



QUARTERLY SUMMARY

The corporate governance landscape changed dramatically during the fourth quarter of 2008 as Congress passed ground-breaking executive compensation regulations as part of the \$700 billion Troubled Asset Relief Program (TARP). While the remuneration practices of financial

services companies receiving TARP funds created a public outcry, the new legislation allowed lawmakers to swiftly curb the compensation excesses.

The Securities and Exchange Commission (SEC), widely criticized for its limited response to the ongoing financial crisis, moved ahead on two

regulatory fronts. First, the SEC proposed a plan for transitioning U.S. companies to International Financial Reporting Standards (IFRS), beginning as early as 2010. Second, the SEC issued a final ruling on the governing of credit rating agencies.

EXECUTIVE COMPENSATION LEGISLATION

Landmark legislative concessions on executive compensation were adopted in the fourth quarter, as policymakers attempted to prop up ailing U.S. financial institutions. The authority granted to the Treasury by the Emergency Economic Stabilization Act of 2008 (EESA)¹ to regulate financial institution compensation was the most influential ever issued on the subject by any legislative body. Executive compensation legislation has evolved since the fourth quarter and will

continue to develop. This discussion outlines the executive compensation provisions as established by the TARP and provides some of the early reaction of stakeholders.

According to the EESA, any financial institution that sells assets (e.g., the preferred stock that was issued by Goldman Sachs, Bank of America, Citigroup, etc.) to the Treasury Department under the \$700 billion Troubled Asset Relief Program (TARP) must:

- 1) Exclude incentives for senior executive officers² (SEOs) to take unnecessary and excessive risks that threaten the value of the institution.
- 2) Include a clawback³ provision whereby any bonus or incentive compensation paid to a SEO that are later proved materially inaccurate may be recovered.
- 3) Prohibit issuance of any golden parachute⁴ payment to any SEO

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¹The EESA was passed by Congress on October 3, 2008. It authorized the U.S. Treasury to spend up to \$700 billion to buy illiquid mortgage assets from financial institutions via the Troubled Assets Relief Program (TARP)

²Section 111 of EESA defines a "senior executive officer" as an individual who is one of the top five executives of a public company.

³Claw-back policies allow company boards to recover executive pay when fraud or poor management leads to financial restatements.

⁴EESA defines a "golden parachute" as any payment given to a senior executive officer by reason of an involuntary termination or in connection with any bankruptcy, liquidation, or receivership of the employer.

Corporate Governance Committee

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SEC ANNOUNCES IFRS TRANSITION PLAN



On November 14, 2008, the Securities and Exchange Commission (SEC) released a formal proposal for U.S. companies to transition to International Financial Reporting Standards (IFRS). According to the plan, approximately 110 large U.S. companies will be eligible to begin using IFRS in 2010 and all U.S. companies could be required to adopt the international standards by 2014.

According to the proposal, several milestones must be reached by 2011 before the SEC can decide whether to proceed with mandating IFRS for all U.S. companies. These include issues such as 1) ensuring that accounting standards are “of high quality and sufficiently comprehensive”,⁶ 2) establishing accountability and funding for the International Accounting Standards Committee (IASC) Foundation⁷, and 3) furthering IFRS education and training in the U.S. for public companies, investors, accountants and others involved in the preparation and use of financial statements.

The SEC estimates the total cost of transitioning to IFRS for the first 110 companies will be approximately \$32 million per company, or \$3.5 billion. The Commission believes that an incremental rollout will help to mitigate the costs of the shift and the resource demands on auditors, consultants and others. However, the Commission acknowledges that the proposed rollout could lead to a lack of comparable financial information and temporarily create a dual system of reporting that would require investors to be familiar with both U.S. GAAP and IFRS.

The Council of Institutional Investors (CII) endorses the concept of IFRS cautiously.⁸ In October 2008, Council members approved a new policy pledging support for “a common goal of convergence to a single set of high quality standards designed to produce comparable, reliable, timely, transparent and understandable financial information.” The policy calls for U.S. accounting or auditing standards or standard setters to be replaced with international standards only after numerous mandatory steps are achieved (see Attachment).

The SEC’s proposal does not define the method the Commission would use to mandate IFRS for U.S. issuers.⁹ One of the options, according to the transition plan, would be for Financial Accounting Standards Board to continue to be the designated standard setter for purposes of establishing the financial reporting standards in company filings with the Commission. Under that option, FASB would likely incorporate all provisions under IFRS and all future changes to IFRS directly into U.S. GAAP. According to the proposal, similar approaches have been used by a “significant number of other jurisdictions when they adopted IFRS as the basis of financial reporting in their capital markets.”

The Commission set a longer-than-expected 90-day comment period for the proposal, which shifted the responsibility for the IFRS transition plan to the newly appointed SEC Chair, Mary Shapiro. At her confirmation hearing, Ms. Shapiro indicated that she “won’t feel bound” by the proposal and may “slow the push” for its adoption¹⁰.

⁶ SEC Proposed Rule Release No. 33-8982; 34-5860; File No. S7-27-08

⁷ The IASC Foundation is responsible for the activities of the International Accounting Standards Board (IASB).

⁸ “SEC Announces Roadmap Toward Adoption of International Financial Reporting Standards,” Council of Institutional Investors Alert, Volume 14, Number 1, January 8, 2009.

⁹ “SEC Road Map for Transition to IFRS Available,” Journal of Accountancy, November 16, 2008.

¹⁰ Neil Roland, “SEC Nominee Shapiro ‘Won’t Feel Bound’ by IFRS Roadmap”, Financial Week, Jan 15, 2009.

SEC ISSUES FINAL RULES ON CREDIT RATING AGENCIES

On December 3, 2008, the Securities and Exchange Commission (SEC) issued final rules governing credit rating agencies. The new measures, first proposed in June 2008, aim to strengthen the existing rules adopted by the SEC in June 2007 under the Credit Rating Agency Reform Act. By issuing the new rules, the SEC took steps to improve disclosure and reduce conflicts of interest among the credit rating firms; however it tabled two controversial proposals that were viewed favorably by investors.

The first proposal shelved would have created different ratings for structured finance products¹¹ and corporate bonds. The other would have eliminated the rules of reliance on debt ratings to protect investors in money-market mutual funds. Both measures were supported by investors for increasing transparency and improving the safety of money market investments.

To increase disclosure, the SEC's latest rules now require rating agencies to publish annually credit rating transition statistics (i.e. upgrades, downgrades and default rates) for one-, three-, and ten-year

periods. In addition, they must provide details regarding whether, and to what degree, they verify the information they use to rate structured finance products. They must also make publicly available a random sample of ten percent of their issuer-paid credit ratings within six months of the ratings being issued.

To reduce conflicts of interest, the SEC is prohibiting rating agencies from rating any debt that they helped to structure. In addition, employees who are involved in issuing ratings are precluded from participating in any fee negotiations with issuers or receiving gifts or entertainment worth more than twenty-five dollars from clients.

The SEC also imposed new record-keeping requirements. Rating agencies must retain records of all rating actions from the initial rating to the current rating. If a quantitative model is a substantial component of the credit rating process for a structured finance product, an agency must keep a record of the rationale for any material difference between the credit rating implied by the model and the final credit rating issued. Rating agencies must also maintain a history of complaints against credit analysts.

The three major rating firms¹² released statements voicing support for the SEC's new rules.¹³ However, academic and investment professionals expressed harsh criticism, stating that the latest rules are vague and misdirected. James Angel, finance professor at Georgetown University, says the SEC's latest action "is repainting the deck chairs on the Titanic after it sank."¹⁴ Ann Rutledge, co-founder of structured product consulting firm, R&R Consulting, points out that the ten percent disclosure rule is of "little value to investors because disclosure comes too far after the fact." She believes that it will be easy for firms to circumvent the rule by picking the ten percent sample that reflects most favorably on them.

The SEC's latest rules for credit rating agencies are not likely to be the last. In response to the SEC's latest release, New York Senator, Charles Schumer, a senior member of the Senate Banking Committee, said, "None of the rules adopted [by the SEC] are a substitute for the larger regulatory reform that is coming next year."¹⁵

¹¹ Structured finance products are securities backed by mortgage, auto, student and credit card loans.

¹² Moody's Corporation, McGraw-Hill Companies' Standard & Poor's unit and Fimalac SA's Fitch Ratings

¹³ Kara Scannell, "SEC Tightens Rules for Ratings Firms," Wall Street Journal, December 4, 2008

¹⁴ Neil Roland, "SEC's Long Anticipated Crackdown on Bond Raters a Dud", Financial Week, Dec. 5, 2008

¹⁵ Scannell

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during the period that the Treasury holds an equity or debt position.

- 4) Limit the tax deduction of any covered executive⁵ compensation to \$500,000 for any taxable year that falls within the period that the Treasury holds equity or other assets.

On November 24, 2008, the Council of Institutional Investors held a Teleconference on Executive Compensation and Bailout Legislation. The following is a summary of the viewpoints provided to Council members on the teleconference:

On October 20, 2008, the U.S. Department of the Treasury issued a statement on the EESA's executive compensation rules to both clarify the standards and allow stakeholders to comment on their efficacy. Shareholders and corporate advocates both agreed that the requirement prohibiting incentives for "excessive risks that threaten the value of the institution" provides the Treasury with enormous discretion over counteracting these potential abuses. Given that every institution faces different material risks, the Treasury must act to clearly delineate

what risks are appropriate and which are excessive.

While many shareholders agree that excessive risk-taking contributed to the recent market demise, they also believe that regulations shouldn't discourage prudent risk-taking that might limit innovation and value creation. There was consensus that executive compensation should continue to be determined by the compensation committee and the incentives should be resolved by allowing a non-binding shareholder advisory vote on executive compensation.

From the corporate perspective, the excessive risk-taking provision is onerous for companies to implement. The regulation requires that compensation committees meet with their senior risk officers, review SEO incentive compensation arrangements, and identify any incentives tied to excessive risk-taking. Boards must then change their compensation programs to eliminate any inappropriate incentives and certify each year in their financial statements that excessive risk incentives do not exist. As part of this process, shareholders would like to see the compensation committee disclose the details regarding both

their risk overview and their short-term and long-term incentive programs.

Given that many companies have already adopted clawback provisions to recover executive pay, the clawback provision in the EESA has not garnered significant controversy. Shareholders believe, however, that the compensation committee should provide full disclosure of any review related to a clawback evaluation, whether it is material or non-material. Regarding the golden parachute provision, shareholders would rather see an advisory vote rather than a strict prohibition of their use.

The EESA tax deduction provision on executive pay changes the current tax deduction from \$1,000,000 to \$500,000 and removes the "performance-based pay" exception to the deduction limit. Corporations and stakeholders concur that performance-based compensation reinforces the importance of pay for results and better aligns their interests. As a result, removing the performance-based pay exception sends the wrong signal to companies and hurts shareholders, not executives.

⁵ Section 302 of EESA defines a "covered executive" as the CEO, CFO and three other highest-paid executives.

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