Testimony of

Thomas F. Brier

Deputy Chief Investment Officer and Director of Corporate Governance

Pennsylvania State Employees' Retirement System

before the

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Committee on Financial Services

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Corporate Governance and Shareholder Empowerment

Chairman Kanjorski, Ranking Member Garrett, and Members of the Subcommittee:

Good morning. I am Tom Brier, Deputy Chief Investment Officer and Director of Corporate Governance for the Pennsylvania State Employees' Retirement System ("SERS"). I am pleased to appear before you today on behalf of SERS.

Our testimony includes a brief overview of SERS, including how we participate in corporate governance and make investment decisions, and a discussion of our views on the following matters that you informed us were the basis, at least in part, for this important hearing:

- . . . how . . . inadequate corporate governance contributed to the 2008 financial meltdown.
- . . . the remedies currently available to shareholders dissatisfied with . . . performance at public companies.

. . . .

- . . . how corporate boards should be made more responsive to shareholder concerns.
- . . . how corporate governance standards differ among States and public companies.[1]

Some Background on SERS

Established in 1923, SERS is one the nation's oldest and largest statewide retirement plans for public employees and ranks among the top pension plans in the nation with net assets exceeding twenty-four billion dollars. Our members number more than 220,000, including more than 110,000 active employees and more than 109,000 retirees and other beneficiaries.

[1] Letter from Paul E. Kanjorski, Chairman, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises to Mr. Thomas F. Brier, Deputy Chief Investment Officer and Director of Corporate Governance, Pennsylvania State Employees' Retirement System 1 (Apr. 14, 2010) (on file with witness).

SERS mission is to provide retirement benefits and services to our members through sound administration and prudent investments. Over the past ten years, we have paid out approximately eighteen billion dollars in benefits and expenses.

We are a long-term investor largely as a result of our long-term obligations and investment horizon. Moreover, our significant passive investment strategies limit our ability to simply sell our shares when we are dissatisfied. As a result, corporate governance issues are of great interest to us and improving corporate governance is of great benefit to the tens of thousands of workers that rely on us for their retirement security.

SERS' Participation in Corporate Governance Decisions

SERS has been a long–time proponent of good corporate governance, which serves to protect, preserve and grow the assets of the fund. As a shareowner of each of the stocks held in its portfolios, SERS' board 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 SERS will vote on director nominees in uncontested elections and in proxy contests.

SERS' votes its proxies in accordance with our guidelines. Both the SERS' proxy policy and the actual proxy votes cast are published on the our website, www.sers.state.pa.us, so that all SERS' constituents and interested parties can know our positions on these important issues.

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 SERS' guidelines are not dispositive on shareowner or management proposals, SERS' Chief Investment Officer reviews and makes proxy voting recommendations that are consistent with the best interests of the fund and our fiduciary duties.

SERS' Investment Decision Making Process

As indicated above, SERS' takes a long–term strategic approach to its investment decision–making process. Annually, a comprehensive "Strategic Investment Plan" is developed jointly by SERS' investment staff and its external consultants, with input from and subject to final approval of the eleven–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 SERS. 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 meltdown represented a massive failure of oversight.[2] Too many CEOs pursued excessively risky strategies or investments that bankrupted their companies or weakened them financially for years to come.[3] Boards of directors were often complacent, failing to challenge or rein in reckless senior executives who threw caution to the wind.[4] And too many boards approved executive compensation plans that rewarded excessive risk taking.[5]

More specifically, a common element in the failure of Lehman Brothers, AIG, Fannie Mae, and many other companies implicated in the 2008 financial meltdown,[6] 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 most recent 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 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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[2] *See, e.g.,* 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 [hereinafter IWG Report].
[3] *Id.*
[4] *Id*.
[5] *Id*.; *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") [Hereinafter Wolin Remarks].
[6] *See* Editorial, *Who's Not Sorry Now?,* N.Y. Times, Apr. 11, 2010, http://www.nytimes.com/2010/04/11/opinion/11sun1.html ("The crisis was the result of irresponsibility and misjudgments by many people, including Mr. Prince and Mr. Rubin. Citi, under their leadership, epitomized the financial recklessness that ruined the economy.").
[7] 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.

> 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 of regulators, who will never be able to find every problem.[10] Unfortunately, the inadequacies of existing corporate governance requirements and practices prevented (and continues to prevent) shareowners from holding boards accountable.

[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 7, at 2.
[10] *Id.*

Why Shareowners Do Not Currently Have Effective Remedies When Dissatisfied With Performance at Public Companies

The most fundamental right of investors is the right to nominate, elect, and remove directors.[11] At least two major roadblocks, however, prevent this fundamental right from being an effective remedy for shareowners dissatisfied with the performance of their public companies.[12]

First, federal proxy rules have historically prohibited shareowners from placing the names of their own director candidates on public company proxy cards.[13] 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 SERS.[14]

Second, relatively few U.S. public companies have adopted majority voting for director elections. Thus, most board elections have a predetermined result.[15]

[11] IWG Report, *supra* note 2, at 22.
[12] *Id.* Other corporate governance improvements contained in H.R. 2861, the "Shareholder Empowerment Act of 2009," H.R. 3272, the "Corporate Governance Reform Act of 2009," or H.R. 3351, the "Proxy Voting Transparency Act of 2009," referenced in Pennsylvania State Employees' Retirement System 2009 U.S. proxy voting policy guidelines include: independence of chairman of the board; shareowner advisory vote on executive compensation; clawback provisions; and severance pay.
[13] IWG Report, *supra* note 2, at 22.
[14] *Id.*
[15] *Id.*

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.[16] If they oppose a particular nominee, they may *only* withhold their vote.[17] 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.[18]

How Corporate Boards Should Be Made More Responsive to Shareowner Concerns

As indicated, the most fundamental right of investors is the right to nominate, elect, and remove directors. As also indicated, two roadblocks to the exercise of that right must be promptly removed to make corporate boards more responsive to shareowner concerns.

Fortunately, due to the extraordinary leadership of this Subcommittee, the full Committee on Financial Services, and the U.S. Securities and Exchange Commission ("Commission or SEC"), the first road block—the inability for shareowners to place director nominees on the company's proxy card—will likely soon be lifted. As you are aware, 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.[19] After careful consideration of the input received in response to two separate comment periods for the proposal, the SEC appears poised to soon issue a final uniform proxy access rule that we believe, like the proposal, will be responsive to the needs of long-term investors like SERS.

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[16] *Id.*
[17] *Id.*
[18] *Id.* at 23.
[19] Facilitating Shareholder Director Nominations, 74 Fed. Reg. 29,024 (June 18, 2009), http://www.sec.gov/rules/proposed/2009/33-9046.pdf.

To ensure that the implementation of the SEC's pending final rule will not face unnecessary, costly and time-consuming litigation brought by opponents of the rule, this Subcommittee and the full Committee on Financial Services had the foresight to include a provision in the *Wall Street Reform and Consumer Protection Act* that reaffirms that the SEC has unambiguous authority to issue their final rule permitting shareowner access to the proxy.[20] We again commend the Subcommittee for their leadership in pursuing this provision. We are also pleased that the provision is strongly supported by the Administration.[21]

The remaining roadblock to making boards more responsive to shareowner concerns is the continued existence of plurality voting for the election of directors in uncontested elections. As indicated, the accountability of directors at most U.S. public companies is severely weakened by the fact that shareowners do not have a meaningful vote in director elections.

Under most state laws, including Delaware, the default standard for uncontested elections is a plurality vote, which means that a director is elected even if a majority of the shares are withheld from the nominee. We, and many other long-term investors, believe that a plurality standard for the uncontested election of directors is unfair, fosters a lack of responsiveness to shareowner needs, and, thus, should be promptly replaced by a majority vote standard.[22]

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[20] H.R. 4173, 111th Cong. § 7222 (as passed by House, Dec. 11, 2009), http://financialservices.house.gov/Key_Issues/Financial_Regulatory_Reform/FinancialRegulatoryReform/hr4173eh.pdf.

[21] *See, e.g.,* Wolin Remarks, *supra* note 5, at 4.

[22] *See, e.g.,* The Council of Institutional Investors, Corporate Governance Policies, § 2.2 **Director Elections** (Apr. 13, 2010), http://www.cii.org/UserFiles/file/council%20policies/CII%20Corp%20Gov%20Policies%20Full%20and%20Current%204-13-10.pdf ("Directors in uncontested elections should be elected by a majority of the votes cast").

In recent years, many public companies, including more than two-thirds of the S&P 500, have indicated that they agree with SERS and other investors on this point, and have voluntarily adopted majority voting standards.[23] At most public companies, however, plurality voting still inexplicably remains the rule, despite the unequivocal message from investors in support of majority voting.

We note that the *Shareowner Empowerment Act of 2009*, that was referenced in the letter provided to us in connection with this hearing,[24] includes a provision that would require the Commission to "direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer" if the company does not have majority voting for the uncontested election of directors.[25] We generally support that provision. The benefits of removing this roadblock by requiring publicly listed companies to adopt a majority voting standard are many. It would democratize the corporate electoral process; put real voting power in the hands of long-term investors like SERS; and, most importantly, make boards more accountable to shareowners.[26]

[23] Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to The Honorable Christopher J. Dodd, Chairman, Committee on Banking, Housing, and Urban Affairs 3 (Mar. 19, 2010), http://www.cii.org/UserFiles/file/resource%20center/correspondence/2010/3-19-10%20Dodd%20Committee%20Print%20Letter%20(final)%20(2).pdf.
[24] Letter from Paul E. Kanjorski, *supra* note 1, at 1.
[25] H.R. 2861, 111th Cong. § 2 (as referred to the H. Comm. on Fin. Serv., June 12, 2009), http://www.govtrack.us/congress/billtext.xpd?bill=h111-2861.
[26] *See* IWG Report, *supra* note 2, at 22.

How Corporate Governance Standards Differ Among States and Public Companies

While we are not experts on the corporate governance standards of all States and public companies, there clearly are differences in corporate governance standards among those parties. Moreover, those differences and the long standing patchwork of state and federal corporate governance standards in the U.S. have generally served SERS and its beneficiaries well. When, however, the differences and patchwork of corporate governance standards present roadblocks to long-term investors' fundamental right to nominate, elect, and remove directors, and when the effect of those roadblocks contributes to one of the most devastating financial crises in U.S. history, we believe the time has come for the prompt enactment of uniform rules for proxy access and majority voting.

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