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Before the

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"Corporate Governance and Shareholder Empowerment"

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Chairman Kanjorski, Ranking Member Garrett, and Members of the Subcommittee, I am Steve Irwin, Pennsylvania Securities Commissioner and Chairman of NASAA's[1] Federal Legislation Committee. State securities regulators are pleased that many of our proactive policy recommendations to better protect investors and restore confidence in our financial markets are now being debated as part of the broader regulatory reform agenda. Today, I would like to highlight the suggestions that we believe are most vital to sound corporate governance policy.

The securities administrators in your states are responsible for enforcing state securities laws, the licensing of firms and investment professionals, registering certain securities offerings, examining broker-dealers and investment advisers, pursuing cases of suspected investment fraud, and providing investor education programs and materials to your constituents. Ten of my colleagues are appointed by state Secretaries of State, five fall under the jurisdiction of their states' Attorneys General, some are appointed by their Governors and Cabinet officials, and others, like me, work for independent commissions or boards. As a result of our geographic proximity, we are the first line of defense for Main Street investors and for us, enforcement is a top priority. While the recent financial crisis was the result of many failures, I am very proud to say that a failure of state securities regulation was not one of them.

Were I to specify the single most important task which confronts legislators and securities regulators, it would be the need to restore public faith and confidence in American financial institutions whether we speak of securities, banking or insurance products and services. Without belief that investors will be afforded fair and honest mechanisms to carry out their financial goals, these activities will continue to suffer, as they have already suffered, dramatic contractions. The impact of the loss of public confidence can be seen in two ways: First, in terms of daily experience we know that investors have withdrawn from participation in the securities market. In my own agency, the Pennsylvania Securities Commission, our employees have the opportunity to

[1] The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc., was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, the U.S. Virgin Islands, Canada, Mexico and Puerto Rico. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

participate in a state-sponsored deferred compensation program. Many have elected to withdraw investments in stock funds in order to seek safe haven in more conservative investments including a money market fund. Others have simply ceased to participate in the deferred compensation program.

The Pennsylvania Securities Commission sponsors a very active investor education program. From 2008 to the present, the Pennsylvania investor education program made 486 presentations to a large population of residents situated in 62 counties. Ranging from the most heavily populated to the most sparsely populated, the audience was diverse and included but was not limited to teachers, students, retirees, working adults, senior citizens and small business owners.

Often, the Pennsylvanians who attend these programs speak of their worries about a secure retirement or paying for a child's education. Their worries stem from the financial insecurity resulting from the meltdown including issues related to unemployment. Many complain about their losses because of the decreasing value of stocks and others indicated their fear of getting involved in the stock market altogether. Those who still have money invested pulled it out in order to not subject it to any more risk and were afraid to 'get back in.' Some have kept their money in the market in the hope of riding it out and recouping their loss value.

Unfortunately, the staff of the Pennsylvania Securities Commission often finds investors who sell when the market is down or only buy when the market is at its peak. They have a lack of knowledge of how the market works and may not understand that they must take their time horizon into consideration when making investment decisions. Some people think the scam artists triggered the meltdown and complain that "Madoff poisoned the market." The Madoff scandal appears to have paralyzed a lot of people when it comes to investing. Some quotes from senior citizens attending educational programs include the following:

> "You don't want to know what I think." (Tell me.) "All of this should have been stopped long ago...the scams, Madoff, all these other companies doing whatever they wanted with other people's money or investing it however they wanted. There was no control. Something needs to be done to protect people...it should have been done yesterday...but they're doing stuff now to protect people so that is better

> than nothing but it should have been done yesterday." (female retiree-had to take an early retirement and doesn't have skills at this stage to re-enter workforce)
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> "I don't have thousands and thousands to invest to make thousands and thousands now...oh well, I'm trying to do what I can. You know, we're the little people. We don't have a lot of money...I had to retire early but I'm trying to be careful in terms of where I put my money...I just don't know where to put it where it will be safe."
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> "I am definitely staying on the sidelines...definitely...cause if I invest now I'll expect/want things to recover overnight." (working adult, male)
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> "People have to watch out with their banks ‘cause a lot now also offer investments but they don't tell you that the investment part is a separate part of the bank. They trust the bank teller and then they think they can trust the investment person at the bank. People need to realize that those investment people at the bank are separate from the people behind the counters." (working adult, state employee, male)
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> "It's scary. You saw what happened. People invested with these brokers they trusted for years and years and then it turns out it was a scam and now they have nothing." (male retiree)
>
> "I think a lot of seniors are still being ripped off because they think they can get back in now and recover all of their losses OVERNIGHT and that's not going to happen. But someone tells them they can get them good returns right now and they believe it." (working adult, male)

Second, it has become clear that investor distrust in the markets is an ongoing phenomenon. The March 19, 2010 issue of *Business Week* contained an article entitled “Small Investors Remain Wary After 69% U.S. Stock Bounce.” Despite the year-long stock market rally they note that “polls of individual investors show persistent levels of skepticism about the outlook for stocks” and this assessment is concurred in by securities professionals. While institutional investment managers have been returning to the market, the small investor is clearly cynical.

From a statistical standpoint, it’s clear that there continues to be a lack of public faith and confidence in our markets. The 200-day moving average volume on the New York Stock Exchange is now at 1.2 billion shares, down nearly 25 percent from a year ago. As stock prices have risen over the past year, the lower volume of trading reflects the fact that Main Street investors have largely stayed out of the market.

Investors have not lost confidence because of a single issue; they have lost confidence because over and over again they have seen market abuses which, in the final analysis, target their savings whether invested in the market by themselves or through other modalities such as pensions, money market or mutual funds administered through institutions.

Here are some of the sources of investor cynicism:

1. Enron taught investors that they could not trust the numbers contained in financial reports. As one sophisticated Pennsylvania investor said, "If I cannot trust the numbers, I do not want to play in the game."

2. The market timing scandals demonstrated that investor savings in mutual funds were not safe from unscrupulous schemes to skim profits to which the investors were entitled in order to increase the profits of participating hedge funds.

3. The auction rate securities scandal taught that even when they invested in products that were touted as being "as safe and as liquid as a money market fund" they were being lied to because the products were anything but liquid. The products were really illiquid and might tie funds up for 30 to 40 years.

4. As they realized that their pension plans were increasingly invested in extremely complex and non-transparent products, it became apparent that unanticipated risk was to be found in the safest of savings mechanisms.

5. Investors, including institutional investors, had come to a belief that they could rely on the assessments of investment products by credit rating agencies only to learn that the highest ratings were often attached to the most risky products in return for fees paid to the agencies engaged in a competitive race to lower standards to achieve business.

6. Even money market investments came to be seen as less secure until ultimately backed up by federal deposit insurance in the same fashion as bank deposits.

7. As the full impact of AIG's activities in undertaking to engage in SWAPs on outrageously risky collateral default obligations became clear, the American public began to fear that speculative conduct had reached down to endanger the value of even their life and home insurance policies. This was not the case because these insurance products had long been regulated by state insurance regulators who assiduously sought to make sure that these policies were issued by companies that had adequate reserves to back their contractual undertakings.

8. If one needed a scandal to crystallize market danger, it is to be seen in the Madoff matter and the spate of similar Ponzi schemes which touted performance coupled with safety to lure generally conservative investors to their financial doom.

This is by no means an exhaustive catalog of the market abuses perceived by investors. The abusive conduct has spawned a veritable industry of books and publications describing the financial abuses, and not a week goes by but that the daily newspapers do not recount newly discovered schemes, all of which repeatedly say to investors "Abandon hope, all ye who enter here."

No one solution can restore investor faith and confidence; however, today's hearing is an important step in addressing the dangers to the American economy.

Today we look at one piece of the puzzle, the loss of investor confidence due to perceived failures of adequate corporate governance.

I grew up in a world where businesses, and they were mostly what we regard as small businessmen, took their roles in the community very seriously. They provided goods, products and services to consumers. In so doing, they also created employment for their neighbors and thus filled the rice bowls of their employees' families. They provided benefits to employees and sometimes their families, such as health care, and they assisted their employees in providing for their retirement through pensions. Pensions were administered by experts so that the employee did not have to bear the burden of making daily investment decisions. In fulfilling their roles, these entrepreneurs made a good living for themselves, their families and, successful in accumulating surplus, were able to invest themselves and pass wealth to later generations or endow charitable endeavors as part of their estates. In closely held corporations, these decision makers were responsible to themselves and to their sense of duty to their communities because they were the owners of the enterprise.

Growth of the enterprise and involvement of public investors led to a separation of enterprise ownership from control. The managers provided expertise, but with the separation there was also a conflict of interest, particularly between management and ownership, over the subject of what constitutes fair compensation for management. Traditionally government has not involved itself in the process whereby management compensation is set, but the present crisis has highlighted the fact that in publicly held corporations, there was a lack of effective input by shareholders concerning managerial compensation. It is difficult to define the line between fair and negotiated compensation and corporate looting in breach of fiduciary responsibility.

Corporate governance has largely been a matter for state corporation law, which has viewed the matter of executive compensation as one for the discretion of boards of directors who are supposed to exercise that discretion in light of their fiduciary duty to investors. Historically state laws rightly recognized the danger of attempting to prescribe detailed standards for executive compensation. While state corporation laws vary somewhat from state to state, this is the cardinal principle which all follow. Individual small investors have little or no power to influence the exercise of this discretion under state laws.

We deal today with the questions, “Should there be limits? Are there already limits posed by ethical, legal and economic constraints? How should compensation be structured? What goals should properly be fostered through compensation packages?”

Clearly, individuals who bring to a company imagination and organization skills upon which the company’s success or failure is dependent, ought to be compensated for their time and their talents. We well recognize that unique sports and entertainment stars have a limited time span during which they can earn by the use of their skills. The same is true of business executives.

In less complex economic times, smaller enterprises clearly recognized that the executive team responsible for continued success was entitled to reap rewards beyond the norm in return for their efforts and by definition the availability of such rewards depended upon successful performance. Separation of corporate decision making from corporate ownership muddied the picture. Public ownership meant increased organizational complexity and a concomitant increase of dependence on individuals possessed of high management skills. The problem in part arises from the fact that when corporate ownership resides in essentially passive public investors, control over corporate decision makers decreases to the point of nonexistence. In most instances, shareholders are no longer individuals who are taking a close interest in the affairs of the company but pension funds, mutual funds and even hedge funds which have at all times a variety of investment options. If they are not satisfied with current returns, they sell and move on thereby providing little long-term oversight of management or direct incentive for improvement of performance.

It has been a struggle to infuse mechanisms into corporate governance to provide responsible management oversight. Management is frequently able to control board selection to provide compliant members with compensation packages that are most often constructed or reviewed by friendly "independent" consultants under circumstances rife with conflicts of interest including selection of the consultant, approval of the consultant's compensation and continuing financial relationships by consultants with the corporation and members of management. In short, those interested in issues of corporate governance have long recognized a lack of effective oversight in the area of compensation.

In the most egregious cases managers have sometimes treated public corporations as their private "piggy banks" to the detriment of shareholders. Dennis Kozlowski of Tyco and the Rigas family of Adelphia illustrate that the law has always imposed limitations, including criminal penalties, on managers' ability to loot corporate assets. The recent problem has been that the limitations only kick in under the most egregious circumstances. Moreover, there has come to be a sense of managerial entitlement amounting to "it's alright to take as much as I can, for as long as I can, if I can."

With regard to individual corporate entities, we have to make clear that a position in management does not represent an entitlement to steal from the corporate owners, the shareholders. We must assure adequate incentive for creative management while at the same time tying that incentive to actual production of long-term value for shareholders, rather than manipulation to achieve short-term financial results.

State laws governing the formation and management of corporations should be applied and interpreted in such a manner to facilitate sound corporate growth. This is good for business and investors. As we have seen time and time again in the corporate world, decisions made to reap short-term returns often result in long-term disasters. I would submit that effective enforcement of state laws designed to facilitate sound management decisions and long-term growth are good for business and for investors.

We applaud the SEC's recent efforts to allow for greater shareholder access to information, particularly amendments to proxy disclosure rules that require disclosure of risks arising from compensation policies and practices. However, such disclosure is required only if the risks arising from the practices are reasonably likely to have a material adverse effect on the registrant. We believe that all shareholders deserve this disclosure, regardless of the perceived "risk" arising from these practices.

Likewise, we endorse the SEC's recent approval of the New York Stock Exchange's rule to eliminate broker discretionary voting in director elections.

I would be remiss were I to overlook the efforts of states securities regulators, through NASAA, which on October 3, 2007 adopted a resolution on disclosure concerning executive compensation and underlying conflicts of interest in the process by which it is recommended or approved. This resolution is attached as Exhibit A.

The person in the street sees salaries of corporate decision makers constantly increasing to a level viewed as obscene, while at the same time the corporations being managed are decreasing in value, losing money, failing in competition and eliminating productive jobs. It is not an easy piece of the economic puzzle to understand or to apologize for.

Executive compensation should provide incentive for corporate success. That does not mean success defined by manipulation of accounting concepts to provide a short-term picture of success that lacks long-term substance.

Compensation standards should also recognize that the ultimate source of funds to pay managers is the owners of the corporation, the shareholders. A dollar paid to the manager is a dollar decrease in the value of corporate assets and the balance sheet should reflect a dollar or more of corporate value added in return for the payment.

The standards have evolved through decisions rendered in cases where management simply went too far in treating the assets of shareholders, particularly public shareholders, as their own piggy banks. These had little effect on the day to day practices of corporate management which diverted substantial assets from investors to themselves by means of compensation packages that included stock options that would significantly dilute shareholder ownership. In the guise of objective evaluation of executive compensation, instances where the corporation engaged captive consultants to rubber stamp management objectives have been all too frequent. Moreover, boards of directors, including independent directors, were chosen not to be truly independent, but to place their imprimatur on executive compensation packages.

Although individual small shareholders have little power to influence executive compensation, except by selling their shares, institutional investors acting in concert, have the potential to provide a significant counterbalance to the compensation demands of management. Clearly, in order to affect such a counterbalance, shareholders must and should have access to full and accurate information concerning management compensation. Sunlight is one of the most effective forms of disinfectant, but disclosure cannot be the sole remedy. An effective counterweight must incorporate legal mechanisms by which these issues can be raised and decided by shareholders having a real interest in the outcome.

This solution requires that those shareholders who are possessed of the means of providing independent analysis actually do so and aggressively articulate their concerns, rather than simply stick their heads in the sand and ignore compensation abuses when they occur.

As I stated initially, the abuse of corporate compensation programs is only one of the many courses of conduct which are perceived to be outrageous by individual investors who are participating either directly or indirectly in the securities market.

All three of the bills which are the subject matter of this hearing attempt to address these issues.

Financial regulatory reform should also embrace extension of the concept of fiduciary duty to all financial professionals who provide advice to investors. Moreover, it must prevent abuse of the process by which capital is raised by those more interested in soliciting funds than promoting legitimate enterprises; establishing disqualifications for repeat offenders of this process is a logical and effective deterrent to such abuse.

In closing, the unique experiences of state securities regulators on the front lines of investor protection have provided the framework for my testimony. NASAA and its members are committed to continuing to work with the Committee as the nation's financial services regulatory regime undergoes the important changes that are necessary to enhance Main Street investor protection, which state securities regulators have provided for nearly 100 years.

Exhibit A

SBS-POLICY, NASAA-REPORTS ¶7056 NASAA RESOLUTION ON EXECUTIVE COMPENSATION Adopted October 3, 2007

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WHEREAS the North American Securities Administrators Association ("NASAA") is the oldest international member organization devoted to investor protection. Its membership consists of the securities administrators of the 50 US States, the provinces and territories of Canada, Mexico, Puerto Rico, the District of Columbia, and the US Virgin Islands;

WHEREAS the role of state securities regulators continues to grow in importance as increasing numbers of Americans rely on the securities markets to prepare for their financial futures, including planning for retirement and paying for college educations;

WHEREAS each state securities administrator shares the common goal of protecting citizens from investment fraud and abuse;

WHEREAS the disclosures of material facts and circumstances as a condition to registering securities helps protect investors from fraud and abuse by providing them more information upon which to make their investing decisions;

WHEREAS certain facts surrounding executive compensation and the use of compensation consultants can be material;

BE IT RESOLVED that NASAA encourages the disclosure of executive compensation such as the following in a public offering:

A. The issuer's current executive compensation plan, including the amount and kind of compensation paid to each executive;

B. The process by which executive compensation is set, including who determines the amount and type of compensation, whether a compensation consultant is used, and when and how the amount of compensation can be changed;

C. Any potential conflicts of interest between who sets, approves, or advises on the amount of executive compensation, and who receives the compensation; and

D. Bylaw provisions governing the shareholders' ability to review and approve or reject changes in the issuer's executive compensation plan, including increases in the amount of executive compensation.

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