



Measuring and Rating Ethical Corporate Governance

June 15, 2010

By email: baselcommittee@bis.org

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Comments on "Principles for enhancing corporate governance", March 2010

Dear Ladies and Gentlemen,

We appreciate the opportunity to provide comments on "Principles for enhancing corporate governance", March 2010.

Our firm, Ethics Metrics LLC, has a patent-pending process that measures, compares and prices the effectiveness of corporate governance of U.S. financial holding companies.

Ethics Metrics is a member of the International Corporate Governance Network and the UN Principles of Responsible Investment.

We concur with the overall theme and objectives set forth in your consultative document of March 2010.

Our patent-pending process has identified material weaknesses as well as strengths in the corporate governance of U.S. financial holding companies from 2002 through 2009.

Fundamental weaknesses in the banking sector include ineffective oversight and lack of transparency. Material violations of safety and soundness regulations have not been disclosed to investors and regulators. Specifically, violations of U.S. federal well-managed standards require prompt remediation but, nevertheless, have not been cured, thus inflating capital adequacy ratios and prolonging the unsafe and unsound practices that caused the recent financial crisis. These violations led to firms reaching a troubled condition whereby banks and financial holding companies require external capital and liquidity, including from the U.S. government, to remain viable. Failures to disclose and remediate violations of the well-managed standards have inflated earnings, compensation and capital adequacy ratios. The failure to disclose violations of the well-



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managed standards is a breach of U.S. auditing standards and federal securities laws in respect to disclosing material illegal acts and material compliance violations. In many cases, there are material misstatements in audited financial statements that qualify for restatement. These violations are required to be cured but have not yet been cured thus inflating earnings, equity values, bond values and credit default swap prices of financial holding companies. These violations have occurred in domestic and foreign financial holding companies operating in the U.S.

Complying with the federal well-managed standards prevents banks and financial holding companies from reaching a troubled condition and generating systemic risk.

Ethics Metrics measures the effectiveness of corporate governance by boards of financial holding companies based on their compliance with the federal well-managed and well-capitalized standards as well as federal securities laws and the corporate governance listing standards of the U.S. exchanges.

Ethics Metrics provides independent metrics and ratings on exposure to systemic risk from 2002 through 2009 and beyond in the U.S. banking industry.

Ethics Metrics measures audit risks or the expectations gap, a material risk for shareholders and banking supervisors as cited in Basel's paper, "External audit quality and banking supervision", December 2008.

Ethics Metrics brings transparency and accountability to compliance with the safety and soundness standards of being well-managed and well-capitalized as cited in Basel's paper, "Enhancing Bank Transparency", September 1998.

Ethics Metrics' EGS Exchange for Ethics, Governance and Systemic Risk (EGS)

Ethics Metrics' EGS Exchange™ is an information exchange that enables its subscribers to measure, compare and price the governance of material risks by financial holding companies and investment advisers.

Actionable intelligence from the EGS Exchange empowers buyers and sellers of debt, equity and derivatives issued by U.S. financial holding companies to determine accurate valuations for those securities.

The dynamic for evaluation of securities is based on the ethical corporate governance and regulatory compliance of financial holding companies with



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applicable banking and securities regulations and codes of ethics. The Securities and Exchange Commission has established codes of ethics for publicly traded firms and investment advisers. Among other things, those codes mandate compliance with applicable laws and regulations.

1. Violations of SEC Codes of Ethics, manifested in regulatory violations, erode earnings, equity values and enterprise values due to the requirement to cure breaches of federal regulations. In other words, there is no free lunch or free ride. There are consequences for compliance failures. Regulatory violations must be cured and that process directly impacts earnings, equity values and enterprise values.
2. Ethical behavior and regulatory compliance enhance earnings, equity values and enterprise values.

The mission of the EGS Exchange is to restore ethics and integrity in the financial markets through a range of services to price governance risks. These services are described within our enclosed documents. These services are based on many of the principles for sound corporate governance, transparency and market discipline set forth by the Basel Committee on Bank Supervision.

Please contact us with any questions or comments.

Sincerely,

Beckwith B. Miller, CEO

Enclosures:

Ethics Metrics' Regulatory Alert, June 14, 2010

Ethics Metrics' EGS Exchange, June 14, 2010



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Ethics Metrics' Regulatory Alert: Systemic Risk - Disclosure & Reporting Issues

For: Boards of Directors of Financial Holding Companies and Investment Advisers, Chief Executive Officers, Chief Investment Officers, Chief Risk Officers, and Chief Legal Officers

Executive Summary

Pending Congressional legislation requires reporting of systemic risk exposure by investment advisers, including hedge funds, to federal financial regulators.

Satisfying this new reporting requirement is significantly more difficult than it should be, thanks to material omissions on the part of financial holding companies to disclose violations of the U.S. federal well-managed banking standards. Violations of the well-managed standards lead to financial holding companies reaching a troubled condition and thus generating systemic risk to the financial system, as defined by the Federal Deposit Insurance Corporation Improvement Act of 1991 and the Gramm-Leach-Bliley Act of 1999.

Cascading legal risks that flow from these material omissions to disclose violations include:

- breach of the fiduciary duty of financial holding company boards of directors to disclose material risks to investors.
- material misstatements and related misrepresentations of the financial condition of financial holding companies. These constitute a material weakness in internal controls over financial reporting, and are required to be cured promptly by restatement. Restatements impact earnings, equity values and enterprise values.
- ineffective oversight of compliance risk and audit risk by boards of directors. This also constitutes a material weakness in internal controls over financial reporting. Audit risk arises from the inherent failure of generally accepted accounting principles and current internal controls over financial reporting to detect and disclose all material illegal acts and regulatory violations that may have a material impact on financial reporting.
- false certification by management of effective internal controls over financial reporting. Management is not permitted to certify internal controls over financial reporting are effective if there are one or more material weaknesses.
- violations of the SEC's codes of ethics for publicly traded firms and



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investment advisers as they relate to compliance with laws and regulations.

- delisting risks of securities on U.S. exchanges. The foregoing violations are breaches of the corporate governance listing standards of the U.S. exchanges. These violations must be cured to prevent delisting of securities.
- federally imposed limitations on the activities of financial holding companies until breaches of the well-managed standards are cured. These violations are required to be cured within 180 days, according to Federal Reserve regulations.

Looking Ahead: Financial Reform Reporting Requirements

The Congressional financial reform legislation creates an obligation for investment advisers to measure and report systemic risk in two sections of the House and Senate bills.

1. Both the House and Senate bills require private funds with assets over \$100,000,000, in the case of the Senate bill, or \$150,000,000, in the case of the House bill, to collect data on systemic risk and counterparty risk.

SEC. 5004. COLLECTION OF DATA.

RECORDS AND REPORTS OF PRIVATE FUNDS; Section 204 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-4)

- (A) the amount of assets under management;
 - (B) the use of leverage (including off-balance sheet leverage);
 - (C) **counterparty credit risk exposures**;
 - (D) trading and investment positions;
 - (E) trading practices; and
 - (F) such other information as the Commission, in consultation with the Board of Governors of the Federal Reserve System, determines necessary or appropriate in the public interest and for the protection of investors or for the assessment of **systemic risk**.
2. The Senate bill also includes a provision in Section 405, that expands the reporting obligation on **systemic risk** to all investment advisers registered under the Investment Advisers Act of 1940.

Products and Services of Ethics Metrics LLC

The Ethics Metrics' EGS Exchange™ is an information exchange that enables its subscribers to measure, compare and price the governance of material risks by financial holding companies (FHCs) and investment advisers.



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Private and Confidential

June 14, 2010

Ethics Metrics' EGS Exchange for Ethics, Governance and Systemic Risk (EGS)

For: Boards of Directors of Financial Holding Companies and Investment Advisers, Chief Executive Officers, Chief Investment Officers, Chief Risk Officers, and Chief Legal Officers

Executive Summary – Governance Directly Impacts Financial Performance

Ethics Metrics' EGS Exchange™ is an information exchange that enables its subscribers to measure, compare and price the governance of material risks by financial holding companies (FHCs) and investment advisers.

Actionable intelligence from the EGS Exchange empowers buyers and sellers of debt, equity and derivatives issued by U.S. FHCs to determine accurate valuations for those securities.

The dynamic for evaluation of securities is based on the ethical corporate governance and regulatory compliance of FHCs with applicable banking and securities regulations and codes of ethics. The SEC has established codes of ethics for publicly traded firms and investment advisers. Among other things, those codes mandate compliance with laws and regulations.

1. Violations of SEC Codes of Ethics, manifested in regulatory violations, erode earnings, equity values and enterprise values due to the requirement to cure breaches of federal regulations. In other words, there is no free lunch or free ride. There are consequences for compliance failures. Regulatory violations must be cured and that process directly impacts earnings, equity values and enterprise values.
2. Ethical behavior and regulatory compliance enhance earnings, equity values and enterprise values.

The EGS Exchange provides independent metrics on the following questions:

1. Are boards and management ethical in their conduct?
2. How effectively do they discharge their fiduciary duty on overseeing and disclosing material risks to the shareholders?



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3. What is the impact of material risks, not disclosed to the public, on earnings, enterprise values, and investment valuations?
4. How will boards of investment advisers report on exposure to systemic risk, as required in the pending financial reform legislation, when FHCs fail to disclose material compliance violations that directly contribute to systemic risk?

The mission of the EGS Exchange is to restore ethics and integrity in the financial markets through a range of services to price governance risks. The EGS Exchange:

1. brings transparency, market discipline and accountability to bear on FHCs that have failed to disclose material ethics, governance and systemic risks, while also highlighting those FHCs that manage these critical issues effectively.
2. empowers the capital markets to reallocate capital based on the true financial condition of FHCs. The exchange is the only private-sector organization that provides independent metrics and ratings on the effectiveness of compliance by FHCs with the federal well-managed and well-capitalized standards. The U.S. government hides its internal well-managed ratings, known as CAMELS Ratings, from the public through claims of privacy and confidentiality.
3. measures and rates systemic risk as it flows from FHCs past compliance gatekeepers and into investment portfolios.
4. provides subscribers access to accurate and timely data on inadequately disclosed FHC material risks that qualify for a restatement of earnings, claw back of compensation and repricing of equity values, bond values and credit default swap prices based on degrees of regulatory compliance by FHCs.
5. offers transparency to address the material, system-wide **governance risks** that result from audit risks, fiduciary breaches, ineffective internal controls over financial reporting, systemic risk, regulatory capture, and moral hazard.
 - a. **Audit risks** arise when auditors fail to detect, disclose and quantify material illegal acts and regulatory violations, leading to material misstatements in reported financial statements. Often these misstatements can only be cured by restating the financial statements, at



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great cost and reputational risk to the non-compliant FHC. These audit failures result from the inherent limitations of generally accepted accounting principles and current internal controls over financial reporting with respect to detecting and disclosing material illegal acts that have a material adverse effect on reported financial statements. Restatements may trigger clawback of compensation as well as reveal the need for injections of new capital to meet capital adequacy standards.

- b. **Fiduciary breaches** occur when boards of directors fail to conduct adequate risk oversight, fail to disclose material risks to shareholders and fail to effectively oversee compliance with laws and regulations as required by codes of ethics.
- c. **Ineffective internal controls over financial reporting** result when there are one or more material weaknesses. These include material misstatements, restatements of material misstatements, ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee, and fraud, including false certification by management of effective internal controls over financial reporting.
 - i. **Material misstatements** include the failure of the company to disclose material illegal acts or regulatory compliance violations that have a material impact on reported financial statements. An example includes the failure of FHCs to disclose violations of the federal well-managed standards that led to firms reaching the troubled condition, which triggered systemic risk or federal bailouts.
 - ii. **Fraudulent statement** is defined by the SEC in Rule 17 §240.3b-6(d) as meaning "a statement which is an untrue statement of a material fact, a statement false or misleading with respect to any material fact, an omission to state a material fact necessary to make a statement not misleading, or which constitutes the employment of a manipulative, deceptive, or fraudulent device, contrivance, scheme, transaction, act, practice, course of business, or an artifice to defraud, as those terms are used in the Securities Exchange Act of 1934 or the rules or regulations promulgated thereunder."
- d. **Systemic risk** occurs when FHCs breach federal well-managed standards to the point of reaching the troubled condition. FHCs in a



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troubled condition require external capital and liquidity from the government to remain viable. In the ongoing financial crisis, taxpayers have often been lenders of last resort to troubled banks, thanks to federal bailouts.

- e. **Regulatory capture** results from undue industry influence over federal financial regulators, leading them to under-enforce federal safety and soundness banking regulations and securities laws.
- f. **Moral hazard** refers to the possibility that effectively insured parties, in this case banks that may have recourse to federal bailouts, will fail to take appropriate loss-mitigating actions and will not candidly accept accountability thus increasing risk, such as systemic risk, for the insurance provider, in this case, American taxpayers who fund federal bailouts.

Products and Services of Ethics Metrics LLC

The EGS Exchange provides access to a range of actionable intelligence and related services for boards to effectively manage their fiduciary duties on the oversight of material risks and for the capital markets to reprice equities, debt and derivatives of U.S. FHCs.

Membership benefits of the EGS Exchange include:

1. ***Quarterly notification of material and cascading illegal acts*** and regulatory breaches that flow from violations of the federal well-managed and well-capitalized standards, corporate governance listing standards of the U.S. exchanges, material weaknesses in internal controls over financial reporting by FHCs and audit risks.
2. ***Regulatory Alerts***
 - a. Please see the Ethics Metrics' Regulatory Alert, dated June 4, 2010, for a review of regulatory risks, including pending legislation in Congress.
3. ***New shareholder communications*** based on 10 critical EGS issues that directly impact enterprise values.
 - a. Ethics Metrics has identified 10 critical Ethics, Governance and Systemic Risk (EGS) issues that both boards of directors and shareholders of U.S. banks, bank holding companies and FHCs need to consider as they



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evaluate corporate governance and its impact on systemic risk and related investment and counterparty risks.

- b. The 10 EGS issues are defined in the Ethics Metrics' report of June 4, 2010, ***"Impact of EGS Risks on Investment Values, 2002 through 2009 and Beyond"***.
4. ***Standards for enhancing corporate governance***, ethical behavior, enterprise values and shareholder value.
 - a. A core recommendation is the formation by the board of directors of an Ethics/Compliance Committee. The purpose of the committee is to oversee and manage material risks in accordance with the SEC's codes of ethics.
 - b. Integrate material governance risks into risk oversight. This is a fundamental principle of the
 - i. fiduciary duty of care for boards of directors.
 - ii. SEC's new Rule 17 §229.407(h), effective, February 28, 2010 for investment advisers and publicly traded firms that include FHCs.
 - iii. ESG (Environment, Social and Governance) sustainability initiatives. Examples include the:
 1. UN Principles of Responsible Investment (UN PRI). The principles include:
 - a. We will incorporate ESG issues into investment analysis and decision-making processes.
 - b. We will be active owners and incorporate ESG issues into our ownership policies and practices.
 - c. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
 - d. We will promote acceptance and implementation of the Principles within the investment industry.



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- e. We will work together to enhance our effectiveness in implementing the Principles.
 - f. We will each report on our activities and progress towards implementing the Principles.
2. The International Corporate Governance Network (ICGN) Global Corporate Governance Principles: revised December 2009. These state, under Section 9 on Shareholder Responsibilities, that:
- a. 9.2. Integration into mandates. Pension funds and those in a similar position of hiring fund managers should insist that fund managers put sufficient resources into **governance** analysis and engagement which deliver long term value.
 - b. 9.3. Integration into investment decision-making. Shareholders should take **governance factors** into account and consider the riskiness of a company's business model as part of their investment decision- making....
 - c. 9.4. Collaboration. Where appropriate, shareholders should collaborate where this will enable them to achieve results most effectively.

Ethics Metrics' services include EGS Ratings and Research Reports plus the national Systemic Risk Index™. These services measure and rate exposure to ethics violations and governance risks, including systemic risk for FHCs and their securities. Ethics Metrics provides a portfolio valuation service for investment advisers as well as an enterprise risk management and related counterparty credit risk service for the boards of FHCs and investment advisers.

Portfolio Valuation and Compliance Risk Analysis. Quarterly reports measure and rate portfolio exposure to Ethics Metrics' national Systemic Risk Index™ as well as to related regulatory compliance violations on the part of FHCs.

1. **The Systemic Risk Index™ (SRI)** measures systemic risk exposure on a national basis since March 2001. The SRI is the leading indicator of financial distress in the banking industry. ***The SRI brings transparency to material regulatory compliance risks that are not disclosed by banks to the***



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public. As a service for monetary policy, risk management, investing and portfolio management, the SRI

- a. Measures systemic risk for the U.S. banking industry.
 - b. Predicts financial distress earlier than credit default swaps and the VIX index. The VIX is a widely used measure of market risk and is often referred to as the "investor fear gauge".
 - c. Predicts changes in equity prices, bond prices and credit default swap prices. For example, the SRI predicts changes in equity prices before they are reflected in individual stocks as well as the Russell 3000 Index.
2. **The Portfolio Valuation Services measure and rate portfolio exposure to systemic risk.** This is a service for Management Investment Companies and Investment Advisers based on new and expected SEC regulatory reporting requirements for managing, measuring and reporting systemic risk, counterparty risks and related investment risks. Investment valuation services refine investment values based on quantifiable measurements of corporate governance and related risk that include ethical behavior, illegal acts, violations and related audit risks, including restatements. The Ethics Framework predicts investment values in the U.S. financial sector for equities, bonds and credit default swaps.

Enterprise Risk Management. Ethics Metrics' full set of enterprise risk management systems, for both financial holding company and investment manager boards of directors, covers the full spectrum of ethical and regulatory compliance, the effectiveness of corporate governance and exposure to and mitigation of systemic risk. Reports include:

1. **Board Ratings on Ethical Corporate Governance and Material Fiduciary Risks:** The Ethics Framework measures and rates the ethical corporate governance of boards of banks and investment managers on an Ethics Rating scale of 1 to 5.
 - a. Ethical corporate governance means compliance with laws and regulations. It also means meeting the fiduciary duties of care and duty of loyalty to shareholders through monitoring, detecting and disclosing material risks to investors. Ethical corporate governance



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smooths boom and bust banking cycles while reducing systemic risk, moral hazard, regulatory capture and related investment risks.

- b. Ethics Ratings™ of 1 and 2 represent ethical corporate governance that drives value. These track CAMELS Ratings 1 and 2 for banks and the SEC's code of ethics for investment advisers (17 CFR §275.204A-1). Ethics Ratings of 1 and 2 represent effective oversight of risk, based on publicly available information, by banks.
 - c. Ethics Ratings of 3, 4 and 5 track CAMELS Ratings 3, 4 and 5 for banks and related fiduciary breaches for boards of banks and investment advisers. Ethics Ratings™ 4 and 5 represent firms in a troubled condition that contribute to systemic risk. Financial performance matching the Ethics Ratings of 3, 4 and 5 indicates material illegal acts and related material misstatements including ineffective oversight of risk. Each of these constitutes a material weakness in internal controls over financial reporting. One or more material weaknesses prevent management from certifying the effectiveness of internal controls over financial reporting as required by SEC Rule 17 CFR §229.308 (a)(3). Certifying that internal controls over financial reporting are effective with one or more material weaknesses constitutes fraud. Such shortcomings are required to be promptly remediated to restore compliance as a financial holding company. Remediation and restatements frequently erode earnings, equity values, and capital.
 - d. Compared to credit ratings, Ethics Ratings offer a superior benchmark for assessing regulatory governance risks and their impact on earnings, capital and investment values.
 - e. **FHC Counterparty Risks.** Ethics Ratings provide transparent and independent analysis of FHC counterparty risks arising from violations of safety and soundness regulations, including the well-managed and well-capitalized standards required for companies to operate as a financial holding company.
2. The **Director Scorecard** for managing risk tolerances and counterparty risk exposures based on the EGS Ratings. The **Director Scorecard**™ empowers Boards to set and manage risk tolerances for 10 critical EGS issues affecting ethics, governance and systemic risks based on the Ethics Rating scale of 1 to 5.



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- a. The Director Scorecard enables bank directors to set and manage risk tolerances across the enterprise that directly impact enterprise values.
- b. The Director Scorecard brings transparency for shareholders to hold boards accountable for oversight of material risks.

The EGS Exchange:

