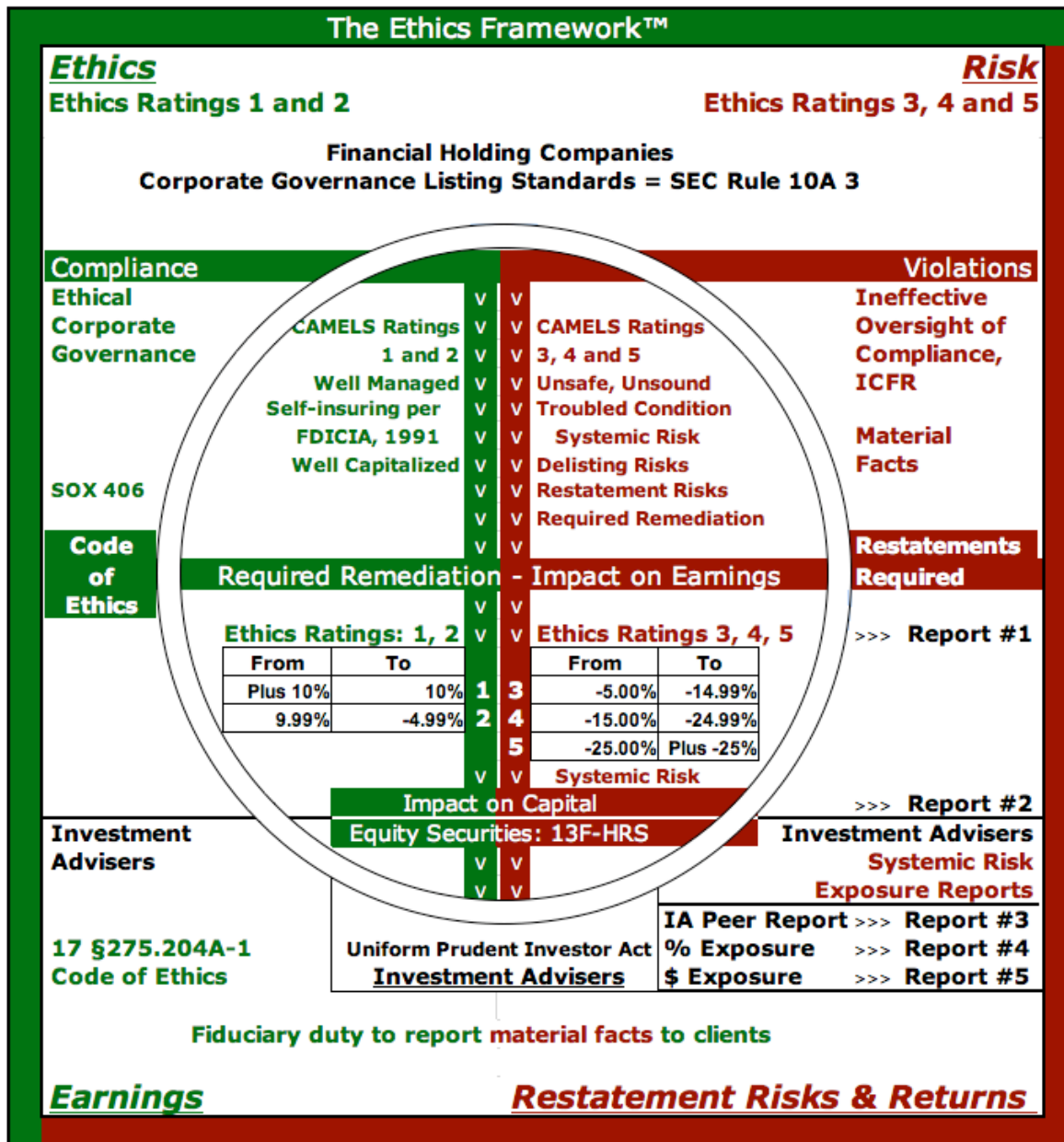




# Measuring and Rating

## Ethical Corporate Governance

The core principles and features of the Ethics Framework™, a patent-pending process, include managing, measuring, rating, quantifying and reporting the effectiveness of corporate governance on compliance, including systemic risk, throughout the financial markets on an Ethics Rating Scale of 1 to 5. As described herein, the model measures the impact of ethical behavior, including compliance violations, on earnings, equity values, delisting risks and loss of capital through systemic risk.





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For a Glossary of terms, please visit [www.ethicsmetrics.com](http://www.ethicsmetrics.com).

- 1) **E's** – Ethics directly impacts earnings, and equity values.
  - a) Ethical corporate governance (Ethics Ratings 1 and 2) has a positive impact on earnings, capital, and equity values based on compliance with all interconnected laws and regulations as required by:
    - i) the Code of Ethics, Sarbanes-Oxley 406,
    - ii) Corporate Governance Listing Standards of the exchanges,
    - iii) Safe and sound practices per FDICIA (CAMELS Ratings 1 and 2), and
    - iv) The Well-managed and well-capitalized requirements per GLBA, the FDICIA risk profiles of CAMELS Ratings 1 and 2 and the Federal Reserve's Bank Holding Company Act. These firms are self-insuring as required by FDICIA in 1991 whereby firms must generate "minimum earnings sufficient to absorb losses without impairing capital."
      - (a) Operating as a well-managed firm aligns with shareholder interests and taxpayer interests as the firm self-insures through the interest rate cycle thus aligning compensation with long-term performance and avoiding a troubled condition and systemic risk.
    - v) The Code of Ethics, 17 §275.204A-1, for Investment Advisers. This includes the fiduciary duty to disclose material facts to clients. The 2009 Congressional bills include provisions for designated investment advisers to assess, record, record and disclose counterparty risk and exposure to systemic risk for the protection of investors.
  - b) Unethical corporate governance (Ethics Ratings 3, 4 and 5) or compliance violations trigger required remediation or restatement of earnings and capital to cure illegal acts per Section 10A or covenant violations that are material misstatements and material weaknesses. An example includes banks and financial holding companies operating in an unsafe and unsound manner per CAMELS Ratings 3, 4 and 5 that run their firms into a troubled condition per FRB 12 §225.71 (d) with poor management per FRB 12 §225.14 and CAMELS Ratings 4 and 5. Troubled condition is defined per FDICIA in 1991 as CAMELS Ratings of 4 and 5 whereby it is "unlikely that the institution can meet all currently applicable capital standards without assistance." Firms in a troubled condition since 1991 are ones that have

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failed to correct early stage violations per CAMELS 3 to restore safe and sound practices. These firms are subject to prompt corrective action but instead received in 2008 and 2009 external assistance from the federal government to remain viable, thus triggering systemic risk and massive losses in equity values. Firms, in a troubled condition include (1) poor management that have not complied with safe and sound banking practices as required by the M in the CAMELS rating plus (2) ineffective corporate governance on compliance. These compliance violations are material misstatements and material weaknesses that require:

- i) a qualified audit opinion due to ineffective internal controls over financial reporting (ICFR). One or more material weaknesses prevent management from certifying ICFR is effective. Certifications by CEO's and CFO's that ICFR is effective with one or more material weakness through SOX 302 is fraud and creates fraudulent statements with one or more material facts, such as the foregoing material misstatements and material weaknesses for a troubled firm.

(1) Financial holding companies do not disclose in their SEC filings whether they are well managed or not.

(a) Being well managed is 50% of the requirement to operate as a financial holding company. This includes management's compliance with laws and regulations per CAMELS Ratings of 1 and 2.

(b) Violations of the well-managed standards directly impact capital ratios that impact degrees of compliance with the other part of being a financial holding company, i.e., being well capitalized.

(c) The Ethics Framework is the only independent rating service that measures and rates degrees of ethical corporate governance that includes compliance with the well-managed and well-capitalized standards for financial holding companies.

(i) Being well-managed and well capitalized is a central requirement for financial holding companies, as broadly defined in the Congressional bills for financial reform in 2009.

- ii) delisting of securities due to violations of the corporate governance listing standards per the exchanges.

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- iii) restatement of earnings and capital to restore:
  - (1) safe and sound conditions per CAMELS Ratings of 1 and 2.
  - (2) compliance with the corporate governance listing standards.
  - (3) the well-managed and well-capitalized standards required for a financial holding company per:
    - (a) GLBA,
    - (b) the Federal Reserve's Bank Holding Company Act and
    - (c) the 2009 Congressional bills on financial reform.
- 2) **G** – Ineffective corporate **g**overnance on compliance risks.
  - a) "The board's role in the oversight of a company's management of risk is a significant policy matter regarding the **g**overnance of the corporation."
    - i) SEC's Staff Legal Bulletin No. 14E (CF), dated October 27, 2009.
  - b) Ineffective corporate governance on compliance risks is a material weakness requiring a restatement of compliance violations and qualified audit opinion due to ineffective internal controls over financial reporting (ICFR) per Sarbanes-Oxley 404.
    - i) A material weakness requiring a qualified audit opinion and restatement of compliance violations is defined as "Ineffective oversight of the company's external financial reporting and internal control over financial reporting (ICFR) by the company's audit committee."
      - (1) PCAOB's Auditing Standard No. 5 .69.
    - ii) "Management is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting."
      - (1) SEC: 17 §229.308 (a)(3).



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- iii) The Ethics Framework measures, rates and helps price ineffectiveness of corporate governance on compliance.
- (1) This service represents a new avenue for shareholders seeking greater transparency and accountability over boards of directors and management as it relates to their degree of compliance with the regulatory obligations of being a well-managed and well-capitalized financial holding company as required by FDICIA, GLBA, the Code of Ethics, corporate governance listing standards of the exchanges and the pending bills on financial reform in Congress.
- (2) The Ethics Framework measures and rates degrees of compliance by financial holding companies as described in the core principles of the Ethics Framework. It includes measuring 3 interconnected factors that each qualify as a material weakness in internal controls over financial reporting (ICFR) – just one material weakness requires a qualified audit opinion. The three interconnected material weaknesses per SEC securities laws and PCAOB Auditing Standard No. 5. .69 are (1) ineffective oversight of compliance by the Board, (2) restatement of previously issued financial statements to reflect the correction of a material misstatement, and (3) identification of fraud, whether or not material, on the part of senior management. The Ethics Framework provides a holistic process to measure and rate the following interconnected material weaknesses:
- (a) Material Weakness No 1: Ineffective oversight of compliance by the Board. A primary cause of the financial crisis is the failure of boards and their financial holding companies to comply with the well-managed and well-capitalized regulatory standards.
- (i) A practical example includes the failure of boards to prevent firms reaching a troubled condition requiring a federal bailout.
1. Firms that breach the well-managed and well-capitalized standards violate the safe and sound practices required by FDICIA and GLBA for firms to have the privileges of federal deposit insurance and operating as a financial holding company.
- a. Regulations require cures of the unsafe and unsound practices through a restatement of earnings and capital



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to restore safe and sound practices and the well-managed standard.

i. Restatements are a second material weakness.

2. "ineffective oversight of the company's external financial reporting and internal control over financial reporting (ICFR) by the company's audit committee" includes the foregoing regulatory breaches plus the requirement for restatements to cure material compliance violations or material misstatements that, individually and in the aggregate, represent multiple material weaknesses that prevent management from certifying internal controls over financial reporting are effective. Management's certification, through SOX 302, of effective internal controls over financial reporting in the face of one or more material weaknesses is a violation of the SEC's rule 17 §229.308 (a)(3):

a. "Management is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting."

(ii) Ineffective oversight of compliance by the Board is also a violation of the corporate governance listing standards of the exchanges. The listing standards require compliance with laws and regulations, including the Code of Ethics. Violations require delisting of securities unless cured.

1. Curing requires a restatement, which is a second material weakness.

(b) Material Weakness No 2: Restatement of previously issued financial statements to reflect the correction of a material misstatement. Restoring a state of compliance is a fundamental requirement of law and achieving this requires restatement of compliance violations.



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- (i) The Ethics Metrics Reports quantify required restatements of compliance violations so firms operate as well-managed firms with the related impact on capital.
  - 1. Restatements are the second material weakness requiring a qualified audit opinion per the SEC and PCAOB's Auditing Standard No. 5 .69.
- (c) Material Weakness No 3: "Management is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting." SEC: 17 §229.308 (a)(3). Two examples of material weaknesses are provided above.
  - (i) Issuing false certifications under SOX 302 by CFO's and CEO's that internal controls are effective when there are one or more material weaknesses qualifies as a material misrepresentation of material facts that triggers two significant compliance issues.
    - 1. The first is that the omission of material facts such as the three material weaknesses noted herein that fit the SEC's description of fraudulent statement per 17 §240.3b-6(d).
    - 2. The third material weakness is the "Identification of fraud, whether or not material, on the part of senior management". Improper certification of effective internal controls over financial reporting with the foregoing material weaknesses is a violation of securities law.
- 3) **C's, R's, M's, E's – Consequences** of compliance violations, per CAMELS Ratings 3, 4 and 5, require restatements of material covenant breaches to restore ethical behavior, safe and sound practices and the well managed standards required to operate as a financial holding company.
  - a) Failure to cure material covenant breaches or material illegal acts per Section 10A, that have a direct impact on financial reporting, qualify as material misstatements and material weaknesses due to ineffective corporate governance on compliance per the corporate governance listing standards and securities laws. These violations require a qualified audit



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- opinion and restatement of the Illegal acts per Section 10A Audit Requirements to restore compliance.
- i) Restatements directly impact earnings and equity values.
  - ii) Restatements are the second material weakness requiring a qualified audit opinion per the SEC and PCAOB's Auditing Standard No. 5 .69.
- b) Additional consequences, that require remediation to restore compliance or ethical behavior thus impacting earnings and capital, include:
- i) risk of termination of federal deposit insurance,
  - ii) limitations on financial activities by financial holding companies,
  - iii) downgrading of capital adequacy categories and
  - iv) delisting of securities.
- c) Compliance violations include breaches of safe and sound banking practices including the well-managed standards that led to firms in a troubled condition that caused systemic risk in 2008.
- i) Compliance violations are measured by CAMELS Ratings of 3, 4 and 5.
  - ii) Troubled condition is defined per FDICIA in 1991 as CAMELS Ratings of 4 and 5 whereby it is "unlikely that the institution can meet all currently applicable capital standards without assistance."
  - iii) CAMELS Ratings 3, 4 and 5 must be cured to operate in a safe and sound manner and to comply with the well-managed standard required for financial holding companies.
- (1) Restatements to restore compliance directly impact earnings, capital and equity values and qualify as a material weakness.
- 4) **D's** - Directors and investment advisers have a fiduciary duty to disclose material facts to clients, including the consequences of non-compliance, such as delisting risks of securities due to the material weakness of ineffective oversight of compliance and audit risks that violate corporate governance listing standards and internal controls over financial reporting (ICFR). These violations must be cured through restatements that impact earnings and equity values.



#### 5) **F's: Fraud & Material Weaknesses in Internal Controls Over Financial Reporting**

- a) The failure to have effective oversight of the code of ethics and related compliance risks and audit risks by a board is a material weakness per PCAOB's Auditing Standard No. 5 .69.
- b) The need for restatements to correct material illegal acts or material misstatements is a material weaknesses per PCAOB's Auditing Standard No. 5 .69.
- c) One or more material weaknesses prevent management per 17 §229.308 (a)(3) from certifying per Sarbanes-Oxley 302 that internal controls over financial reporting are effective per Sarbanes-Oxley 404. A qualified audit opinion is the consequence for not having effective internal controls over financial reporting (ICFR) per SOX-404.
- d) Fraud is committed if management certifies internal controls over financial reporting (ICFR) is effective with one or more material weaknesses.
  - i) SEC: 17 §229.308 (a)(3).
- e) Fraudulent statements trigger claw back of excess compensation per multiple federal regulations cited in the Glossary of Ethics Metrics.
- f) Fraud, misrepresentations and malfeasance in the offering of financial products are addressed within the Emergency Economic Stabilization Act (EESA).
  - i) Section 104 of EESA requires members of the financial stability oversight board to report Fraud, misrepresentations and malfeasance to the US Attorney General or the Special Inspector General for TARP.
  - ii) Section 127 of EESA requires cooperation by the federal financial regulators with the FBI and other law enforcement agencies such as state attorney generals on the investigation of fraud, misrepresentations and malfeasance in the offering of financial products.

#### 6) **R's** – Restatement risks directly impact risk/return.



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- a) Earnings restatements to restore CAMELS Ratings 1 and 2 by correcting violations of CAMELS Ratings 3, 4 and 5 directly impact capital that can trigger prompt corrective action, which is a government take-over of failed firms, resulting in loss of capital for shareholders.
  - b) Restatements are a material weakness in internal controls over financial reporting that prevent management from certifying internal controls are effective per PCAOB Auditing Standard No. 5 .69 and 17 §229.308 (a)(3).
- 7) The Ethics Framework is a patent-pending model that:
- a) Provides an independent path or solution to the financial crisis without the influence of politics. It provides transparency, accountability and market discipline on systemic risk for the financial markets.
  - b) Provides transparency and market discipline for measuring, rating and pricing ineffective corporate governance on compliance as it relates to well-managed and well-capitalized financial holding companies. Consequences of compliance violations include required remediation so as to prevent termination of federal deposit insurance, delisting of securities, qualified audit opinions and firms in a troubled condition causing systemic risk.
  - c) Provides independent metrics on measuring audit quality or audit risks due to the limitations of generally accepted accounting principles and internal controls over financial reporting to detect and disclose material illegal acts that are material misstatements and material weaknesses requiring a qualified audit opinion and restatement of fraudulent statements.
  - d) Empowers the market to measure, rate and manage exposure to systemic risk and counter party risk from financial holding companies.
  - e) Enables insurance companies to reprice Directors and Officer's insurance based on the exposure of a firm to systemic risk.
  - f) Measures, rates and reports on degrees of ethical behavior and related compliance violations that directly impact earnings, capital, and equity values for shareholders.
  - g) Enables investment advisers to comply with the Uniform Prudent Investor Act (UPIA) and Code of Ethics,17 §275.204A-1, for Investment Advisers. This includes:



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- i) the fiduciary duty to disclose material facts to clients.
  - (1) Material facts per the SEC include material illegal acts of compliance violations and related material misstatements and material weaknesses, including ineffective oversight of compliance by boards of directors that qualify for delisting of securities, a qualified audit opinion and restatements to cure compliance violations.
  - (2) Material facts per the 2009 Congressional bills include provisions for designated investment advisers to assess, record, record and disclose counterparty risk and exposure to systemic risk for the protection of investors.
- ii) measuring, rating and pricing ineffectiveness of corporate governance on compliance that directly impacts:
  - (1) earnings and equity values as part of the risk/return model. This includes the risk of restatements to cure compliance violations:
    - (a) Restatements of earnings and capital, depending on the severity, may trigger one of two options for the government. These options include:
      - (i) prompt corrective action. This includes an option for the government or FDIC takeover of failed institutions resulting in a loss of capital for shareholders.
      - (ii) special risk-based assessments for “financial companies” to cover the cost of systemic risk through the Systemic Resolution Fund per the Congressional bills.
- iii) comply with the Uniform Prudent Investor Act’s
  - (1) Duty to Monitor: “Subsections (a) through (d) apply both to investing and managing trust assets. “Managing” embraces monitoring, that is, the trustee’s continuing responsibility for oversight of the suitability of investments already made as well as the trustee’s decisions respecting new investments.”
  - (2) Duty to investigate. “Subsection (d) carries forward the traditional responsibility of the fiduciary investor to examine information likely to bear importantly on the value or the security of an investment. “



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- (3) Loyalty: "A trustee shall invest and manage the trust assets solely in the interest of the beneficiaries."
- (4) Reviewing Compliance. "Compliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight."
- 8) The Ethics Framework is a patent-pending model that provides transparency with independent ratings on degrees of compliance with core historical regulations on being well-managed and well-capitalized that are being broadly expanded, within Congressional bills on financial reform to:
  - a) Cover Financial Companies. Financial companies may be subjected to Stricter Prudential Standards for Financial Stability Purposes; SEC 1103 and regulated as the equivalent of financial holding companies, "Financial Holding Company subject to stricter standards", with the requirement that they be and remain well-managed and well-capitalized.
    - i) Financial Companies are defined as including:
      - ii) Insurance companies
      - iii) firms conducting financial activities per section 4(k) of the Bank Holding Company Act of 1956. These include:
        - (1) Investment Advisers
        - (2) Investment Management Companies
        - (3) Capital markets activities.
    - b) Provide external financial assistance to firms defined as a financial holding company, that are in a troubled condition per FDICIA's definition, through:
      - i) A Liquidity Assistance program that is similar to the FDIC's Debt Guarantee Program.
        - (1) The House Congressional Bill provides this through the "EMERGENCY FINANCIAL STABILIZATION. SEC. 1109. Liquidity Event"



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- ii) The Systemic Resolution Fund, also called the Systemic Dissolution Fund. Firms reaching a near death condition defined as systemic risk, i.e., critically undercapitalized and incurring losses that will deplete or substantially deplete capital will be funded through these funds and then wound down.
- c) Fund the external financial assistance in b) above with risk-based assessments on financial companies with assets in excess of \$10,000,000,000. Financial Companies are defined as including:
  - i) Insurance companies
  - ii) firms conducting financial activities per section 4(k) of the Bank Holding Company Act of 1956. These include:
    - (1) Investment Advisers
    - (2) Investment Management Companies
    - (3) Capital markets activities.
    - (4) Hedge funds.
- 9) The Ethics Metrics' system measures, rates and quantifies exposure to systemic risk as it flows from financial holding companies, past regulatory gatekeepers, through counterparty risks and high risk equity securities into the investment portfolios of shareholders, investment advisers and investment companies.
  - a) Visit [www.ethicsmetrics.com](http://www.ethicsmetrics.com) for reports and ratings on financial holding companies and investment advisers.