Yale SCHOOL OF MANAGEMENT

Millstein Center for Corporate Governance and Performance

POLICY BRIEFING NO. 6

Agenda for Private Sector Reform

Omnibus Policy Recommendations for a Post-Crisis Market

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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, 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. The Agenda for Private Sector Reform Briefing is a compilation of findings from five 2007-2009 Policy Briefings designed to assist policymaking.

The Center's efforts are circulated via multiple mechanisms, including conferences, workshops, the internet, interviews, and last but not least, through a series of policy briefings issued by the Center. These briefings are framed as concise think tank reports and designed to serve as pointers to guide policy discussion, to further detailed empirical research, and to act as a resource for market practitioners. They consider a diversity of perspectives and are based on a combination of historical research and the experiences of market-leaders and thought-leaders who have participated, worldwide, in the Center's topic-specific roundtables and workshops. These include corporate board members, institutional investors, service providers, shareowners, leading academics, and regulators, among others.

This Omnibus Briefing assembles in one place the executive summaries of reports covering seven key areas in need of policy attention. The remedies suggested in these briefings are particularly timely, since the financial crisis has exposed market flaws in an acute fashion.

Agenda for Private Sector Reform was prepared under the supervision of Ira M. Millstein, Senior Associate Dean for Corporate Governance, Yale School of Management; Milica Boskovic, Center Managing Director; Stephen Davis, Center Senior Fellow; and Jonathan Koppell, Center Faculty Advisor and Associate Professor of Politics & Management, Yale School of Management. Steve Alogna, the Center's Visiting Research Fellow for Corporate Governance, served as lead editor – seconded to the Center by Deloitte & Touche LLP-Corporate Governance Services. Contributors were Mariana Pargendler, Visiting Research Fellow and Meagan Thompson-Mann, Senior Project Consultant.

The Center is grateful to the following bodies, which provided assistance with or input in one or more of the Policy Briefings summarized, or referred to, herein: participants in the working groups; the CFA Institute; Weil Gotshal and Manges, LLP; Deloitte & Touche LLP; Spencer Stuart; and the Working Group on Advisory Votes. Any positions taken in this report, and any errors within it, are solely the responsibility of the Center.

OVERVIEW

The global financial crisis has exposed a raft of market weaknesses and failures The Center has concentrated on probing urgent, corporate governance-related issues where it identified apparent gaps in knowledge, insight and infrastructure. Policy Briefings have addressed the advisory vote on executive compensation; board-shareowner communications; proxy voting reform; independent board leadership; risk oversight; pay for performance; and shareowner stewardship. Using global perspectives, they address key concerns within the relevant subject areas and attempt to gather and present practical recommendations and ideas.

This report compiles summaries of the Center's recommendations on these seven key areas from 2007 through mid-2009. The objective is simple: to present a one-stop, omnibus governance reference for private sector players to use when considering reforms to restore public and regulatory confidence in the capital market.

Sections in this report provide a brief overview of each subject area, the findings of each Policy Briefing, and the subsequent recommendations. The actual policy briefings may be found on the Center's website at http://millstein.som.yale.edu/projects.shtml.

Section A: Shareowner Advisory Vote on Executive Pay

- With executive pay spotlighted as having contributed to the crisis, the shareowner advisory vote on executive pay continues to be a hotly debated remedy, even as legislators in the US consider a statute that would require it. Similarly, in the UK, market institutions are engaged in discussions over whether investors and boards have made 'say on pay' work. This 2007 briefing is an early analysis of the advisory vote in Britain and its potential for application in North America and other markets, together with a review of risks and implications for corporations and investors.

Section B: Board-Shareowner Communications

- A chronic absence of robust communication between boards and investors may have exacerbated the crisis. Many companies experimenting with the various models of board-shareowner dialogue have found value in their efforts. This briefing addresses the current state of dialogue in the US and international markets, best practices, and the advantages and challenges implicit in these communications.

Section C: Proxy Voting Reform

- Proxy contests and controversial director elections are more frequent. Not surprisingly, shareowners and proxy voting advisory services face rising pressure to safeguard the integrity of voting ballots. This briefing addresses the key threats to the integrity of proxy voting, such as conflicts of interest, opacity, technical faults in the chain by which ballots are transmitted, and a shortage of resources devoted to informed decision-making. The Center offers practical recommendations, including a draft code of professional practices, for the proxy advisory industry and institutional investors to consider.

Section D: Independent Board Leadership

- The crisis has focused attention on the capacity of boards to oversee executive competency, as well as such matters as remuneration and risk management. Attention, in turn, has shifted to models of board leadership. Global experience has shown that independent chairmanship is a tested instrument of governance, a means to ensure the CEO is accountable for managing the company in close alignment with stakeholder interests, while recognizing that managing the board is a separate and time-intensive responsibility. This briefing explores the application of non-executive independent board leadership through research, as well as the experiences of the Chairmen's Forum.

Section E: Risk Oversight

- The financial crisis has opened up the question of how boards do, and can, oversee risk management systems within corporations. This briefing offers 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. It offers a menu of suggestions, including on 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.

Section F: Pay for Performance

- Executive remuneration—in particular, pay that incentivized short-term performance and the assumption of unsustainable risks—is at the center of the financial crisis. Superior risk management requires the consideration of poor incentives/compensation practices as risk, and consequently calls for a reassessment of executive compensation practices including such issues as the relevance of internal pay equity; the incentive structure of compensation packages; the role of compensation consultants; and the importance of board accountability to shareowners for executive pay decisions. This briefing advances recommendations to render executive compensation practices consistent with the goal of long-term value creation.

Section G: Shareowner Stewardship

- Are shareowners complicit in the crisis? This briefing addresses the responsibilities of investors in their role as owners of portfolio companies. Legal and institutional reforms fostering superior fund governance and investor coordination are essential in the evolution toward active and responsible ownership. Shareowners in a Center roundtable assessed the extent to which certain institutions fell short in fulfilling responsibilities as owners of enterprises and allowed, or even encouraged, companies to undertake excessive risk in hopes of short-term gain. The Shareowner Stewardship working group addressed the role and responsibilities of shareowners as the constituency that ultimately elects and holds boards accountable; various structural impediments that have prevented effective shareowner stewardship; 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.

Findings of Policy Briefing No. 1*: Does 'Say On Pay' Work? Lessons on Making CEO Compensation Accountable*

Based on a review of UK experience, advisory shareowner votes on executive compensation policies appear practical for adaptation in North America and other markets. They represent a lever that could strengthen both boards and shareowners in the quest to better align top corporate pay with performance. But they are hardly a panacea on their own; rather they are likely to spur dialogue between boards and shareowners. However, market parties in the UK—which pioneered the advisory vote concept—remain concerned that boards and investors are both falling short of success in tethering pay to performance. US players may be able to adjust advisory votes to avoid flaws evident in the UK. Indeed, turning advisory votes into a value-driving tool in the US could involve fitting the practice into a package of accountability reforms. Further, boards, shareowners, and service providers face the challenge of hard-wiring material changes in their operations to get ready for advisory votes.

Despite the recent adoption of the advisory vote on executive compensation by multiple US organizations, there has been surprisingly little analysis about whether or not the measure better aligns pay and performance, or the impact it would have where implemented. This 2007 policy briefing explored those unanswered elements and the potential impact in the North American setting by reviewing lessons learned from the UK experience, assessing its adaptability for the US market, and probing a series of commonly asked questions on the topic.

Lessons from the UK

A.1 Votes on a company's compensation policy resulted in a marked rise in dialogue between corporate boards and management, on the one hand, and institutional investors on the other, transforming the way compensation policies are constructed.

A.2 While top executive pay in the UK continues to outpace inflation and average workforce wage increases, advisory votes are widely seen as having been an important contributing factor in taming the rate of increase, curbing opportunities for 'pay for failure' and linking compensation closer to performance.

A.3 Many corporate board compensation committees have re-tooled the way they design and communicate executive pay plans so as to draw support from institutional shareowners.

A.4 Institutional investors have stepped up scrutiny of executive pay packages but continue to search for effective methods of monitoring compensation.

A.5 Providers of proxy analysis and recommendation services have found their role enhanced, either through providing guidance in voting or via the expectation to vet remuneration plans with companies and engaging in dialogue with boards in search of improvements before plans are finalized.

A.6. Advisory votes have proven particularly effective in a context of measures that provide substantial board accountability. Investors in the UK possess the real, but rarely exercised, authority under corporate law to remove directors by majority vote.

A.7 Advisory votes are seen by regulators as having succeeded not only in handing investors a voice on compensation, but in contributing to the competitiveness of the British economy and the attraction of London as an international capital market.

Adapting advisory votes to the US

A.8 Corporate resistance to advisory votes on pay has tended to backfire, fueling support for legislative action mandating the policy for all listed firms.

A.9 Corporate boards can develop effective proactive strategies to secure investor loyalty in advisory votes. For instance, compensation committees can oversee design-stage consultation with investors on pay policies in advance of the annual meeting.

A.10 In the US, funds may need to expand resources to address corporate compensation at portfolio companies, or depend further on analysis produced by outsource agents such as proxy or engagement services.

Frequently Asked Questions about Advisory Votes

The policy briefing addressed a series of questions developed in conjunction with the Working Group on Advisory Votes.[1] Following are the key findings in answering those questions:

A.11 *What precisely goes before investors for a vote?* The UK resolution is not an endorsement of any specific employment contract or pay arrangement. Rather, shareowners are asked to approve the full report of the remuneration committee. The rough equivalent of the US would be the Compensation Discussion and Analysis (CD&A), which is prepared by management and approved by the board.

A.12 *Is there an increase in cases of votes against management?* The onset of the advisory vote in Britain did not produce a substantial increase in votes against management. In fact, investors have come to view a vote against board pay policies as an option of last resort.

A.13 *In the case of a "no" vote, won't companies be forced to guess which components of the report proved of most concern?* Dialogue with investors is a key component to effectively utilizing the advisory vote on compensation. Companies engaging in discussions with investors and proxy advisors would be made aware of potential criticism of pay policies.

A.14 *How does a corporation best engage in dialogue with its shareowners on compensation policy?* Lessons learned through the UK experience include:

- Prepare an outreach plan well before the annual meeting.
- Consult with shareowners before the compensation report is finalized to consider revisions or persuasion strategies.
- Offer investor meetings with remuneration committee compensation consultants.
- For US companies, design road shows, webcasts and conference calls on the topic of executive compensa tion for fund officials responsible for corporate governance, rather than the portfolio managers.

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1 The Working Group on Advisory Votes is an ad hoc coalition of investing institutions and corporations assembled to develop common research and approaches to the issue of the shareowner advisory vote on compensation.

A.15 *Would a 'no' vote require a company to revise its pay strategy or renegotiate contracts? Would the advisory vote change the CD&A?* No, the vote is advisory and has no legal impact, nor does it require a change to the CD&A. However, there are practical consequences to the reputation of the company if left unaddressed. The CD&A's function may evolve from merely compliance, to that of persuasion.

A.16 *Why is an advisory vote necessary in cases where companies maintain channels to dialogue on compensation?* In many cases, current dialogue is between the company and the portfolio manager, who is often disconnected from the governance function of the fund which is responsible for voting. The advisory vote could prompt healthier dialogue between boards and investor agents responsible for governance.

A.17 *Do investors need to change their engagement policies to handle the responsibilities of an advisory vote?* Institutional investors in Britain continue to debate incorporating various methods to handle the added responsibility, including: raising in-house capacity to analyze compensation and meet with companies, revisiting voting guidelines, and potentially hiring their own outside compensation experts to review plans.

A.18 *Is there a risk that boards will design plans to pass proxy advisory specifications rather than do what is best suited for the company?* Proxy advisors in the UK claim to review plans via a qualitative approach, rather than through a "check the box" exercise. Most services have ramped up internal expertise to increase their analyses and consultation exercises with companies.

A.19 *Wouldn't it be better to simply vote against compensation committee members rather than assess pay policies?* There are many cases where funds will take issue with compensation policies, but otherwise consider the company well-governed. UK investors view advisory votes by first issuing a warning if they are dissatisfied with the remuneration plan. If directors fail to show responsiveness, investors may then decide to vote against the director.

A.20 *Do companies benefit or suffer material downsides from the process?* Companies involved in the roundtables expressed advantages including: increased quality of dialogue with investors; early identification of criticism; increased transparency; reputational enhancement; and a better focus on compensation strategy.

Findings of Policy Briefing No. 2: *Talking Governance: Board-Shareowner Communications on Executive Compensation*

Prompted by universal adoption of the shareowner advisory vote on executive compensation, UK companies have moved to integrate regular engagement with domestic investors into the annual process of framing corporate remuneration policies. Most US companies have not fully endeavored to engage their shareowners in the same manner, but some are experimenting with various models of dialogue.

Companies can best manage effective engagement when they provide shareowners with access to appropriate board directors and other governance personnel. Likewise, institutional investors need to develop internal coherence between their fund managers and governance professionals to enhance their capacity to engage with corporate boards and executives on governance and executive compensation. Companies that are successful in this endeavor credit communication programs with improvement in investor loyalty, as demonstrated by fewer instances of confrontation.

Talking Governance sought to explore the constraints, risks, benefits, and sustained commitments by investors and boards in engaging one another in substantive dialogue. The report is based on in-depth reviews of historical research and media reports and individual and group interviews in the US and UK with directors, corporate management, institutional investors and other governance professionals.

The findings of the report include:

B.1 Sustained, two-way dialogue between boards and shareowners is rare in the United States.

B.2 There is no insurmountable legal obstacle to boards and shareowners engaging in constructive dialogue on governance matters, including executive pay policies.

B.3 Investor and corporate officials identify concrete and significant advantages from board-shareowner communications.

B.4 Constructive director-shareowner dialogue on governance hinges on three features, for both investing institutions and corporate boards: high-level commitment of involved parties, resources of appropriate governance expertise, and informed strategies on how to engage boards and shareowners.

B.5 Compulsion through crisis or other acute events is the foundation under which most current US corporate initiatives now foster governance dialogue with shareowners.

B.6 There are few common best practices for board-shareowner communications on governance and executive pay. Companies and investors continue to experiment with various methods of interaction.

B.7 UK companies see the advisory vote on pay as having catalyzed dialogue with shareowners. Boards commonly integrate such dialogue into an annual process framed to produce corporate remuneration policy and the board compensation report. Nascent US practice, by contrast, tends to be based on 'vote first, consult later.'

A series of common fundamentals were identified as crucial by those corporations successfully engaged in constructive board-shareowner dialogue:

B.8 Clarify the process for investors to engage the company in dialogue regarding governance-related matters.

B.9 Know when to directly involve the board in dialogue.

B.10 Make available personnel with appropriate governance knowledge to address governance-related shareowner concerns.

B.11 Personnel engaging in dialogue should have a direct reporting relationship to the board.

B.12 Maintain an ongoing and consistent level of dialogue with shareowners.

B.13 When engaging investor institutions, be sure there is coherence between the governance and investment functions.

B.14 Take time in advance to clarify the topics, define the purpose of the communication, and determine the appropriate personnel to attend the meeting.

Findings of Policy Briefing No. 3: *Voting Integrity: Practices for Investors and the Proxy Industry*

The proxy ballot is one of the most important tools a shareowner can employ in communicating with, and influencing, the operations of a company, and it is a signal corporate directors rely on to test investor confidence in board stewardship. With each stage a ballot moves away from the hand of the effective owner, there is greater possibility of "the voice" losing its impact or even its intention. Key threats include conflicts of interest, opacity, and faults in the chain by which ballots are transmitted. Shareowner and the proxy voting advisory services face rising pressure to safeguard the integrity of the ballots and the voting intentions behind them.

The issue of how investors make voting decisions is especially critical given the recent crisis and the related rise of shareowner meetings with contentious votes. Further, as proxy voting turnout rises worldwide, institutional investors are addressing voting decisions with a more critical eye. US investors, in particular, face the consequences of expanded voting rights. It is vital to shed light on how institutions go about making choices that can have profound consequences for the way corporate boards are composed and how they operate.

The *Voting Integrity* policy briefing was designed to explore how various market institutions around the world develop, set, and maintain their standards for proxy voting; how potential conflicts of interest are identified and controlled; and what resources are available in the standard setting process. The report was based on independent research of voting-related topics, interviews with institutional investors and proxy advisors, and the Voting Standards roundtable[2] conducted by the Millstein Center in January 2008.

Key recommendations from the report focused on four major areas of concern:

C.1 *How investors and their advisors set their voting policies*

o Advisory services should consider disclosing their voting and governance policies for public comment. Such outreach could help produce amendments not yet considered and enhance transparency of the policy-setting process. They might also consider assigning an external independent advisory board the ultimate decision-making power over general policies.

C.2 *Recognizing and managing conflicts of interest*

o The proxy advisory industry should consider adopting a code of conduct for recognizing, managing, and disclosing conflicts of interest. The briefing provides such a sample professional code.

o Institutional investors could consider adopting their own code of ethics. The briefing provides links to such codes already in existence.

C.3 *Impediments to efficient and accurate voting*

o The US SEC could consider convening a blue ribbon panel of investors and corporate representatives to find practical approaches to modernizing the US proxy voting system and promoting similar initiatives that address barriers to cross-border international voting.

o Investors may consider sponsoring collective initiatives to tackle impediments to effective proxy voting such as, re-registration, requirements for personal attendance at annual meetings, shareblocking, and overly conservative cut-off dates for casting a ballot.

C.4 *Providing adequate resources to the proxy voting function*

o Institutions could assess the skills and numbers of permanent staff to determine if they need individuals on the stewardship team with corporate experience. This may facilitate more robust and effective interaction with corporate board members.

o Sponsor further research on the effects of active and engaged proxy voting on the ROI for investors. This may encourage shareowners to identify institutional investors that are more engaged.

2 Chaired by former US SEC chief accountant Lynn Turner, the roundtable included participants from the US and European state sector pension funds, mutual funds and fund managers, for the purpose of exploring how improvements might be made to the proxy voting process.

Findings of Policy Briefing No. 4: *Chairing the Board: The Case for Independent Leadership in Corporate North America*

Chairing the Board was issued both as part of the Center's Policy Briefing program and as background analysis for the Chairmen's Forum, a group of non-executive chairs from the US and Canada convened under the leadership of Harry Pearce, Non-Executive Chairman of Nortel Networks Corporation and MDU Resources Group, Inc. Participants met for the purpose of addressing steps that enhance the accountability of corporations to owners, discussing matters of common interest, promoting deeper understanding of independent board leadership practices and reaching out to the wider market on effective practices of board chairmanship. A section of the briefing is drawn from peer discussions at these events and based on the real-world experiences of independent chairs at North American public corporations.

Despite a movement toward independent chairmanship there is little practical advice on what a non-executive chair does and how the role differs from a chair with executive powers. Also lacking is guidance on the profile and the ideal attributes of non-executive chairs, or whether appointing a lead director is an adequate alternative to separating the roles of the chair and CEO. Chairing the Board addresses these and other issues as they relate to the non-executive chairman.

A substantial majority of group members concluded that independent chairmanship should become the default model of board leadership in corporate North America.

Findings of the report include:

D.1 Independent chairmanship of a public company is now a growing successful model of corporate board leadership in the US and Canada.

D.2 The economic crisis has fueled strong support among shareowners, directors, the public and legislators for more robust oversight of CEOs by independent minded boards, and more management accountability to investors.

D.3 Global experience has shown that the model of a separate CEO and chair is a tested instrument of governance. Having an independent chair is a means to ensure that a CEO is accountable for managing the company in close alignment with the interests of shareowners, while recognizing that managing the board is a separate and time-intensive responsibility.

D.4 The independent chair curbs conflicts of interest, promotes oversight of risk, manages the relationship between the board and CEO, serves as a conduit for regular communication with shareowners, and is a logical next step in the development of an independent board.

D.5 The responsibilities of an independent chair are clear and defined – the CEO runs the company, the chair runs the board. A corporate board can mitigate concerns about overlapping responsibilities by clearly spelling out the responsibilities of the chair and CEO roles to the company and shareowners, agreeing on a definition of independence, effectuating successful strategies and risk management policies, and making careful choices in filling the two posts.

D.6 Peer independent chairs believe that lead directors are not considered the equivalent of board chairmen by the board or shareowners, even when such directors are provided with comparable authorities.

To accelerate board reform, the Chairmen's Forum is calling on all North American public companies to voluntarily adopt independent chairmanship as the default model upon succession to a combined CEO and chair. A board could do so, for instance, through bylaw or charter amendments. If corporate directors choose to take a different course, either by combining the two posts or naming a non-independent chair, they should explain to their corporation's shareowners why doing so represents a superior approach to optimizing long-term shareowner value.

Findings of Policy Briefing No. 5: *Pay, Risk and Stewardship Setting voting policies*

The *Pay, Risk and Stewardship* policy briefing reflects the findings of three concurrent working groups of practitioners and scholars convened in New York City on February 13, 2009. The Center focused the sessions on key issues raised in the financial crisis as part of its overall project on Private Sector Architecture for Future Financial Markets. This is a summary of the findings and recommendations from the Risk Oversight working group.

A significant underlying cause of the current financial crisis is a massive failure of risk management and oversight. 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 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. The Risk Management working group, from which this briefing was adapted, opted not to engage in finger pointing, but rather focused on making constructive suggestions for the future improvement of risk management systems.

Among the issues discussed were the definition of "risk" for risk management 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.

Findings of the report include:

E.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.

E.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.

E.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.

E.4 *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 the requisite knowledge to assess the plausibility of management's assumptions.

E.5 *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 independent of management are especially valuable in ensuring the clout and independence of the chief risk officer.

E.6 *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.

E.7 *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.

E.8 *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.

E.9 *Risk should be managed primarily to the benefit of shareowners.* Emphasis on short-term value can increase exponentially the company's risk in the long term. Therefore, boards should be mindful of preferences expressed by shareowners with a short-term investment horizon. Moreover, in companies that are too big to fail, risk officers should take into account market integrity and systemic risk considerations.

Findings of Policy Briefing No. 5: *Pay, Risk and Stewardship*

The *Pay, Risk and Stewardship* policy briefing reflects the findings of three concurrent working groups of practitioners and scholars convened in New York City on February 13, 2009. The Center focused the sessions on key issues raised in the financial crisis as part of its overall project on Private Sector Architecture for Future Financial Markets. This is a summary of the findings and recommendations from the Pay for Performance working group.

Risk management deficiencies alone do not explain the behavior of financial institutions that ultimately led to debacles of the past year. There is increasing consensus that the existing compensation structures encouraged, often 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 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 compensation practices consistent with the goal of long-term value creation.

Findings of the report include:

F.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.

F.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.

F.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.*

F.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.

F.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 shareowner wealth.

F.6 *Pay caps are not a sustainable solution for executive pay reform.* Pay caps are ineffective in promoting lower pay levels and inefficient as a method of aligning management and shareowners' incentives.

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

F.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.

F.9 *The focus and expertise of the compensation committee is critical, but ultimately the whole board should be responsible for executive pay decisions.* Also, mirroring similar requirements for financial expertise on audit committees, compensation committees should have at least one member with a working knowledge of executive compensation practices.

F.10 *Greater board accountability to shareowners is essential to improve executive compensation practices.* Improvements of shareowner rights, though not necessarily through a direct say on executive compensation, are warranted.

Findings of Policy Briefing No. 5: *Pay, Risk and Stewardship*

The *Pay, Risk and Stewardship* policy briefing reflects the findings of three concurrent working groups of practitioners and scholars convened in New York City on February 13, 2009. The Center focused the sessions on key issues raised in the financial crisis as part of its overall project on Private Sector Architecture for Future Financial Markets. This is a summary of the findings and recommendations from the Shareowner Stewardship working group.

The exercise of identifying failures leading to the financial crisis in management and board practices alone is fundamentally incomplete. Shareowners must look at themselves and assess the extent to which they failed—owing to internal error or external restrictions—to serve as responsible owners of enterprises, and allowed, or even encouraged, companies to take excessive risk. The Shareowner Stewardship working group addressed shareowners as the constituency that ultimately elects and holds corporate boards accountable.

The working group focused on the various structural impediments that have prevented effective shareowner stewardship. Discussions covered the influence of 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 shareowner monitoring and engagement efforts; the importance of transparency and accountability to the ultimate fund beneficiaries; legal and regulatory restrictions on rights investors may exercise in furtherance of their fiduciary missions; and the need to overcome collective action hurdles to shareowner stewardship.

Findings of the report include:

G.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.*

G.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.

G.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]

G.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.*

G.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 their voting records; comprehensive voting and engagement corporate governance guidelines; core values; and 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.

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

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

G.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

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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.

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 police. 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.

G.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.*