Testimony of

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of the

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"Corporate Governance and Shareholder Empowerment"

Full Text of Written Statement

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

Good morning. I am Gregory W. Smith, Chief Operating Office and General Counsel of the Colorado Public Employees' Retirement Association ("CoPERA"). I am pleased to appear before you today on behalf of CoPERA.

My testimony includes a brief overview of CoPERA and its investment approach followed by a discussion of our views on several bills related to corporate governance the Congress has under consideration. My remarks will also cover the following issues that you informed me were the basis for this important and timely hearing:

- Whether—and if so, how—inadequate corporate governance contributed to the global financial crisis;
- Remedies currently available to shareowners dissatisfied with management performance at public companies; and
- How corporate boards should be made more responsive to shareowner concerns.

About CoPERA

With over $34 billion under management, CoPERA is responsible for investing and safeguarding assets used to fund retirement benefits for over 460,000 employees of Colorado state government, public schools, universities and colleges, and many cities and local government districts. Due to the fund's far investment horizon and heavy commitment to passive investment strategies, CoPERA is naturally a long-term, patient investor.

Because CoPERA's passive strategies restrict our fund from exercising the "Wall Street walk" and fully eliminating our holdings when we are dissatisfied, corporate governance issues are of great interest to our members. CoPERA believes good corporate governance practices are essential to maximize and protect shareowner value and interests.

CoPERA primarily participates in corporate governance decisions by voting its proxies. We firmly believe that the right to vote our shares of stock is, in itself, an asset of the fund, and therefore our responsibility as fiduciaries to manage our members' assets includes proxy voting. Accordingly we have developed and actively maintain a written proxy voting policy covering a variety of corporate governance issues.[1] All proxy issues are reviewed by CoPERA staff on a case-by-case basis and then voted according to the policy's guidelines. CoPERA also participates in corporate governance decisions and company engagement as an active member of the Council of Institutional Investors.[2]

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[1] *Colorado PERA Proxy Voting Policy*. Colorado Public Employees' Retirement Association, 2003. www.copera.org/pdf/Policy/proxy_voting.pdf.
[2] For more information about the Council, please visit www.cii.org.

With over 50 percent of our portfolio invested in domestic stocks and bonds, CoPERA is deeply committed to U.S. capital markets. As an owner of the Nation's largest and most prominent corporations, our fund is strongly aligned with corporate America—we have every interest in its long-term success and profitability. CoPERA believes that market discipline and accountability are hallmarks of a vibrant and healthy capitalist system. These values must begin in the boardroom with strong corporate governance.

Corporate Governance and the Financial Crisis

CoPERA firmly believes that the global financial crisis represents a massive failure of board oversight as well as regulation. CoPERA's members have paid a steep price for these failures. Not only have they suffered billions of dollars in investments losses, they have also lost confidence in the integrity of our markets and in the effectiveness of board oversight of corporate management.

Clearly boards of directors failed to adequately understand, monitor and oversee enterprise risk. In a special February 2010 report, for example, the *Economist* recently noted this failure of boards as an important takeaway of the financial crisis: "Another lesson [of the crisis] is that boards matter too. Directors' lack of engagement or expertise played a big part in some of the worst slip-ups…Too few boards defined the parameters of risk oversight."[3]

[3] "Special Report on Financial Risk: Cinderella's Moment." *The Economist* 11 Feb. 2010. www.economist.com/specialreports/displaystory.cfm?story_id=15474145.

The role of inadequate corporate governance in the meltdown is well recognized. Representing the governments of 30 developed nations across the world including the United States, the Organization for Economic Cooperation and Development concluded in February 2009, "The financial crisis can be to an important extent attributed to failures and weaknesses in corporate governance arrangements."[4]

Some corporate boards failed to include directors with the necessary blend of independence, competencies and experiences to adequately oversee management and corporate strategy. And far too many boards structured and approved executive compensation programs that motivated excessive risk taking and yielded outsized rewards—with little to no downside risk—for short-term results.

As the costly fallout of such poor board oversight became clear, however, investors were left with few effective tools to hold directors accountable. In 2007, for example, a concerned institutional investor at Lehman Brothers was left with no recourse when the fund's shareowner proposal requesting greater disclosure of Lehman's mortgage risk exposure was excluded from a shareowner vote.[5] This lack of meaningful, investor-driven market discipline only serves to encourage board mismanagement and complacency. There should accordingly be no doubt that the failure of board oversight and inadequate corporate governance were significant contributors to the global financial crisis.

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[4] Grant Kirkpatrick, Organization for Economic Cooperation and Development, *The Corporate Governance Lessons from the Financial Crisis*, 2 (Feb. 2009), www.oecd.org/dataoecd/32/1/42229620.pdf.

[5] E-mail from Jeffrey A. Welikson, Vice President and Corporate Secretary, Lehman Brothers Holdings Inc. to the Office of Chief Counsel, Division of Corporation Finance, Securities and Exchange Commission regarding a shareholder proposal submitted to Lehman by the Central Laborers Pension Fund. 17 Dec. 2007. www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2008/lehmanbrothersholdings020508-14a8.pdf.

Remedies for Dissatisfied Shareowners

Few meaningful remedies are available to shareowners dissatisfied with management and board performance at U.S. public companies. As the financial crisis demonstrates and the blue-ribbon Investors Working Group notes, current rules and regulations failed investors, particular in the area of director elections:

> [S]hareowners currently have few ways to hold directors' feet to the fire. The primary role of shareowners is to elect and remove directors, but major roadblocks bar the way. Federal proxy rules prohibit shareowners from placing the names of their own director candidates on proxy cards. Shareowners who want to run their own candidates for board seats must mount costly full-blown election contests. Another wrinkle in the proxy voting system is that relatively few U.S. companies have adopted majority voting for directors. Most elect directors using the plurality standard, by which shareowners may vote for, but not against, a nominee. If they oppose a particular nominee, they may only withhold their votes. As a consequence, a nominee only needs one "for" vote to be elected and unseating a director is virtually impossible.[6]

[6] Investors Working Group, *U.S. Financial Regulatory Reform: The Investors' Perspective* (July 2009) (available online at www.cii.org/UserFiles/file/IWGreport.pdf), at 22.

Some boards are dominated by the CEO, who plays the key role in selecting and nominating directors. All-independent nominating committees ostensibly address this concern, but problems persist. Some companies do not have nominating committees, others refuse to accept shareowner nominations for directors, and institutional investors’ sense is that shareowner-suggested candidates—whether or not submitted to all-independent nominating committees—are rarely given serious consideration.

Shareowners can now only ensure that their candidates get full consideration by launching an expensive and complicated proxy fight—an unworkable alternative for most investors, particularly fiduciaries such as CoPERA who must determine whether the very significant costs of a proxy contest are in the best interests of plan participants and beneficiaries. While companies can freely tap company coffers to fund their campaigns for board-recommended candidates, shareowners must spend their own money to finance their efforts. And companies often erect various obstacles, including expensive litigation, to thwart investors running proxy fights for board seats.

Today shareowners around the world—including in countries with far less developed capital markets than the U.S.—enjoy basic rights that shareowners of American companies are denied. Rights such as requiring directors to be elected by majority vote, giving owners advisory votes on executive pay, and providing owners modest vehicles to access management proxy cards to nominate directors are noticeably absent in much of corporate America. Their absence weakens the ability of shareowners to oversee corporate directors—their elected representatives—and hold directors accountable.

The U.S. has long been recognized as a leader when it comes to investor protection, market transparency and oversight. But America has seriously fallen short when it comes to corporate governance issues. CoPERA believes that corporate governance enhancements are a long overdue and essential component of the bold reforms required to restore confidence in the integrity of the U.S. capital markets.

Enhancing Board Responsiveness and Accountability

A number of key corporate governance reforms including many of those featured in several bills the Congress has under consideration are essential to providing meaningful investor oversight of management and boards, and restoring investor confidence in our markets. Such measures—in particular proxy access and majority voting—would address many of the failures of board oversight that contributed to the financial crisis, and more importantly, empower shareowners to anticipate and address unforeseen future risks. These measures, rather than facilitating investors seeking short-term gains, are consistent with enhancing long-term shareowner value.

The financial benefits of greater board oversight are well documented. According to Professor Lucian Bebchuk of Harvard Law School, "There is a substantial body of empirical evidence that is consistent with the view that making boards more accountable by invigorating corporate elections increases shareholder value."[7] Professor Bebchuk also reports that there is considerable evidence that "reducing incumbent directors' insulation from removal" leads to better corporate management, and that increased insulation conversely leads to poor performance.[8]

Proxy Access

I am happy to report that through the work of the Securities and Exchange Commission ("SEC" or "Commission"), the House, and the Senate Banking Committee, perhaps the most powerful corporate governance reform is well on its way to finalization. Nearly 70 years have passed since the SEC first considered whether shareowners should be able to include director candidates on management's proxy card, commonly known as "proxy access." This reform, which has been studied and considered on and off for decades, is long overdue. Its adoption would be one of the most significant and important investor reforms by any regulatory or legislative body in decades.

[7] Lucian A. Bebchuk and Scott Hirst, *Private Ordering and the Proxy Access Debate*, The Business Lawyer, 8 (Feb. 2010) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1513408).
[8] *Id.*

CoPERA believes reasonable access to company proxy cards for long-term shareowners would address some of the various problems with director elections. We believe such access would substantially contribute to the health of the U.S. corporate governance model and U.S. corporations by making boards more responsive to shareowners, more thoughtful about whom they nominate to serve as directors and more vigilant about their oversight responsibilities.

Only a uniform, federal proxy access rule can truly remedy the deeply flawed director election process and empower investors to hold boards accountable, however. From a practical standpoint, leaving proxy access to Delaware and other states could result in a hodge-podge of standards that would differ from company to company and from state to state. This would be burdensome, costly and unnecessarily complex for investors, particularly those like CoPERA with diversified portfolios of thousands of companies incorporated in multiple states.

A state by state approach is furthermore fundamentally inconsistent with the notion that a minimum level of access to the proxy is needed to level the electoral playing field and give substance to investors' fundamental right to nominate directors. Proxy access at its core is a disclosure matter most appropriately handled by the SEC, which since its creation has been responsible for setting uniform proxy statement disclosure standards. Leaving proxy access to the states would be thus be a radical departure from 75 years of investor protection that ultimately would be harmful to the investing public. CoPERA therefore strongly support's the Commission's proposed proxy access rule and we applaud the SEC for its leadership on this important issue.[9]

[9] CoPERA's August 2009 comment letter regarding the SEC's proxy access proposal *Facilitating Shareholder Director Nominations* (File No. S7-10-09) is available at www.sec.gov/comments/s7-10-09/s71009-268.pdf.

We also commend the House for affirming the SEC's authority in this area in the Wall Street Reform and Consumer Protection Act of 2009 (H.R. 4173). While CoPERA believes the SEC already has the authority to approve an access standard, others disagree, and the Commission is likely to face unnecessary, costly and time-consuming litigation in response to a proxy access rule, delaying implementation of this much needed reform. By affirming the SEC's authority to promulgate rules allowing shareowners to place their nominees for director on the corporate proxy card, the House has already taken a decisive and historic step toward meaningful corporate governance reform. With strong recent endorsements from both the Department of the Treasury and the White House, we fully expect similar proxy access affirmation language approved by the Senate Banking Committee to pass the entire Senate as part of its broad regulatory overhaul.

With the SEC's authority to issue a proxy access rule no longer a matter of legal debate, the governance improvements that CoPERA believes would have the greatest impact and, therefore, should be considered by the House include:

- *Majority Voting for Directors*: Directors in uncontested elections should be elected by a majority of the votes cast.
- *Executive Compensation Reforms:* Recommended reforms include enhanced disclosure requirements, an advisory shareowner vote on executive pay, independent compensation advisers, and stronger clawback provisions.
- *Independent Board Chair:* Corporate boards should be chaired by an independent director.

Majority Voting for Directors

Directors are the cornerstone of the U.S. corporate governance model. And while the primary powers of shareowners—aside from buying and selling their shares—are to elect and remove directors, U.S. shareowners have few tools to exercise these critical and most basic rights. CoPERA believes the accountability of directors at most U.S. companies is weakened by the fact that shareowners do not have a meaningful vote in director elections. Under most state laws the default standard for uncontested director elections is a plurality vote, which means that a director is elected in an uncontested situation even if a majority of the shares are withheld from the nominee.

CoPERA believes that a plurality standard for the election of directors is inherently unfair and undemocratic and that a majority vote standard is the appropriate one. The concept of majority voting is difficult to contest—especially in this country. And today majority voting is endorsed by all types of governance experts, including law firms advising companies and corporate boards.

Majority voting makes directors more accountable to shareowners by giving meaning to the vote for directors and eliminating the current “rubber stamp” process. The benefits of this change are many: it democratizes the corporate electoral process; it puts real voting power in hands of investors; and it results in minimal disruption to corporate affairs. Majority voting simply makes boards representative of shareowners.

The corporate law community has taken some small steps toward majority voting. In 2006 the ABA Committee on Corporate Laws approved amendments to the Model Business Corporation Act to accommodate majority voting for directors, and lawmakers in Delaware, where most U.S. companies are incorporated, amended the state's corporation law to facilitate majority voting in director elections. But in both cases they stopped short of switching the default standard from plurality to majority.

Majority voting for directors is not an alien concept. It is standard practice in the United Kingdom, France, Germany and other European nations, and it is also in place at some U.S. companies. Since 2006 some companies have volunteered to adopt majority voting standards, but in many cases they have only done so when pressured by shareowners forced to spend tremendous amounts of time and money on company-by-company campaigns to advance majority voting.

To date larger companies have been receptive to adopting majority voting standards. Plurality voting is the standard at less than a third of the companies in the S&P 500. However, plurality voting is still very common among the smaller companies included in the Russell 1000 and 3000 indices. Over half (54.5 percent) of the companies in the Russell 1000, and nearly three-quarters (74.9 percent) of the companies in the Russell 3000, still use a straight plurality voting standard for director elections.[10] The international and U.S. experience indicates that majority voting is not harmful to the markets and does not result in dramatic and frequent changes to corporate boards.

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[10] Annalisa Barrett & Beth Young, *Majority Voting for Director Elections*, Directorship 1 (Dec. 16, 2008), http://www.directorship.com/contentmgr/showdetails.php/id/33732/page/1.

Plurality voting is a fundamental flaw in the U.S. corporate governance system. It is time to move the default standard to majority voting. Given the failure by the states, particularly Delaware, to take the lead on this reform, CoPERA believes the time has come for the U.S. Congress to legislate this important and very basic shareowner right.

Executive Compensation Reforms

As a long-term investor with a significant stake in the U.S. capital markets, CoPERA has a vested interest in ensuring that U.S. companies attract, retain and motivate the highest-performing employees and executives. We are supportive of paying top executives well for superior performance.

However, the financial crisis has offered yet more examples of how investors are harmed when poorly structured executive pay packages waste shareowners' money, excessively dilute their ownership in portfolio companies and create inappropriate incentives that reward poor performance or even damage a company's long-term performance. Inappropriate pay packages may also suggest a failure in the boardroom, since it is the job of the board of directors and the compensation committee to ensure that executive compensation programs are effective, reasonable and rational with respect to critical factors such as company performance and industry considerations.

Beyond ensuring that corporate boards can be held accountable for their executive pay decisions through majority voting and access mechanisms, CoPERA believes executive compensation issues are best addressed by requiring companies to provide full, plain English disclosure of key quantitative and qualitative elements of executive pay; by giving shareowners meaningful oversight of executive pay via non-binding votes on compensation; by ensuring boards receive independent compensation advice; and by requiring disgorgement of ill-gotten gains pocketed by executives.

- *Enhanced Disclosures*: Of primary concern to CoPERA is full and clear disclosure of executive pay. As U.S. Supreme Court Justice Louis Brandeis noted, "sunlight is the best disinfectant." Transparency of executive pay enables shareowners to evaluate the performance of the compensation committee and board in setting executive pay, to assess pay-for-performance links and to optimize their role of overseeing executive compensation through such means as proxy voting. CoPERA is accordingly very supportive of the SEC's new rules enhancing the disclosure of executive compensation. Nevertheless, we believe the disclosure regime in the U.S. would be substantially improved if companies would have to disclose the quantitative measures used to determine incentive pay. Such disclosure—which could be provided at the time the measures are established or at a future date, such as when the performance related to the award is measured—would eliminate a major impediment to the market's ability to analyze and understand executive compensation programs and to appropriately respond.

- *Advisory Vote on Compensation*: CoPERA believes an annual, advisory shareowner vote on executive compensation would efficiently and effectively provide boards with useful information about whether investors view the company's compensation practices to be in shareowners' best interests. Nonbinding shareowner votes on pay would serve as a direct referendum on the decisions of the compensation committee and would offer a more targeted way to signal shareowner discontent than withholding votes from committee members. They might also induce compensation committees to be more careful about doling out rich rewards, to avoid the embarrassment of shareowner rejection at the ballot box. In addition, compensation committees looking to actively rein in executive compensation could use the results of advisory shareowner votes to stand up to excessively demanding officers or compensation consultants. Of note, to ensure meaningful voting results, federal legislation should mandate that annual advisory votes on compensation are a "non-routine" matter for purposes of New York Stock Exchange Rule 452.

- *Independent Compensation Advisers*: Compensation consultants play a key role in the pay-setting process. The advice provided by these consultants may be biased as a result of conflicts of interest. Most firms that provide compensation consulting services also provide other kinds of services, such as benefits administration, human resources consulting and actuarial services. Conflicts of interest contribute to a ratcheting up effect for executive pay and should thus be minimized and disclosed.

- *Stronger Clawback Provisions*: CoPERA believes a tough clawback policy is an essential element of a meaningful "pay for performance" philosophy. If executives are rewarded for "hitting their numbers" – and it turns out that they failed to do so – they should not profit. While Section 304 of the Sarbanes-Oxley Act gave additional authority to the SEC to recoup bonuses or other incentive-based compensation in certain circumstances, some observers have suggested this language is too narrow and perhaps unworkable. CoPERA recommends that Congress consider ways to cover cases where performance-based compensation may be "unearned" in retrospect but not meet the high standard of "resulting from misconduct" required by Section 304.

Independent Board Chair

The issue of whether the chair and CEO roles should be separated has long been debated in the U.S., where the roles are combined at most publicly traded companies. Interest in the issue renewed in recent years in the wake of Enron and other corporate scandals and, most recently, in response to the financial crisis.

The U.S. approach to the issue differs from other countries, particularly the U.K. and other European countries which have comply-or-disclose requirements regarding the separation of the roles and/or recommend it via nationally recognized best practices. According to the Millstein Center for Corporate Governance and Performance at the Yale School of Management:

> Up until the early 2000s, the percentage of the S&P 500 companies with combined roles remained barely unchanged in the previous 15 years, at 80%. Today, approximately 36% of S&P 500 companies have separate chairs and CEOs; this is up from 22% in 2002. However, only 17% of S&P 1500 firms have chairs that can be qualified as independent and the incidence of independent chairs is concentrated on small and mid-cap firms. This is in sharp contrast to the landscape of other countries.[11]

At the heart of the issue is whether the leadership of the board should differ from the leadership of the company. Clearly the roles are different, with management responsible for running the company and the board charged with overseeing management. The chair of the board is responsible for, among other things, presiding over and setting agendas for board meetings. The most significant concern over combining the roles is that strong CEOs could exert a dominant influence on the board and the board's agenda and thus weaken the board's oversight of management.

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[11] *Chairing the Board: The Case for Independent Leadership in Corporate North America* 17 (2009), http://millstein.som.yale.edu/2009%2003%2030%20Chairing%20The%20Board.pdf [hereinafter *Chairing*].

The Conference Board Commission on Public Trust and Private Enterprise discussed the issue in its post-Enron corporate governance report.[12] The Commission suggested three approaches—including naming an independent chair—for ensuring the appropriate balance of power between board and CEO functions, and it recommended that "each corporation give careful consideration, based on its particular circumstances, to separating the offices of the Chairman and Chief Executive Officer."[13]

As described in our proxy voting guidelines, CoPERA believes a Board that has separate positions for Chief Executive Officer and Chairman appropriately reflects the differences in the roles, "promotes greater management accountability, helps create a board atmosphere of independent leadership, and allows for an unbiased evaluation of the performance of the Chief Executive Officer by the Board."[14]

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[12] The Conference Board, *Commission on Public Trust and Private Enterprise* 19 (Jan. 9, 2003), http://www.conference-board.org/pdf_free/SR-03-04.pdf.
[13] *Id*.
[14] *Colorado PERA Proxy Voting Policy*. Colorado Public Employees' Retirement Association, 2003, at 3. www.copera.org/pdf/Policy/proxy_voting.pdf.

Conclusion

As the House considers steps to enhance corporate governance and empower shareowners, Congress must remember that boards are the first line of defense against the risks and excesses that led to the global financial crisis. Vigorous financial regulation on its own cannot solve many of the issues that contributed to the crisis. In order to restore market confidence and ensure that such a crisis never happens again, regulators and *investors* must be given stronger market-based tools necessary to guarantee robust oversight and meaningful accountability of corporate managers and directors. As a result, CoPERA believes corporate governance improvements are a critical component of the needed package of reforms.

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