

*Testimony
Of
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On Shareholder Rights and Financial Market Stabilization*

*Domestic Policy Subcommittee
Oversight and Government Reform Committee
Wednesday, December 16, 2009
2154 Rayburn House Office Building
10:00 a.m.*

***“The Government as Dominant Shareholder: How Should the
Taxpayers’ Ownership Rights be Exercised?”***

Chairman Kucinich and Ranking Member Jordan and Members of the Subcommittee:

Thank you for the opportunity to testify before you in order to share our experience in corporate governance as you consider the issue of shareholder rights and financial market stabilization under the Troubled Assets Relief Program (TARP).

I am here to represent the California Public Employees’ Retirement System (CalPERS), the largest public pension fund in the United States. CalPERS is responsible for over \$200 billion in global assets, which include equity and debt positions in more than 9,000 public companies worldwide. CalPERS invests these assets on behalf of more than 1.6 million beneficiaries in order to fund their retirement and health benefits.

CalPERS is fundamentally a long-term, fiduciary investor, with a systemic interest in financial market stability. We consider the reforms being proposed by the House and Senate to be vitally important to ensure the transparency and accountability which are needed to restore stability.

CalPERS has both a direct and indirect interest in the successful execution of the Troubled Asset Relief Program (TARP):

- Direct, because we own over \$7 billion in debt and equity in financial sector TARP recipient companies. This number reflects a loss of more than 40 percent in the value of equity holdings in this sector alone since the crisis hit;
- Indirect, because CalPERS faced devastating financial consequences if markets collapsed. TARP funds played an essential role in strengthening balance sheets at

a vital moment and in a critical sector. As equity investors we were diluted; as debt holders, we were given a life line.

We are now thinking ahead and considering how the exit from emergency can also foster a return to robust good health. There are many factors to consider here – but governance is fundamental.

As TARP funds are being repaid and the corporate governance provisions required by Treasury and its agent, the Special Master for Compensation, are withdrawn, the question of continuing governance reform for recipients and graduates of the TARP program is a focus of our close attention.

Here we draw upon CalPERS longstanding work in the field of corporate governance. At the core is our 15 years of experience engaging directly with financially troubled companies through our Focus List program. Through this work we have come to understand some of the critical elements.

We have strong conviction and some compelling evidence that governance reform underpins the mitigation of risk and the enhancement of returns.

CalPERS external pension consultants, Wilshire Associates, have tracked the progress of companies in the Focus List program since its inception. Their conclusion in a 2009 report to the CalPERS Board of Administration stated that after the first five years of engagement by CalPERS, the companies concerned averaged excess returns of 15 percent above their benchmark return on a cumulative basis. This result is all the more striking as the universe of companies on average came onto the Focus List with a collective underperformance relative to their benchmark of some negative 8 percent.¹

The time period is important: These results were observed over a five-year period. Governance reform is a long-term engagement. We also would offer the caveat that there is no clear evidence that any isolated element in the Focus List program is the key. CalPERS engagement on the governance reforms itself is part of the value. In other words, the attention of owners in itself contributes to the process of renewal.

In short, the Focus List program offers an example of sustained, shareowner engagement around a clear governance framework being followed by a significant and sustained financial improvement.

We regard this experience as highly relevant to the governance reforms that are needed to foster transparency and accountability, not just for TARP recipients, but across the market.

¹ The “CalPERS Effect” on Targeted Company Share Prices, Wilshire Associates Incorporated, July 31, 2009

We have no reason to consider that governance principles should be disregarded or downgraded by any shareowner for reasons of provenance.

Governance is intended to ensure the productive allocation of capital, with effective oversight for those responsible for this task. All providers of capital have an interest in this, regardless of their origin or type. Their financial goals may differ; for example, the time period or quality of return will vary according to need or liability. However, we do not see circumstances in which corporate governance fails to be relevant to risk and return.

We note that international guidelines have been developed that provide specific guidance for Government shareholders (reference here to the IMF and OECD guidelines, on state shareholding holdings). These are consistent with CalPERS Global Principles of Accountable Corporate Governance. As the Committee considers global best practices, we highlight the following from our CalPERS core principles:

1. **Optimizing shareowner return:** Corporate governance practices should focus the board's attention on optimizing the company's operating performance, profitability, and returns to shareowners. Compensation here plays a part and our comments are below.
2. **Accountability: Directors should be accountable to shareowners, and management accountable to directors.** To ensure this accountability, directors must be accessible to shareowner inquiry concerning their key decisions affecting the company's strategic direction. We specify detail in the shareholder rights section below.
3. **Transparency: Operating, financial, and governance information about companies must be readily transparent.** We have recently submitted our comments to the SEC on the need for expanding disclosure in the realm of critical areas such as risk management and board qualifications, diversity, and performance evaluation.
4. **Equitable treatment: All investors must be treated equitably, that is, according to the principle of one share, one vote.**
5. **Long-term vision:** Shareowners should encourage companies to resist short-term behavior by supporting and rewarding long-term superior returns.

These core principles translate into specific corporate governance best practices. We promote these through our engagement with companies, including Focus List companies, advocacy with policymakers, and through CalPERS proxy voting program. Full details can be accessed through CalPERS Corporate Governance Web site, which provides details about the largest 300 holdings in our U.S. portfolio.

Of particular relevance to the Committee's considerations of corporate governance best practices are the following, taken from the CalPERS Principles:

Board Independence and Leadership: Competence and Resources

CalPERS considers that a majority of the board of directors should be independent, and that the board should be chaired by an independent director.

We also consider that the board and its committees should have access to adequate resources to provide independent counsel, advice, or other tools which allow the board to perform its role in full. Where companies are operating in particularly complex or volatile environments, this is potentially a way to strengthen the board's competence and independence.

Board, Director and CEO Evaluation: Fostering Diversity and Critical Thinking

Boards need to develop a system for evaluating the performance of its directors, assessed against strategic objectives. Each board should adopt and disclose a statement of its own governance principles and ensure these are re-evaluated on an annual basis.

CalPERS also considers that each board must establish and disclose the mix of attributes, experiences, diverse perspectives, and skill sets that are most appropriate for the company. In this we include core attributes, such as accounting or finance skills and experience, but other areas are also relevant, such as leadership, strategic planning, and risk management.

With each director nomination, the board should consider the issue of continuing director tenure, as well as board diversity, and take steps as necessary to ensure that the board maintains openness to new ideas and a willingness to critically examine the status quo.

CEO succession planning is critical. The board should lead and be accountable for the development, implementation, and review of its succession plan. We also want to see disclosure made to shareowners on the process that has been established. This should apply not just to the key executive(s) on the board, but also to the directors themselves.

Executive and Director Compensation

Compensation programs are one of the most powerful tools available to the company to attract, retain, and motivate key employees to optimize performance targeted at providing sustainable, long-term shareowner returns. The financial crisis has also shown what damage can be done through poor alignment of risks.

Well-designed compensation programs will be adequately disclosed and management aligned with the long-term economic interests of shareowners.

CalPERS believes shareowners should have an effective mechanism by which to periodically promote substantive dialogue, encourage independent thinking by the board, and stimulate healthy debate.

CalPERS considers that companies should submit their executive compensation policies to shareowners for non-binding approval on an annual basis.

We also consider that performance assessments should be carried out by wholly independent compensation committees, who consider peer relative performance against multiple metrics. Companies should be able to recapture incentive payments which were made on the basis of activities that were later found to have been a material misstatement of results. This is colloquially known as a 'claw back policy.'

The comment on the long-term cannot be over emphasized. If rewards are structured to pay out before risks are realized, then regardless of the scope of a claw back policy, the compensation plan is misaligned.

CalPERS supports disclosure of the incentive compensation policy below board and senior executive level as this relates to risk management.

Integrity of Financial Reporting

Risk management is an integral part of a company's internal controls. Both external and internal parties play a role: Management, the board, and the external auditor.

CalPERS wants to ensure oversight by shareowners through the ability to ratify or reject the external auditor annually. Also, we support the audit committee requiring the auditor's opinion to include commentary on any management assertion that the system of internal financial controls is operating effectively and efficiently, and that financial information is reliable as of a specific date, based on an integrated framework of internal controls. This reporting needs to be illuminating, and not by rote.

We also consider that in addition to the skill sets for audit committees set out in regulation S-K and listing requirements, boards should consider in their annual assessments the effectiveness of the audit committee and designated financial experts. This consideration ties in with our concern to see more useful and comprehensive reporting by boards on their performance goals and on the skills sets and experience needed to achieve them.

Corporate Responsibility

CalPERS expects companies in its portfolio to conduct themselves with propriety and a clear view toward responsible corporate conduct. If improper practices arise, companies should move decisively to eliminate these and introduce adequate controls to prevent a recurrence. A level of performance above minimum adherence to the law is generally expected.

Shareowner Rights: The Specifics

CalPERS considers that providing shareowners with the rights to ensure accountability is a necessary and effective complement to legal and regulatory requirements. Specifically we consider that companies should adopt the following standards in support of shareowner rights.

Majority Vote Requirements

Shareowner voting rights should not be subject to supermajority voting requirements. A simple majority of proxies cast should be able to amend the company's governing documents and remove a director with or without cause.

Majority Vote Standard for Director Elections

In an uncontested director election, a majority of proxies cast should be required to elect a director. Resignation should be required for any director who receives a withhold vote greater than 50 percent of the votes cast.

Shareowners should have the right to cumulate votes in a contested election of directors.

Special Meetings and Written Consent

Shareowners should be able to call special meetings or act by written consent.

Sponsoring and Implementation of Shareowner Resolutions

Shareowners should have the right to sponsor resolutions, and if approved by a simple majority of proxy votes case, they should be implemented by the Board.

Takeover Defenses

Companies should prohibit 'greenmail' and allow shareowners to approve all 'poison pills.'

Annual Director Elections

CalPERS considered that 'staggered boards' should be reformed in favor of annual election for each director.

Broker Non-Votes

Broker non votes should be counted for quorum purposes only.

Proxy Access

Shareowners should have the ability to nominate candidates for consideration by their fellow investors by placing proposals on the proxy. We regard this as the single most important measure that could be provided to significant, long-term owners. CalPERS

has been vocal in its support for the SEC's rule making efforts on this issue, and applauds the House and Senate for endorsing the SEC's authority to introduce reforms. To allow management to use the proxy for proposing directors, and to exclude owners, removes the single most important channel for ensuring accountability.

Conclusion

CalPERS has extensive and longstanding experience in corporate governance. We have seen that promoting transparency and accountability fosters sustained value creation and supports effective risk mitigation. While governance reform provides no guarantee, it gives us a framework to hold boards accountable and bolster the overall effort to restore market sustainability. In short, we urge government as a fellow shareowner to help us develop and use the good governance tools we need to hold corporate boards accountable, embrace corporate governance best practices and thereby ensure alignment of interests as a shareowner. Thank you for the opportunity to share our views on this vitally important element of financial market reform. I would be glad to provide additional comment on any of the points raised and to answer questions.