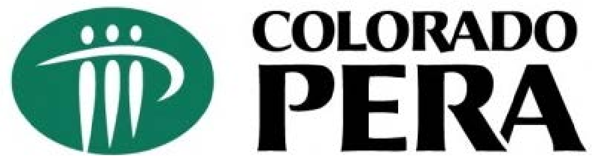

Testimony of

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before the

United States House of Representatives

Committee on Financial Services

Subcommittee on Oversight and Investigations

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Who's In Your Wallet? Dodd-Frank's Impact on Families, Communities and Small Business

Chairman Neugebauer, Ranking Member Capuano, and Members of the Subcommittee:

Good morning. I am Greg Smith, Chief Operating Officer 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 those key provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank")[1] that we believe have improved, and when fully implemented and effectively enforced, will further improve, corporate governance practices and, thereby, benefit long-term investors like COPERA and the hundreds of thousands of retirees and employees that are the beneficiaries of our fund.

CoPERA

With over $39 billion under management, CoPERA is responsible for investing and safeguarding assets used to fund retirement benefits for over 480,000 current and former employees of Colorado state government, public schools, universities and colleges, and many cities and local government districts.

Colorado PERA provides over $3.3 billion in annual benefit payments to over 95,000 beneficiaries. Ninety percent of these payments are made to beneficiaries living in Colorado. Using commonly recognized economic impact measures such as output, value-added, and labor income and employment, these payments in Colorado represent $4.31 billion in output (all goods and service transactions), $1.87 billion in value-added (State gross domestic product), $1.01 billion in labor income, and over 23,000 jobs.[2]

The annual benefit payments made by Colorado PERA to our beneficiaries represent approximately 3.3 percent of Colorado statewide payroll. In the rural counties in Colorado, this percentage is far greater. In some counties, PERA benefit payments represent over 25 percent of payroll. This infusion of income into the local economies in Colorado creates a chain of economic activities whose total impact on "main street" is greater than the initial benefit payment. This "multiplier effect" plays an important role in supporting main street businesses in Colorado.

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 fund and members. CoPERA believes good corporate governance

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010), http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf.

[2] Highlights of the Economic and Fiscal Impacts of Colorado PERA 1(Nov. 2011), http://www.copera.org/pdf/Impact/State%20of%20Colorado.pdf.

practices are essential to maximize and protect long-term 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. 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.

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 many of the Nation's public 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

It is well established that a key cause of the global financial crisis was a failure in corporate governance.[3] As the Financial Crisis Inquiry Commission concluded:

> [D]ramatic failures of corporate governance at many . . . institutions were a key cause of this crisis.
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> . . .
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> 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. Often, those systems encouraged the big bet—where the payoff on the upside could be huge and the downside limited.[4]

CoPERA's members have paid a steep price for those failures. Not only did they suffer billions of dollars in investment losses, many lost confidence in the integrity of our markets and in the effectiveness of board oversight of corporate management.

Some corporate boards failed to include directors with the necessary blend of independence, competencies and experiences to adequately oversee risk management and corporate strategy. And, as the Financial Crisis Inquiry Commission noted, far too

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[3] *See* Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report *xviii-xix* (Jan. 2011); Grant Kirkpatrick, The Corporate Governance Lessons from the Financial Crisis 2 (Feb. 2009), http://www.oecd.org/dataoecd/32/1/42229620.pdf.
[4] Financial Crisis Inquiry Commission at *xviii-xix*.

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 investors were left with few effective tools to hold directors accountable. As the July 2009 report of the Investors Working Group explained:

> [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.[5]

The lack of meaningful, investor-driven market discipline over boards only served to encourage board mismanagement and complacency.

Dodd-Frank Corporate Governance Reforms

While Dodd-Frank did not provide investors with all of the tools that they need to improve market based oversight of corporate boards,[6] Congress did respond to the corporate governance failures identified during the financial crisis by including in Subtitles E and G of Title IX of Dodd-Frank several measures that address some of the corporate governance problems that contributed to the financial crisis. Those measures, rather than facilitating investors seeking short-term gains, are consistent with enhancing long-term shareowner value.

<u>Proxy Access</u>

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[5] 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.

[6] A provision that would have required "the SEC to direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer who has on their board members that did not receive a majority vote in uncontested board elections" was unfortunately dropped from the Dodd-Frank Wall Street Reform and Consumer Protection Act during the House-Senate conference committee despite broad support for the provision from institutional investors. Comm. on Banking, Hous., & Urban Affairs, Rep. on The Restoring American Financial Stability Act 118 (Mar. 22, 2010), http://banking.senate.gov/public/_files/RAFSAPostedCommitteeReport.pdf.

Nearly 70 years have passed since the Securities and Exchange Commission ("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.

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.

We strongly supported Section 971 of Dodd-Frank affirming the SEC's authority to issue a mandatory proxy access rule giving long-term shareowners greater influence over the director nomination process. We agreed with the conclusion of Congress as indicated in the legislative history to this provision that "it is proper for shareholders, as the owners of the corporation, to have the right to nominate candidates for the Board using the issuer's proxy under limited circumstances."[7]

In August 2010, under the authority granted by Section 971, the SEC promulgated a comprehensive proxy access rule that would have applied to all U.S. public companies. But on October 4, 2010, the SEC delayed the implementation of the rule in response to a legal challenge from the Business Roundtable.

On July 22, 2011, the D.C. Circuit Court of Appeals agreed with the Business Roundtable's arguments and struck down the provisions of the rule that would have established a uniform proxy access rule. The SEC, however, implemented the unchallenged provisions of the rule that facilitates shareowner proposals for proxy access on a company-by-company basis. In response, over 20 proxy access shareowner proposals were submitted during the 2012 proxy season.

The most noteworthy of the proxy access proposals to-date may have been at Hewlett-Packard where the shareowner proxy access proposal was voluntarily withdrawn after the company negotiated with shareowners and agreed to put a proxy access bylaw up for a shareowner vote at its 2013 annual meeting.

Of the 9 proxy access shareowner proposals that have made it to a vote during the 2012 proxy season, the average vote in support of the proposals is 35%, and at 2 of the 9 companies the proposal has been approved:

- On June 5th, 56 percent of the shareowners at Nabors Industries voted to give shareowners—who own at least 3 percent of the company's shares for three

[7] *Id.* at 119.

years—the right to nominate directors on the company's proxy ballot, for up to 25 percent of the board, and

- On June 8th, 60 percent of the shareowners at Chesapeake voted for proxy access on terms consistent with those at Nabors Industries.

While CoPERA supports these company-by-company developments, we and many other institutional investors continue to believe that the SEC should give priority to the reissuance of a proxy access rule that sets uniform standards and requirements for access at all public companies.[8]

Executive Compensation Reforms

As long-term investors 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.

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

CoPERA, therefore, strongly supported, and continues to support the following four Dodd-Frank provisions that provide long term investors like CoPERA with some of the tools that we need to hold directors more accountable with respect to the critical corporate governance issue of executive compensation.

1. Advisory Vote on Compensation

Section 951 of Dodd-Frank provides shareowners an advisory vote on executive compensation. The legislative history in support of this provision indicates that Congress believed that the "economic crisis revealed instances in which corporate

[8] Press Release, Council of Institutional Investors, Council Statement on Shareowner Proposals Addressing Proxy Access (Nov. 23, 2011), http://www.cii.org/UserFiles/file/11-28-11%20release%20on%20Council%20statement%20on%20access%20proposals.pdf.

executives received very high compensation despite the very poor performance of their firms."[9]

CoPERA believes that the Section 951 requirement, which first became effective for the 2011 proxy season, efficiently and effectively provides boards with useful information about whether the investors' view the company's compensation practices to be in shareowners' best interests.[10] We note that during the 2012 proxy season shareowners have rejected 55 executive compensation resolutions compared to 44 failures in 2011. While the failure rate is only about 3 percent of all say-on-pay votes, the numbers underplay the importance of this requirement.

Many experts agree that in the two years since Section 951 has been in effect, it has had a significant and positive impact on the design and magnitude of pay packages.[11] As a direct result of the requirement, compensation committees of boards are concerned about how investors will react to executive pay packages so they are actively reaching out to shareowners ahead of the vote and voluntarily reducing pay that is not tied to performance. As recently reported in Businessweek:

> Almost all of the companies that faced "no" votes last year have done away with practices that irked their investors. Hewlett-Packard (HPQ) no longer uses the formula that allowed CEO Leo Apotheker to pocket $30 million for an 11-month run during which the stock fell by almost half. Successor Meg Whitman has a salary of $1, with the bulk of her $16.5 million package tied to the company's share performance. Nabors Industries' (NBR) former chief agreed in February to waive his $100 million termination payment in the face of last year's no vote.[12]

The bottom line is that Section 951 is working as intended, inducing compensation committees to reach out to investors and engage with them in a dialogue about how executive pay programs can be better aligned with company performance and better serve the interests of long-term investors like CoPERA.

2. Stronger Clawback Provisions

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[9] Rep. on The Restoring American Financial Stability Act at 109.

[10] *See* Katherine Reynolds Lewis, The 5 Best and 5 Worst Regulations in Dodd-Frank, Fiscal Times 2 (July 19, 2011), http://www.thefiscaltimes.com/Articles/2011/07/19/The-5-Best-and-5-Worst-Regulations-in-Dodd-Frank.aspx#page1 (Describing "Investor protections" generally and the "provisions giv[ing] shareholders more say in matters such as executive compensation" as one of the five best regulations in Dodd-Frank.).

[11] *See* Diane Brady, Say on Pay: Boards Listen When Shareholders Speak, Businessweek, June 7, 2012, http://www.businessweek.com/articles/2012-06-07/say-on-pay-boards-listen-when-shareholders-speak.; Robin Ferracone et al., Say on Pay, Identifying Investor Concerns 21 (Sept. 2011) http://www.cii.org/UserFiles/file/resource%20center/publications/Say%20On%20Pay%20-%20Identifying%20Investor%20Concerns.pdf ("Compensation committees and boards have become much more thoughtful about their executive pay programs and pay decisions.").

[12] Diane Brady at 1.

Section 954 of Dodd-Frank imposes on executive compensation a "clawback" requirement on public companies. Under a listing standard to be mandated by SEC rule, public companies must set policies to recover incentive based compensation that was paid out based on inaccurate financial statements that do not comply with accounting standards. The legislative history in support of this provision indicates that Congress concluded that "it is unfair to shareholders for corporations to allow executives to retain compensation that they were awarded erroneously."[13]

Like many investors, CoPERA believes a tough clawback policy is an essential element of a meaningful "pay for performance" philosophy.[14] 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 of 2002 ("SOX") gave additional authority to the SEC to recoup bonuses or other incentive-based compensation in certain circumstances, CoPERA shares the view of Congress that the SOX clawback language was too narrow. Importantly, unlike the Section 304 clawback, the clawback under Section 954 is not conditioned on an adjudication of misconduct in connection with the problematic accounting that required the restatement.

While the SEC has yet to propose a rule to implement Section 954, public support for a strong clawback requirement continues to grow. That support was reflected in JPMorgan's recent decision to go beyond the clawback requirements of Section 954 and voluntarily clawback pay from senior executives linked to the nearly $6 billion dollars in trading losses incurred at its Chief Investment Office.[15] Commenting on JPMorgan's action, Kenneth Feinberg, the former Special Master for Executive Compensation for the Troubled Asset Relief Program stated:

> 'I think the fact that that JPMorgan is publicly announcing an implementation of its clawback policy is a major step in the right direction.'[16]

We agree with Mr. Feinberg and look forward to commenting on the SEC's proposed rule implementing Section 954.

3. Independent Compensation Consultants

Section 952 of Dodd-Frank mandates that members of board compensation committees and any compensation counsel or adviser be independent. It also requires the SEC to adopt rules requiring the national securities exchanges and associations to prohibit the listing of any equity security of an issuer that does not comply with Dodd-Frank's

[13] Rep. on The Restoring American Financial Stability Act at 111.
[14] Paul Hodgson et al., Wall Street Pay, Size, Structure and Significance for Shareowners 2 (Nov. 2010), http://online.wsj.com/public/resources/documents/CIIWhitePaperWallStreetPayFINAL11302010.pdf (Paper commissioned by Council of Institutional Investors concluding that strong clawbacks are an important step to improving compensation practices.).
[15] Mary Thompson, JPMorgan Breaks New Ground on 'Clawback' Front, CNBC, July 13, 2012, http://www.cnbc.com/id/48175180/JPMorgan_Breaks_New_Ground_on_Clawback_Front.
[16] *Id.*

compensation committee independent requirements. Those rules were issued by the SEC on June 30th and are expected to be put in place by the exchanges later this year.

CoPERA believes that compensation consultants and advisors 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 thus should be minimized and disclosed.

We agree with SEC Chair Shapiro that the recently issued SEC rule in response to Section 952, if properly implemented by the exchanges and aggressively enforced, will:

> Help to enhance the board's decision-making process on executive compensation matters, particularly the selection, engagement and oversight of compensation advisers, and will provide more transparency with respect to conflicts of interest of consultants engaged by boards."[17]

4. Enhanced Disclosures

Section 953 of Dodd-Frank includes a "pay v. performance" disclosure requirement for proxy statements. Specifically, the SEC must require companies to disclose in their annual proxy statement a clear description of any compensation required to be disclosed under Regulation S-K Item 402, including information that shows the relationship between executive compensation actually paid and the company's financial performance, taking into account the change in the value of shares, dividends and distributions. The legislative history in support of this provision indicates that Congress concluded that these disclosures "will add to corporate responsibility as firms will have to more clearly disclose and explain executive pay."[18]

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 requirement of Section 953 to enhance the disclosure of executive compensation. A clearer description of the relationship between executive compensation and company performance would eliminate a major impediment to the market's and investor's ability to analyze and understand executive compensation programs and to appropriately respond.

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[17] Press Release, U.S. Securities and Exchange Commission, SEC Adopts Rule Requiring Listing Standards for Compensation Committees and Compensation Advisers 1 (June 20, 2012), http://www.sec.gov/news/press/2012/2012-115.htm.

[18] Rep. on The Restoring American Financial Stability Act at 110.

We look forward to commenting on the SEC's proposed rule to implement the requirements of Section 953.

SEC Funding

Finally, as you are aware, the SEC is responsible for implementing and enforcing many of the requirements of Dodd-Frank, including the critically important corporate governance provisions discussed in this testimony. Those responsibilities are in addition to its day-to-day responsibilities as the only federal agency responsible for protecting investors and policing the capital markets.

CoPERA agrees with the conclusion of the Investors Working Group and many others that "starving" the SEC of needed resources while at the same time increasing its responsibilities is a strategy that is unlikely to benefit investors and the capital markets, or lessen the odds of another financial crisis.[19] In that regard, we believe the SEC's FY2013 funding request appears to be quite reasonable and appropriate particularly given the scope of the SEC's core responsibilities, as well as the many new responsibilities required by Dodd-Frank.[20] We, therefore, respectfully request that the Subcommittee and its individual members consider actively supporting the SEC's funding request.

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

[19] Investors' Working Group at 1.
[20] *See* Erick Wasson, Bill Limiting SEC Funds to Enact Dodd-Frank Headed to House Floor, Hill, June 20, 2012, http://thehill.com/blogs/on-the-money/banking-financial-institutions/233871-bill-limiting-sec-heads-to-house-floor.