



August 10, 2009

Bob Dannhauser
Senior Policy Analyst
CFA Institute Centre for Financial Market Integrity

Dear Bob,

Thank you for your sending the Investor Working Group report and for your request for ideas and reactions in response to the report. I share my perspective from a combination of experiences – expertise in financial institutions practices and analytics and in the corporate and fund board and governance arenas. Attached are my thoughts, as promised. If you or any of the members of the working group would like to discuss this further, I would be happy to do so.

With best regards,
Eleanor Bloxham
CEO, The Value Alliance and Corporate Governance Alliance
614-571-7020
ebloxham@thevaluealliance.com

**Comments to the Investor Working Group Report from
Eleanor Bloxham, CEO, The Value Alliance and Corporate Governance Alliance**

I commend the Investor Working Group and the efforts of the CFA and CII in bringing this process together. I share the views of the commission that bolstering investor and consumer protection with respect to the financial system is paramount. And I believe that the protection of citizens and taxpayers is paramount also. When resources are diverted as they have been from helping the less fortunate because those who are more fortunate could have chosen differently but chose not to, governments that represent the greater good cannot fail to act.

Page 2 **Corporate and Fund Governance.** As the report states, corporate governance is important and I would emphasize that both corporate and fund governance need to be improved – and both corporate and fund (pension, mutual fund) governance were responsible for the failures. This is not in any way to lessen the responsibility of corporate boards. I think, however, that fund boards share responsibility in continuing (following previous investor crises) to not sufficiently hold investment managers accountable for their analytics and fiduciary duty in investment decision making and not holding the investor consultant community accountable as well.

Page 3 **Proprietary Trading.** As the report states, proprietary trading is an important issue and the extent of proprietary trading in listed firms is an important issue more broadly. At some point, I think there needs to be consideration of the appropriate regulatory framework (ala the 40 act) for firms that essentially function in substance if not form as proprietary traders with disclosure requirements with respect to investment intent, risks and the institution of formalized disciplines of holdings and asset pricing and reporting.

Re: agency consolidation, mergers of corporations are fraught with issues of differing cultures that often result in value destruction. I can imagine the same could be true with government agencies. Before any actions were taken in this direction, I would recommend a thorough evaluation of the cultures and requirements for success.

Page 4 **International Cooperation.** As the report states, international cooperation and consultation is important and I think the G20 agreements have contained a solid basis for improvements in their recommendations. As well, there are many good ideas in the Walker report. I think the US needs to better participate in learning as well as facilitating.

Page 5 **Strengthening Federal Regulators.** As the report states, federal regulators should be properly funded and acquire deeper knowledge and expertise. In the December 2008 edition of the Corporate Governance Alliance, I proposed the following areas for strengthening federal regulators, encouraging them to work on the following areas: “1. Developing analytics for decision making purposes and priority setting processes that work 2. Enforcing existing regulations – and determining the right mix (in the public interest) of public enforcement and private litigation/action 3. Determining the long term impacts of their actions on the economy as a whole 4. Defining public goods and how best to protect and enhance them 5. Creating a governmental culture which encourages the exploration of new ideas 6. Increasing their own competency and holding themselves accountable.”

Securitization and Value Destruction Impacts on Originators. As the report makes clear, securitization is an important issue and the recognition of its potential value destruction for originating institutions is little recognized although I discuss and illustrate it in my book Economic Value Management (published 2002/2003). Investors need to understand that as a general matter securitization particularly of credit card and subprime mortgage portfolios is a relatively expensive form of capital for an originating institution due to the fees the investment banks siphon out as part of the packaging. Disclosure requirements with respect to bank funding sources, including securitizations as one of those sources, would be helpful for investors in understanding the capital structure of the banking institution and its intentions with respect to using such expensive forms of funding.

Page 5 – 6 **Fund Oversight and the role of “Investment Consultants” and Compensation.** As the report states, fund oversight is important and necessary. As mentioned earlier, critical on an ongoing basis is the role of fund boards. Fund boards need to exercise more due diligence with respect to oversight and better examination of the level of risk mitigation and analytical capability of investment managers/advisors and hold them accountable. Further, following so many investor crises (tech boom/bust, Enron/Worldcom and now the financial crisis), additional regulation of the “investment consultant” community as gatekeepers should be considered along the lines of accountabilities required of credit rating agencies.

Compensation practices should be reformed as the report states and as I wrote in the December 2008 Corporate Governance Alliance publication, “Structuring their own compensation based on sustainable long term results, not short term annual jumps” for long term holdings so that there is not a mis-match between investor objectives and that of their hired hands. Where there is the potential for mis-match those should be prominently disclosed as a risk of the product offering.

Page 6 **Mortgage Originators, Compensation and Securitizations.** Within a framework of consumer protections In addition to retaining a residual interest, another useful approach would be to encourage compensation based on long term outcomes, similar to those I have designed and described in Economic Value Management. Also, as noted earlier, there should be disclosures related to the relative cost of funding where securitizations (and loan sell offs) are employed as well as the reasons for those decisions. One executive I know likened the use of securitizations and loan selloffs to being hooked on cocaine; the more the economics of them are brought to the surface, the better.

NRSROs and Accountability. The accountability recommendation is important. One particular example I have related to credit rating formulations was one in which I pointed out a fundamental flaw in credit risk determination, described in Economic Value Management, to the person in charge at a rating agency for a series of ratings of financial institutions. The response I received was that the math was simpler to do the conventional way.

Mortgage and Credit Card Servicers. Mortgage servicers weren’t listed on this page but in terms of protecting consumer interests I think requirements as well as fulsome disclosure of practices and obligations to consumers are vitally important. Credit card consumer protections are needed as well.

It is little recognized that one force that helped drive a split between origination and servicing were bad (analytically speaking) economic analyses, at times promulgated by outside consultants, following changes in accounting for mortgage servicing rights. This is just one example that demonstrates that accounting requirements/changes, combined with lack of analytical intelligence at financial firms and

The Value Alliance. 6834 Willoughby Ct. Westerville, OH 43082 USA www.thevaluealliance.com

Eleanor Bloxham. 614-571-7020. ebloxham@thevaluealliance.com

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the lack of compensation alignment with core economics, can be and has been a lethal cocktail. Investment advisers need to increase their savvy with respect to these matters as well. One major reason this is important is that if financial institutions are not equipped and vigilant analytically, it not only can negatively influence consumers but also can weaken those institutions and put stress on the financial system as well.

Page 10 **Regulator Knowledge and Appropriate Sources.** Just as with directors, it is important regulators gain knowledge from diverse sources. I recently attended a National Academy of Public Administrator's meeting related to the science of regulation and the potential conflicts when regulators gain their understanding by talking to "industry". What struck me in that conversation is that it did not seem obvious to the participants that valuable resources in addition to industry would be investors, advisors and critics with a broad understanding of industry practices.

Page 12 **Accounting for Derivatives.** This is a vitally important area for review as the huge exposures are hidden in footnotes and specific risks of instruments are difficult to discern. See also comment above related to page 2 – Proprietary Trading.

Page 14 **Disclosure of Maximum Potential Losses and the Important Role of Analyses in Ameliorating the "Financial Innovation" Problem.** I think this is very important to improve disclosures not only for the recipients of the reports but also the preparers because of the mindsets that develop when full disclosure is not required. For example, I worked with a client who wanted to justify a particular (low) capital requirement (non regulatory) based on the off balance sheet status of certain loans and the purchase of insurance protection for the tranche. I found myself the only one arguing for substance over form. In this case I won as I helped them understand that in reality based on the actions the firm would take to unwind and make whole in the event of distress, the capital requirement was in fact the same. Further, if they did not take those actions in the event of distress, other capital would still be required to handle the reputational fallout. These kinds of analyses help organizations determine the appropriate economics irrespective of regulation or accounting. As noted in my previous discussion on securitization, by making both buyer and seller aware of the true economics of the transaction, when such analyses are systematically performed they can help to eliminate some unnecessary and harmful financial innovations without the necessity of regulatory intervention because the "innovations" are shown to fail to provide real value for both sides.

Page 16 **Fiduciary Standards.** As noted above, fund boards should better oversee the arenas of fund manager compensation (internal and external) and associated risks. In particular, where funds are long term vehicles (e.g. pension funds), as I wrote in the December 2008 Corporate Governance Alliance publication, "Structuring ... compensation based on sustainable long term results, not short term annual jumps" should be required.

Page 19 **Mortgage Originators and Servicers.** As noted earlier, it would be helpful to include mortgage servicers with respect to consumer protection. Also, as noted earlier, better education with respect to the value propositions (i.e. economics) to originators of mortgage sales, securitizations, and the separation of origination and servicing would be helpful to stem value destroying behaviors.

Page 21 **NRSRO Accountability.** See comment above regarding this in the section of comments related to Page 6.

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Page 23 **Compensation Adviser Disclosure and Conflicts.** As the report states, the conflicts of interest do lead compensation advisers to offer biased advice. Of course, as with the credit rating agencies, the issues are much deeper than conflicts. As an outsider that has worked to change the dialogue and practice of compensation, I can say that one issue is that the expertise does not exist within the profession as currently constituted to do otherwise than it has been doing. This is because compensation advisory work as practiced is primarily focused on determining plan structures and payouts, not influencing behaviors or beneficial performance. In addition, it is a money making operation that operates on satisfying needs and it works to satisfy the board and management not a conceptual construct. As with the credit rating agencies, if the profession were codified, that would only make the needed changes more difficult. Rather, the profession needs to be formed anew, a more daunting task but one that would be more effective than window dressing solutions.

Complicating the issue of the profession is the historical fact that for as long as my memory, the profession in substance, if not form, has worked for those who write the checks, management, not the board. Management not the board effectively screens compensation candidates in advance. And management has not nor will it easily lose its grip on its role. Similar to some corporations today where the CEO in effect still chooses the auditor, the issue with the compensation adviser is widespread/the norm. That said, however, even if the choice of a different adviser were really in the hands of the board, because compensation advisory work as practiced is primarily focused on determining plan structures and payouts, not influencing behaviors or beneficial performance, in the current environment, that would not effect much change. Also this would not create much change because boards and compensation committees themselves act in lockstep (as the consultants do) with each other focused not on the behaviors created or beneficial performance but with a keen eye to keeping the CEO and top executives happy. The recent financial crisis has not changed this. It has not persuaded boards that another alternative would better serve them.

I am happy to see the SEC proposal on risk with respect to compensation as I first recommended it in 2006. <http://www.sec.gov/rules/proposed/s70306/ebloxham041006.pdf> I do not think it will change the focal lens of the board, however, unless it is implemented specifically in direct answer to specific questions along the lines I suggested in 2006. The reason I say this is because of my review of board reaction to compensation in light of the financial crisis and the conferences that are including mainline compensation consultants and attorneys who are taking the meaning out of the requirement in their suggestions to managers with respect to implementation. In sum, based on my experience, conflicts of interest are important but relatively minor influences compared with the structural issues outlined above.

Compensation and Say on Pay and Clawbacks. I have publicly stated I think Say on Pay is a good idea in encouraging shareholder and board communication on pay. And I agree with respect to the important use of clawbacks. I would also argue for its further extension as outlined in this letter published by the New York Times.

<http://www.nytimes.com/2008/06/15/business/15backpage.html?scp=1&sq=eleanor%20bloxham&st=cse>

Page 26 **Systemic Risk Oversight Board.** If such a board is developed, the board should develop and report publicly on its goals and performance metrics. If history is any judge, I am not sure that Presidential appointees will bring the level of expertise and the kind of objective, analytical reviews required. Most important is the establishment of mechanisms for public interaction with a requirement

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Eleanor Bloxham. 614-571-7020. ebloxham@thevaluealliance.com

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that the board review and respond to those comments. Specifically, mechanisms should be established for open public comment and concerns as well public comment mechanisms structured around specific topics so that the interests of consumers, investors, and the public as a whole can be served. The board should also be engaged in active education from those who have expertise outside of the members' spheres and influence.

Again, I commend the Investor Working Group for its report. It is far easier to comment than to construct. Thank you for asking for my thoughts.