

BILL NUMBER: H.R. 10 (Hensarling, R-TX) as introduced April 26, 2017

SUMMARY

H.R. 10, entitled the Financial CHOICE Act of 2017, repeals provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act and changes shareholder proposal thresholds.

BOARD POSITION

Oppose. The board's policy is to oppose legislation that restricts the investment authority of the board or is inconsistent with the investment policy adopted by the board as presented in CalSTRS Investment Policy and Management Plan.

REASON FOR THE BILL

According to the bill, it ends bailouts, holds Washington and Wall Street accountable, eliminates red tape and repeals provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act that make the country less prosperous, less stable and less free.

ANALYSIS

Shareholder Proposals

Currently, shareholders who own 1 percent or \$2,000 worth of outstanding shares for at least one year can submit a proposal to be included on a company's proxy statement. CalSTRS has used the shareholder proposal process as one part of its engagement activities. Companies are generally very responsive to CalSTRS concerns and often collaborate with staff to improve their governance practices. However, there are instances when companies are not responsive or disagree with CalSTRS request. The ability to file a shareholder proposal is an important tool, which allows CalSTRS (or any investor who owns \$2,000) to bring such issues to the broader shareholder base. H.R. 10 dramatically changes the shareholder proposal process by eliminating the \$2,000 threshold and requiring investors to own a minimum of 1 percent of the issuer's voting securities over a three year period. Although many would consider CalSTRS a very large investor, CalSTRS rarely holds 1 percent of a single company. For example, 1 percent of Apple Inc., the largest U.S. company by market capitalization, equates to \$7 billion worth of stock. CalSTRS currently owns \$1.98 billion of Apple Inc. stock, just 0.26 percent of outstanding shares. H.R. 10 effectively prevents investors like CalSTRS from participating in the shareholder proposal process.

Advisory Votes on Executive Compensation

The Dodd-Frank Act requires companies to provide for a shareholder vote on executive compensation, consistent with the CalSTRS Corporate Governance Principles. The advisory vote on executive compensation, commonly referred to as Say-on-Pay, allows shareholders to communicate their views on the most recent compensation plan. Previously, if shareholders were unhappy with a compensation plan, the only vehicle to express concern was through a vote against the directors, which some shareholders are reluctant to do solely for compensation reasons. While CalSTRS reviews compensation

plans annually as part of the proxy voting process, Say-on-Pay is a more direct way to communicate acceptance or rejection of a plan. Advisory votes on executive compensation are widely recognized as improving company, board and shareholder relations, and boards actively and frequently reach out to shareholders to solicit feedback. This proactive engagement allows CalSTRS to raise other pertinent issues as part of our passive investment strategy. H.R. 10 reduces the frequency of Say-on-Pay votes by requiring a vote on executive compensation only if the plan has materially changed from the previous year. While the plan structure may not change, payouts under the plan can change, and what constitutes a “material change” is unclear. H.R. 10 eliminates CalSTRS ability to vote annually on the compensation plans and communicate rejection of the plan through proxy votes.

Proxy Research

The CalSTRS Corporate Governance Principles establish the foundation for the proxy voting activities. Not only is the voting of proxies a fiduciary duty, CalSTRS also believes that the execution of proxies is a fundamental shareholder right, and staff always seeks to exercise this right consistent with our principles and in the best interest of our beneficiaries. As a large institutional investor that holds more than 7,000 public companies, proxy advisors help inform CalSTRS proxy voting. Proxy advisory firms provide useful research regarding the governance and finances of our portfolio companies. Staff uses this research to supplement their due diligence and research in order to make informed decisions in a cost-effective manner. Proxy advisory firms also provide proxy voting platforms that allow for the efficient execution of proxy votes. In conjunction with CalSTRS principles, the proxy voting platform votes “routine” items, which allows staff to focus on more contentious issues or those issues that require a higher level of analysis. H.R. 10 imposes new regulatory burdens and restrictions on proxy advisory firms by requiring them to provide corporations that are the subjects of their analysis with access to drafts of proxy research reports and an opportunity to provide comments. The bill also requires proxy advisory firms to employ an ombudsman to receive complaints from corporations on the “accuracy” of information used in forming vote recommendations and to resolve complaints prior to distributing the proxy analysis. Given the short time period between when companies issue proxy materials and the shareholder meeting date, this process would severely limit CalSTRS ability to review and vote proxies in a timely manner. In addition, the multi-layered review process would provide corporations with substantial influence over the work of the proxy advisors, potentially undermining the independence and objectivity of that work.

Disclosures and Reliable Financial Reporting

Clawbacks – The U.S. Securities and Exchange Commission’s (SEC) issuance of a final rule in response to the Dodd-Frank Act provision entitled, “Recovery of Erroneously Awarded Compensation”, otherwise known as clawbacks, is consistent with the CalSTRS Corporate Governance Principles. H.R. 10 narrows the required scope for clawbacks of unearned compensation to only those executives who control the company’s financial reporting. This would be inconsistent with CalSTRS current principle that requires any and all unearned compensation to be clawed back. In addition, federal securities law is based upon a philosophy of disclosure, meaning issuers are required to disclose all material information that a reasonable shareholder would require for investment decision making. Understanding a company’s policies around clawbacks is vital to analyzing compensation plans.

Hedging – The SEC’s issuance of a final rule in response to the Dodd-Frank Act provision entitled, “Disclosure Regarding Employee and Director Hedging,” is consistent with the CalSTRS Corporate Governance Principles. H.R. 10 repeals the requirement that public corporations disclose whether their employees and directors can hedge their company’s equity compensation. This is inconsistent with CalSTRS current principle requiring companies to develop and disclose policies around hedging. Similar to clawback policies, federal securities law applies, and disclosure of hedging policies is an important aspect of a company’s compensation plan.

Chair and CEO Structures – In December 2009, the SEC adopted rules implementing the Dodd-Frank Act provision entitled, “Disclosure Regarding Chairman and CEO Structure.” CalSTRS believes board leadership is critical to effective corporate governance. Although CalSTRS principles dictate that the board should be led by an independent chair, CalSTRS believes those companies that have a combined chair and CEO structure should comply with the disclosure requirements. H.R. 10 repeals the required disclosures of public corporation chairman and CEO structures, which is inconsistent with CalSTRS overarching policies on disclosure and transparency.

Internal Controls – The Sarbanes-Oxley Act requires companies to have an outside auditor attest to a company’s internal financial controls, and following the scandals at Enron and WorldCom, investors welcomed the protection this would provide. The Dodd-Frank Act exempts companies with market capitalization of less than \$75 million from those requirements. H.R. 10 raises the exemption threshold to companies with market capitalizations of \$500 million or \$1 billion in assets for banks. There are approximately 680 companies in the Russell 2000 Index with market capitalizations less than \$500 million. H.R. 10 eliminates the protection of an outside auditor’s oversight of a company’s financial statements.

SEC Authority and Ability to Protect Investors

Universal Proxy Ballot – Currently, if shareholders want to vote for candidates on different proxy cards, they must travel to the shareholder meeting. Not only does this disenfranchise shareholders, it creates a different process for voting in contested elections, a mechanism designed solely to protect incumbent directors. In October 2016, the SEC voted to propose amendments to require parties in a contested election to use universal proxy cards that include the names of all board of director nominees. Subsequently, a public comment period opened, and CalSTRS submitted comments supporting the proposed rule. The SEC’s proposal gives shareholders the ability to vote by proxy for their preferred combination of board candidates and replicates how shareholders can vote in person at the shareholder meeting. H.R. 10 bars the SEC from issuing a final rule for a universal proxy ballot. Voting for director nominees is a fundamental right, and as a long-term investor, CalSTRS supports the ability to choose among the best suited candidates to represent their interests inside the boardroom.

Proxy Access – CalSTRS believes that proxy access – a mechanism that enables shareholders to place their nominees for director on a company’s proxy card – is a fundamental right of long-term shareholders. Proxy access gives shareholders a meaningful voice in board elections and is consistent with CalSTRS Corporate Governance Principles. Through the collective efforts of shareholders, to date more

than 50 percent of the companies in the S&P 500 have adopted a proxy access bylaw. H.R. 10 removes the SEC's authority to issue a proxy access rule that would apply to all companies.

Cost Benefit Analysis and Congressional Review – H.R. 10 includes the SEC as part of the cost-benefit analysis and congressional review provisions of the Act. The SEC's rule-making process is already governed by a number of legal requirements, including federal securities laws. The SEC is generally required to consider whether its rule-makings are in the public's best interest; protect investors; and promote efficiency, competition and capital formation. H.R. 10 unnecessarily restricts the SEC's ability to issue proposals and works against its mission to protect investors. The requirements could create a false expectation that the SEC can reasonably measure and compare the costs and benefits of its proposals.

Private Equity Advisors – CalSTRS is diversified investor, which includes investment in private equity funds. As a private equity investor, CalSTRS supports the registration of private equity advisors and oversight by the SEC of these funds. H.R. 10 rolls back important investor protections provided as part of the Dodd-Frank Act, which required transparency in the form of registration and certain reporting from these fund advisors. H.R. 10 limits the SEC's investor protection efforts as they relates to private equity funds and could potentially expose long-term investors like CalSTRS to greater financial risk.

LEGISLATIVE HISTORY

H.R. 4173 (Frank, Public Law 111-203—July 21, 2010) enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act to make numerous changes to financial regulations intended to promote the financial stability of the United States.

PROGRAM BACKGROUND

CalSTRS has a fiduciary duty to manage all risks in the portfolio, including environmental, social and governance (ESG) risks. Because the system is invested across the markets with permanent capital, engagement is the way CalSTRS expresses concerns and holds directors accountable. The Corporate Governance Unit proactively engages portfolio companies and is also actively involved with regulatory bodies, such as the SEC, that help protect investors and maintain fair and orderly markets. Companies are generally responsive to CalSTRS concerns, but in those instances where companies are not, staff uses other mechanisms to elevate issues and protect investments. Staff also rely on the SEC to enact rules that help shareholders mitigate risks through effective disclosures and investor rights.

FISCAL IMPACT

Program Cost – Total costs are unknown; however, without engagement tools and the protection of the SEC, CalSTRS ability to effectively manage a passive index strategy could be compromised.

Administrative Costs/Savings – Total costs are unknown. The registration of proxy advisors and related requirements would introduce potentially significant additional costs to the proxy voting process. In addition, CalSTRS could potentially incur

significant increased costs related to engagements if the SEC loses its ability to implement rules, and CalSTRS is required to rely on private ordering to ensure proper disclosures are received from portfolio companies.

SUPPORT

None known.

OPPOSITION

CalSTRS
Numerous others

ARGUMENTS

Pro: None.

Con: Severely limits participation in the shareholder proposal process.

Reduces the required frequency of Say-on-Pay votes.

Places new restrictions on proxy advisors.

Narrows the required scope for clawbacks.

Repeals disclosure of hedging.

Repeals chairman and CEO structure disclosure.

Allows more companies to avoid outside auditor oversight.

Eliminates the enactment of a universal proxy rule by SEC.

Removes the SEC's authority to issue a proxy access rule that would apply to all companies.

Restricts the SEC's ability to issue proposals by requiring additional, potentially unreasonable analysis.

Reverses investor protections that require private fund advisors to register and provide disclosures.

LEGISLATIVE STAFF CONTACT

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