THE MISDIRECTION OF CURRENT CORPORATE GOVERNANCE PROPOSALS

Testimony before the Senate Committee on Banking Subcommittee on Securities, Insurance and Investment Hearing entitled "Protecting Shareholders and Enhancing Public Confidence by Improving Corporate Governance"

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Chairman Reed, Ranking Member Bunning, and distinguished members of the Subcommittee, it is a privilege to testify in this forum today.

My name is J.W. Verret, and I am an Assistant Professor of Law at George Mason Law School, a Senior Scholar at the Mercatus Center at George Mason University and a member of the Mercatus Center Financial Markets Working Group. I also direct the Corporate Federalism Initiative, a network of scholars dedicated to studying the intersection of state and federal authority in corporate governance.

I will begin by addressing proxy access and executive compensation rules under consideration and close with a list of contributing causes for the present crisis.

I am concerned that some of the corporate governance proposals recently advanced impede shareholder voice in corporate elections. This is because they leave no room for investors to design corporate governance structures appropriate for their particular circumstances.

Rather than expanding shareholder choice, these reforms actually stand in the way of shareholder choice. Most importantly, they do not permit a majority of shareholders to reject the federal approach.

The Director of the United Brotherhood of Carpenters said it best, "we think less is more, fewer votes and less often would allow us to put more resources toward intelligent analysis." The Brotherhood of Carpenters opposes the current proposal out of concern about compliance costs. The proposals at issue today ignore their concerns, as well as concerns of many other investors.

Consider why one might limit shareholders from choosing an alternative means of shareholder access. It can only be because a majority of the shareholders at many companies might reject the federal approach if given the opportunity.

Not all shareholders share similar goals. Public Pension Funds run by state elected officials and Union Pension Funds are among the most vocal proponents of shareholder power. Main street investors deserve the right to determine whether they want the politics of Unions and State Pension funds to take place in their 401ks.

The current proposals also envision more disclosure about compensation consultants. Such a discussion would be incomplete without mentioning conflicts faced by proxy advisory firms. Proxy advisory firms advise institutional investors on how to vote. Current proposals have failed to address this issue. The political clout enjoyed by these firms is evidenced by the fact that the CAO of Riskmetrics, the dominant firm in the industry, was recently hired as special advisor to the SEC Chairman.

To close the executive compensation issue, I will note that if executive compensation were to blame for the present crisis, we would see significant difference between compensation policies at those financial companies that recently returned their TARP money and those needing additional capital. We do not.

Many of the current proposals also seek to undermine, and take legislative credit for, efforts currently underway at the state level and in negotiations between investors and boards. This is true for proxy access, the subject of recent rulemaking at the state level, and it is true for federal proposals on staggered boards, majority voting, and independent Chairmen.

The Sarbanes-Oxley Act passed in 2002 and was an unprecedented shift in corporate governance designed to prevent poor management practices. Between 2002 and 2008, the managerial decisions that led to the current crisis were in full swing. I won't argue that Sarbanes-Oxley caused the crisis, but this suggests that corporate governance reform does a poor job of preventing crisis.

And yet, the financial crisis of 2008 must have a cause. I salute this Committee's determination to uncover it, but challenge whether corporate governance is the culprit. Let me suggest six alternative contributing factors for this Committee to investigate:

i) The moral hazard problems created by the prospect of government bailout;

ii) The market distortions caused by subsidization of the housing market through Fannie Mae, Freddie Mac, and federal tax policy;

iii) Regulatory failure by the banking regulators and the SEC in setting appropriate risk-based capital reserve requirements for investment and commercial banks;

iv) Short-term thinking on Wall Street fed by institutional investor fixation on firms making, and meeting, quarterly earnings predictions;

v) A failure of credit rating agencies to provide meaningful analysis, caused by an oligopoly in that market supported by regulation;

vi) Excessive write downs in asset values under mark-to-market accounting, demanded by accounting firms who refused to sign off on balance sheets out of concern about exposure to excessive securities litigation risk.

Corporate governance is the foundation of American capital markets. If this Committee tinkers with the American corporate governance system merely for the appearance of change, it risks irreparable damage to that foundation.

I thank you for the opportunity to testify, and I look forward to answering your questions.