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SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES
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HEARING ON "CORPORATE GOVERNANCE
AND SHAREHOLDER EMPOWERMENT"
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Chairman Kanjorski, Ranking Member Garrett, and members of the Subcommittee, my name is Brandon Rees and I am the Deputy Director of the Office of Investment for the American Federation of Labor and Congress of Industrial Organizations ("AFL-CIO"). Thank you for the opportunity to testify today on the need for corporate governance reform in the wake of the recent financial crisis.

The AFL-CIO is the largest federation of trade unions in the United States with 11.5 million members. The AFL-CIO Office of Investment provides research and assistance in support of corporate governance initiatives by union members' pension funds. Our goal is to enhance the retirement security of union members and workers generally by encouraging greater corporate accountability.

America's workers are major shareholders of publicly traded companies through their retirement savings. Corporate, public, and union sponsored pension plans altogether hold approximately $7.5 trillion in assets for their beneficiaries. Union sponsored plans make up $480 billion of this total amount.[1] By way of comparison, the total market capitalization of the US stock markets is about $15 trillion.[2]

Union members' retirement plans are uniquely suited to long-term, patient capital investing. First of all, union members have greater retirement assets compared to other workers. 86 percent of union workers participate in pension plans versus 51 percent of nonunion workers. More importantly, 77 percent of union workers participate in defined-benefit pension plans, compared with just 20 percent of nonunion workers.

Defined benefit pension plans provide a lifetime annuity stream of retirement income to plan participants. These funds are centrally managed by boards of trustees and investment professionals. Many of these assets are invested passively in the stock market

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[1] Standard and Poor's, Money Market Directory of Pension Funds and their Investment Managers (2010).
[2] World Federation of Exchanges, 2009 Market Highlights, available at http://www.world-exchanges.org/files/file/2009%20Market%20Highlights.doc.

through index funds such as the S&P 500 Index or total market funds. They are invested over long time horizons to cover the average life expectancy of plan participants.

Because many union sponsored pension plans are long-term index fund investors, they do not have the traditional exit strategy of selling their shares in underperforming companies – the so called "Wall Street walk." Selling shares also leaves money on the table that could be realized by improving company performance. This leaves corporate governance as a primary means for pension plans to add value to their portfolio.

Stock market investors have just suffered the worst decade since the Great Depression. During this lost decade between January 1, 2000 and December 31, 2009, stock prices declined 24 percent as measured by the S&P 500 Index. If you include dividends, the total return of the S&P 500 Index actually performed worse during the past ten years than during the 1930s.

At the beginning of America's lost decade, shareholders suffered the corporate accounting scandals at Enron, Worldcom and hundreds of other companies. More recently, shareholders have been battered by the collapse of Lehman Brothers, Bear Stearns and the resulting financial crisis. While stock markets recovered in 2009 from the worst of these losses, the average shareholder lost money during the past ten years.

Needless to say, workers' retirement savings were decimated by the 2008 financial crisis. According to the employee benefits consulting firm Towers Watson, U.S. pension assets fell 21 percent during 2008. Although U.S. pension assets increased 12.2 percent in 2009 with the stock market recovery, the compound annual growth rate of pension assets for the entire decade was only 2.6 percent.[3]

Those workers who are lucky to have defined benefit pension plans have suffered. Pension plan accountants assume that stock market returns will be in line with historical averages. Ten years of stock market underperformance has devastated these assumptions. As a result, many defined benefit pension funds are underfunded, subject to benefit freezes and increased contribution requirements by employees and employers.

Workers who only have access to defined contribution plans are in worse shape. According to the Employee Benefit Research Institute, during the financial crisis the median 401(k) account balance fell from $58,000 in 2007 to under $44,000 in 2008.[4] While stock markets recovered ground in 2009, 27 percent of workers today have less than $1,000 in retirement savings and 54 percent of workers have less than $25,000.[5]

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[3] Towers Watson, 2010 Global Pension Asset Study (Jan. 2010), available at http://www.towerswatson.com/assets/pdf/966/GPAS2010.pdf.

[4] Jack VanDerhei et. al., Employee Benefit Research Institute, 401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2008 (Oct. 2009), available at http://www.ebri.org/pdf/briefspdf/EBRI_IB_10-2009_No335_K-Update.pdf.

[5] Ruth Helman et. al., Employee Benefit Research Institute, The 2010 Retirement Confidence Survey: Confidence Stabilizing, But Preparations Continue to Erode (March 2010), available at http://www.ebri.org/pdf/briefspdf/EBRI_IB_03-2010_No340_RCS.pdf.

There are many reasons why Americans do not have enough money for retirement, including increased longevity, stagnant wages, the substitution of defined benefit pension plans for less generous 401(k) plans, and tax policies that only encourage the rich to save. However, poor stock market performance over the past decade has cheated a generation of American workers who have saved for their retirement.

Corporate governance failures are the primary cause this lost decade for investors. We blame the short-term approach that many CEOs have taken to manage quarterly earnings to keep Wall Street happy rather than making long-term sustainable investments. And we blame boards of directors for failing to focus management on the long term, failing to prevent malfeasance by executives, and failing to properly manage risk.

Nowhere is the breakdown in corporate accountability more apparent than on the issue of executive compensation. Executive compensation is the mechanism by which CEOs have become captive to short-term market forces. It is the incentive structure that guides executive decision making. These compensation incentives motivate executives to choose between long-term strategies that create value or short-term approaches.

While stock market investors have suffered the worst decade since the Great Depression, publicly traded company CEOs have received the fattest paychecks in history. The average S&P 500 Index company CEO earned 42 times the average worker's pay in 1980. In 1990 the ratio was 107 to 1. In 2000, CEO pay peaked at over 500 times the average worker pay, only to fall back to around 300 to 1.[6]

The collapse of Bear Stearns and Lehman Brothers provides a dramatic example of what is wrong with executive compensation. Between 2000 and 2008, the top five executives at Bear Stearns pocketed $1.4 billion in cash bonuses and equity sales. Lehman Brothers executives took home $1 billion.[7] Short-term executive compensation incentivized excessive risk-taking even as long-term shareholders got nothing.

Stock option compensation encouraged excessive risk taking and short-termism. Stock option grants promised executives all the benefit of share price increases with none of the risk of share price declines. This asymmetric payout structure encouraged a shoot-for-the-moon mentality. And it allowed executives to profit from share price volatility by exercising their stock options based on short-term stock price fluctuations.

The AFL-CIO has called on companies to adopt compensation policies that better align executives' interests with the interests of long-term shareholders. We believe CEOs should receive performance-vesting restricted stock instead of stock options. We also

[6] Institute for Policy Studies, America's Bailout Barons: Taxpayers, High Finance, and the CEO Pay Bubble (Sept. 2009), available at http://www.ips-dc.org/reports/executive_excess_2009. Institute for Policy Studies and United For A Fair Economy, Executive Excess 2006: Defense and Oil Executives Cash in on Conflict (Aug. 30, 2006), available at http://www.faireconomy.org/files/ExecutiveExcess2006.pdf.
[7] Lucian Bebchuk et. al., The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008, Yale J. on Reg. (forthcoming Summer 2010), available at http://ssrn.com/abstract=1513522.

believe that executives should be required to hold a substantial percentage of these equity awards for a lockup period after the performance requirements have been met.

Ultimately, it is the job of the board of directors to set fair executive pay packages, to properly supervise company executives, and to manage the company in the interests of shareholders. But we believe that boards of directors have been too complacent in their duties. For this reason, long-term shareholders must be empowered through corporate governance reform to hold boards of directors more accountable.

Existing corporate governance mechanisms have failed to give long-term shareholders an adequate voice in boardrooms. The election of directors is one of the fundamental rights of stockholders. But too often, withhold votes against director nominees are ignored. In 2009, over 90 directors at 50 companies failed to receive majority support. None of these directors has been required to step down.

The AFL-CIO strongly supports the corporate governance reforms encompassed by H.R. 2861, the Shareholder Empowerment Act of 2009; H.R. 3272, the Corporate Governance Reform Act of 2009; and H.R. 3351, the Proxy Voting Transparency Act of 2009. These mandatory corporate governance rules will benefit all publicly traded companies by enhancing investor confidence in our capital markets.

Investors are increasingly concerned with executive compensation including the overall size of CEO pay packages and whether executive pay incentives are aligned with the interests of shareholders. To address this issue, all publicly traded companies should give their shareholders a "say-on-pay" by requiring a non-binding vote on executive compensation packages at each annual meeting of stockholders.

An annual advisory vote would provide boards of directors with useful information about whether shareholders approve of how their company pays its senior executives. This say-on-pay vote would encourage boards of directors to be more proactive in seeking out shareholders' views regarding executive compensation matters. Best practices in executive compensation would disseminate more quickly.

The United Kingdom, Australia, the Netherlands, Norway and Sweden have adopted statutes requiring shareholder votes on executive compensation.[8] Two dozen U.S. companies have voluntarily agreed to conduct say-on-pay annual votes. And more than 300 financial companies who received assistance from the Troubled Asset Relief Program have been required to hold say-on-pay votes.[9]

The AFL-CIO also supports requiring that an independent director serve as board chair as is common in other countries. The designation of a lead independent director or

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[8] Laraine S. Rothenberg and Todd S. McCafferty, 'Say-on-Pay': Linking Executive Pay to Performance, N.Y. Law Journal (Sept. 24, 2008) available at http://www.law.com/jsp/cc/PubArticleCC.jsp?id=1202424735938.

[9] RiskMetrics Group, A New Voice in Governance: Global Policymakers Shape the Road to Reform (Oct. 2009), available at http://www.riskmetrics.com/system/files/private/2009_PSR_Public_final.pdf.

a presiding independent director is not an adequate substitution for an independent board chair. When the CEO serves as board chair, this arrangement may hinder the ability of the board of directors to provide the CEO with objective feedback and guidance.

Furthermore, the AFL-CIO believes that corporate directors should be elected by a majority vote standard. Under a majority vote standard, directors must receive a majority of the votes cast to be elected. A majority vote standard provides shareholders with a more meaningful role in director elections because new nominees would have to receive a majority of votes cast to be elected.

Today's plurality vote director election system reduces the importance of director elections as a mechanism for holding boards accountable. Under the plurality vote standard, a nominee for the board can be elected with as little as a single affirmative vote, even if a substantial majority of the votes cast are "withheld" from the nominee. For this reason, plurality voting should only be used in contested director elections.

While replacing the plurality vote standard with majority vote director elections is valuable, majority voting alone cannot adequately reform the director election process. Majority voting for directors is hobbled by the Delaware holdover rule that entitles incumbent directors to remain on the board. Under the holdover rule, shareholders must affirmatively vote to recall an incumbent director or the director must resign.[10]

Under the current proxy rules, contested director elections are extraordinarily rare because they are so expensive. There were 39 proxy contests in 2009 out of more than 4000 public traded companies.[11] Because running a proxy solicitation can be very expensive, the vast majority of dissident director nominees are put forward as part of hostile takeovers or by hedge fund activists that can take concentrated stakes.

To make director elections more meaningful, the AFL-CIO strongly supports giving long-term shareholders equal access to the proxy as currently under consideration by the Securities and Exchange Commission. Equal access to the proxy will set ground rules for shareholder democracy and limit the advantage of incumbents who have unlimited access to the corporate treasury to finance their proxy solicitation.

Before the adoption of new stock exchange listing standards in 2003, publicly traded companies did not need to have independent nominating committees.[12] Still today, it is no secret that company CEOs influence the selection of directors for nomination on management proxy cards. More importantly, continued board service depends on being viewed as a team player by incumbent directors.

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[10] According to the Delaware Division of Corporations, more than half of all publicly traded corporations are incorporated in Delaware. DCGL § 141(b) provides that "Each director shall hold office until such director's successor is elected and qualified or until such director's earlier resignation or removal."

[11] RiskMetrics Group, A New Voice in Governance: Global Policymakers Shape the Road to Reform (Oct. 2009), available at http://www.riskmetrics.com/system/files/private/2009_PSR_Public_final.pdf.

[12] See NASD and NYSE Rulemaking: Relating to Corporate Governance, Exchange Act Release No. 34-48745 (Nov. 4, 2003), available at http://www.sec.gov/rules/sro/34-48745.htm.

Equal access to the proxy will open up boards to new and divergent viewpoints. This is not an issue of directors being nominally independent according to a definition of director independence; it is an issue of how directors are selected for board service. Long-term shareholders, who are the owners of the company, should have the right to nominate director candidates to appear on the company's proxy.

Just one truly independent thinker on a board of directors can have a profound impact. Good directors question management and critically evaluate their performance. Debate and dissent should be welcomed in corporate boardrooms, not feared. A director whose nomination depends on the backing of a long term institutional investor and not his fellow directors can play that role. That is the goal of proxy access.

Now that Securities and Exchange Commission approval of proxy access appears likely, the opponents of mandatory proxy access have put forward the idea of voluntary proxy access. According to these so-called "private ordering" proposals, companies and their shareholders should be able to opt in or opt out of giving shareholders equal access to the proxy.[13] There are two major problems with such proposals.

First, private ordering is simply not a feasible means for shareholders at many companies to express their views on the desirability of proxy access. Those companies that already have good corporate governance will be the ones likely to adopt proxy access. Those companies with entrenched and unresponsive boards will be the companies whose incumbent managers successfully resist proxy access.

Nearly half of all companies in the Russell 3000 Index restrict the ability of shareholders to amend company bylaws or otherwise disenfranchise shareholders. 7.5 percent of companies have dual class stock voting, 4 percent of companies do not allow shareholders to amend bylaws, and another 39 percent of companies require a supermajority vote requirement for bylaw amendments.[14]

Secondly, allowing companies to opt out of proxy access sets a dangerous securities regulation precedent. State law governs the rights of shareholders to nominate and elect directors. Proxy access is about the federal regulation of proxy solicitations, not state corporate laws. And for the past 75 years, our federal securities regulations have set mandatory requirements for conducting proxy solicitations.

We need to remember what company annual shareholder meetings looked like before the passage of the Securities Exchange Act of 1934. Shareholders were asked to give blanket authority to vote shares for undisclosed directors and for any other matter

[13] See e.g., Joseph A. Grundfest, The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law, 65(2) Bus. Law. 361 (Feb. 2010).
[14] Beth Young, The Council of Institutional Investors and the Shareowner Education Network, The Limits of Private Ordering: Restrictions on Shareholders' Ability to Initiate Governance Change and Distortions of the Shareholder Voting Process (Nov. 2009), available at http://www.cii.org/resourcesPublications.

that may arise at annual meetings. These proxies often included the ratification of past acts by the board without even disclosing to shareholders what had been done.[15]

Section 14(a) of the Securities Exchange Act of 1934 halted these abuses by requiring that management give shareholders full information in the proxy statement about what matters were to be voted on. Under Section 14(a), the Securities and Exchange Commission has the power to regulate the conditions that proxies may be solicited in order to protect investors' interests.[16]

Corporate governance reforms such as equal access to the proxy can be a potent tool to focus companies on long-term, sustainable strategies. We need directors that are willing to focus on long-term value creation and not the short-term pressures of Wall Street. By empowering long-term shareholders, proxy access can revitalize corporate governance as a more democratic process.

The business decisions that today's boards of directors and CEOs make will impact shareholder value for decades to come. These decisions will also determine whether companies provide good jobs, make high quality products, and protect the environment. For these reasons, America's workers believe that director elections must be opened to long-term investors through proxy access.

[15] Address of Robert K. McConnaughey, Commissioner, Securities and Exchange Commission, before the American Society of Corporate Secretaries (Nov. 10, 1948), available at http://www.sec.gov/news/speech/1948/111048mcconnaughey.pdf.
[16] H.R. Rep. No. 1383, 73d Cong., 2nd Sess. (1934).