Yale SCHOOL OF MANAGEMENT
Millstein Center for Corporate Governance and Performance

POLICY BRIEFING NO. 5

Pay, Risk and Stewardship

Private Sector Architecture for Future Capital Markets

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ABOUT THE MILLSTEIN CENTER FOR CORPORATE GOVERNANCE AND PERFORMANCE

The Millstein Center for Corporate Governance and Performance (the “Center”) , as a central element of its core mission, s serves as a vital contributor to the growing architecture of international corporate governance. The Center sponsors research, hosts conferences, generates global databases, designs training and publishes policy briefings on emerging corporate governance policy issues. Pay, Risk and Stewardship is the fifth installment in an on-going series of Policy Briefings designed to assist policymaking.

Center Policy Briefings are framed as think tank reports. They include original material and policy analysis in a concise format. Reports serve both as pointers to further detailed empirical research and as a resource for market practitioners.

This report reflects the findings of three concurrent working groups of practitioners and scholars which were convened in New York City on February 13, 2009 as part of its overall project on Private Sector Architecture for Future Financial Markets. The Center focused the sessions on three key issues raised as factors of the financial crisis. Previous policy briefings and roundtables have addressed board leadership, ‘say on pay,’ board-shareowner communication, voting integrity, ratings agencies and implications of changing equity ownership. They may be found on the Research page of the Center’s website.

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1. INTRODUCTION

The recent financial crisis revealed a massive failure of institutions that populate the world's capital markets. Banks, investors, ratings agencies, regulators and numerous other players demonstrated that confidence in market responses was misplaced. The loss of faith in capital market institutions has represented a significant hurdle to recovery as financial institutions continue to be wary of one another, and the public is wary of all of them.

Restoring trust in the system requires two distinct pillars of reform. The first pillar, reform of the financial regulatory system, both nationally and globally, has received most of the attention so far. Many organizations, such as the G20, the OECD, the US Treasury, professional bodies, universities and free-standing think-tanks, are assessing proposed reforms of laws and regulations, new roles of regulatory agencies, changes in the supervisory process, and the potential need for a unified and overarching international regulatory system.

The second pillar, reform initiatives and actions by the private sector for the private sector, has been largely ignored to date, as faith in these institutions has been shaken. However, trust in capital markets cannot be restored without the action of private sector institutions. The crisis exposed multiple flaws in the existing system, from the apparent inability of boards of directors to manage risk, to the poor stewardship of institutional investors, to compensation and incentive systems that many suggest may have exacerbated risk. Each of these flaws must be taken seriously and addressed thoughtfully.

This policy briefing, as part of the Millstein Center's project on Private Sector Architecture for Future Capital Markets, differs from other efforts at reform in several ways beyond its focus on private sector initiatives. First, the Millstein Center and the CFA Institute Centre for Financial Market Integrity have no stake in the outcome, rendering their analyses impartial and focused on understanding how and why governance systems fell short. Second, the Center has an international reach, enabling it to compare and assess solutions across borders rather than becoming wed to models appropriate in a single market. Third, the project itself brought together experts from a wide variety of fields to inform analysis and reform proposals. The goal was to generate useful and practical recommendations, with the potential to gain real-world traction in efforts to safeguard against such crises in the future.

This project was built upon the Millstein Center's existing Capital Markets program. Since 2007, the Center has been exploring the link between corporate governance challenges and developments in the capital market. This long-term program has included a series of global roundtables, academic conferences, infrastructure-building projects and sponsored research. The roundtables, held in New York, London, Berlin, São Paolo, Dubai, and Paris (a high-level OECD session), revealed five overarching challenges to capital markets development: the emergence of new investors, the introduction of new investor demands, the use of new financial instruments, the assumption of new roles for familiar institutions, and the subsequent increase in uncertainty amongst managers and directors. Each of these challenges contributed to the current implosion and the loss of trust in the market.

On Feb. 13 2009, this project convened concurrent high-level working groups that discussed three critical areas that have been widely identified as necessary areas for reform: *Risk Management and Oversight; Pay for Performance;* and *Shareowner Stewardship.* The respective working group members included private sector representatives, from corporate directors to commercial intermediaries to institutional investors, as well as academics, policymakers and other experts. Appendix A contains a list of participants of each working group.

The three groups addressed key concerns within these broad areas and produced concrete, practical recommendations. The meetings were conducted in accordance with Chatham House Rules, meaning that all quotes in this report are anonymous excerpts of contributions made by participants in attendance. Unless otherwise noted, the conclusions of this policy briefing represent widely held views among roundtables participants, not the existence of a consensus. Some individual participants have expressed views contrary to those described in this report.

On February 13, 2009, the Millstein Center convened high-level working groups as part of its Private Sector Architecture for Future Capital Markets project. This event brought together experts from different fields with the aim of generating useful and practical recommendations for private sector self-improvement in order to restore trust following the financial crisis. Participants were divided into three different working groups, each focusing on key subjects that the Millstein Center identified as necessary areas of reform: *Risk Management and Oversight; Pay for Performance;* and *Shareowner Stewardship.* The respective working group members included private sector representatives, academics, policymakers and other experts.

a Risk Management and Oversight

A significant underlying cause of the current financial crisis is a massive failure of risk management and oversight. Regulators failed to detect the risks, as did the financial firms' boards and internal control systems, not least due to significant incentives for attaining ever-growing returns in the short term. The recent risk-taking spree was not limited to financial institutions, but was instead embedded widely in corporate and social culture. The Risk Management working group opted not to point fingers, but rather to make constructive suggestions for future improvement of risk management systems and oversight practices.

Among the issues discussed by the working group were the definition of "risk" for risk management and oversight purposes; the appropriate division of responsibilities among boards, management and risk officers; the use of risk models; the role of risk managers and the Chief Risk Officer; and the board of directors' oversight function. Participants concluded that, while this crisis originated in the financial industry, it offers a cautionary tale and important lessons for companies in all sectors of the economy about the perils of focusing exclusively on upside potential without due regard for the risks involved. The group developed a menu of findings and recommendations which may be found in Part 6(a) of this policy briefing.

b Pay for Performance

Risk management deficiencies alone do not explain the reckless behavior of financial institutions that ultimately led to debacles of the past year. There is increasing consensus that the existing compensation structures encouraged, often even inadvertently, a substantial amount of risk taking behavior for short-term corporate profit. Consequently, superior risk management and oversight inevitably requires a reevaluation of executive compensation practices.

The Pay for Performance working group addressed the objectives of executive compensation; the relevance of pay equity considerations; the incentive structure of compensation packages; the role of compensation consultants; and the importance of board accountability to shareowners for executive pay decisions. Participants advanced concrete proposals to render executive remuneration practices consistent with the goal of long-term value creation. For a list of findings and recommendations, see Part 6(b).

c Shareowner Stewardship

The exercise of identifying failures leading to the financial crisis in management and board practices alone is fundamentally incomplete. Shareowners must also look at themselves and assess the extent to which they fell short in fulfilling their responsibilities as owners of the enterprise and allowed, or even encouraged, companies to take massive amounts of risk ultimately leading to collapse. While the two other sessions looked at how a lack of adequate risk management mechanisms and poorly designed compensation practices contributed to a financial meltdown, the Shareowner Stewardship working group addressed the role and responsibilities of shareowners as the constituency that ultimately elects and holds boards accountable.

The working group focused on the various structural impediments that have prevented effective shareowner stewardship. Discussions covered the influence of the internal governance of institutional investors on their ability to act as responsible owners; the deficiencies in composition and operation of fund oversight boards; the role of short-termism in thwarting shareholder monitoring and engagement efforts; the importance of transparency and accountability to the ultimate fund beneficiaries; and the need to overcome collective action hurdles to shareowner stewardship. For a list of findings and recommendations, see Part 6(c).

A significant underlying cause of the current financial crisis is massive risk management failure. Regulators failed to detect the looming risks, and so did the financial firms' internal control systems, not least due to significant incentives for attaining ever-growing returns in the short term. The working group discussions recognized that the hunt for culprits by itself is both futile and distracting. The recent risk-taking spree was not limited to financial institutions, but was instead embedded in corporate and social culture in a time of irrational euphoria. Rather than engaging in rhetorical finger pointing, the working group opted to elaborate upon constructive suggestions for future improvement of risk management systems.

There was ample consensus that, while this crisis originated in the financial industry, it offers a cautionary tale and important lessons for companies in all sectors of the economy about the perils of focusing exclusively on upside potential without due regard to the corresponding risks. While reforms to strengthen regulatory oversight of the financial sector are under way, participants agreed that there is considerable room for private sector self-improvement. The groups' discussions and recommendations then revolved around how to improve the contribution of the companies' risk units, boards and senior management to a superior risk management and oversight regime.

What is Risk?

Before turning to the nuts and bolts of risk management practices, the working group addressed basic definitional questions: What is "risk" and what kinds of risk are important to risk management? Working group members agreed that an effective risk management system cannot allow risk to lie in the eyes of the beholder. The design of effective mechanisms first requires a common understanding of the elusive concept of risk.

Participants noted that, in its simplest definition, risk means the degree of uncertainty between expected and actual outcomes. As such, risk can be defined as "the potential for harm or loss, or sub-optimization of the upside," the "potential for disappointed expectations between expected and actual outcomes," or, put more bluntly, the "potential for failure." In this sense, risk constitutes an important part of virtually all business activity. As one participant stated, "if we lived in a deterministic world, there wouldn't be anything that we, as business people, would ever identify as value-creating." Risk, therefore, is part and parcel of business life. In fact, risk is in many ways the very "flip side" of corporate strategy.

If risk is inherent to business decision-making, it becomes crucial to differentiate "risk management" from general business management. In the words of one participant, "for Nabisco's risk manager, 'risk' should not be the potential that the company does not sell enough crackers." Marginal operational risks, such as "a revenue fall from $525 to $520 million," should be the province of business operations personnel, not the risk management unit.

The distinguishing feature between risk management and general business management concerns not the sources, but rather the magnitude and likelihood of the potential loss. Participants agreed that risk managers should be generally concerned with "catastrophic" or "extraordinary" events or, at the very least, occurrences which can be "important" or "significant" to the business in the aggregate. While the business manager is responsible for everyday risks, the risk manager anticipates and addresses more cataclysmic occurrences. However, the group emphasized that "small and apparently unrelated cluster failures can, in a complex system, produce catastrophic consequences," and it is up to the risk management unit to take a holistic approach to risk.

Because risk is an inherent part of business, "perfect prevention is not possible." As one participant noted, "risk is the potential for failure, and everything you do in order to be successful involves some potential for failing." In other words, unlike corporate fraud or corruption, the optimal level of risk is not zero. Consequently, companies need effective risk management, not risk eradication, systems.

Division of Responsibilities

Effective risk management requires the participation, horizontally and vertically, of various corporate divisions and members of management. An isolated group operating in a silo cannot adequately handle all risk issues. Working group members noted that the participation of top management and directors in key risk assessment and management decisions is paramount, as it "produces an elevation of the risk role which does not exist in most companies today."

Participants agreed that, "in the first instance, it is management's responsibility to determine what in that particular business is operational risk." That is, it is management's role to perform the in-depth work in order to better understand and identify the major risks that have an impact on the business. On the other hand, directors' contribution is also critical, as the board is uniquely positioned to provide management with a high-level and long-term perspective with respect to risk.

A useful way to conceptualize the inter-relationship between the board and senior executives in risk management is in terms of delegation of authority. Boards may, for instance, define parameters – the order and magnitude of risks – that management should bring to the boardroom. Risk considerations must become part of the ongoing flow of information that drives the iterative dialogue between management and the board on risk issues.

Participants noted that, in many conglomerates, there are separate and distinct silos and individual profit centers that are not engaged with the rest of the organization. Consequently, a greater potential for inaccuracies in risk reporting emerges. The current meltdown reflects not only a risk management failure, but also a risk reporting deficiency in financial institutions, which should prompt firms in all industries to reassess their reporting practices. Companies should shy away from boilerplate language, and instead view risk reporting as an opportunity to reassess and verbalize risk expectations in the entire organization, not just in different silos. Boards should take a proactive approach to risk reporting.

Participants also stressed the importance of differentiating risk and compliance functions. Acronyms such as GRC (governance, risk and compliance) often lead to an erroneous conflation of risk and compliance obligations which, while complementary, are not synonymous. Indeed, an effective risk assessment and management culture differs from a compliance mindset. As a result, working group members recommended that the risk unit be conversant with, but not subordinated to, the general counsel's office.

Risk Models

Risk models have attracted a substantial amount of public scrutiny following the implosion of the financial crisis. Critics argue that these models failed to warn management and boards about the imminent meltdown. However, working group members remarked that risk modeling is not going away, and rightly so.

There was significant consensus among the participants that the critical issue in the collapse of financial institutions was not the structure of existing risk models, but rather the excessive and undue reliance placed upon them. As one participant expressed it, the problem emerges "when we ask more of models than what they can deliver." Business managers were using risk models as a crutch to dismiss improbable risks without further reflection. Managers at the time were saying "we've got our VAR [Value at Risk] system in place and business is good, so let's just march on and do it." Working group participants agreed that "managers need to be aware of what models are supposed to do, and not kid themselves into thinking that they are a panacea."

The group overwhelmingly agreed that models are tools, not crutches, and should therefore not be used as such. Tools, however, cannot serve as freestanding solutions to risk management issues. There is no technical way to rewrite the VAR or any other model to deal with the risk oversight responsibility of the board, for instance. The recipe for a superior risk management regime has to be deeper and more sensible judgment, not a more advanced risk model.

Hence, "models are necessary but not sufficient," as "they are not substitutes for board and management judgment." The question then becomes, "how do you make the tool better to enable it to help you in your judgment?" The key to a wiser use of models lies in a greater understanding, and questioning, of its inputs and assumptions. Moreover, it is important to distinguish risk measurement from risk management. Models can be useful to measure risk, but not to manage it. As summarized by a participant, prior to the financial meltdown "many employees in financial institutions measured risk, but very few managed it."

Role of Risk Officers

The primary role of risk officers is to deal with the black hole of low-probability events. Effective risk management, however, requires a delicate balancing exercise. A risk officer who views her role as always saying "no" is not doing her job. The objective is to make sure that the risks the company takes are not beyond what the board has established as the company's level of risk tolerance, and that the chief risk officer is properly compensated to minimize risk or promote shareholder and long-term value.

As an important element of its oversight function, the board of directors should have a say as to the compensation of the chief risk officer. The board should be especially mindful about the incentive structure embedded in the chief risk officer's compensation package. It is appropriate for the pay package of the chief risk officer to be less sensitive to profitability than that of other officers. Moreover, it is also a best practice to have board involvement in the hiring of the chief risk officer. Some boards have considered hiring a chief risk officer who does not have a desire to move up though the organization, so as to ensure that he or she is not too sensitive to the wishes of those individuals who could influence his or her future.

The group then turned to the adequate structure of the risk management unit. A consensus emerged around the need for independence of risk officers vis-à-vis other operational divisions. As one participant observed, "the risk management group cannot be tied into the business lines, because there is a conflict. The chief risk officer cannot report to the business heads." Participants also agreed that it could be particularly dangerous to have the chief risk officer report to the chief financial officer due to the potential for conflicts of interest.

Participants agreed that, in addition to independence, it is vital that the risk management unit has both clout and access to adequate resources. As noted by one participant, "risk managers, like it or not, are a cost center, not a profit center. So they start off, right off the bat, behind the eight ball in any organization." Separately reporting to the board of directors is especially valuable in ensuring that the chief risk officer has sufficient authority, as well as independence.

On Whose Behalf is Risk Overseen?

The group agreed that shareowners are the primary beneficiaries of risk management practices, and that increased shareowner attention to risk assessment considerations could be beneficial. Working group members concurred that institutional shareholders should be encouraged to bring early warning risks or concerns to the chief risk officer. One participant went so far as to recommend that large shareholders periodically meet not only with the board of directors, but also with the company's chief risk officer.

However, participants also acknowledged that, at times, shareowner primacy might provide insufficient guidance to the role of risk managers. There was particular concern about the interests of shareholders that have a short-term investment horizon. As one participant put it, "the shareholder activist tool kit until this year was shrink the balance sheet and leverage the company" without due regard for the risks involved. This was a recipe for failure. In the case of institutions whose demise could have a major impact on the entire market's stability, public interest considerations should also play a role in risk management decisions. Shareowners, and the boards they elect, must take into account the potential for causing systemic risk while assessing individual company risk.

The Board's Role in Oversight

The working group then turned to elaborate realistic recommendations on board oversight of risk management practices. Participants agreed that boards must create their own risk-aware culture where risk is a "continuum in the thought process." Importantly, there was ample consensus that one of the board's fundamental roles with respect to risk management is to "set the risk appetite for the company." While management and risk managers are responsible for assessing the various risks involved in the company's operations, it is ultimately the board's responsibility to determine the magnitude and nature of risks to which the company is willing to expose itself to pursue a given strategy. And, obviously, the board has its traditional role of overseeing management; in this case, management's creation and execution of the risk management process.

Participants also criticized an excessive focus on director independence, which at times understates the value of director expertise and may hamper the board's risk oversight function. As one participant described it, independence can have two sides from a risk management perspective. While distance and impartiality strengthen independent directors' oversight capacity, a lack of industry expertise may impair it. It is therefore important to have at least some directors on the board that have greater insight about the fundamentals of the business.

There was no off-the-rack prescription about the advisability of board risk committees. Risk committees may be helpful in highlighting the importance of risk considerations and in insisting on management's attention to risk. However, though they may be especially useful in certain sectors, such as the financial industry, risk committees should not be required in all cases. Regardless of whether or not a company has a risk committee, the entire board needs to be aware of, and have a say on, major risk decisions.

The group also warned against the danger that, in the aftermath of the financial crisis, boards may begin to overemphasize risk management to the detriment of other key strategic issues. As expressed by one participant, "to the extent that 50% of the board meeting is focused on risk, boards are going to miss a lot of other factors." As is the case with other fundamental business issues, risk oversight requires balance in the proper allocation of board time and resources.

Risk management deficiencies alone do not explain the reckless behavior of financial institutions that ultimately led to debacles of the past year. To the contrary, there is increasing consensus that the existing compensation structures encouraged, often even inadvertently, a substantial amount of risk-taking behavior for short-term corporate profit. Consequently, superior risk management inevitably requires a reevaluation of executive compensation practices.

The Pay for Performance working group addressed four dimensions of executive compensation: (i) the objectives of executive remuneration; (ii) the relevance of internal pay equity; (iii) the structure of compensation packages; and (iv) how and by whom executive pay levels and structure should be set. Participants advanced concrete recommendations to render executive compensation practices consistent with the goal of long-term value creation.

Objectives and Metrics of Executive Compensation

Before delving into the practicalities of pay practices, the working group discussed the ultimate objectives of executive compensation, as the answer to the fundamental question of "what are companies paying executives for?" Executive pay has historically moved away from a model which only serves recruitment and retention purposes to one which views compensation packages as a governance tool to align incentives and improve performance. Yet the "pay-for-performance" debate masks an implicit assumption about the definition of superior performance.

There was general agreement that the ultimate criterion corporations have used to define and measure performance, namely "short-term stock price movement," is blatantly insufficient. Many working group participants criticized the predilection for financial achievements, most narrowly read as returns on equity or earnings per share at any given moment, as the relevant metric for performance-based awards. Other participants went one step further and advocated that compensation arrangements should take into account the intangibles that make for good management, but which are not reflected on the statistical side, such as corporate culture, product quality, and other qualitative factors that are hard to measure.

The rejection of short-term shareowner value as the relevant parameter for all compensation decisions led some participants to promote in its place a model that rewards consideration to the interests of multiple stakeholders. Participants argued that the inclusion of stakeholder perspectives would lead to a view of long-term value and sustainability that is now ignored due to the pervasive focus on stock price maximization. As one participant explained, "The board should first identify their stakeholders and prioritize them. Who are they? What do they want?" After all, "it is absurd to think that a company can operate in a vacuum." Other participants felt that the chronic diversity of shareowners' financial interests and viewpoints with respect to any given company also counts against a strong view of shareholder primacy. As one working group member stated, "part of the difficulty, really, with putting shareholders first is determining who the shareholders are and how their motivations differ."

Yet participants agreed that any sensible departure from the existing model of share price targets requires companies to reconcile the importance of addressing intangibles, on the one hand, with the need for management accountability, on the other. As imperfect as stock price movement may be as a measure of an executive's contribution to firm performance, the inclusion of excessively fluid factors in pay decisions could, without more, increase the potential for arbitrary compensation packages. As one working group member put it, "I do agree that the intangibles are important, but if we ever really tried to compensate executives based on intangibles alone, backdating on options would look like a minor scandal."

Most participants eventually agreed that a broader view of relevant performance metrics and targets is ultimately feasible so long as companies implement additional mechanisms to ensure board and management accountability for pay decisions. One participant cited the successful experience of certain European companies that remunerate executives "with a mixed set of performance indicators with financial, operational and environmental metrics." As summarized by another working group member, "there is no reason why boards can't do a better job of spelling out, materially, what intangibles mean, and why shareholders won't respect that. But intangibles cannot be used as an excuse to evade disclosure of the thinking that goes along with it."

Working group members underscored that successful "pay-for-performance" arrangements must ensure that performance payments indeed reflect the executives' performance. In the words of one participant, "we should not be compensating executives for general market movement, but for things that are actually within their control, both upside and downside." Moreover, directors should seek objective measures of performance, rather than blindly rely on targets produced by executives, leading to a scenario in which "management sets its own measures and then achieves them." In this sense, comparisons to a company's competitors can be useful in helping boards differentiate the extent to which the firm's performance is a result of the executives' work rather than chance alone.

As noted by one participant, "while Sarbanes-Oxley focused on the audit committee, it ought to have traced the roots at that point to the compensation committee, because that's where the problem started." There was ample recognition that ill-designed remuneration packages may induce executives to reach targets through inefficient or even artificial or illegal means. As described by one participant, from an executive's perspective "you told me to make the number, the incentive works and I've made that number," however at a "huge risk to the organization and its long-term value." The group stressed that "boards have to take into account pay decisions as an element of risk to the organization."

Pay Equity

Another dimension of executive compensation that has attracted significant public scrutiny is the issue of pay equity. Inspired by a major growth in the gap between the pay of the average worker and the typical chief executive of a U.S. public company, as well as the significant variance of CEO compensation domestically and internationally, pay disparity is now not only an object of political concern but also part of the corporate governance debate. The question then emerges of whether, to what extent, and under which justification boards of directors should take into account pay equity in making executive compensation decisions.

A majority of the group agreed that *internal* pay equity is a legitimate subject for corporate governance engagement at the board level. However, participants stressed that equity considerations within the corporation are not, and need not be, dissociated from "pay-for-performance" objectives. Instead, internal pay equity is an important factor in the design of an adequate incentive structure for the executive team and the employees as a whole.

Participants agreed that a large pay gap among members of the same team or corporate enterprise could have a detrimental effect on incentives and, therefore, performance. One participant stated that "in structuring a management team and motivating your senior executive group, there has to be some coherence in the compensation philosophy; otherwise, they are all in it for themselves." Another participant reinforced that "the greater the gap you create between the top person and the next individual, the more disincentive you build into that group."

There was also ample concern that the magnitude of the existing gap between CEO pay and that of other senior executives or employees did not necessarily translate into each individual's contribution to the company's performance. In fact, participants noted that the board's perception of the CEO's personal contribution to the success of the organization is often skewed. One participant observed that "the problem from the board point of view is that directors select a singular person to run the company and then deal with that person all the time, so the CEO gets conflated with the company and the value it is creating."

In sum, there was heavy agreement that internal pay equity should become an important item on the board's agenda. The relevant theme for board deliberation is equity *within* the corporation, and not vis-à-vis the average outside worker. Hence, the "the relevant element is internal equity, not per se, not in terms of fairness, but in terms of motivation, internal esprit de corps, in terms of the internal turn-off that comes from a huge spread."

The Structure of Compensation Packages

The next discussion item was whether today's typical compensation packages have served as an adequate tool to promote long-term value creation. There was broad consensus that, for a variety of reasons, existing pay structures were faulty and in fact produced improper incentives contributing to the ongoing financial crisis. The main rationale for criticism was that existing pay structures have unduly rewarded artificial short-term share price appreciation to the detriment of long-term sustainable performance.

A main target of disparagement was the excessive use of stock options leading to "cashless exercise," that is, the immediate conversion of stock options into cash. Because the cashless exercise of stock options does not involve continuous share investment in the company, it creates a fundamental misalignment of incentives with respect to long-term sustainability. In the words of one participant, "top people in the company should hold stock until they are off the board or retire; we want executives to really start thinking like owners, and not like hired guns."

The group suggested that a more effective mechanism to align management incentives with long-term value is the adoption of restricted stock in lieu of stock option grants. Unlike stock options subject to cashless exercise, which disproportionately reward the upside without sensitivity to the magnitude of losses, restricted stock subject to longer holding periods produces executive incentives which more closely mirror the effects on shareowner wealth, both upside and downside. Some participants suggested a requirement that management hold stock net of acquisition costs at least until they leave the company or retire. In addition, as one participant put it, "restricted stock grants don't suffer from the gaming issues that you get with options backdating. You can't backdate restricted stock, really."

The following discussions then highlighted how increasing stock ownership by management to encourage executives to "think like owners" is not a magic bullet for the executive compensation problem. One of the participants pointed out that "the problem with trying to make sure that executives think like owners is that there is ownership as stewardship, and ownership as entitlement. And we may have created ownership as entitlement as the problem." Other working group members pondered that, according to various studies, executives actually become risk averse when their proportion of stock holdings in the company increases beyond a certain level. The group thus acknowledged that, while a shift from stock options to restricted stock grants is beneficial, boards must carefully consider what compensation structure best fits the needs of a particular company.

Working group members acknowledged the lack of reliable data on "how a CEO's talent really relates to how a firm performs." This gives rise to the risk that, similar to what happened in the Gilded Age, "CEO pay becomes a status good which leads companies into a bidding war that doesn't really relate to economic fundamentals and the actual contribution of the CEO to the firm's performance." Participants agreed that, while executive compensation can be a powerful source of incentives, boards should be mindful that an infinite increase in pay will not lead to a similar increment in performance.

Participants also recommended the expansion of "clawbacks with teeth," allowing companies to recover payments triggered by results later revealed as artificial. One working group member went so far as to encourage firms to go after members of management to recover past bonuses based on the existing doctrine of fraudulent conveyance. Despite their useful function, however, participants noted that effective clawbacks should be seen as an element of, rather than a surrogate for, sensible compensation arrangements.

The group also focused on the US$500,000 pay cap for senior executives of financial institutions receiving governmental assistance. There was wide consensus that this limitation is not a sustainably viable solution to improve executive compensation practices, but rather a "symbolic" move to appease public opinion with respect to bank bailouts. There was broad agreement that "wage and price regulations" do not work, and that arbitrary pay caps for public company executives are an inefficient way to align management incentives with superior long-term performance. As expressed by one working group member, "you can set caps and over a period of time it becomes a minimum. All you have to do is go back to 162(m) of the Budget Reconciliation Act which set a million dollar cap for compensation as tax deduction in the company unless it was performance based." As put by another participant, pay caps are a very "uneconomic" way to reward executives from an incentives' perspective.

Even if part of the rationale for pay caps is the growing public concern with pay disparity and the ensuing growth in inequality, pay caps are still an imperfect solution. One participant argued that inequality concerns are best addressed by income tax policy at the individual, rather than the corporate, level. In addition, participants observed that, if the goal is to address distributional concerns within the corporation, the evaluation of internal pay equity issues at the board level is superior to an arbitrary ceiling. The debate around internal pay equity deals with "what is appropriate pay in a context, rather than a random cap which may have unintended consequences."

The main contribution of the existing pay caps is not as a viable technique to improve executive pay packages, but rather as food for thought about the recent corporate experience with executive compensation. As summarized by one participant, "the bigger-picture question has to be why are we in this situation in which we need to cap people's salaries?"

The Right Process for Executive Pay Decisions

After addressing the goals of executive compensation and the structure of remuneration packages, the working group turned to discuss how a company reaches a decision about its optimal pay arrangements. The group mainly focused on two hot-button issues from a procedural perspective: the role of compensation consultants in designing executive pay packages and the advisability of shareowner input on pay practices and corporate policy in general.

The group first discussed the widely-held perception that, together with the existing regulatory requirements on disclosure of peer group benchmarks, the increasing use of compensation consultants and their focus on competitive pay practices has contributed to ratchet up executive pay. Working group members acknowledged that, despite the extensive diffusion of best practices for the use of compensation consultants, reality often falls short. For instance, even though there is general agreement that "consultants should work for the compensation committee and not for the CEO," cases persist where "the consultant is ostensibly approved and hired by the compensation committee, but acts as though he is advisor to the CEO against the interests of shareholders."

Another area of disconnect between best practices and actual practice is that of compensation consultant independence. Most participants agreed that, similar to the treatment of auditors after Sarbanes-Oxley, compensation consultants advising the compensation committee should not provide services to management in other capacities. One participant stressed that "independent compensation consultants do not exist across the board." As another participant noted, "if you have the actuarial services being paid by the company, and you've got the compensation consultant going to the committee, there is a smell test there. It may be fine, but it's not going to smell right." One recommendation to cure these shortfalls is for "boards to have in place policies and procedures for selection, retention and evaluation of compensation consultants. Many companies still don't have them."

Compensation consultants should not however become scapegoats for any and all improprieties in compensation packages. As expressed by one participant, "it's very easy to point fingers at compensation consultants in general. There is variance in consultants as in everything else. But compensation consultants are tools for the board to use. It is a tool that directors can use poorly or well." Ultimate responsibility for compensation decisions must stay at the board level, as it is up to "the compensation committee and the board to get input from the various advisors and then make a decision that is in the best interests of the company and its shareholders." One participant suggested that, similar to the requirement for financial expertise for audit committee members, it may be sensible to have at least one person in the compensation committee that has a working knowledge of executive compensation practices.

In addition to compensation consultants, another major area of focus was what role, if any, shareowners should play in executive pay decisions. There was significant agreement that both director accountability and board-shareowner communication on executive compensation issues are crucial. As one participant stated, "both senior management and boards of directors need to be held accountable to shareholders for the decisions they make regarding compensation packages; they need to be able to sit down and explain what kinds of things they took into consideration when they were setting compensation at the compensation committee level and how they arrived at the decisions they did." Participants stressed that companies in the U.K. and across Europe have discussions with major shareholders on executive compensation issues on an ongoing basis.[1]

Most working group members agreed that some form of shareholder oversight of executive compensation decisions would have a beneficial effect on the quality of executive pay packages. One participant pointed to the prophylactic effect of such checks and balances, as "it is a very well-known tendency in human psychology that people behave differently when they know that others are watching." Moreover, while boards have to be close to senior executives in order to do give strategic advice and oversee them, this proximity may create problems of bias with respect to compensation decisions.

The group deemed superior disclosure and meaningful shareowner and stakeholder input as key elements of accountability for executive pay decisions. Adequate disclosure is a prerequisite for real accountability, and most participants agreed that there is room for regulatory improvements. Working group members stressed the value of more philosophical and qualitative discussions explaining the thinking behind executive compen-

1 The Millstein Center's Policy Briefing No. 2, Talking Governance, addressed this matter in detail. Available at http://millstein.som.yale.edu/projects.shtml.

sation packages in the Compensation Disclosure and Analysis (CD&A) section of proxy statements. Other participants noted that the regulatory requirements limiting disclosure to the ex ante value of compensation packages (grant value) obfuscates the discussion of executive pay levels, and recommended an additional disclosure requirement of the amounts which executives ultimately took home (that is, the realized value).

Nonetheless, the board retains powerful responsibilities, both because of its informational advantage and because shareholders' incentives and perspectives can, and often do, differ. As one participant noted, "one of the main concerns I hear from directors around involving investors in key corporate decisions is that shareholders don't see the full picture and, because directors are closer to management, they do, and therefore their judgment makes more sense. And there is a lot of validity to this point." As put by another participant, "not every shareholder is going to have the same perspective, same time horizon, same interest. Therefore, a board has to be able to weigh what is given by a short-term hedge fund versus a long-term index fund." There was also agreement that companies should reach out to constituencies beyond their shareowners for feedback on executive pay practices.

The working group agreed that "say on pay" (that is, a shareowner advisory vote on executive compensation) is but one form of board accountability to shareholders in the compensation arena. Participants asserted that legislative improvements of shareholder rights, though not necessarily through a direct say on executive compensation, are necessary. The ability of investors to fire directors through true majority voting, as well as shareowner access to the proxy, were raised as important mechanisms for increased accountability. [2]

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2 Millstein Center Policy Briefing No. 1, Does Say on Pay Work?, addressed this matter in detail. Available at http://millstein.som.yale.edu/projects.shtml.

The rationale behind this working group is that the exercise of identifying failures leading to the financial crisis in management and board practices alone is fundamentally incomplete. Shareowners must also look at themselves and assess the extent to which they failed to fulfill their responsibilities as owners of the enterprise, and allowed, or even encouraged, companies to take massive amounts of risk ultimately leading to collapse. While the two other sections of this Private Sector Architecture for Future Capital Markets look at how poorly designed executive compensation practices and a lack of adequate risk management mechanisms contributed to a financial meltdown, this working group aims to address the role of shareowners, since they are the constituency that ultimately elects and holds boards accountable.

Participants agreed that many investors indeed failed to fulfill their ownership duties. The discussion highlighted various structural impediments that currently exist to hinder a system of effective shareowner monitoring and responsibility. First, and foremost, the group noted that corporate governance and agency problems inside many institutional investors impede their mandate as faithful fiduciaries to the millions of households which channel their savings through pension and mutual funds. Second, the working group acknowledged that, even in a world of perfect corporate governance and no agency costs at the institutional investor level, the use of indexing strategies and the resulting ownership fragmentation leads to collective action and free-rider problems thwarting monitoring and engagement levels.

The group concluded that various legal and institutional reforms fostering superior fund governance and investor coordination are essential in the evolution toward active and responsible ownership. Many of these reforms can be taken up by the private sector itself, if only there is sufficient willingness and vision. Nevertheless, governmental action may also be required to override structural impediments that have prevented institutional investors from fulfilling their role as active and diligent owners.

The Role of Institutional Investor Governance

The working group began by discussing how various deficiencies in the internal corporate governance of institutional investors have created obstacles to the fulfillment of their ownership responsibilities. In the words of one participant, "are our institutions in this field truly organized and shaped legally from the governance perspective to do what they are supposed to do?" The consensus answer was a resounding "no," at least for many funds.

There was ample agreement among participants that institutional investor governance matters. Some contributors cited studies showing a strong correlation between fund governance and financial results. As one participant noted, "it is interesting that in this world where we have all kinds of theories about risk and risk adjustment, governance and agency issues in fact dominate in terms of whether you get good results or bad results." Working group members also stated that further studies demonstrating the relationship between fund governance and performance are key to push the political agenda toward reform.

Political interference in public pension fund governance was a target of criticism. As described by one contributor, "lots of boards run into problems where there are certain understandings and quid pro quos between these so-called investment professionals and the governor or other political figures who appoint them." Another problem is the existence of trustees who are political appointees, but lack the expertise and personal capabilities to be effective board members.

Participants agreed that, even in the absence of major structural changes, attention to skill levels among trustees of pension funds is crucial for improved governance. As summarized by one participant, "to enhance performance and make sure that a fund is engaged as an owner, it needs a trustee board that is not only skilled but also capable in other ways as a trustee body. They need to be at arm's length and also free of conflicts of interest." Another participant suggested that "there should be some open certification process where trustees would be trained in both financial skills, but, more importantly, board dynamics skills, so they can function transparently as a board."

The corporate governance of mutual funds also received sharp criticism. "From my point of view," a participant stated, "the governance of mutual funds is a joke. It serves no purpose at all." Although the legislation of mutual funds in the United States provides for oversight boards, "they do zilch," a contributor said. The working group agreed that improvements in mutual fund governance are warranted. Some participants cited the Conference of Fund Leader project of the Millstein Center for Corporate Governance and Performance, which brings together the independent chairs of mutual fund boards to discuss their roles and potentially mobilize them to act as owners, as an important initiative to strengthen the governance of mutual funds.

The working group also raised questions about conflicts of interests at associations of mutual funds. One participant claimed that "the Investment Company Institute [ICI] represents not the people whose assets are under management by mutual funds, but mutual funds as managers; and they work to help them get higher fees." Some participants contended that, on issues that are central to governance, the ICI has sided against investor opinion. The example cited was the New York Stock Exchange initiative to eliminate discretionary broker voting. The Institute came out in favor of keeping discretionary broker voting in respect to their own shareowner meetings, several delegates said, because of their conflicts of interest in having their contracts approved.

The group agreed that deficiencies in mutual fund governance and the prevalence of conflicts of interest are a major public policy issue with regard to oversight of portfolio companies. The group concluded that the for-profit defined-contribution business model produces multiple conflicts of interests that prevent serious engagement efforts in alignment with ultimate savers. Some participants went so far as to claim that "the only way that you change the game is by giving Canadian or American workers an alternative to putting their money through the for-profit sector." Participants urged policymakers to consider alternative vehicles for retirement savings in the form of fewer, more concentrated, non-profit fund pools as a substitute for the for-profit 401(k) defined-contribution model.

The working group also raised the tendency toward short-termism on the part of institutional investors as an obstacle to effective shareowner monitoring and engagement. Participants agreed that short-term thinking is pervasive, particularly due to the compensation structure of fund managers. One working group member noted that "twenty-five years ago, the pension funds regularly discussed their investment strategies on a five and ten-year time horizon. We now rarely see investment strategies that go over one year. Strategic planning tends to be very, very short-term." There was strong agreement among participants that effective shareowner stewardship depends on a longer-term outlook by institutions, which in turn requires a shift in the existing philosophy in terms of strategy and fund manager compensation.

Another barrier to shareowner stewardship is the lack of interaction between silos of fund managers, on the one hand, and governance staff on the other. A major source of such disconnect is that "the responsible investment personnel don't have portfolio investment capabilities," while portfolio managers "don't really want to hear about governance considerations." As one participant put it, "what you really need is the fund manager to take the same [governance] values into the equation as part of the investment decision," a sentiment that may be confirmed through further research correlating governance and performance. Participants also censured the existing culture among fund managers that rejects the concept that shareowners should monitor portfolio companies.

Accountability and Transparency

The working group reached a significant consensus on the need for greater accountability of institutional investors to the ultimate beneficiaries. One participant noted that "performance is actually better when you have an engaged set of plan beneficiaries." As put by another participant, "legitimacy comes from arm's-length organizations that stand apart from and are accountable directly to its constituency."

Accountability can come in different forms. In a public pension fund, "arm's length from political interference is absolutely key, as is representation from the beneficial owners or the plan beneficiaries who can give voice to their concerns and make value judgments." Participants also underscored the importance of "making institutional investors more democratic so that the boards of trustees are actually elected by their beneficiaries instead of appointed by a CEO of their employer, by a family that controls the company that controls their employer, or by a state government." Concrete proposals for more democratic governance arrangements included granting access to the proxy to mutual fund investors, and a "say on governance" by pension fund beneficiaries with respect to the practice of their boards of trustees.

A major ingredient in the recipe for increased accountability is greater transparency of fund governance and operations. Participants agreed that market efficiency in a world of institutional, rather than direct, ownership requires access to information not only about public corporations, but also about institutional investors. As one participant noted, "we might advocate greater transparency generally on the part of institutional investors so that the whole regulatory scheme in this country becomes more balanced, because corporations are held to a very high standard of disclosure and transparency, and institutional investors are not." In addition, "as shareholders have become larger, the inappropriateness of these arrangements has become obvious, because now shareholders have become as big or bigger, economically, than most public companies, and yet they are allowed to operate in secret." There was also broad agreement that the private sector cannot on its own produce market-wide standards of transparency and accountability among funds. In this case, government legislation or regulation is essential to level the playing field.

The working group then turned to discuss the benefits of transparency and greater accountability. One participant cited the experience of a fund that only disinvested from its operations in land mines after a documentary revealed its holdings. In that case, despite the exemplary corporate governance practices of the fund, changes only took place "due to the outside pressure that came about because of the transparency." Another participant recommended the mandatory disclosure of pension and mutual funds holdings as "a light touch regulation that is going to force some sunlight into the system."

Another area where transparency can help increase accountability to beneficiaries is that of disclosure of voting practices by institutions. Enhanced disclosure could compel institutional investors to better use their strongest corporate governance weapon – their voting rights. While mutual funds are already required to disclose their voting policies, participants noted that the quality of such disclosure is still inadequate. A handful of pension funds have started publishing detailed voting reports, but this trend is not yet widespread. In addition to their equity holdings and voting records, funds should also be required to disclose their core values and corporate governance and engagement guidelines, which will then allow interested parties such as grassroots members, and even the media, to exercise informed scrutiny over fund behavior.

Addressing the Collective Action Problem

Even if all institutional investors had ideal corporate governance practices and faithfully represented the interests of their beneficiaries, the fragmentation of ownership structures could serve as a powerful impediment to effective shareowner monitoring and engagement. In economic terms, because a given shareowner pays for all costs but receives only part of the benefits of engagement, shareowners will remain passive. As one participant noted, "the trouble is that the free rider problem is perfectly rational. I'm a small shareholder in all sorts of firms. And even if I mail in my proxy, it probably benefits me less than the cost of the stamp in terms of whether it will affect share price. And so it becomes a matter of how do you aggregate."

This collective action problem is only aggravated by the pervasive use of indexing strategies focusing on ample diversification and the resulting minimization of costs associated with active portfolio management. As one participant put it, "if you are investing in indexes, what are your incentives to work with individual companies on their problems?" In the words of another participant, "everybody hides behind the index. You can blame performance on the index. Nobody wants not to be indexed, because the second you step out and underperform the index, you get your head ripped off."

Indeed, "in an indexing strategy, everybody has a drop of money in every single company out there, which really fragments your ability to engage with companies." Another participant cited a study showing that, "the worst mutual funds for proxy voting decisions – the most passive, if you will – are the index funds." As a result, "our philosophy of long-termism and low fees, which could pull us to invest in mutual funds, also indicates that they are the least active in terms of their ownership." The question is then "how do you strengthen your ability to monitor when you've got so many thousands of companies and it's so difficult to focus? We are really battling this herd mentality where nobody wants to break out."

Moreover, the fragmentation of share ownership poses challenges to monitoring and engagement not only in terms of willingness, but also in terms of power, to affect outcomes. As one participant stated, "one of the points often missed is that even if you are a responsible investor and do your voting and all the things you are meant to do, your ability to influence companies is still very, very limited. You own such a small percentage of that company. So despite the fact that you've got a big reputation as a pension fund, there really isn't that much you can do."

There was consensus among the group about the importance of creating alternative institutional arrangements to circumvent the collective action problem and foster shareowner stewardship. In the words of one participant, funds must finally recognize that "the only way that you can generate value if you own the market is by improving corporate governance in the market."

As put by another participant, "the shortage of institutional investor resources allocated to monitoring and engagement has had a very penny-wise and pound-foolish cost for not only the pension fund beneficiaries but society as a whole."

Participants concurred that shareowners should focus on creating adequate mechanisms for investor collaboration in engagement efforts. As one participant observed, "we need new kinds of organizational structures that can take an issue and get rid of the free-rider problem so that collectively we are all in this." However, working group members agreed that such a system would not emerge spontaneously. Instead, as one participant noted, "We have to proactively think about what the structure should look like, and then we have to create it, and then we have to empower it to fulfill its goal."

The group agreed that, while crucial, the design of institutional solutions to aggregate shareowner interests is not without difficulties. A significant problem is the heterogeneity of shareowner preferences. Participants observed that "shareholders are not all of one mind" and that "any time you try to form partnerships with other investors, you see that everybody has his or her own issues."

Nonetheless, the group agreed that superior mechanisms for investor collaboration are both feasible and necessary. Participants devoted special attention to the model, inspired by the U.K. experience, in which "one institutional investor is supposed to take the lead if there are problems that turn up in a particular firm, and everybody else knows who that is and looks to that person to do their duty." The group recommended two new missions for shareowner organizations such as the U.S. Council of Institutional Investors (CII), namely (i) the coordination of shareowner activism at specific portfolio companies by identifying a key investor to lead in each case and (ii) the identification and training of fund trustees and oversight boards.

6. RECOMMENDATIONS

a Risk Management and Oversight

a.1 *Risk is part and parcel of business activity.* Risk is the flip side of strategy, and value creation depends on the ability of corporations to consciously take risks. Companies need effective risk management, not risk eradication programs.

a.2 *Effective risk management requires an iterative process between management and the board of directors.* Risk matters should be part of the ongoing flow of information to the board. Both the board and management need to create a risk-aware culture where risk is seen as a continuum in the thought process.

a.3 *It is the board's responsibility to set the risk appetite for the company.* While executives and risk managers are responsible for assessing the various risks involved in the company's operations, it is ultimately the board's responsibility to determine the magnitude and nature of risks to which the company is willing to expose itself to pursue a given strategy.

a.4 *It is the board's responsibility to oversee management's creation and execution of the risk management process.*

a.5 *Both director independence and in-depth industry knowledge are essential to ensure adequate risk oversight by the board.* While the objectivity associated with director independence is essential for the board's risk oversight function, so is director expertise in the company's industry and lines of business. It is critical that at least some directors have greater expertise to assess the plausibility of management's assumptions.

a.6 *Risk management units should have sufficient clout, independence and access to resources.* Risk officers should not report to business lines, given the potential for conflicts of interest. Direct reporting obligations to the board independently of management are especially valuable in ensuring the clout and independence of the chief risk officer.

a.7 *Risk officers should focus on events or occurrences which can have a catastrophic or, at least, significant impact on the company.* Small operational risks, such as marginal decreases in sales revenue, should remain under the auspices of business operations personnel.

a.8 *Risk models are a tool, not a crutch.* The roots of the crisis are not in the structure of risk models, but in the undue reliance placed on them to the detriment of qualitative assessments. Risk models can be useful if their limitations and assumptions are well understood, but they are not substitutes for board and management judgment.

a.9 *Risk management should be kept separate from compliance functions.* Proper risk culture differs from compliance mentality. As a result, the risk unit should not be under the umbrella of the general counsel.

a.10 *Risk should be managed primarily to the benefit of shareowners.* Emphasis on short-term value can exponentially increase the company's risk in the long term. Therefore, boards should be concerned with preferences expressed by shareowners having a short-term investment horizon. Moreover, in companies that are too big to fail, risk officers should also take into account market integrity and systemic risk considerations.

a.11 *Risk management and oversight after the crisis is an issue which needs increased attention and evolution.* The field is not yet sufficiently defined, and different market parties are far from consensus on best practices.

b Pay for Performance

b.1 *Internal pay equity should be an important item on the board's agenda.* An arbitrary pay gap among members of the same team or corporate enterprise can have a detrimental effect on executives' incentives and, consequently, firm performance.

b.2 *The goal of executive pay should be to compensate and incentivize executives for their contribution to long-term value creation.* The existing focus on short-term stock price movement as the relevant metric for compensation decisions is misplaced. Intangibles that make for good management, but that are not reflected on the statistical side, should be taken into account in compensation arrangements.

b.3 *"Pay-for-performance" arrangements must reflect executive contributions to actual performance due to factors that are within his or her control, not general market movements.*

b.4 *Boards should approach pay decisions as an element of risk to the organization.* The structure of certain compensation packages may induce executives to reach performance targets through inefficient, artificial or even illegal means, at a huge risk to the organization's long-term interest.

b.5 *Restricted stock grants are the preferable form of incentive compensation.* Unlike stock options, which disproportionately reward share price appreciation without sensitivity to the magnitude of losses, restricted stock grants subject to long-term vesting periods produce incentives that more closely mirror the effects on shareholder wealth.

b.6 *Pay caps are not a sustainable solution for executive pay reform.* Pay caps are ineffective in ensuring lower pay levels and inefficient as a method of aligning management and shareholders' incentives. Wage and price controls do not work.

b.7 *Companies should expand the availability of "clawbacks with teeth," which allow them to recover performance payments based on artificial results, fraudulent or otherwise.* Effective clawbacks are an element of, but not a substitute for, sensible compensation arrangements.

b.8 *Compensation committees should hire their own compensation consultants and be mindful of their independence.* Boards should implement policies and procedures for the selection, retention and evaluation of compensation consultants. Compensation consultants advising the compensation committee should not provide other services to the company.

b.9 *The focus and expertise of the compensation committee is critical, but the whole board should be ultimately responsible for executive pay decisions.* Similarly to the requirement of financial expertise for audit committee members, compensation committees should have at least one member with a working knowledge of executive compensation practices.

b.10 *Greater board accountability to shareholders is essential to improve executive compensation practices.* Legislative improvements of shareholder rights, though not necessarily through a direct say on executive compensation, are warranted.

c *Shareowner Stewardship*

c.1 *There is a clear need to stimulate and disseminate further research and case studies that explore the correlation between fund governance and fund performance.*

c.2 *Trustee or oversight boards should be composed of members skilled both in fund issues and board dynamics.* Further, such fund boards should feature member representation with a clear structure of accountability—for instance, annual member votes for board members. Such bodies should also be free of conflicts of interest, and in cases of public sector funds, at arm's-length from political control.

c.3 *Trustees or fiduciaries should meet skill requirements and undertake trustee training, continuing education and perhaps certification.* The Australian government set a model for such investor infrastructure when, in 2009, it allocated federal seed money to establish the Responsible Investor Academy.[3] The UK Pensions Act also requires standards of pension trustees; the Pensions Regulator even provides an interactive e-learning program. [4]

c.4 *Fund trustees or fiduciaries should ensure that job descriptions for the chief investment officer and fund CEO include understanding and appreciation of environmental, social and governance risks in investment portfolios.*

c.5 *Funds should be held to as high a standard of accountability as they ask of portfolio companies.* In particular, funds should be required to disclose (a) their voting records; (b) comprehensive voting and engagement corporate governance guidelines; (c) core values; and (d) their equity holdings. Such transparency may then provide opportunities for parties such as grassroots members and outside-media to exercise informed scrutiny over fund behavior.

c.6 *The private sector cannot on its own produce market-wide standards of transparency and accountability among funds.* Federal and state/provincial governments, where appropriate, need to step in with legislation or regulation.

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3 See www.responsibleinvestment.org/html/s02_article/article_view.asp?keyword=RIAA-RI-Academy.

4 See www.thepensionsregulator.gov.uk/trustees/trusteeKnowledge/index.aspx

C.7 *Collective investment groups should consider two new missions: (a) coordinating shareowner activism at specific portfolio companies by identifying a key member fund to serve as lead in each case; and (b) identifying and training or certifying members of fund trustee or oversight boards.*

C.8 *Fund scrutiny can be advanced by grassroots scheme members using social networking tools.* The US Department of Labor, for instance, could require each plan it supervises to mount an interactive website enabling employees and retirees to review and comment on savings arrangements. Web 2.0 now enables collective user-generated ratings of services from medical practices to restaurants. It would be possible to do the same with pension plans to spur a race to the top, and help regulators in their oversight. In some markets (the Netherlands, for example) such ground-up scrutiny is subsidized by the public sector. Another funding option is being pioneered by the US-based shareowners.org and by Canada's Fund for the Advancement of Investor Rights (FAIR). They have positioned themselves to qualify for a share of class action settlements.

C.9 *Strong consideration must be given at public policy level to the structure of retirement savings, and whether such savings should be directed into fewer, more concentrated, non-profit fund pools instead of the for-profit 401(k) defined contribution model.*

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