“Averting Financial Crisis: Regulatory Reform & Corporate Governance”
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(Prepared text)

Good morning.

It’s a pleasure to be here in this very special place of American journalism.

It’s personally meaningful to me since my father served as National Press Club President in 1964. I used to call his office after I got home from school often to be told that he was at the Press Club. I thought reporting must be pretty cool work if you got to hang out at a club all day.

As I stand here now, I’m thinking mainly not about the ‘60s but what happened just one year ago.

When Lehman Brothers collapsed, a worldwide financial panic ensued. For those of us responsible for investment portfolios, the following weeks presented a series of extraordinarily difficult and sometimes frightening challenges. There were moments when I thought I was staring into the abyss. And as long as I remain in this business, I will never forget the wrenching fear that we were headed for financial Armageddon.

Today, things are better, but not as good as they seem. Our economy, the financial and housing sectors in particular, is propped up by government spending and credit guaranties. Could we be staring into the abyss again anytime soon? It is not impossible, especially if we fail to learn what caused the crisis and apply those lessons to prevent a repetition. This morning, I want to focus on one of the main causes—the total failure of the financial services regulatory system. I will outline the steps that are required to reform it and stress the imperative that this reform be done right and soon.

I am worried that as memories of the crash fade and the resistance to reform intensifies, that all we’ll be left with is the façade of reform, not the real thing. It’s like putting a badly damaged house back on the market. Are we going to get a completely rebuilt structure from the foundation up or are we going to get a fixer upper with a new paint job and better landscaping that will blow away when the next big storm hits?

So do we want to just slap some paint on it or a complete remodel? Well, I'm pleased to say that in recent days there's been some movement toward a remodel.

Legislation coming up for a vote tomorrow in the House Financial Services Committee reaffirm's the statutory authority of the Securities and Exchange Commission to give shareowners access to the proxy ballots that companies use for board elections. The single most powerful thing we can do to improve corporate governance in America's boardrooms is to give shareowners a way to hold directors more accountable.

This proxy access proposal is one piece of a major fix for our regulatory system and corporate practices so there won't be another financial crisis.

Real market reform is about:

- plugging regulatory gaps;
- empowering and motivating regulators by giving them the authority, independence and resources to protect the public interest; and
- providing investors with a tool kit that will make corporate boards and managements truly accountable to their owners.

Without strong action, we risk another crisis – this time with the government's ability to massively increase spending… to shore up credit… and to inject public capital that keeps key financial institutions from collapsing severely limited. Limited by the sheer magnitude of spending and credit provision it's taken thus far and by a skeptical publics' decreasing willingness to believe that there is any justification for more of the same.

Now, you may be wondering if CalPERS is practicing what we preach about risk management and plugging the holes in our own policies to sustain our Fund.

- Well, we have 1.6 million State and local public agency employees, retirees and family beneficiaries.
- Our 13 member Board of elected and appointed officials and state officeholders sets policies for investing the contributions of active workers and employers.
- Our market value is about $200 billion.
- We are long horizon investors with a permanent stake in global markets which is why market reform and corporate governance are so important to us.

So how is CalPERS weathering the crisis? Well, you can ride out a typhoon better on an aircraft carrier than in a row boat – but it's a typhoon nonetheless.

In retrospect, we found that we've been right all along to stay focused on the long term.

- Our long-term investment strategy has allowed only four years of falling portfolio value in our 77-year history.
- Even in the past 20 years – with two recessions that accounted for those four down years – we met our annual average return target of 7 and three-quarters percent.
- We reviewed our asset allocation, made some fine tuning adjustments and reaffirmed our belief in the resiliency of capital markets and the virtues of keeping a steady course in the face of the inevitable fluctuations that come from investing in markets that have cyclical patterns.
- Our portfolio gained $40 billion since the market low last March.
- We have the cash to pay benefits and shop for investment bargains.
- And we're positioning the Fund for market recovery and growth.

At CalPERS, we're tackling the risk issue head-on by seeing to our <u>own</u> regulatory and risk management models.

You may have heard about our response to "pay-to-play" and conflict-of-interest allegations involving brokers and investment firms that court pension funds for business.

- To clarify, the fees that these placement agents get come from the investment companies that hire them – <u>not</u> from CalPERS.
- Our Board recently adopted strict reporting requirements for firms that do business with us, and new California legislation tightens conflict-of-interest law for former pension board members in such cases.
- We support the SEC's proposal to ban political contributions from entities that do or are seeking to do business with pension funds.

We're developing new internal risk management models that account for non-quantitative market factors.

And we're realigning our relationships with private equity and hedge fund managers to improve fee structures, transparency and better control our committed capital.

CalPERS is not alone in its quest to assure that voice of institutional investors is heard as the reform of our financial system is debated. We are members of, and I chair, the Council of Institutional Investors, an association of 128 public, labor and corporate pension plans who collectively manage over $3 trillion of assets.

CII advocates <u>real</u> market regulatory reform to protect not <u>only</u> big institutions like CalPERS – but also the majority of American households that have a stake in the capital markets through investments in their personal retirement savings and other accounts.

Specifically, what <u>should</u> be on our market reform agenda?

We have answered that through the report of the Investors' Working Group. This panel was sponsored by the Council of Institutional Investors and the CFA Institute Centre for Financial Market Integrity. Former SEC Chairs William Donaldson and Arthur Levitt co-chaired this independent group to develop recommendations for federal policymakers and regulators.

The nonpartisan panel of experts was created in February to ensure that investors' views are heard as policymakers and market participants debate how to modernize the U.S. system of financial regulation. I am a member of the group and the Council of Institutional Investors has endorsed its principles and recommendations.

The group's pragmatic roadmap for reform focuses on

- strengthening and reinvigorating existing federal regulatory agencies
- closing critical gaps in regulation
- and improving the corporate governance of U.S. public companies

Revitalizing the SEC and other federal agencies begins with making sure that they have the necessary staffing and budget resources to fulfill their mission.

- That, in turn, will enhance the independence regulators need to protect investors and stabilize the financial system—without political interference or dependence on the firms they oversee.

Second, the nation's regulatory umbrella needs to be comprehensive. Closing regulatory gaps will help guard against the kinds of short-term binges that inflated the earnings of financial firms and contributed to excessive executive compensation packages.
New regulations are also needed to bring transparency to what are now opaque markets. That will help protect investors from deception, fraud and the complex shell games that have kept us from following the money.

In particular

- Most over-the-counter derivatives contracts should trade on exchanges. Exchanges let investors comparison-shop, reducing prices.

  Just as important, exchange trading would let regulators trace OTC transactions, curb runaway leverage and bring some order to what has been a Wild West market.

  Every firm has reasons why its contracts are "exceptional" and should trade privately; in reality, most derivatives contracts are standardized – or standardizable – and could trade on exchanges.

- Credit rating agencies should be held accountable for their assessments. And Congress and the administration should do more to encourage alternatives to the predominant rating-agency business model that lets credit raters receive fees from the firms whose product they rate. Ideally, such conflicts of interest should be eliminated.

- We also support creation of a Consumer Financial Protection Agency to police abusive mortgages, credit cards and overdraft fees that contributed to the financial crisis.

Finally, our Investors' Working Group is urging adoption of strong corporate governance practices among public companies at the board level.

- We need to strengthen the independence of boards by separating the CEO and board chair positions.

- And we could enhance accountability by having directors stand for annual election.

- Shareowners are well overdue for the right to a say on pay, the authority to cast advisory votes on executive compensation packages.

- The Obama administration's pay czar is a temporary expedient. He has trimmed compensation of executives of TARP recipients, but he has only a limited reach and a limited time. Long after the pay czar is gone, shareowners ought to have a defined role in assessing the reasonableness of their company's compensation plan.

- People are outraged of obscenely generous compensation schemes at failed companies. Even more disturbing is the sense of entitlement by displayed executives. Sure talent and value creation should be amply rewarded, but it's galling to see those executives, placed on third base by government aid, claiming they deserve huge bonuses because they hit a triple.

- The most substantial, far reaching and important addition to the toolkit of investors is the right of shareowners to place their nominees for boards directly on the proxy ballots in annual elections – the "proxy access" issue.

- SEC Chair Mary Schapiro says proxy access would… in her words… *"turn what would otherwise be a somewhat illusory right to nominate into something that is real – and (that) has a real chance of holding boards of directors accountable to company owners."*[1]
  - Weak director elections can breed complacent boards.

- Complacent boards tend to take the path of least resistance to oversight.
- And without stronger alignment with company owners, directors are reluctant to challenge excessively risky management decisions and lavish pay packages that inspired so many executives to take companies over a bridge too far.

- Proxy access is important because under current rules it is prohibitively expensive for most investors, even big institutions like CalPERS, to nominate their own board candidates and send out their own proxy ballots.

- Proxy access is the lever that will enable long term investors to hold boards of directors accountable for the stewardship of the companies on whose boards they serve.

- Nowhere is proxy access more important than on the issue of executive compensation. It will make directors think twice before larding up pay packages with unearned bonuses, tax gross-ups and other shameful excesses. And in the rare instances where board members persistently fail in their duty to shareowners, there must be a timely, cost-effective way to replace them with directors who are responsive to the concerns of long-term owners.

- The amendment to the Investor Protection Act up for a vote tomorrow merely reaffirms the SEC's existing statutory authorization to adopt proxy access regulations. This step will help forestall costly and time consuming litigation that is likely in the absence of this clarification.

In recent weeks, I've been talking with policymakers in the White House, Treasury and Congress about market regulatory and corporate governance reform.

I'm pleased to see legislation advancing to regulate <u>derivative</u> transactions… to hold <u>credit rating agencies</u> accountable, strengthen the SEC and CFTC and to create a federal <u>Consumer Financial Protection Agency</u>.

But we're finding that the headwinds of entrenched Wall Street interests still blowing briskly on the Hill.

- Even big pension funds like CalPERS lack the lobbying clout of Wall Street… and there are <u>few</u> lobbyists for individual investors.
- Wall Street sometimes pleads passionately on behalf of America's investors. Somehow, I keep hearing sharks pleading on behalf of the swimmers.

Behind the total failure of the regulatory system to protect individual and institutional investors was the belief that markets are self regulating and that the least government action is always the preferred option. In the annals of mistaken beliefs, this has to be one of the most expensive and consequential ones. Yet as I listen to the debates on the legislation now moving through Congress, I hear echoes of this pernicious idea. Can our memories really be that short?

We are all too familiar with events predicted by risk models to be exceedingly rare happening several times a week. Who thinks that we should head into the future with a superficially better regulatory system that can once again enable the reckless risk taking whose consequences we will be dealing with – and paying for – in the years ahead?

As I close my remarks here… I think about people far removed from the corridors of power here in Washington, D.C. and for whom Wall Street is an abstraction.

I'm thinking about pension fund members and other Americans who are the real stakeholders in what happens to our financial markets.

They don't have tickets on the Wall Street gravy train.

They have no part in extravagant pay packages and government corporate welfare handouts.

No, they just pay for those pay packages and those bailouts – in devalued stock shares, higher taxes, lost jobs, deferred retirement and shattered dreams.

Their trust in government and confidence in markets are essential for our prosperity.

To protect these investors, large and small, let's close our regulatory gaps with substantial – not superficial – reform. Let's empower regulators with the authority, resources and independence they need to protect the public interest. And let's give investors the tools they need to hold corporate boards accountable.

We now know with certainty the consequences of a failed regulatory system. We need action now so we won't have to learn this terrible lesson again.

I welcome your questions.

> "If our response to the crisis focuses only on the symptoms rather than the underlying causes of the crisis, then we shall bequeath to future generations a serious risk of another crisis even worse than the one we have experienced."
>
> Mervyn King, Governor of the Bank of England