Testimony of

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before the

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Enhanced Investor Protection After the Financial Crisis

Chairman Johnson, Ranking Member Shelby, and Members of the Committee:

Good morning. I am Anne Simpson, Senior Portfolio Manager, Global Equities at the California Public Employees' Retirement System (CalPERS). I am pleased to appear before you today on behalf of CalPERS and share our views on a number of important investor protections included in Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).

My testimony includes a brief overview of CalPERS, including how we participate in corporate governance and make investment decisions. My testimony also includes a discussion of our views on those key provisions of the Dodd-Frank we believe significantly enhance corporate governance and thereby contribute to the quality of risk adjusted returns in our portfolio.

Some Background on CalPERS

CalPERS is the largest public pension fund in the United States with approximately $232 billion in global assets and equity holdings in over 9,000 companies worldwide. CalPERS provides retirement benefits to more than 1.6 million public workers, retirees, their families and beneficiaries. We payout some $15 billion in benefits a year, and 70 cents on the dollar comes from investments, a significant portion of which in internally managed.[1]

Those we support are on modest incomes: typically, $2,000 in benefits a month. For that reason, as a significant institutional investor with a long-term investment time horizon, CalPERS has a vested interest in maintaining the integrity and efficiency of the capital markets. Moreover, size and long term liabilities mean we have to look for market solutions. We cannot simply sell our shares when things go wrong. As a result, corporate governance issues are of great concern to us and those on whose behalf we are investing: the public servants such as

[1] Approximately three-quarters of CalPERS global equities portfolio is managed by internal investment professionals.

the police officers, firefighters, school employees and others who rely on us for their retirement security.

Participation in Corporate Governance Decisions

CalPERS has been a long–time proponent of good corporate governance, which serves to protect, preserve and grow the assets of the fund, and we strongly support the corporate governance reforms found in Dodd-Frank. We have also strongly supported other measures which are vital to a coordinated and comprehensive reform effort. These are not the focus of today's discussion, but they are critical to the project: systemic risk oversight, proper funding and independence for regulators, derivatives reform, credit rating agency overhauls among them.

As a shareowner of each of the stocks held in its portfolios, CalPERS has developed, and periodically updates, a comprehensive set of corporate governance principles and detailed guidelines that govern the voting of the related proxies. These principles and guidelines focus on a broad range of issues including how we will vote on director nominees in uncontested elections and in proxy contests.

CalPERS votes its proxies in accordance with our guidelines. Both the CalPERS proxy policy and the actual proxy votes cast are published on our website, so that all constituents and interested parties can know our positions on these important issues. Moreover, as part of our proxy voting diligence process, we have detailed discussions with many companies in our portfolio. We engage underperforming companies in extensive dialogue through our Focus List program, which was found to produce superior returns over a 10-year period.[2]

[2] See *The CalPERS Effect on Targeted Company Share Prices*, Wilshire Associates, (November 2010). http://www.calpers.ca.gov/eip-docs/about/board-cal-agenda/agendas/invest/201008/item05a-2-02-01.pdf

Shareowner proxy voting rights are considered to be valuable assets of the fund. Attention to corporate governance promotes responsible business practices that serve as an integral component to a company's long–term value creation. In instances where guidelines are not dispositive on shareowner or management proposals, the Office of Corporate Governance, which I oversee, reviews and makes proxy voting recommendations that are consistent with the best interests of the fund and our fiduciary duties.

Investment Decision Making Process

As indicated above, CalPERS takes a long–term strategic approach to its investment decision–making process. Annually, a comprehensive "Strategic Investment Plan" is developed jointly by CalPERS' investment staff and its external consultants, with input from and subject to final approval of the thirteen–member board. The plan is based on careful analysis of the long–term outlook for the capital markets and major qualitative and quantitative factors including the unique needs, preferences, objectives and constraints of CalPERS. This detailed investment plan manifests itself in the development of an asset allocation framework designed to achieve the ongoing commitment to diversification and provide guidance in the investment decision–making process including advancing investment strategies, the hiring and monitoring of external investment advisors, portfolio rebalancing and meeting cash needs.

How Inadequate Corporate Governance Contributed to the 2008 Financial Meltdown

It is widely acknowledged that the 2008 financial crisis was fuelled by a toxic combination of lax oversight and misaligned incentives.[3] Too many CEOs pursued excessively risky strategies or

[3] *See* Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report *xviii* (Jan. 2011), http://www.gpoaccess.gov/fcic/fcic.pdf ("We conclude dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of this crisis") [hereinafter FCIC Report]; Investors' Working Group, *U.S. Financial Regulatory Reform, The Investors' Perspective* 22 (July 2009), http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors'%20Working%20Group%20Report%20(July%202009).pdf ("The global financial crisis represents a massive failure of oversight") [hereinafter IWG Report].

investments that bankrupted their companies or weakened them financially for years to come.[4] Boards of directors were often complacent, failing to challenge or rein in reckless senior executives who threw caution to the wind.[5] And too many boards approved executive compensation plans that rewarded excessive risk taking.[6] Others simply did not have robust risk management systems in place, or had these subservient to short term revenue chasing. The Dodd Frank focus upon improving transparency around incentives and giving shareowners the tools to improve oversight of boards is therefore absolutely on target. We look forward to further improvements in disclosure also under discussion by financial regulators, for example to ensure that compensation below board level is disclosed for those who can have an impact upon the company's over risk profile, and also to improve understanding of pay equity across companies.

More specifically, a common element in the failure of Lehman Brothers, American International Group, Fannie Mae, Washington Mutual, and many other companies implicated in the 2008 financial meltdown, was that their boards of directors did not control excessive risk-taking, did not prevent compensation systems from encouraging a 'bet the ranch' mentality, and did not hold management sufficiently accountable.[7] As famed investor Warren Buffett observed in his 2009 letter to the shareowners of Berkshire Hathaway Inc.:

> In my view a board of directors of a huge financial institution is *derelict* if it does not insist that its CEO bear full responsibility for risk

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[4] IWG Report, *supra* note 1, at 22.

[5] *See* Staff of S. Permanent Subcomm. on Investigations, Wall Street and the Financial Crisis: Anatomy of a Financial Collapse 185-86 (Apr. 13, 2011), http://hsgac.senate.gov/public/_files/Financial_Crisis/FinancialCrisisReport.pdf (providing evidence that board oversight of Washington Mutual, Inc., including oversight of enterprise risk management, was "'less than satisfactory'"); IWG Report, *supra* note 1, at 22.

[6] FCIC Report, *supra* note 1, at *xix* ("Compensation systems—designed in an environment of cheap money, intense competition, and light regulation—too often rewarded the quick deal, the short-term gain—without proper consideration of long-term consequences); *see also* Deputy Secretary of the Treasury Neal Wolin, Remarks to the Council of Institutional Investors 4 (Apr. 12, 2010), http://www.ustreas.gov/press/releases/tg636.htm (noting that ""irresponsible pay practices . . . led so many firms to act against the interests of their shareholders"); IWG Report *supra* note 1, at 22.

[7] *See, e.g.,* Press Release, CalPERS, *Investors Speak Out on Dodd's Financial Reform Bill – Offer Do's, Don'ts as Bill Reaches Critical Stage* 2 (Mar. 19, 2010), http://www.calpers.ca.gov/index.jsp?bc=/about/press/pr-2010/mar/investors-financial-reform-bill.xml.

> control. If he's incapable of handling that job, he should look for other employment. And if he fails at it – with the government thereupon required to step in with funds or guarantees – the financial consequences for him and his board should be severe.
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> It has not been shareholders who have botched the operations of some of our country's largest financial institutions. Yet they have borne the burden, with 90% or more of the value of their holdings wiped out in most cases of failure. Collectively, they have lost more than $500 billion in just the four largest financial fiascos of the last two years. To say these *owners* have been "bailed-out" is to make a mockery of the term.
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> The CEOs and directors of the failed companies, however, have largely gone unscathed. Their fortunes may have been diminished by the disasters they oversaw, but they still live in grand style. It is the behavior of these CEOs and directors that needs to be changed: If their institutions and the country are harmed by their recklessness, they should pay a heavy price – one not reimbursable by the companies they've damaged nor by insurance. CEOs and, in many cases, directors have long benefited from oversized financial carrots; some *meaningful* sticks now need to be part of their employment picture as well.[8]

Accountability is critical to motivating people to do a better job in any organization or activity.[9] An effective board of directors can help every business understand and control its risks, thereby encouraging safety and stability in our financial system and reducing the pressure on regulators, who, even if adequately funded, will be unlikely to find and correct every problem.[10] Unfortunately, long-standing inadequacies in corporate governance requirements and practices have limited shareowners' ability to hold boards accountable.[11]

Fortunately, Dodd-Frank contains a number of corporate governance reforms that when fully implemented and effectively enforced will reduce those inadequacies by providing long-term investors like with better tools, including better information, to hold directors more accountable going forward.[12]

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[8] Letter from Warren E. Buffett, Chairman of the Board, to the Shareholders of Berkshire Hathaway, Inc. 16 (Feb. 26, 2010), http://www.berkshirehathaway.com/letters/2009ltr.pdf.
[9] Press Release, *supra* note 5, at 2.
[10] *Id.*
[11] IWG Report, *supra* note 1, at 22 ("shareowners currently have few ways to hold directors' feet to the fire").
[12] S. Comm. On Banking, Housing, & Urban Affairs, Rep. On The Restoring American Financial Stability Act 30 (Mar. 22, 2010), http://banking.senate.gov/public/_files/RAFSAPostedCommitteeReport.pdf

The remainder of my testimony highlights some of the key corporate governance provisions of Dodd-Frank and why CalPERS believes those provisions are beneficial to investors in terms of improving the accountability of boards and enhancing investor protection.

Dodd-Frank Corporate Governance Provisions

SEC. 971 Proxy Access

The most fundamental of investor rights is the right to nominate, elect and remove directors.[13] Anything less provides a fundamental flaw in capitalism. The providers of capital need to be able to hold boards accountable, and boards in turn need to have effective oversight of management. The United States is virtually alone in world markets by not providing capital providers the ability to hold their stewards to account. Several roadblocks, however, have prevented this fundamental right from being an effective remedy for shareowners dissatisfied with the performance of their public companies.[14]

One of the most significant roadblocks is that federal proxy rules have historically prohibited shareowners from placing the names of their own director candidates on public company proxy cards.[15] Thus, long-term shareowners who may have wanted the ability to run their own candidate for a board seat as a means of making the current directors more accountable have only had the option of pursuing a full-blown election contest—a prohibitively expensive action for most public pension funds like CaPERS.[16]

(Noting that the Senate version of Dodd-Frank contained provisions designed to give investors "more protection" and shareholders "a greater voice in corporate governance") [hereinafter S. Rep.].

[13] *See* IWG Report, *supra* note 1, at 22.

[14] *Id.*

[15] *Id.*

[16] *Id.*

Fortunately, due to the extraordinary leadership of this Committee and the U.S. Securities and Exchange Commission ("Commission or SEC"), this roadblock—the inability for shareowners to place director nominees on the company's proxy card— we hope will soon be lifted.[17] As background, in June 2009, the Commission issued a thoughtful proposal providing for a uniform measured right for significant long-term investors to place a limited number of nominees for director on the company's proxy card.[18] Some opponents of the proposal subsequently raised questions about whether the Commission had the authority to issue a proxy access rule.[19] In response, Senator Schumer introduced, what would later become Section 971 of Dodd-Frank, removing any doubt that the Commission had the authority to issue a proxy access rule.[20]

After careful consideration of the input received in response to two separate comment periods on the proposal, the SEC issued a final rule on September 16, 2010.[21] The final rule provides the ability for CalPERS, as part of a larger group of long-term investors, to place a limited number of nominees for director on the company's proxy card and, thereby, effectively exercise its traditional right to nominate and elect directors to company boards.[22]

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[17] We note that a second roadblock to the fundamental right of investors to nominate, elect, and remove directors—"plurality voting"—was not addressed by Dodd-Frank and remains a significant impediment to improving board accountability. More specifically, most companies elect directors in uncontested elections using a plurality standard, by which shareowners may vote for, but cannot vote against, a nominee. If shareowners oppose a particular nominee, they may only withhold their vote. As a consequence, a nominee only needs one "for" vote to be elected and, therefore, potentially unseating a director and imposing some accountability becomes virtually impossible. We would respectfully request that the Committee consider stand alone legislation to remove this roadblock. Id.

[18] Facilitating Shareholder Director Nominations, 74 Fed. Reg. 29,024 (proposed rule June 18, 2009), http://www.sec.gov/rules/proposed/2009/33-9046.pdf.

[19] Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,674 (final rule Sept. 16, 2010), http://www.gpo.gov/fdsys/pkg/FR-2010-09-16/pdf/2010-22218.pdf ("Several commentators challenged our authority to adopt Rule 14a-11").

[20] *See id.*

[21] *Id.* at 56,668.

[22] *Id.*

Unfortunately, despite Section 971 of Dodd-Frank, opponents of the Commission's final rule have chosen to sue the SEC to delay its implementation.[23] The legal challenge, based largely on Administrative Procedure Act grounds, is currently before the D.C. Circuit Court of Appeals ("Court") on an expedited review.[24] A decision is expected this summer.[25] Whatever the Court's decision, we fully expect that the Commission will, after curing any administrative deficiencies, promptly implement the final rule and remove this long-standing roadblock to the exercise of shareowners' fundamental right to nominate, elect, and remove directors.

SEC. 951 Shareholder Vote on Executive Compensation Disclosures

As described by the Financial Crisis Inquiry Commission, the financial crisis revealed compensation systems:

> [D]esigned in an environment of cheap money, intense competition, and light regulation—too often rewarded the quick deal, the short-term gain—without proper consideration of long-term consequences. Often those systems encouraged the big bet—where the payoff on the upside could be huge and the downside limited. This was the case up and down the line—from the corporate boardroom to the mortgage broker on the street.[26]

During the development of Dodd-Frank, this Committee concluded that "shareholders, as the owners of the corporation had a right to express their opinion collectively on the appropriateness of executive pay."[27] The result was Section 951 of Dodd-Frank that provides that any proxy for an annual meeting of shareowners will include a separate resolution subject to shareowner advisory vote to approve the compensation of executives.[28]

We agree with the Council of Institutional Investors that Section 951 provides with

> a tool . . . [to] effectively, efficiently and regularly provide boards with useful feedback about whether investors view the company's

[23] Ted Allen, U.S. Appeal Court to Hear Proxy Access Lawsuit, ISS (Apr. 6, 2011), http://blog.riskmetrics.com/gov/2011/04/us-appeals-court-to-hear-proxy-access-lawsuit.html.
[24] *Id.*
[25] *Id.*
[26] FCIC Report, *supra* note 1, at *xix*.
[27] S. Rep., *supra* note 10, at 109.
[28] *Id.*

> compensation practices to be in shareowners' best interests. Nonbinding shareowner votes on pay offer a more targeted way to signal shareowner discontent than withholding votes from compensation committee members, and can serve as a helpful catalyst and starting point for dialog on excessive or poorly-structured executive pay. Also, the possibility of a majority "against" vote might serve as an additional deterrent against devising incentive plans that promote excessive risk-taking and/or enrichment.[29]

Section 951 became effective for the first time this proxy season. As recently discussed by SEC Commissioner Luis Aguilar, it appears that the new requirement is benefitting investors in at least three ways:

> First, say-on-pay seems to have resulted in increased communication between shareholders and corporate management. Reports seem to indicate that both shareholders and corporate management are pro-actively initiating discussions regarding executive compensation, which is far from the predictions that say-on-pay would lead to disrepair or at best be ineffective — this sounds like a positive development to me.
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> Second, the reports indicate that shareholders are making their voices heard. For example, as of this month, 31 public companies have failed to obtain majority support for their executive compensation packages.
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> Lastly, some pay practices appear to be changing in deference to shareholders' views. Some companies have actually altered the pay and benefits of top executives. Many companies are putting in more performance-based compensation plans and they are addressing items that shareholders often criticized, such as: excessive severance; perks; federal income tax payments; and pensions. For example, approximately 40 of the Fortune 100 companies have eliminated policies that had the company pay certain tax liabilities of executives. As another example, General Electric modified the pay of its CEO two weeks prior in anticipation of the shareholder vote, deferring the vesting of certain options and conditioning the vesting on whether the company meets certain performance targets. According to news reports, this was apparently done to avoid losing a say-on-pay vote.[30]

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[29] Letter from Justin Levis, Senior Research Associate, Council of Institutional Investors to Mr. Mike Duignan, Head of Market Supervision, Irish Stock Exchange 1-2 (Aug. 11, 2010), http://www.cii.org/UserFiles/file/resource%20center/correspondence/2010/8-11-10CIILetterIrishCorpGovCode%20.pdf

[30] Commissioner Luis A. Aguilar, U.S. Securities and Exchange Commission, Speech at the Social Investment Forum 2011 Conference 3-4 (June 10, 2011), http://www.sec.gov/news/speech/2011/spch061011laa.htm.

Section 954 Recovery of Erroneously-Awarded Compensation

Another means identified by this Committee, the Investors Working Group, the Council of Institutional Investors, and many other parties to combat poorly structured executive pay plans that rewarded short term but unsustainable performance was to enhance current clawback provisions on unearned executive pay.[31] In response, Section 954 of Dodd-Frank strengthens the existing clawback provisions in three important ways: First, it expands the application of the existing clawback requirements to any current or former executive officer (not just the CEO or CFO).[32] Second, it clarifies that a clawback is triggered by an accounting restatement due to material noncompliance without regard to the existence of misconduct.[33] Finally, it strengthens the existing clawback requirements by extending the clawback to three years from the existing 12-month period.[34]

CalPERS' support for Section 954 is based on our belief, shared by the Council of Institutional Investors, and many other corporate governance and compensation experts, that a tough clawback policy is an essential element of a meaningful pay for performance philosophy.[35] If executives are rewarded for hitting their performance metrics—and it later turns out that they failed to do so—they should return to shareowners the pay that they did not rightly earn.[36] We look forward to the Commission's proposed and final rules to implement Section 954 scheduled for later this year.

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[31] *See, e.g.*, Letter from Laurel Leitner, Senior Analyst, Council of Institutional Investors to Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation 1-2 (May 19, 2011), http://www.fdic.gov/regulations/laws/federal/2011/11c07Ad73.PDF.
[32] John E. McGrady, III, & Kristen R. Miller, Executive Compensation Clawbacks—Effective Deterrent or Effective Remedy?, BNA Insights, Daily Rep. Executives, at B-4 (July 7, 2011).
[33] *Id.*
[34] *Id.*
[35] Letter from Laurel Leitner, *supra* note 29, at 1.
[36] *Id.*

Section 973. Disclosures Regarding Chairman and CEO Structures

Finally, as indicated, the financial crisis represented an enormous failure of board oversight of management. We share the view of the Council of Institutional Investors, the Investor's Working Group and many others that board oversight may be weakened by forceful CEO's who also serve as a chair of the board.[37] In our view, Independent board chairs are a key component of robust boards that can effectively monitor and, when necessary, rein in management.[38] To have the CEO effectively running the board means the oversight process is fundamentally comprised. No one can grade their own performance objectively. Independent board oversight of the CEO is vital.

While not requiring the separation of the role of the chair and CEO, Section 973 of Dodd-Frank provides an important step forward by directing the SEC to issue rules, which are already in place, requiring those companies who have a Chairman/CEO structure to disclose an explanation of the reasons that it has chosen that structure. [39] This is an important advancement in corporate governance disclosure that we continue to support.

That concludes my testimony. Thank you, Mr. Chairman for inviting me to participate at this hearing. I look forward to the opportunity to respond to any questions.

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[37] Letter from Justin Levis, Senior Research Associate, Council of Institutional Investors, to Jose Manuel Barroso, President, European Commission 1-2 (Aug. 31, 2010), http://www.cii.org/UserFiles/file/resource%20center/correspondence/2010/CII%20Letter%20on%20EC%20Green%20Paper%20on%20Bank%20Governance%208-31-10%20final.pdf.
[38] *Id.*
[39] S. Rep., *supra* note 10, at 119.