Testimony of Richard Ferlauto
Director of Corporate Governance and Pension Investment
on behalf of the
American Federation of State, County and Municipal Employees
before the
Subcommittee on Securities, Insurance, and Investment
Committee on Banking, Housing and Urban Affairs
United States Senate
on
Protecting Shareholders and Enhancing Public Confidence by Improving Corporate Governance
July 29, 2009

Good Afternoon, Chairman Reed and members of the Subcommittee. My name is Richard Ferlauto, Director of Corporate Governance and Investment Policy at the American Federation of State, County and Municipal Employees. AFSCME is the largest union in the AFL-CIO with 1.6 million members who work in the public service. Our members have their retirement assets invested through public retirement systems with more than one trillion dollars in assets. They depend on the earnings of these systems to support their benefits in retirement. Large public pension system investments in the public markets are diversified, largely owning the market, and heavily indexed, which operate with time horizons of 20 years or more to match the benefit obligations they have to their plan participants. Indeed, public pension systems are the foundation of patient capital investment in this economy, which seeks long-term shareholder value creation.

AFSCME places strong emphasis on improving corporate governance through direct company engagement, regulation and legislation as a way to achieve long-term shareholder value. As an active shareowner, we have been a leading advocate for a shareholder advisory vote on CEO compensation and shareholder proxy access to nominate directors on company proxy materials.

I am also chairman of ShareOwners.org, a new nonprofit, nonpartisan social network designed to give a voice to retailers or individuals who rarely have opportunities to communicate with regulators, policymakers and the companies in which they are invested.

We urge the Committee to create better protections for the average American investor in the financial marketplace. The severe losses suffered by tens of millions of Americans in their portfolios, 401(k)s, mutual funds and traditional pension plans all point to the need for a new emphasis on shareowner rights and meaningful regulation in order to ensure the financial security of American families.

America has tried going down the road of financial deregulation and reduced corporate accountability. That path has proven to be a dead end that is now imperiling the financial well-being of millions of long-term shareowners. Unfortunately, shareholders in America's corporations – who actually should more correctly be thought of as "shareowners" – have limited options today when it comes to protecting themselves from weak and ineffectual boards dominated by management, misinformation peddled as fact, accounting manipulation, and other abuses.

Under the disastrous sway of deregulation and lack of accountability, corporate boards and executives either caused or allowed corporations to undertake unreasonable risks in the pursuit of short-term financial goals that were devoid of real economic substance or any long-term benefits. In most cases, it is long-term shareowners – not the deregulators and the speculators – that are paying the price for the breakdown in the system.

According to a recent scientific survey that the Opinion Research Corporation conducted for ShareOwners.org of 1,256 U.S. investors, American investors clearly want to see tough action taken soon by Congress to reform how our financial markets work and also to clean up abuses on Wall Street. Support for such action is strong across all groups by age, income, educational achievement and political affiliation. It is particularly noteworthy that such a high percentage of investors (34%) would use a term as strong as "angry" to describe their views about the need for such action. And, even though they are not angry, the additional nearly half of other investors (45%) who want to see strong clean-up action taken sends an unmistakable message to policy makers. This is particularly true when you look at that data alongside the finding that nearly six out of 10 investors (57%) said that strong federal action would help to restore their lost confidence in the fairness of the markets." The full survey from ShareOwners.org is attached as an addendum to this testimony, but I would like to point out the following findings:

- More than four out of five American investors (83%) agree that "shareholders should be permitted to be actively involved in CEO pay and other important issues that may bear on the long-term value of a company to their retirement portfolio or other fund."

- More than four out of five investors (82%) agree that "shareholders should have the ability to nominate and elect directors of their own choosing to the boards of the companies they own." Only 16% of Americans say that "shareholders should NOT be able to propose directors to sit on the boards of the companies they own."

- Nearly nine out of 10 investors (87%) say that "investors who lose their retirement savings due to fraud and abuse should have the right to go to court if necessary to recover those funds." Only one in 10 American investors think that "investor lawsuits clog up the courts and make it more expensive for companies to run their businesses."

- The No. 1 reason for loss of investor confidence in the markets: "overpaid CEOs and/or unresponsive management and boards" at (81%).

It is time for America to get back on the road of prudent financial regulatory oversight and increased corporate accountability. We urge you to recognize the devastating impact that a lack of appropriate regulation and accountability has had on our economy. In order to restore the confidence of investors in our capital markets, it is now necessary to take the following steps:

I. Strengthen the <u>regulation of the markets</u>. Key reforms needed to protect the interests of shareowners include the following:

   - **Beef up the Securities and Exchange Commission (SEC).** Congress should assess the funding needs of the SEC and take steps to bring the agency as quickly as possible to the point that it can fully carry out its mission of oversight of the markets and financial professionals in order to protect and advocate for investors. Among other priorities, the

SEC should impose requirements for the disclosure of long and short positions, enhance disclosures for private equity firms bidding for public companies, and require both the registration of hedge fund advisors with the Commission as investment advisors and additional disclosures of the underlying hedge fund. Following the request of the administration, the SEC should be given additional authority to create a full-fledged fiduciary standard for broker dealers, so that the interests of clients who purchase investment products comes before the self interest of the broker. The SEC Division of Enforcement should be unshackled to prosecute criminal violations of the federal securities laws where the Department of Justice declines to bring an action.

- **Clear the way for forfeiture of compensation and bonuses earned by management in a deceptive fashion.** Legislation should be adopted to allow for the "clawing back" of incentive compensation and bonuses paid to corporate executives based on fraudulent corporate results, and should provide for enforcement through a private right of action. There is no reason why directors and executives should not give back ill-gotten gains when innocent shareowners are victimized by crippling losses. The outrageous bonuses at AIG, Morgan Stanley and other banks responsible for our financial meltdown were not deserved and should not be allowed to stand. If they know their compensation is on the line, corporate managers and directors will be less likely to engage in or turn a blind eye toward fraud and other wrongdoing.

- **Strengthen state-level shareowner rights.** Corporation structures and charters are regulated under state law. The corporate law in most states has not clarified the rights, responsibilities and powers of shareholders and directors or ways that they should communicate outside of annual general meetings. If regulation to strengthen shareholder rights does not occur at the federal level, it will be up to the states to move forward. State corporate law should require proxy access, majority voting and the reimbursement of solicitation expenses in a board challenge. We would encourage robust competition among states for corporate charters based on a race to the top for improved shareowner rights. If necessary, federal law should be changed to allow for shareholders to call a special meeting to reincorporate in another state by majority vote, in order to avoid being shackled by the corporate state laws that put the interests of management ahead of shareowners.

- **Protect whistleblowers and confidential sources who expose financial fraud and other corporate misconduct.** Confidential informants – sometimes called "whistleblowers" – are of immeasurable value in discovering and redressing corporate wrongdoing. The information provided by these individuals may be crucial to victims' ability to prove their claims. Often, these individuals only come forward because they believe their anonymity will be preserved. If their identities were known, they would be open to retaliation from their employers and/or others with an interest in covering up the wrongdoing. Whistleblowers might lose their job or suffer other harm. Legislation is needed to clearly state that the corporate whistleblowers and other confidential informants will be protected when they step forward.

II. Increase the <u>accountability of boards and corporate executives</u>. Key reforms needed to protect the interests of shareowners include the following:

- **Allow shareowners to vote on the pay of CEOs and other top executives.** Corporate compensation policies that encourage short-term risk-taking at the expense of long-term corporate health and reward executives regardless of corporate performance have contributed to our current economic crisis. Shareowners should have the opportunity to vote for or against senior executive compensation packages in order to ensure managers have an interest in long-term growth and in helping build real economic prosperity. The recently enacted stimulus bill requires all companies receiving TARP bail-out funds, nearly 400 companies, to include a "say on pay" vote at their 2009 annual meetings and at future annual meetings as long as they hold TARP funds. It is now time for Congress to implement Treasury Secretary Geithner's plan for compensation reform by passing "say on pay" legislation for all companies and to make it permanent as the center piece of needed reforms to encourage executive accountability.

  A key item to making the advisory vote meaningful will be not to permit brokers to cast votes on management sponsored executive compensation proposals as was recently done by the SEC in support of changes to NYSE Rule 452 in board elections. Stockbrokers who hold shares in their own name for their client investors have no real economic interest in the underlying corporation but can cast votes on routine items on the proxy. These pay votes are not routine items and should not be treated as such by investors, issuers or the regulators and we do not believe would be the intent of Congress if they give authorization to the SEC to require advisory votes on pay. Brokers almost universally vote for management's nominees and proposals and, in effect, interfere with shareowner supervision of the corporations they own.

- **Empower shareowners to more easily nominate directors for election on corporate boards through proxy access.** The process for nominating directors at American corporations is dominated today by incumbent boards and corporate management. This is because corporate boards control the content of the materials that companies send to shareholders to solicit votes (or "proxies") for director elections, including the identification of the candidates who are to be considered for election. The result is that corporate directors often are selected based on their allegiance to the policies of the incumbent board, instead of their responsiveness to shareowner concerns. Unless they can afford to launch an expensive independent proxy solicitation, shareowners have little or no say in selecting the directors who are supposed to represent their interests. The solution is to enable shareowners, under certain circumstances, to require corporate boards to include information about candidates nominated by shareowners in the company's proxy materials.

  We are very encouraged that the SEC is in the process of rule making on the issue but this is such an important right that we believe that it should not become a political football for future commissions. There needs to be long-term consistency in securities law and the Exchange Act is the appropriate place to clearly codify the authority that the Commission has to require the disclosure of nominees running for board seats. And to further enunciate that access to the proxy is fundamental to free and fair elections for directors.

- **Require majority election of all members of corporate boards at American companies.** Corporate directors are the elected representatives of shareowners who are responsible for overseeing management. Under the default rule applicable to virtually every corporation in the United States, however, corporate directors can be elected with just a single affirmative vote, even if that director's candidacy is opposed by the overwhelming majority of shareowners. While a few corporations have adopted policies that would require a director to receive support of the majority of shareowners in order to be elected, most corporations – particularly those not in the S&P 500 – have not. True majority voting should be mandatory in every uncontested director election at all publicly traded corporations.

- **Split the roles of chairman of the board and CEO in any company.** (1) receiving federal taxpayer funds, or (2) operating under federal financial regulations. It already is the practice in most of the world to divide these two key positions so that an independent chairman can serve as a check on potential CEO abuses. Separation of the CEO and board chair roles helps to ensure good board governance and fosters independent oversight to protect the long-term interests of private shareowners, pension funds and institutional investors. A strong independent chair can help to address legitimate concerns raised by shareowners in a company. Splitting these roles and then requiring a prior shareowner vote to reintegrate them would be in the best interests of investors.

- **Allow shareowners to call special meetings.** Shareowners should be allowed to call a special meeting. Shareowners who own 5% or more of the stock of a company should be permitted, as they are in other countries, to call for a special meeting of all shareowners. They also should be given the right to call for a vote on reincorporation when management and corporate boards unduly use state laws detrimental to shareowner interests to entrench themselves further.

III. Improve financial <u>transparency</u>. Key reforms needed to protect the interests of shareowners include the following:

- **Crackdown on corporate disclosure abuses that are used to manipulate stock prices.** Shareowners in securities fraud cases have always had the burden of proving that defendants' fraud caused the shareowners' losses. When corporate wrongdoers lie to shareowners and inflate the value of publicly traded stock through fraudulent and misleading accounting statements and other chicanery, those culpable parties should be held responsible for the damage wrought on the investing public that is caused by their fraud. Defendants should not be allowed to escape accountability to their shareowners for fraudulent conduct simply by cleverly timing the release of information affecting a company's stock price.

- **Improve corporate disclosures so that shareowners can better understand long-term risks.** To rebuild shareowner confidence regulators should emphasize transparency by creating more mechanisms for comprehensive corporate disclosure. The SEC should devote particular attention to the adequacy of disclosures concerning such key factors as credit risk, financial opacity, energy and climate risk and those reflecting the financial challenges to the economy as identified by the

transition team and the new administration. The SEC should develop internal expertise on issues such as environmental, social, and governance factors that pose material financial risks to corporations and shareowners, and also to require disclosure of these types of risks.

- **Protect U.S. shareowners by promoting new international accounting standards.** Our current financial crisis extends far beyond the borders of the U.S. and has affected financial markets and investors across the globe. Part of the problem has been a race to the bottom in favor of a more flexible international accounting standard that would decrease disclosure protection for the average investor. The current crisis makes a compelling case for why we need to slow down the movement towards the use of international accounting standards that could provide another back door route to financial deregulation and further erode confidence in corporate book keeping. A slower time frame is necessary to protect shareowners and allow the administration to reach out to other governments that share a commitment to high accounting and transparency standards.

IV. Protect the legal rights of defrauded shareowners. Key reforms needed to protect the rights of shareowners include the following:

- **Preserve the right of investors to go to court to seek justice.** Corporate and financial wrongdoers in recent years have effectively denied compensation to victims of fraud by requiring customers to sign away their rights to access federal courts as individuals and participate with other victims in class actions when their individual claims are small. Absent the ability to proceed collectively, individuals have no means of redress because – as the wrongdoers know – it is frequently economically impossible for victims to pursue claims on an individual basis. The ability of shareowners to take civil actions against market wrongdoers provides an effective adjunct to securities law enforcement and serves as a strong deterrent to fraud and abuse. Shareowners should have the right to access federal courts individually or as a member of a class action.

- **Ensure that those who play a role in committing frauds bear their share of the cost for cleaning up the mess.** What is known as private "aiding and abetting" liability is well established in criminal law, and private liability for engaging in an unlawful and fraudulent scheme is widely recognized in civil law. In cases of civil securities fraud, however, judicial decisions effectively have eliminated private liability of so-called "secondary actors" – even when they knowingly participated in fraud schemes. Eliminating the private liability of such "secondary actors" as corporate accountants, lawyers and financial advisors has proven disastrous for shareowners and the economy. Most recently, in the sub-prime mortgage-backed securities debacle, bond rating agencies – who were paid by the very investment bankers who created the securities they were asked to rate – knowingly gave triple-A ratings to junk sub-prime debt instruments in order to generate more business from the junk marketers. The immunity from private liability that these culpable third parties currently enjoy should be eliminated.

- **Allow state courts to help protect investor rights.** The previous decade saw the greatest shift in governmental authority away from the states and to the federal government in our history. The effect of this shift was to deny individuals their legal rights under state laws and to protect corporate defendants. Corporate interests and an administration devoted to the ideology of deregulation used the "doctrine of preemption" (that federal law supersedes state law) to bar action at the state level that could have stopped many of the abuses in sub-prime mortgage lending that are now at the heart of our economic crisis. Indeed, state attorneys general were blocked from prosecuting sub-prime lenders who violated state laws. The integrity of state law should be restored and both state officials and shareowners should be allowed to pursue remedies available under state law. Federal policy should make clear that state law exists coextensively with federal regulations, except where state law directly contradicts federal law.

In conclusion, I would like to thank the Chairman for the opportunity to testify today. Rebuilding investor confidence in the market depends upon thoughtful policy making that expands investor rights and authorizes the SEC to strengthen its advocacy role on behalf of all Americans' financial security. I would be pleased to answer any questions.

Attachment