United States House of Representatives

Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises

[B-304] Rayburn Office Building, Washington, D.C.

April 21, 2010

STATEMENT OF JAMES ALLEN, CFA

HEAD OF CAPITAL MARKETS POLICY AT CFA INSTITUTE

Introduction

Good [morning]. I want to thank Chairman Kanjorski, Ranking Member Garrett, and all the members of the subcommittee for inviting me to come speak to you on behalf of CFA Institute. I am Jim Allen, Head of Capital Markets Policy at CFA Institute and I would like to use this opportunity to address some of the important provisions in the three bills the Subcommittee is considering.

Background on CFA Institute

For those of you not familiar with CFA Institute, we are a non-profit membership organization of more than 97,000 investment analysts, advisers, portfolio managers and other investment professionals. Our mission is to lead the investment profession globally by setting the highest standards of ethics, education, and professional excellence. CFA Institute is most widely recognized as the organization that administers the Chartered Financial Analyst examination program and awards the CFA designation, a designation held by more than 88,000 investment professionals in 137 countries. Since 2006, this program has included corporate governance studies as an integral part of the core curriculum that reaches more than 60,000 first-year exam takers every year.

With offices in Charlottesville, New York, London, Brussels, and Hong Kong, the Capital Markets Division of CFA Institute represents the views of investment professionals worldwide on issues affecting the practice of financial analysis and investment management, especially on issues that affect the efficiency and integrity of the global capital markets.

In keeping with our belief that what is good for the investor is good for financial markets in general, CFA Institute has long supported strong corporate governance measures that give shareowners an effective voice without unreasonably interfering with the corporate board room. This often requires a finely-tuned balance of interests and reasonable restraints on both investors and corporate issuers.

As an organization of professional investors who rely upon governance checks and balances to prevent and manage various conflicts of interest within companies, CFA Institute has conducted extensive research and produced many publications and position papers on a broad range of corporate governance issues. These include investor manuals on corporate governance[i], executive compensation[ii], environmental, social and governance factors[iii], and global shareowner rights[iv].

In the interest of time, I’d like to provide our views and recommendations on a number of issues raised in the bills, in hopes that these will help inform this Subcommittee’s actions about professional investors’ views on the scope of corporate governance measures included in these bills.

Role of Governance Failures

In general, we believe that corporate governance failures on the part of financial institutions played an important, though by no means exclusive, role in the market crisis that began in August 2007. In particular, neither the banks that developed large concentrations of high-risk loans funded through highly leveraged structures and unreliable wholesale funds, nor the boards that were overseeing managers who adopted these policies, fully appreciated the potential downsides that would come from these structures. At the same time, these banks were operating under regulatory supervision that both permitted and in some cases encouraged such strategies, creating a recipe for disaster.

With regard to the potential corporate governance remedies for these situations, the bills under consideration today cover a number of corporate governance issues, most of which we and our membership have long supported.

Executive Compensation

We strongly support the provision in all three bills being considered that would give shareowners a non-binding (or advisory) vote on executive compensation. These so-called "say-on-pay" provisions give shareowners the ability to voice their views about the compensation being awarded to senior executives. It also can serve to open a meaningful dialogue between shareowners and management. We hear from our members in Australia and the United Kingdom that these votes have focused board attention on securing investor approval prior to their votes. Consequently, boards have engaged major shareowners on the best manner in which to structure executive pay, which, in turn, has helped to reduce the rate of increase in senior management pay.[v]

Likewise, we support greater transparency about both the metrics used to determine executive compensation and the actual pay awarded during a given fiscal year. In recent years, we have submitted letters to the U.S. Securities and Exchange Commission on this very issue, arguing for greater disclosure of the performance targets that each company uses to gauge eligibility for variable compensation. Unfortunately, we have found companies less than forthright in their compensation disclosures, employing legal boilerplate language that may satisfy the letter of the law but falls short of the intent to offer meaningful insight into management incentives. To help improve this situation, we are developing a CD&A template that we hope to offer to the SEC as a way toward better compensation discussions and analyses.

With regard to special compensation arrangements for senior management related to removal without cause, including as a result of mergers or acquisitions, these matters are currently disclosed in proxy statements. We support prominent disclosure of such arrangements to inform shareowners generally as to the Board's performance in fulfilling their stewardship responsibilities. We also support prominent disclosure of any special arrangements related to mergers or acquisitions that have not been previously negotiated so that shareowners may be fully informed about all relevant terms of any proposed transactions. This, we believe, will allow shareowners to make more informed votes on board nominees. However, because these arrangements are typically negotiated as part of employment contracts with management, it would be potentially cumbersome to require shareowner approval prospectively. So we would not support such a provision included into any final law.

Likewise, while we also support companies adopting and implementing "clawback" provisions that enable them to recoup compensation based on restated or fraudulent financial reporting, we believe such decisions are best left to a company's shareowners rather than be part of a legislative, one-size-fits-all mandate.

Majority Voting and Proxy Access

The **Shareholder Empowerment Act of 2009** includes a number of measures which CFA Institute has long advocated and which we are eager to support. In particular, we believe that in uncontested elections, directors of listed companies should be elected by a majority, not a plurality (as currently required), of shareowner votes. We believe that this will not only strengthen board accountability to shareowners, but we also believe it will provide investors with a meaningful way to choose their representatives and thus give them a true voice in director elections.

A second measure that we have felt strongly about and supported since the SEC first offered its proposal in 2003 is the right for shareowners to have access to companies' proxy statements for the purpose of nominating candidates for director positions. Implementation of such a measure alone would confirm that shareowners have a meaningful voice (other than "voting with their feet") as to the companies in which they own interests. We also believe it would send a strong message to company boards that shareowners will have the tools to hold them more accountable in the future. Furthermore, including such provisions into legislation would avoid much of the expensive litigation that has helped prevent SEC action on this issue in the past.

Chair Independence

We recognize that there has long been a call in some quarters for a requirement that the chairman of the board be independent from management—a proposal that appears in both the **Corporate Governance Reform Act of 2009 and the Shareholder Empowerment Act of 2009.** In our Corporate Governance Manual, we encourage investors to determine the independence of the chair as an important factor in determining whether to invest in a company.

Nevertheless, we do not believe this requirement is necessary, and may instead lead to situations where form is valued over substance—where the knowledge and expertise of corporate "insiders" is traded for the functional "independent" figurehead. Instead, we believe it is up to the board of directors and shareowners to decide who should chair the board. In those cases where the board chooses the CEO as chair of the board, we take the position that the independent members of the board should appoint a "lead director" who takes on the responsibility for chairing separate meetings of independent directors and addresses issues that may involve conflicts with management. We also believe that the Board should make full disclosure to shareholders as to why the CEO was selected as Chair rather than appointing an independent director.

We believe this approach strikes an appropriate balance for ensuring the continued independence of the board deliberation and decision-making processes.

SEC Vetting of Board Members

Finally, we are not comfortable with the proposals that would have the SEC certify that every member of the board for each of the thousands of companies trading publicly in the United States has the requisite expertise and experience. Our concern is that such activities will divert valuable SEC resources and attention away from the Commission's existing mandates.

Moreover, we are not convinced that the SEC possesses the expertise to determine what each individual company needs in terms of board member qualifications. We are further concerned that such a provision would lead companies and boards to nominate only those individuals who have already received approval by the Commission—typically incumbent directors—or those with specific types of expertise that have garnered SEC approval in other situations. Such a situation would limit the broadening of the pool of board members available to company boards, concentrate board room power among an elite, politically connected group of individuals, and lead to a herd mentality in the board room. We do not believe this is what American companies need right now.

Instead of an SEC vetting process, we encourage more thorough disclosure of board member expertise, especially at the committee level, so that shareowners can decide for themselves whether board members possess adequate expertise. To that end, we encourage a thorough description of board member expertise, such as required for audit committee members, so that shareowners can better understand whether nominees are qualified to discharge their duties in this increasingly complex boardroom environment.

Conclusion

Over time, researchers have found that companies with strong corporate governance structures have regularly and significantly outperformed those with weak governance systems.[vi] As fiduciaries acting on behalf of the owners of these companies, therefore, our members are particularly sensitive to the need for strong corporate governance structures. This is why we have made corporate governance a focus of our organization and for our curriculum.

Thank you for your time, and I am willing to answer any questions that you may have.

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[i] http://www.cfapubs.org/doi/abs/10.2469/ccb.v2009.n12.1
[ii] http://www.cfapubs.org/doi/abs/10.2469/ccb.v2007.n8.4932
[iii] http://www.cfapubs.org/toc/ccb/2008/2008/2
[iv] http://www.cfapubs.org/doi/abs/10.2469/ccb.v2009.n2.1
[v] New Bridge Street Consultants. 2005. "Technical Update: New ABI Guidelines" (December). New Bridge found that growth in executive compensation in the United Kingdom declined to around 8 percent after growing at twice that rate prior to the introduction of the nonbinding vote.

[vi] Paul A. Gompers, Joy L. Ishii, and Andrew Metrick, "Corporate Governance and Equity Prices," *Quarterly Journal of Economics* (revised January 2009). The authors compared the investment performance of some 1,500 U.S.-listed companies with a corporate governance index that the authors constructed from 24 distinct governance rules. The authors found that portfolios of companies with strong shareowner-rights protections outperformed portfolios of companies with weaker protections by 8.5 percent per year. Also see Lucian Bebchuk, Alma Cohen, and Allen Ferrell, "What Matters in Corporate Governance," *Review of Financial Studies* (February 2009).

Addendum A to the Statement of James C. Allen, CFA, before the Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises on April 21, 2010.

We would like to supplement the written testimony of James C. Allen, CFA, with the following results of a survey of CFA Institute members conducted between 29 October 2009 and 11 November 2009:

Should shareowners have "say on pay" -- a proxy vote on executive pay packages?		
		Responses
Yes	81%	1886
No	15%	352
Don't know	3%	61
Don't care	1%	19
Total Respondents: 2315 Did Not Answer: 2		

Addendum B to the Statement of James C. Allen, CFA, before the Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises on April 21, 2010.

We would like to supplement the written testimony of James C. Allen, CFA, to consider the issue of mandating a risk committee for all publicly traded companies in the United States, as proposed in HR 3272.

Specifically, these provisions would require each company to have a chief risk officer to establish, evaluate, and enforce risk management, to report directly to the risk management committee, and, by implication, to establish a risk management committee. It also would require that each member of the risk management committee be independent, and that the risk management committee review periodically the issuer's risk management policies.

While we see a risk management as an important safeguard for many companies, particularly diversified financial institutions involved with a wide variety of complex derivative instruments, we do not support a blanket requirement for all listed companies to have such committees. Such a requirement might prove unnecessary for some firms, depending on the nature of their business models, customers, financing sources, size, and other factors.