders to submit proxy access proposals provided such proposals had certain minimum characteristics (such as minimum shareholdings, etc). The second proposed rule, however, would amend Rule 14a-8(i)(8) to bar any proposals advocating proxy access regimes in their entirety. In the fall of 2007, again succumbing to intense lobbying efforts from business interests, the SEC adopted the latter rule.

The current SEC Chairman and Commission deserve much credit for again proposing new rules giving shareholders equal access to the proxy with management. However, the Chamber of Commerce has indicated it would consider taking legal action against the SEC if it did so. As a result, Congress should clarify and make certain the authority of the SEC to do this important rule making.

Although proxy access proposals no longer can be introduced by shareholders through the resolution process established in SEC Rule 14a-8, "proxy access" bylaws themselves remain legal. At least one corporation – Comverse Technology – has voluntarily adopted a proxy access bylaw, and UnitedHealth Group, Inc., has agreed to adopt a proxy access procedure as part of a settlement of a securities class action recently announced by the corporation.

Asset Managers Fail as Fiduciaries

For many years, including the past couple of years, investors of all types – mutual funds, public and corporate pension funds, labor funds and broker dealers have all continued to vote again and again for the members of the compensation committees of many of the institutions that have failed to perform and required government assistance to remain sustainable. This has included boards of such companies as AIG and Citigroup where investors have publicly voiced their concerns regarding excessive compensation. These investors also share part of the blame for the current financial crisis as they have quite frankly, reaped what they voted for.

A report issued earlier this year titled “Compensation Accomplices – Mutual Funds and the Overpaid American CEO” found that:

> “…mutual funds are increasingly supportive, as a group, of management positions on proposals dealing with executive pay, despite the current outrage over CEO pay amounts and disconnection from company performance. As a group, the 26 mutual fund families had the following voting patterns:
>
> - The average level of support for management proposals on compensation issues was 82% in 2007 and 84% in 2008, a steady increase from 75.8% in 2006.
> - The average level of support for the categories of compensation-related shareholder proposals we selected was 42% in 2007 and 40% in 2008. This represents a significant decrease from the 46.5% support found in 2006.”

The report also found that some fund families including AllianceBernstein, Barclays and Ameriprise have “consistently ranked as “Pay Enablers”…T. Rowe Price was among the “Pay Constrainers” in 2006 as well as both years covered by this study, while Templeton has been a “Pay Constrainer” for a couple of years.

Many mutual fund and asset managers have an inherent conflict in that they strive to gather assets to manage, often soliciting corporate executives for the contracts to manage the pension fund assets of companies. They receive significant fees for such arrangements. At the same time, asset managers are voting the shares held by the funds in which investors have placed their money and may well be required to vote for or against management and board members at companies they are soliciting business from. This creates a very significant conflict. As noted in the survey cited above, it appears all to often fund and asset managers may be putting their own interests ahead of the best interest of those investors whose money they are managing.

The New Entrepreneurial and Destructive Financial Products

While sub prime loans were being made, Wall Street and banking financial institutions also created new financial products, some of which were derivatives of such products, which created further and in some cases, increased risks to the market. Various types of loans, including sub prime loans, were packaged by the banks and Wall Street into pools of loans, placed in trusts, and debt and equity investments in the trusts were sold to investors, often referred to as Collateralized Mortgage Obligations (CMO’s) or Collateralized Debt Obligations (CDO’s). By doing these transactions, often referred to as securitizations, the risk of not collecting on the loans was transferred to someone other than the person making the loan, leaving the person making the loan with “no skin in the game” and transferring the risk to the investor. As a result, the loan originator became was incented by the up front loan origination fees to do the highest volume of loans possible, without concern for collecting the loan, as that was no longer a risk to it.

And of course we have witnessed the explosion in the credit derivatives market which at one time was in excess of $60 trillion in dollars, much larger than the amount of debt underlying those derivatives. Unfortunately, Congress created a very serious gap in the regulation of such securities with the passage of the Commodities Modernization Act in 2000. That is a gap that must be filled by legislation requiring greater transparency of contracts and pricing, centralized clearly and trading, more timely settlement, and the ability of the CFTC and SEC to oversee, regulate and when necessary, enforcement capabilities in order to protect markets, investors and American taxpayers.

As the House has learned in earlier Committee Hearings, executives at companies such as AIG were compensated handsomely, and paid bonuses for engaging in devising these new financial products, some of which have had enormous destructive impact on financial markets. Yet the reward for creating and selling these products has proven to be much more lucrative for those who engaged in such activities than the risks they faced.

And certainly, the risk of reputational damage to individuals, senior executives and the firms they managed did not sway those at Wall Street and Banks who reaped the huge rewards previously outlined. In fact, reputational risks seldom do overcome the opportunity for a "fast buck" as we previously have seen during the corporate scandals of Enron and Worldcom, the Wall Street analysts' fiasco, the mutual fund late trading and market timing and now the current financial crisis.

Recommendations

Despite the shortcomings I have mentioned above, I would caution the government that compensation should be decided by and between compensation committees of boards of directors, with input and counsel from management, and independent consultants. More importantly, investors should and must have a voice on compensation and the negotiated terms, especially when directors and management fail in their fiduciary and agency obligations.

I strongly urge that the government not get involved in setting compensation, either directly, through taxation legislation, or by establishing government overseers of compensation. Past attempts at legislating compensation such as through limits on tax deductibility of pay have had negative impacts on companies and their stock values, and ultimately investors. I believe compensation should be determined by transparent free markets.

However, the free markets today do not provide the necessary transparency or accountability to operate effectively. To correct those serious deficiencies, I would urge the Committee, its leadership and members to consider and pass legislation and push for regulations addressing the following recommendations.

<u>Improving Transparency</u>

To improve transparency, the SEC should enhance its disclosure of compensation arrangements. Former Chairman Cox and the Commission made significant strides in enhancing disclosures to investors regarding compensation arrangements, provided investors actually took the time to read them. Yet the SEC did not require disclosure of perhaps the most significant data one uses in assessing compensation – that is the performance metrics a management team and board compensation committee uses when judging performance versus competitors including the nature, types and level of triggers for payment of bonuses. While many companies have voluntarily provided these performance metrics and triggers, many have not. The SEC should be requested to level the playing field for all and require all companies make these disclosures to their investors.

In addition, the SEC should require disclosure of the value of all equity grants in the year those grants are made by the board. At Glass Lewis, we found directors and investors used the value of the grants when they were made as a determining factor in assessing compensation. Yet the SEC, in a "late midnight" rule making changed their rules from requiring such disclosures, to one of requiring the amount of expense recorded in the financial statements to be disclosed. This error in rulemaking which was quite controversial at the time it was done without adequate and timely solicitation of investors input, should be reversed.

Investors have also asked for disclosure regarding consultants used by compensation committees and whether they are independent from management or not. Having served boards of directors of public companies and watched these consultants in action, I have all too often seen their lack of independence contribute to excessive compensation. All too often they have done peer comparisons on compensation which constantly raised the "average" pay, while ignoring whether or not performance among the peers was comparable. As such, I strongly support disclosures regarding the independence of compensation consultants and their fee arrangements, just as we do for independent auditors.

I believe all asset and investment fund managers, including corporate and public pension funds, should be required to publicly disclose their votes on proxy matters, including votes on boards of directors including compensation committee members as well as compensation arrangements. Such transparency is necessary if accountability is to be established in a free market system. Recently at the public pension fund I serve as a trustee for, we have adopted a policy of making such disclosures, even though there is no rule requiring it. Such a policy is in the best interests of our investors and members and is a positive step in establishing our accountability to them.

A requirement should also be established to require investment and asset fund managers to disclose the compensation arrangements under which they pay their portfolio managers. As was highlighted in the Conference Board Report of the Commission on Public Trust and Private Enterprise in 2003, a vast majority of such managers are paid for short term, not long term performance, including quarterly or annual bonuses. Whether or not a fund pays for long term results on behalf of its investors or continues to pay for short term results which has included high levels of turnover in the portfolio's driving up costs to investors, should be made transparent to investors and the markets. It is critically important that investors quite investing on a short term quarterly to quarterly "what have you done for me lately" basis to a longer term view focused on long term shareholder value creation. All to often executives at financial firms have created products and a business model focused on short term profitability to the detriment of the long term sustainability and value of the company, as that is what some investors have wrongly and incorrectly pushed for.

I believe the SEC and/or the Financial Accounting Standards Board should adopt a requirement for greater disclosures of risks by all public companies including financial institutions. Current disclosure requirements are woefully inadequate, have missed the target, and have not provided investors with adequate information to assess whether compensation arrangements have been appropriately designed in light of risks the company is facing or has engaged in. Over two decades ago, the major international accounting firms urged the SEC to adopt a rule that would have placed all such risk disclosures in a single section of the reports of public companies. That recommendation and the recommendations of The Working Group on Public Disclosure were for the most part ignored in what has become a very expensive lesson with a great cost to investors and taxpayers. I would urge the committee to consider those recommendations and others that focus on the risks of changing business products and environments, increasing degrees of leverage, and how cash flows are affected by both short term and long term funding and liquidity needs and requirements.

Creating Accountability

Greater accountability for the oversight of compensation arrangements should be established by making corporate boards of directors more accountable to those who they are elected to represent. To establish that accountability, the following is required:

1. Requiring directors be elected by a majority of investors who vote.

2. Elimination of broker dealer votes as the SEC has taken steps to do so.

3. Giving investors an advisory vote on the compensation arrangements disclosed each year in the proxy. However, if a company had a majority of investors vote against such compensation scheme for two or more consecutive years, the vote would become binding. Also investors should be provided a vote on golden parachutes or other forms of severance, that had not been previously disclosed and voted on in connection with a proxy, provided it gave compensation to the executives that exceeded one year of compensation.

4. Giving investors a private right of action to claw back bonuses and other incentive or equity based compensation, or profits from sales of securities, when one of the top executives of a company have been found to have engaged in reckless or fraudulent conduct which has violated securities laws, and it can be demonstrated

that as a result of such misconduct, investors have suffered losses. This would of course include, but not be limited to misstatements of financial statements.

5. Giving investors the same access to the proxy that management has, for the purpose of nominating directors, provided an investor has held at least one percent of the stock of the company for a period of two years or more. This will give investors not only a greater ability to hold directors accountable by running alternative slates of directors, but also encourage them to take a longer term view with respect to holding their investments. Some say this will give special interests the ability to gain control of a company through an unduly influenced vote. That couldn't be further from the truth, and to date, no single shareholder has even come close to achieving that.

In addition, I fear shareholder votes cast by fund managers are often cast in the interest of those managers and their institutions and not in the best interests of those whose money they are managing. As such, proxy voting has and will continue to be ineffective in establishing accountability, even through say on pay or majority voting regulations unless those votes are cast in the interest of investors. To achieve that goal, the SEC should be given the power to require those voting proxies on behalf of investors - mutual funds, public and corporate pension funds, and other asset managers - to cast those votes solely in the best interests of the investors. In addition, these fund and pension managers should also be required to disclose to their investors if they have a financial conflict when casting such votes. As voting shares is critically important to a public company and investors, firms who provide proxy advice on voting such shares should be much more transparent and subject to regulation by the SEC.

Systemic Risk Regulation

This year former SEC Chairman Richard Breeden testified before the U.S. Senate on risk regulation and the concept of a risk regulator. I found his testimony to be most informative and thoughtful and would urge you to consider it.

I do believe that if the current federal regulators had done their jobs, much, but perhaps not all of the damage that has been done the capital markets and financial system in the U.S. and abroad could have been avoided. I think the first and most important step to creating a successful risk regulation system is to adequately oversee the current federal regulators to ensure they are doing their jobs. However, that requires greater transparency on the part of these federal regulators. To achieve that necessary transparency and accountability I would require that each of the regulators in their annual reports to Congress:

- Identify both currently existing and potential risks;

- The risks should include broader economic risks as well as industry or sector specific risks, and risks for specific entities for which it is more likely than not that the regulator would recommend governmental support;

- Discuss what steps are being taken to manage and mitigate those risks.

In addition, I would require the examination reports of the federal banking and securities regulators be made public when completed. A recent GAO report has cited shortcomings in such reports when they were allowed to remain out of the public eye. I have had the opportunity to read such reports, including during audits of troubled financial institutions. I believe such reports would be beneficial to investors and depositors and do not agree that they would result in "runs" on a bank. Rather I believe that with public disclosures of such reports, it is likely the management team of the financial institution would be much more proactive in preventing serious deficiencies in the management and operation of the institution.

There has been much discussion of whether or not a new government agency and systemic risk regulator should be created. I believe this is not necessary if the current federal and state regulators do their job and actively cooperate and communicate with one another. Where legislation is necessary to permit timely sharing and exchange of information, including between state and federal agencies, it should be passed by Congress.

Some have discussed and suggested a council of existing regulators. Unfortunately, this sounds all to much like yet another Presidents Working Group which failed to identify and mitigate the risks leading up to the current crisis.

If Congress were to decide yet another risk regulator is necessary, then I would recommend it consider creating an equivalent of the National Transportation Safety Board for the financial markets. Such an agency would:

- Have an independent agency chair, sufficient staff and knowledgeable independent board members with requisite expertise.
- Its board could include members of the other federal agencies.
- Be charged with responsibility for identifying systemic risks to the financial system and just as the NTSB does, issue reports to the public and responsible federal and state agencies with recommendations for managing and mitigating those risks. This would include identifying risks with respect to financial products being sold in the capital markets.
- Have the ability to investigate capital markets and their participants when a serious risk or problem exists on its own or in cooperation with other federal regulators and issue reports with their findings and recommendations.
- The rulemaking for corrective actions would remain with the respective federal financial or securities market regulator, provided corrective actions were taken within one year or a reasonable period of time. This is consistent with the relationship between the NTSB and FAA.
- The agency would have the ability to pay private sector wages so as to attract the breadth and depth of knowledge necessary to identify, clearly understand, and then make smart recommendations on how to manage and mitigate the risks.

- The agency would need to be transparent to the public with respect to its work, findings and recommendations.

Closing

In closing I would like to urge the committee to focus on the principles of transparency, accountability, independence, effective regulation and enforcement when it comes to designing regulatory reforms. I believe these principles apply to most if not all components of the capital markets including compensation as well as risk management. They are principles that history has demonstrated time and time again are necessary for efficient capital markets that fulfill their critical role for not only investors, but also business and American taxpayers.

I have worked with others to draft legislation that would accomplish many of the recommendations set forth above. If it would be of interest to the committee or any of its members, I would be happy to share it with you.