EMPOWERING SHAREHOLDERS ON EXECUTIVE COMPENSATION: H.R. 1257, THE SHAREHOLDER VOTE ON EXECUTIVE COMPENSATION ACT

HEARING

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U.S. HOUSE OF REPRESENTATIVES

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EMPOWERING SHAREHOLDERS ON EXECUTIVE COMPENSATION: H.R. 1257, THE SHAREHOLDER VOTE ON EXECUTIVE COMPENSATION ACT

Thursday, March 8, 2007

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Present: Representatives Frank, Maloney, Watt, Sherman, Moore of Kansas, Capuano, McCarthy, Baca, Lynch, Miller of North Carolina, Scott, Green, Cleaver, Moore of Wisconsin, Davis of Tennessee, Ellison, Klein, Wilson, Perlmutter; Bachus, Castle, Paul, Gillmor, Manzullo, Biggert, Capito, Feeney, Garrett, Barrett, Pearce, Neugebauer, McHenry, Campbell, Bachmann, and Roskam.

The CHAIRMAN. This hearing of the Committee on Financial Services will now come to order. The procedures that we worked out, the ranking member and myself, are that we will have 10 minutes on each side for opening statements. The 10 minutes will be divided on our side between myself and the gentleman from Georgia, Mr. Scott. The 10 minutes on the minority side will be divided as the ranking member sees fit. I will begin with my statement in a minute.

This is a hearing on executive compensation, and I will begin—I was struck as I came in with a document I was handed that says salaries should be set by market forces, not government regulation. I agree. And if anyone finds a bill where by government regulation we set salaries, call me. I will help you stamp it out. I would also try to stamp out absolutely misleading, false, and incorrect arguments, but the First Amendment intrudes, fortunately. I am a great believer in peoples' right to say outrageously inaccurate things. We have an example of it here.

There have been past efforts to have the government set salaries. That would be a mistake. What the legislation we are discussing today contemplates is enhancing the ability of shareholders to vote on the salaries of those they employ. I say enhancing, because I do want to make it very clear—this was called to my attention by some who have done a lot more work in this field than I—that the bill we hope to pass could be interpreted as somehow being limiting and preemptive in that it might provide one avenue for a vote to

the exclusion of others. That is definitely not the case, and we will make that clear.

It is often the case when one is legislating that people who disagree with a bill, but aren't ready to fully articulate their reasons why they disagree with the bill as it exists, impute to the bill other things that it does not contain, and oppose it on that basis. And now that I'm chairman, I may have this generic amendment proposed for every piece of legislation, which will say: This bill does not do what this bill does not do. That is a more controversial subject than people might think.

We will make it very clear as we legislate that nothing in this bill either adds to or subtracts from existing rights of shareholders under whatever laws they operate, whatever the rules are of those corporations. This is simply an additional channel.

What it says is that the shareholders of a company should be allowed to vote on an advisory basis to the board of directors on the compensation of the CEO. Years ago, this would have presented a difficulty in deciding what it was that would be presented to the shareholders. I congratulate Chairman Cox, who intervened in the process. Chairman Cox, correctly in my judgment, led the Securities and Exchange Commission to set rules by which companies have to present compensation to the public, including the shareholders.

Now by the standards that this bill is being judged, that's an intervention. He is requiring private corporations and boards of directors to do what they otherwise would not have done, what presumably some of them didn't want to do, because if they wanted to do it, no one was stopping them. So I implored Chairman Cox's intervention into this process in a procedural way.

It has also made it easier for us to go forward, because we will not have to have controversy about what it is people are being asked to vote on; they will be asked to vote on what the SEC has proposed. And so what we are left with is this proposition. I have listened to a lot of my colleagues talk about how well the private market works. I have listened to people describe the fact that collective wisdom is often better than individual judgment, and that the collective wisdom of those who buy stocks and own stocks, as reflected in the stock market, is a very good place to make decisions.

I am puzzled, however, when people who tell me that the collective ability of shareholders to make these decisions, and that the wisdom that they collectively can bring to this process, somehow evaporates when it comes to paying the people whom they hire to run companies. I do not understand how people who are in so many ways so intelligent collectively become so stupid when the question is whether they do or don't agree with the table that is presented from the SEC. We will, of course, be discussing that further, and I now recognize the gentleman from Alabama for as much time as he consumes, and he will divide the 10 minutes among his members.

Mr. BACHUS. I thank the chairman. And let me start by saying that this is a hearing, and "hearing" is what I intend to do—to listen, and to try not to come into this hearing with any preconceived

notions, other than the basic notions I have of government and its proper role.

There is concern among the American people about the level of executive pay. That concern is for various reasons expressed to me by my constituents. Some of them, obviously, are just concerned with the size of executive paychecks, and they're just envious. But for every one of those, there are probably five or six who at least are showing real—everything from disgust to concern. Let me highlight some of their concerns. One of their concerns is that a company that's successful, that is doing well, that has this level of executive pay, are all employees of that company participating in it? You know, are employees down the line, not just the top executives, are they participating? And if they're not, what does this do to company morale? What does this do to their loyalty to the company?

They should have an expectation that they're participating in the success of the company because their efforts are a part of that success. They're concerned on occasions that boards and CEO's and consultants that either the CEO hires or the board hires are sort of all in collusion, and they're all taking care of each other, but in the process, the average employee is not being taken care of. I think the number of people who work and yet do not have health care benefits, they obviously, when they see these rich compensation packages, and they're working hard every day, maybe for that same corporation, they wonder about the equity of it.

Another concern that we've all seen expressed the widening gap between the rich and the poor, and they wonder if this is a part of it or this is a driving factor or a contributor to that. These inequities, inequalities concern them.

I have some of those concerns, many of them. But I also have another concern. My concern involves when you compare the United States with other countries and what their executives make, and I certainly think that American companies by and large are more successful in competing with those companies.

But you wonder if we are paying a larger percentage of our corporate profits in revenues than these companies, and how is it affecting our ability to compete with those companies? When we're diverting money away from research, new equipment, job training, and recruitment of skilled employees, I wonder if that affects us long term?

Yes, it may—short term, it may not affect the company, but long term, in fact, this Congress on any given day, we have industries that come to us and say we need a tax break so that we can spend money on equipment, or so that we can spend money on research or we can spend money on innovation. Or when we say something about their profits and someone proposes a tax increase, they say wait a minute. Those profits are plowed back into research. Those profits are plowed back into exploration if it's an oil company. If it's a drug company, they say these profits are being turned around, and they're used to develop new drugs to save people's lives.

Well, our concern is that, is this money going into new research for new drugs when we see a drug company executive retire with a $200 million package?

Now, having said all that, this distress that there is tremendous concern out there, I have an abundance of caution because of the government's track record in "fixing things." I do believe that disclosure and transparency ought to be a given, and the SEC, for the first time since 1992, has taken a major step in that direction. And now, perhaps for the first time, the average shareholder can go to those reports and see exactly what that executive is paid. And I believe that, in and of itself, may play out and address this in a major way.

I also applaud companies like Aflac, who have voluntarily agreed to let their shareholders participate in these decisions.

I'll close simply by saying, as I said at the beginning of the hearing, that I'll continue to listen, and I will listen knowing that even if this is a problem, there may not be a government solution that makes it any better.

The CHAIRMAN. The gentleman from Georgia is recognized for 5 minutes.

Mr. SCOTT. Thank you very much, Mr. Chairman, and this is an extraordinarily important hearing, and a very timely hearing. I quite honestly believe that a very critical part of our economic foundation as a free enterprise system is at stake, and what we do with this very serious and real threat to confidence in our system with our stockholders, our investors, and the American public.

Our investor system is a crucible. It is the glue that holds our free society together. And that confidence is being shaken because of this wide disparity within the pay structure. Executives with clearly, quite honestly, obscene pay packages of $2-, $3-, or $400 million, when the average rank-and-file worker in our system is not making a sufficient amount of money to actually provide for his day-to-day care.

I want to thank Chairman Frank for having the courage and the vision to provide transparency in the executive pay package, and for giving me a chance to work with him as a lead co-sponsor on this important issue.

Now let me just start out by saying that I want to make it clear that I am a capitalist. I graduated from the Wharton School of Finance with an MBA. And as many of you know, Wharton is the citadel of capitalism. I've been a stockholder ever since grade school. But I think that corporate executives should certainly be adequately compensated, and especially if they perform well. However, I am concerned that executive pay has become dangerously outsized when compared both in historical pay to CEO's and rank-and-file employees.

Rank-and-file employees are being left behind in pay. You look back over our recent history. As early as the 1960's, it was more like 60:1 in ratio. Perhaps the corporate executives at the top were making maybe about 60 times as much. Now it's hovering in the thousands times as much. This is dangerous. And that's why I say that our economic system is being threatened.

There was a great philosopher, his name was Sir Edmund Burke, and Sir Edmund Burke made this profound statement. He said these words: "The only thing necessary for the triumph of evil is for good men to do nothing." And that's what I see this committee—we're a group of good people—trying to do something.

We've had some sterling examples recently from my own home State of Georgia of some good people and some good corporations who are doing something and providing the leadership and the vision. And let me just talk about two of them. Delta Airlines, for example. Delta Airlines is probably going to be recognized as probably the greatest American business recovery story in the history of American business, and they did it because they were good people trying to do something to triumph over what was wrong.

Not only did they—they looked very carefully at their pay packages. They cut pay up and down the line, and at the head of the line of cutting that pay were the top executives, and they're rebounding. A great story in Delta.

Another one is Aflac. Let us commend Aflac for stepping up to the plate, and they not only got a hit, they hit a home run, because they're setting the curve. And we're going to see other companies do the same thing.

Now this legislation is very simple. It will allow shareholders to hold yearly advisory votes on executive compensation plans. Further, it would allow an advisory vote on so-called golden parachute pay packages when the company is going through ownership changes. Both votes are nonbinding. However, they are powerful tools for providing transparency and accountability to the process.

This is not extreme. This is a very moderate, common sense approach to dealing with a very, very serious issue that is threatening the very fabric of our free economic system.

Again, I thank the chairman for providing the leadership. I look forward to the hearing, and I yield back the balance of my time.

The CHAIRMAN. I thank the gentleman. And the Chair will now recognize the gentleman from Alabama to distribute the remaining time. He has 6 minutes left.

Mr. BACHUS. Thank you. I yield 1 minute to the gentleman from Delaware, Mr. Castle.

Mr. CASTLE. Well, I thank the ranking member a great deal. And I agree with the tenor and tone of what we are doing here, although I'm a little concerned about the legislation. I think we do need transparency. I think we need total disclosure in terms of executive packages. I believe that the SEC has actually done a good job in this, and perhaps that's where it should happen. Their new disclosure rules, I think, speak to it.

As a stockholder and a woebegone investor myself, I will tell you that I'm not sure I'm really capable of judging fair compensation packages, and I worry about that a little bit. I worry about those mailings you get from companies and whether you really read them or pay attention to them and whether that's a good way to do it or not. But my mind is open, and I will listen to the chairman on that.

My greatest concern, though, is with terminated CEO packages. I don't know if they fall within the bounds of the agreement or not. They seem to exceed it, as far as I can see. That's what gets in the newspaper and that's what we read a lot about. All of a sudden you have a CEO who's getting a $10 million, or $20 million, or $30 million package to walk away from a business which has essentially failed. It's sort of like a short stop who hits 240 and leaves his

team and goes to another team and they both seem to get $10- or $20 million is the best comparison I can give.

And I'm not at all sure that we have a proper telescope as far as that is concerned, understanding exactly what is happening with the failed executives in terms of some of those termination packages. I don't think paying to get rid of somebody is something we should do if that person has not actually succeeded.

So I'm pleased with the panel. I'm pleased to listen to the testimony, and I have an open mind to the legislation, but we're certainly approaching a problem which I think needs to be addressed. I thank Mr. Bachus for yielding me the time, and I yield back.

Mr. BACHUS. I yield 3 minutes to the gentleman from New Jersey, Mr. Garrett.

Mr. GARRETT. Thank you, Mr. Chairman. And I'd also like to thank the witnesses for your testimony that you're about to give. I commend the chairman also for having this important discussion today, and I would like to begin my comments with just one small observation. It was just about a week ago, I guess last week, during this committee's markup of the views and estimates that our esteemed chairman had such great things to say about Chairman Cox and also the SEC.

But in regards to members' concerns from this side of the aisle about Sarbanes-Oxley, he indicated how we all just needed to be patient and let the SEC do its job, how we needed to wait and see if the new regulations would fix the problem. Interestingly, the SEC has now just recently issued new disclosure regulations on executive compensation. However, these new rules have not yet had the opportunity to bear any results yet.

So without giving any time to see if these new SEC rules will work, this committee now is rushing ahead to consider legislation to address the problem. You know, I might be more inclined to address executive compensation legislatively if our chairman would be inclined to consider Sarbanes-Oxley reform legislation that I have introduced just recently as well.

But to address the issue of executive compensation, I do have a variety of concerns with legislating in this area. For instance, this legislation would now allow shareholders to take a nonbinding vote on executive pay. I'm really not sure why our friends from across the aisle have this fascination with nonbinding votes, but this appears to be a topic coming up quite frequently during their brief tenure in the majority.

I'm also concerned with the road that this legislation might lead us down. To use an oft-used analogy, this appears to me to be possibly letting the camel's nose under the tent. And I just wonder where we might go next. Might the chairman support the idea, for example, of allowing Boston Red Sox fans the right to have a nonbinding vote on whether or not the Red Sox management should spend over $100 million on a Japanese pitcher who has never even thrown a pitch in the major leagues.

You know, when you think about it, with the exorbitant ticket prices for baseball games these days and the fact that lower- and middle-income families are basically getting squeezed out of the ballpark, this may be something that this committee should be looking into next.

I believe that executive compensation is something that this committee can consider and monitor, but I do believe also that the SEC's new rules should be given a chance to be looked at and given a chance to work.

So, thank you, Mr. Chairman, and I yield back.

Mr. BACHUS. Thank you. I yield the remaining 2 minutes to the gentleman from Texas, Dr. Paul.

Dr. PAUL. I thank the gentleman for yielding. I was pleased to hear the chairman of the committee say that he is in favor of market forces setting salaries, so I think this is a good step in the right direction in debating this issue.

As many of you know, I happen to advocate the position that all social and economic relationships should be voluntary, and I think where the fallacy comes here with the regulations that we're talking about is the interference with the voluntary contract between stockholders and management. So, therefore, it is a violation of a free market, because in the free market, what would happen is if salaries got out of whack, the shareholders have an option. They can sell their shares. That's the voluntary arrangement that they have, rather than individuals coming in and saying that we can regulate a fair system.

And the one other factor that I think we tend to forget about is the inflationary factor. Salaries become outrageous because governments create credit loosely, and it gravitates to certain areas, so you will have bubbles form. You have bubbles form on Wall Street, you have housing bubbles form. They make too much money when they're selling too many houses.

Then you have government interfering in places like economics or education. So, we pump a lot of money into education, teachers' salaries don't go up, but the bureaucrats' salaries go up.

Once we interfere in the marketplace, salaries will go up, and we can't control where the credit goes. So unless we deal with that, we can't deal with the obscene salaries and bonuses given to one company on Wall Street of $16.5 billion. I consider that obscene, but it's not because we lack interference in the marketplace. We have too much interference by government through monetary policy, so I am not very optimistic that regulating and abusing the privilege of voluntary economic arrangements is any better than interfering in social arrangements when we'd like to make people act better and behave better.

My position is very clear that we should be advocating volunteerism both economically and socially. I think we would all be a lot better off.

I yield back.

The CHAIRMAN. The time for opening statements agreed upon has expired, and we will now listen to the witnesses. They are seated in order, which I believe is random. And that's probably the best way for us to proceed, and we will begin with Professor Lucian Bebchuk of Harvard Law School, who has done a lot of work on this subject. Professor Bebchuk, please.

STATEMENT OF PROFESSOR LUCIAN A. BEBCHUK, WILLIAM J. FRIEDMAN AND ALICIA TOWNSEND FRIEDMAN PROFESSOR OF LAW, ECONOMICS, AND FINANCE, DIRECTOR OF THE CORPORATE GOVERNANCE PROGRAM, HARVARD LAW SCHOOL

Mr. BEBCHUK. Mr. Chairman and distinguished members of the committee, thank you very much for inviting me to testify today.

During the 2006 proxy season, roughly one quarter of the proposal that was submitted by shareholders focused on executive pay. Why does pay attract so much attention from investors? To begin with, the amounts that are paid are large, and they can have a large effect on investors' bottom line.

In a study that Yaniv Grinstein and I did, we estimated that the aggregate compensation that was paid by public firms to their top five executives during the period 1993 to 2003, added up to about $350 billion. Adding the amounts that have been paid since then, aggregate compensation during 1993 to 2006 is probably on the order of half a trillion dollars.

Furthermore, and perhaps more importantly, closing pay arrangements have costs that go far beyond excess amounts that are paid to executives. And the reason is that such flows can dilute and distort the incentives of executives. To illustrate, let me just quickly mention several examples of practices that are likely to have adverse effect on incentives.

First, firms often provide executives that are pushed out for failure with a soft landing.

Second, firms don't use claw-back provisions to recoup compensation that is paid on the basis of results that are subsequently found to be incorrect.

Third, equity compensation and bonus compensation are commonly designed in a way that rewards executives for market-wide and industry-wide movements that do not reflect executives' own performance.

Fourth, firms commonly do not prohibit executives from engaging in hedging or derivative transactions that can undo the incentives that equity compensation is supposed to produce. And there are more examples that one could refer to.

Another concern arises from the fact that public companies have provided compensation consistently in ways that made the amount of compensation, and the extent to which compensation was linked to performance, not transparent to investors. And although the recent disclosure reform is going to make compensation more transparent in the future, past efforts by companies to camouflage pay do raise significant concerns about how companies have been setting pay arrangements.

And there is backdating as well. In a recent study that Grinstein and Payer and I co-authored, we estimate that about 12 percent of public firms provided one or more grants at the lowest price of the month due to opportunistic timing. And although increased regulatory attention and investor attention would likely curtail such timing in the future, the widespread use of such timing in the past again raises significant concerns about the internal pay-setting processes that we have.

Now as we all know, recognizing the intensity of investor concern about executive pay, the SEC adopted expanded disclosure requirements. But although those disclosure requirements are going to provide a lot of information to the marketplace, they cannot by themselves improve pay arrangements. For disclosures to improve matters, investors must have the ability to use the information that is going to be provided to them to influence the setting of pay arrangements. And this is where introducing advisory votes is going to help.

Steve Davis is going to discuss later how advisory votes have had a beneficial effect in the United Kingdom, but I would like to stress that putting advisory votes aside, shareholders have much weaker rights in the United States than they have in the United Kingdom. And given the weakness of shareholder rights in the United States, providing shareholders with some tools to influence companies' pay decisions is especially needed.

There are members of this panel who have much more favorable assessments of executive compensation than I do. But I want to stress that this committee does not have to make a choice between the panelists' alternative accounts. What matters most is not how Steve Kaplan or John Castellani or Lucian Bebchuk grade the performance of companies on this important subject, but how investors view this issue. There is no question that many investors have serious and legitimate concerns.

And the board of a given company in the marketplace simply cannot infer from our analysis here how the shareholders of the company view the company's pay arrangement.

The CHAIRMAN. Professor Bebchuk, we'll have to have you sum up fairly quickly.

Mr. BEBCHUK. Sure. So advisory votes are going to make shareholders' views clear, and that's what the issue is about, not choosing among competing accounts.

[The prepared statement of Professor Bebchuk can be found on page 65 of the appendix.]

The CHAIRMAN. Thank you, Professor. Next Mr. Richard Ferlauto, who is the director of pension and benefit policy for the American Federation of State, County and Municipal Employees. Mr. Ferlauto.

STATEMENT OF RICHARD FERLAUTO, DIRECTOR OF PENSION AND BENEFIT POLICY, AMERICAN FEDERATION OF STATE, COUNTY AND MUNICIPAL EMPLOYEES

Mr. FERLAUTO. Thank you, Mr. Chairman, and members of the committee. I'm very pleased to be here, and what I'd like to do is orally summarize fairly extensive legislation.

The CHAIRMAN. The Chair has been delinquent in not saying that without objection, all of your written statements and any supporting material, graphs, cartoons of members, or anything else you wish to put in, will be entered into the record.

Mr. FERLAUTO. Thank you very much, Mr. Chairman. Let me talk about AFSCME for a minute. AFSCME has 1.4 million members who work in public service. They have retirement benefits of assets over $1 trillion that are invested in the public marketplace.

This investment through the public pension systems that they are involved in, because of the size of the investments and the long-term time horizons they have of 20 or 30 or more years that are required to pay retirement benefits over time, means that they have a long view. These investments are broadly diversified in their index. It means that we don't have the opportunity to buy and sell. Fiduciary duty requires that we hold companies for the long term and that the market opportunity of the Wall Street walk is not one that our large investment firms have an opportunity to engage with.

That means for many years, we've been highly concerned about executive pay and the distortion that executive pay creates in the marketplace. Spiraling pay not based on performance at all tends to provide an incentive to manipulate earnings, to obfuscate financials, and unfortunately, in many cases, to cook the books.

But probably the worst incentive is an incentive towards short termism, where a market does not make appropriate decisions regarding capital investment because the wrong incentives are in place for highly paid CEO's to cash out rather than do what's good for the long-term shareholders.

Shareholders, these institutional shareholders, have tried for years to do something about this, and we've been rebuffed at every turn. Sure, we congratulate Chairman Cox for the new SEC disclosure rules, but those disclosure rules are necessary and not sufficient to do something about unaligned pay.

The SRO's, the self-regulatory organizations, the exchanges, have the power to require an advisory vote on pay. But the conflicted regulatory scheme where they try to self-regulate means that we hold out little hope that the SRO's will take that power and use it to shareholder advantage.

And finally, shareholders are actually disempowered compared to shareholder rights in much of the world. That is, we only have very blunt instruments of withholding votes from directors who aren't aligned with shareholders, and do not have effective tools to engage companies in a long-term conversation about what appropriate executive compensation means.

The AFSCME fund began to look for solutions last year, and we looked at the United Kingdom and other European experience in this area, and we found that the advisory vote is a powerful and important tool that helps improve market.

Last year, the AFSCME pension fund submitted seven shareholder resolutions, the first time ever that such resolutions appeared on shareholder ballots in the United States. Those resolutions got over 40 percent of a vote on average, the highest average vote of any first-time resolution ever, according to the large proxy advisory firm, ISS.

Following that, this year, AFSCME and a broad network of institutional investors, public funds, international funds, and mutual funds, have filed over 60 of these proposals that will appear on company ballots this year.

Those proposals led to two things. It has led to the creation of a working group of major companies and major investors to look at how an advisory vote might be applied in this country, and they've

also led to the Aflac early adopter that a number of people talked about earlier.

We find a number of things, that when an advisory vote is in effect, based on what we've learned from the United Kingdom and other countries, first of all, consultation with shareholders increases. It's early, it's intense, and it's detailed. Second, when you have consultations in place, performance becomes much better aligned with long-term shareholder value initiatives. When long-term shareholder value and performance alignment is in place, it means that there are incentives for the company to invest in and to execute its strategic plan. That's good for everyone.

And finally, we find that disclosure many times actually can spiral up pay, as a CEO wants to be better than his or her payers, so that an advisory vote actually is an antidote to the tendency of disclosure leading to a ramp-up in pay.

Finally, what I would like to say is that an advisory vote really is not effective unless it's paired with an increased shareholder right at the ballot box, and that is the ability for shareholders to replace and nominate directors who fail to be responsive to the advisory vote. Without proxy access, an advisory vote just becomes another moot voice for shareholders.

We need both. We need to enjoy all the benefits that other international markets have through an advisory vote. We're actually falling behind the competitiveness of the European markets because they have this particular requirement, and that needs to be paired with the other international requirement or ability that shareholders have, that is to use their rights as owners of corporations to replace directors that have failed them on executive pay and other similar issues.

Thank you very much, Mr. Chairman, and members of the committee. I'd be happy to answer questions.

[The prepared statement of Mr. Ferlauto can be found on page 111 of the appendix.]

The CHAIRMAN. Thank you, Mr. Ferlauto. And next, we're glad to welcome John Castellani, who has been a very constructive participant with us in a whole range of issues, the CFIUS bill, for example, and we welcome Mr. Castellani today. Please go ahead.

STATEMENT OF JOHN J. CASTELLANI, PRESIDENT, BUSINESS ROUNDTABLE

Mr. CASTELLANI. Thank you, Chairman Frank, Ranking Member Bachus, and members of the committee. I'm pleased to be here today to provide you with the perspective of the Business Roundtable, who are 160 chief executive officers of America's leading companies.

To put it in perspective, the Business Roundtable companies represent more than 10 million employees in the United States, nearly one-third of the value of the U.S. stock markets, and over 40 percent of all corporate income taxes that are paid. Collectively, they have returned $112 billion in dividends to the shareholders and to the economy in 2005.

Our companies represent a substantial share of the U.S. economy, and as such, we have a vested interest in ensuring that the United States is able to compete in the worldwide marketplace. We

are committed to promoting public polices that will foster economic growth, create American jobs, enhance investor confidence, and bring long-term value to all shareholders, including the millions of Americans who are invested in our markets through their retirement plans.

The Roundtable has long supported efforts to improve our systems of corporate governance, and embed ethics within our companies. In 2002, we issued our Principles of Corporate Governance which provided the foundation for many of the ideas reflected in the Sarbanes-Oxley Act passed that same year. We've supported the law from the beginning, and we've worked closely with the SEC to improve upon the law while maintaining its spirit throughout implementation.

In 2003, we issued our Principles of Executive Compensation, which I'll discuss in a moment. And in 2004, we created the Institute for Corporate Ethics, which conducts ethics research and helps to embed ethics training in the curricula of the leading U.S. business schools.

In addition to the changes required by law, companies have responded to shareholders by moving toward more independent boards. According to our own 2006 survey, 85 percent of our member company boards are composed of at least 80 percent independent directors. Directors are also more active, as they should be. In the Roundtable survey, 75 percent of our companies reported that their independent directors meet in executive session without the presence of management at every meeting.

In addition, many companies have made the voluntary change for their director election process, shifting to the system of majority voting. And currently, 52 percent of the S&P 500 has adopted some form of majority voting.

Together these reforms have been meaningful, and the Business Roundtable remains committed to working with shareholders, this committee, other policy makers and the public to strengthen the role of corporate governance.

Every Business Roundtable member understands that all eyes remain on corporate America today to ensure that the businesses are run with the highest ethical standards. And we recognize that the spotlight is perhaps brightest when it comes to the issues of compensation.

Our own Principles of Executive Compensation set guidelines for independent boards to determine compensation for executives through a process that emphasizes transparency and accountability. Those principles underscore that the executives should be paid for results, and that compensation should be closely aligned with the long-term interest of shareholders and corporate goals and strategies.

We believe that the best mechanism to set executive compensation and to hold CEO's accountable for company performance are those independent members of the companies' board of directors acting upon the recommendation of the compensation committees. These committees are subject to strict independence requirements, and the directors are accountable to all shareholders.

We've supported the new rule that has been cited here at the SEC to make it easier for investors to understand exactly what ex-

ecutives are being paid. Increased transparency will benefit the marketplace and will give investors more information to make decisions.

In addressing the question of whether or not additional reforms are needed in this area, and in particular whether shareholders should approve executive compensation decisions, it's vital to examine the existing structure of corporations, a structure that has worked very well throughout history.

Corporations are, at their core, private entities. They are designed to create value for shareholders. Directors, who are shareholders themselves, have a legal obligation to act in the best interests of all shareholders and to not represent particular constituencies. While cooperation and consensus is critical for a board to function, effective directors maintain an attitude of constructive skepticism, ask incisive questions, and require honest answers.

The role of the shareholders is equally important. They provide capital, elect directors, approve mergers and other significant actions, and they are the owners of the corporation. However, corporations were never designed to be democracies, and their decision-making process was not established to be run like a New England town hall meeting. While shareholders own the corporation, they don't run it. And unlike the management, they are not liable if something goes wrong. Management has both the responsibility and the risk, and that is the key to our discussion.

Shareholders have different motivations and goals. Some seek immediate gain in their investment, and others look for long-term growth. They come in all sizes. Investment in corporations is voluntary and shareholders are free to invest elsewhere for any reason.

The basic structure of American companies and shareholders has kept our capital markets viable for generations, and that's why we're concerned about the underlying issues in the consideration of this proposal.

We think that any advisory vote could seriously erode critical board responsibility, and we think it runs the risk of turning the process into a process that could disrupt the board's ability to act in a cohesive way to make important decisions quickly to enhance shareholder value.

There are also irregularities in the current voting process that have been identified that present problems. Hedge funds use short-term securities for empty voting. We have securities that are held by many shareholders that are voted by unregulated proxy advisory service, and indeed we do not have the ability to communicate with a large portion of shareholders whose shares are held in Street name.

We want the boards to be able to communicate with all shareholders. We want boards to spend less time in the politics of elections and more time in planning product development, oversight and forwarding the value of the company.

I would argue, Mr. Chairman, that the proposal that you've brought forward has the potential of being analogous to this body, the U.S. Congress, being asked to have a referendum on every decision it makes. Adversarial shareholder groups with divergent interests could form coalitions in an effort to influence the proxy out-

comes and then dictate policies and operational decisions to boards and to the management. It is not a process that we think enhances shareholder wealth.

There are problems with the U.K. system that I would be happy to go into in the questions, but I would conclude by saying that our boards are more independent than they have been in the past. They are working hard to align compensation with results. We must give our boards, whom we elect, the ability to be able to act quickly and to act in the interest of all shareholders.

Thank you.

[The prepared statement of Mr. Castellani can be found on page 90 of the appenidx.]

The CHAIRMAN. Thank you, very much. And now, Dr. Davis, we very much appreciate your accommodating us, and please go ahead. I say that because we invited Dr. Davis on fairly short notice, and we appreciate his being available. Thank you.

STATEMENT OF STEPHEN M. DAVIS, FELLOW, YALE SCHOOL OF MANAGEMENT, THE MILLSTEIN CENTER FOR CORPORATE GOVERNANCE AND PERFORMANCE

Mr. DAVIS. Thank you, Mr. Chairman, Ranking Member Bachus, and distinguished members. I appreciate the opportunity to appear. As the market has addressed the issue of advisory votes, there have been naturally important questions raised about the one market where there has been a track record of use of this process, and that's Britain. And as a result, the Millstein Center at Yale, the School of Management, decided to put together a whitepaper which is titled, "Does Say on Pay Work? Lessons on Making CEO Compensation Accountable."

We'll be presenting that in the spring, but it's—what I'm pleased to do today is to give you a sense of what the conclusions are of that report, having just completed a very intense set of research, including roundtables in Britain talking to directors, shareholders, and a variety of players.

As you can imagine, there is a lot of puzzlement about how the system works. But can I present to you and be clear what our conclusion is, having looked at the U.K. system, that advisory votes on executive pay policies are rational, they're timely, they're road tested, and they're practical for use in the United States.

In fact, one surprise that I think we encountered was how uniform among all market players, including directors, corporations, and investors in Britain, the feeling was that advisory votes have proven to be an important plus to the U.K. market.

What I'll do is just summarize some of the main points that we have discovered. One is that votes on compensation resulted in a dramatic increase in dialogue between corporations and investors. It, in effect, transformed the way compensation policies are constructed. We now have evidence that companies and shareholders that never used to talk to each other over these important issues are now in a constructive, not a hostile, but a constructive and regular annual dialogue on this important issue.

The second thing that is evident from the United Kingdom is that while advisory votes have not proven to be a panacea in curbing the quantum increases in pay, they have had a dramatic in-

crease—or a dramatic effect on the way plans are framed and structured. The architecture of compensation is different today than it was before advisory votes. And the way they are different is in one principal effect, and that is that pay is tied much more strictly to performance, to real performance from the company.

And the latest information that I'd refer to you is a recent Deloitte report that goes point by point showing how these changes have occurred.

A third point that we came across is that the U.K. government, while they originally put this in place to fix the political problem of what they call fat cat pay, now sees advisory votes as critical to the competitive advantage of Britain as a marketplace and London as a capital market. In other words, what they argue is that if you create a level playing field for shareholders, it's a winner for the capital market. It puts British companies in a better position because it makes them—keeps them in fighting trim when you have shareholders looking out for them.

The fourth point was that corporate boards have had to change the way they operate. They used to—the compensation committees used to have to persuade fellow board members about compensation. Now they have to persuade the broad shareholder base. It means stronger boards and stronger compensation committees, not weaker ones.

Another point was that institutional investors have stepped up to the plate and done far more work in looking at these pay packages and expressing their views about what makes sense for a company and for their own long-term value.

So if I could conclude with this general comment, advisory votes on pay are best introduced on a legislative basis. It's light touch legislation. It's actually gets to, as Mr. Scott, I think, said earlier, you know, we are all capitalists here, and what this really represents is giving shareholders, giving the owners the tools that they need to act as real owners of a corporation.

Thank you very much, Mr. Chairman.

[The prepared statement of Dr. Davis can be found on page 103 of the appendix.]

The CHAIRMAN. Thank you. And now, Dr. Kaplan, who's done a great deal of work on this, and we appreciate your sharing it with us. Please go ahead.

STATEMENT OF STEVEN N. KAPLAN, NEUBAUER FAMILY PROFESSOR OF ENTREPENEURSHIP AND FINANCE, UNIVERSITY OF CHICAGO GRADUATE SCHOOL OF BUSINESS

Mr. KAPLAN. Thank you, very much. Good morning, Chairman Frank, Ranking Member Bachus, and members of the committee.

In the United States today, as you've heard, public company CEO's are routinely criticized for setting their pay and being overpaid. Boards are criticized for not paying for performance and for being too friendly to CEO's.

I believe the critics are largely wrong. While CEO pay practices are not perfect, they are nowhere near broken. The typical CEO is, arguably, not overpaid. The typical CEO is paid for performance.

Boards do fire CEO's for poor performance, and public company CEO's are leaving to run private equity-funded companies usually

for higher pay. The proposed bill will generate little, if any, benefit, but will impose costs relative to the current system.

So first, I want to put the U.S. economy in context. Over the last 15 years, the period in which CEO pay has been criticized, the U.S. economy and shareholders have done very well both absolutely and relative to other countries, including Europe. And many have benefitted from that good performance.

Second, are CEO's overpaid today? While there have been pay abuses, the answer for the typical CEO is likely "no." Average CEO pay peaked in 2000 and has declined since. While CEO pay has increased since the early 1990's, and is quite high, other fortunate groups have increased their pay by at least as much.

For example, hedge fund, private equity, and venture capital investors increased their fees by over 7 times since 1994, and those increases have translated into very high pay.

In 2005, the top 20 hedge fund managers earned more than all 500 CEO's in the S&P 500 put together. Pro athletes, investment bankers, and even lawyers also have benefitted greatly.

So while CEO's earn a lot, they are not unique, and rising CEO pay appears to be part of not the cause of the increase in inequality that we've seen recently. The pay of the other groups has been driven by market forces, and this seems likely to be true for CEO's as well.

Third, critics, and they're here, argue CEO's are not paid for stock performance, and that is just not true. The key question is whether CEO's who perform better earn more in actual pay, and the answer is "yes."

CEO's in the top 10 percent of actual pay outperformed their industries by more than 90 percent in the previous 5 years. CEO's in the lowest 10 percent of actual pay underperformed by almost 40 percent. So the typical CEO is paid for performance.

Fourth, are boards too friendly to their CEO's? The evidence again suggests not. CEO tenures are shorter than they've been since at least 1970, and CEO turnover is strongly related to poor firm stock performance, again, at least as much as in previous periods.

Fifth, and I hesitate to say this, good CEO's may even be underpaid at public companies. Last year a record volume of private equity transactions occurred.

Andrew Sorkin of the New York Times reported, "Chief executives are being lured by private equity-owned businesses which offer higher pay." I should add that private equity investors have strong incentives not to overpay CEO's, because such overpayment would reduce their profits.

In other words, the regulation and criticism of CEO's have costs. Good CEO's can and do quit public companies. That leaves the U.S. economy with less transparency and leaves public companies with less able CEO's.

Given that, what do I make of the proposed bill? Well, under current rules, as Mr. Ferlauto confirmed, when shareholders believe a company has CEO pay problems, shareholders can generate a vote. They're doing that.

They can also generate adverse publicity for companies that resist, and the new SEC disclosure rules will make any remaining pay problems more transparent.

On the other hand, when a company doesn't have any problems, nothing happens today, so the market is working under current rules.

Under the proposed bill, companies with problems would have a vote and be identified. That's what happens today. However, companies with no problems will be forced to have a vote as well, and that is likely to impose unnecessary costs on good companies.

In summary, the current system is not broken. The bill doesn't have appreciable benefits relative to the current system.

The bill will impose costs, and on the margin the bill will further reduce the attractiveness of being a public company CEO, particularly for good CEO's, and that is not good for U.S. companies. It's not good for U.S. workers, and it's not good for the U.S. economy. So thank you for inviting me to present my views.

[The prepared statement of Mr. Kaplan can be found on page 120 of the appendix.]

The CHAIRMAN. Finally, someone who has been a long-time worker in this area and has been, again, one who is quite willing to share the work of her and her organization with us, Nell Minow from The Corporate Library.

STATEMENT OF NELL MINOW, EDITOR, THE CORPORATE LIBRARY

Ms. MINOW. Thank you very much, Mr. Chairman, Mr. Bachus, and members of the committee. It's an honor to be invited back to speak to you about this vitally important subject for the credibility of our capital markets.

I will concede that Wharton is the citadel of capitalism, in fact, I'm speaking there to a group of corporate directors on Monday. But I will fight to the death for the right of my alma mater, the University of Chicago, as the citadel of the free market.

So I have to begin by saying that I am a passionate capitalist, a passionate devotee of the free market. And what I know about the free market is this, that it depends on information and the ability to respond. And information we are now going to be getting better thanks to the SEC, but the ability to respond is equally important.

You can have all the information, all the transparency in the world, but if there's no way for you to respond, you're not going to be able to have that all important market feedback.

I am not here to ask anybody to interfere with the free market. I am here to ask you to remove one of the impediments to the free market that currently obstructs shareholders from responding on this critical issue.

If I thought that high pay as it is currently structured resulted in better performance, I would stand up and cheer for it. You don't hear anybody complaining here about Bill Gates' pay or Warren Buffet's pay. They are both just fine.

It's when pay and performance are not linked that we get very upset. I have learned that the only way to look at pay is to look at it, in University of Chicago terms, like any other asset alloca-

tion. What is the return on investment of that asset allocation? The same way that you would look at money that is spent on research or marketing or any other task.

And the fact is that the return on investment for these CEO pay packages, as the ones that we saw late last year where Mr. Nardelli and Mr. McKinnell got $200 million pay packages for being fired, the return on those investments is less than a piggy bank.

So what we need is we need a way to make sure that we get what we pay for. I appreciate and I agree with what my colleague, Mr. Castellani, said about boards doing a better job. There is no question about it.

But let's talk about independent directors for a minute. The fact is that management and the board itself still have too much control over who serves on the board.

Warren Buffet, again, a big friend of capitalism, said that in his own experience he has been unable to speak out against what he knew were outrageous pay packages because, in his words, collegiality trumped independence.

If Warren Buffet is too chicken to stand up in the board room and say we are paying this guy too much, then we have to give him some backbone. And the only way to do that is to give shareholders a chance to speak back.

I want to commend this committee for staying away from the mistakes made by the other body, which is trying to solve the problem through the Tax Code. We have learned that is not a good approach; it does not work.

The way to do it is a very modest step forward like the one proposed in this legislation, giving shareholders an advisory vote. The only objection that I have really heard to this idea is that the shareholders are too stupid to make good use of the information.

That is simply not true. Our entire economy is based on the fact that shareholders can understand the footnotes to the financial reports; and when you see shareholders like that represented by Mr. Ferlauto, you see how thoughtful and intelligent and perceptive they are and how well they have responded.

In the United Kingdom, do you know how many people have actually voted "no" on a pay plan since they got the right to vote on these advisory responses to pay? One. One company has had a "no" vote. What did they do? They revised the pay plan. Everyone else has engaged fully with shareholders. It has been a very, very productive experience.

I am concerned that the current system that we have for pay is so excessive that it undermines the credibility of our economy. People will invest elsewhere. If we cannot solve this problem, then we will pay much too much for what we're getting from the CEO's. Thank you very much.

[The prepared statement of Ms. Minow can be found on page 148 of the appendix.]

The CHAIRMAN. Thank you. We will begin the questioning. I am told that we may have votes at 11:15 a.m., but I believe we will be able to get some questioning in. We will break about 5 minutes into the vote, and we will reconvene immediately after. I apologize

to the panel because they will have to sit through it, but they understand that.

Before I start taking up my time, let me ask unanimous consent to put into the record 2 letters: one from the HR Policy Association, which is a public policy advocacy organization representing the chief human resources offices of 250 employers; and one from CalSTRs, the California State Teachers' Retirement System. If there is no objection, I'll put those in the record.

And I will now begin my 5 minutes. The first thing I want to do is, the gentleman from New Jersey wondered whether we were going to now give Red Sox fans the right to vote. I have heard illogical analogies before, but a prize will go to anyone who can't tell the difference between a fan who buys a ticket to a baseball game and a shareholder in a corporation.

If the gentleman thinks that they ever have been in any way legally analogous, he knows a different legal system, indeed a different universe than I. There is, of course, no remote connection between someone who buys a ticket to a single event and a shareholder.

And if the gentleman thinks that what rights shareholders now have should be given to the fans, then he would be calling for far more change in the law than I. A reasonable discussion we ought to have, but that simply makes no sense whatsoever.

I do want to quote from someone, Warren Buffet, who in his newsletters in 2005 and 2006 was criticizing comp committee behavior.

He wrote in 2005, "Getting fired can produce a particularly bountiful payday for a CEO. He can earn more in that single day than an American worker earns in a lifetime of cleaning toilets. Today in the executive suite the all too prevalent rule is that nothing succeeds like failure." This is that notorious trasher of the capital system, Warren Buffet.

"Huge severance payments and average perks have often occurred because comp committees have become slaves to comparative data. The drill is simple. Three or so directors not chosen by chance are bombarded for a few hours before a board meeting with pay statistics that ratchet upwards.

"In criticizing comp committee behavior, I don't speak as a true insider. I have served as a director of 20 public companies. Only one CEO has put me on his comp committee."

And then he said in 2006, "I mentioned I've been the Typhoid Mary of compensation committees. At only one company was I on the comp committee, and I was promptly outvoted. My ostracism has been peculiar considering I haven't lacked experience in setting CEO pay. I'm a one-man comp committee for 40 significant operating businesses."

And he notes that, frankly, he is not one of the most lavish payers, and he has never has never lost a CEO. No CEO has ever gone into private equity from his firm or become a shortstop or a movie star or gone on to any other more lucrative forms of compensation.

Here is the point I would ask people to comment on in the 2006 newsletter from Warren Buffet: "Irrational and excessive comp practices will not be materially changed by disclosure or by 'independent' comp committee members. I think it's likely that the rea-

son I was rejected for service is that I was regarded as too independent.

"Compensation reform will only occur if the largest institutional shareholders—it would only take a few—demand a fresh look at the whole system. The consultant's present drill of deftly selecting peer companies to compare with their clients will perpetuate present excesses."

I should know that Mr. Buffet does not favor this bill, but he is far more optimistic than I. There are people who are more optimistic. I have colleagues here who, when we get into debates, are more optimistic than I that they will be able to reach the better nature of some on the other side. I quit early when it comes to hoping people will improve their behavior.

Mr. Castellani, you said that the boards have gotten better. When did they get better?

Mr. CASTELLANI. Dramatically they have been—

The CHAIRMAN. As of when?

Mr. CASTELLANI. I would say over the last 5 years. Very much so in the last 5 years.

The CHAIRMAN. When they weren't better, can you send me the critique that the Roundtable made of them when they were in their "not better" phase? How critical were you of them for not being better when they weren't better?

Mr. CASTELLANI. In 1997, we did our first principles of corporate governance, and indeed it was critical. It set a high standard for how boards should operate.

The CHAIRMAN. Were you critical on compensation?

Mr. CASTELLANI. Pardon?

The CHAIRMAN. I'd be interested if you would send me if you were critical on compensation. Mr. Kaplan, you said in the last 15 years things have gotten so much better for American businesses. Would that include the last 5 years as well? Would the last 5 years be included in that improvement period?

Mr. KAPLAN. I think I would say yes.

The CHAIRMAN. Okay. I appreciate that.

Mr. KAPLAN. We have seen productivity grow—

The CHAIRMAN. I appreciate that. I thank you for that only because the last 5 years are the period in which we have had Sarbanes-Oxley. And I appreciate those nice words about Sarbanes-Oxley. There have been people who have suggested it has been corrosive and, apparently, it is one of the reasons.

But I would ask Mr. Castellani and Mr. Kaplan, would you comment on Mr. Buffet's remarks? Mr. Castellani.

Mr. CASTELLANI. At the risk of disagreeing with a national icon, I disagree with—

The CHAIRMAN. Do you mean me or Mr. Buffet?

Mr. CASTELLANI. With Mr. Buffet.

The CHAIRMAN. Please continue.

Mr. CASTELLANI. I disagree with Mr. Buffet. In fact, what our own information is seeing is that the comp committees have been much more independent. They are exclusively independent under the requirement of the listing standards and under Sarbanes-Oxley.

The best practices and their activities that we've seen across our member customer is they get their own—

The CHAIRMAN. Sarbanes-Oxley has brought about improvement in the comp committees?

Mr. CASTELLANI. I believe it has.

The CHAIRMAN. Thank you. Continue.

Mr. CASTELLANI. As a standard answer, Mr. Chairman, the Business Roundtable believes that Sarbanes-Oxley has been very—

The CHAIRMAN. I appreciate it. If I could interject and give myself a few seconds, in the spirit of bipartisanship, I think someone ought to continue to say good words about Mike Oxley. He hasn't been gone that long, and he doesn't get a lot of nice words from the other side, so I want to continue to support his signal achievement in most regards. Please continue.

Mr. CASTELLANI. To be fair, it can be improved on, particularly Section 404, but it can be done through regulatory process.

The CHAIRMAN. Which is now going on, yes.

Mr. CASTELLANI. And we support that. What we have seen and what compensation committees are doing now, and they are independent, is working very, very hard to tie compensation to performance.

They are getting their own outside expertise. They are not relying on management's consultants to set that pay, and that pay has been much more balanced in recent history than it was in the past.

The CHAIRMAN. Thank you. Mr. Bebchuk, would you want to comment on Mr. Buffet's remarks?

Mr. BEBCHUK. I agree with this national icon. I wanted to comment on the general thrust of what was suggested here about the concerns that maybe CEO's are actually underpaid. If one believes this, then one should really support advisory votes. Why?

Because if CEO's are underpaid, and there are good arguments for this, then shareholders would really vote for the existing packages, and companies would be able to raise the packages, and ignore what the media says, because shareholders would vote for them.

So the only reason to be concerned that advisory votes would lead to reduction in pay is if one is assuming that the advisory vote would come out negatively, namely, that investors think negatively about what we have now.

Similarly, it was suggested that companies right now cannot communicate with many shareholders because shares are held in street name. Again, this should lead one to support advisory votes, because this way we will hear from those shareholders.

Again, the only reason why one might be concerned that advisory votes would lead to pressures on pay is if one is afraid that those advisory votes would come out to suggest that there are problems with existing pay packages.

The CHAIRMAN. Thank you. The gentleman from Alabama.

Mr. BACHUS. Thank you. Mr. Kaplan, this idea that a corporate board ought to function more like a democracy, you have written on that. Would you comment on what some of the dangers of that may be?

Mr. KAPLAN. I will go back to part of what Professor Bebchuk said, and answer this question. Boards are elected today every

year, sometimes every 3 years. More and more companies are putting in votes where directors have to receive a majority of the votes in order to retain their seats, and that is a good thing.

In terms of this bill, where you have a requirement that you have a shareholder vote on every company for every year on pay, that is invasive.

The point is not that I worry that pay will go down. The point is that under today's system, shareholders are aggressively going after companies that have a problem. There are ways for them to do it.

Carl Ichan has 1 percent of Motorola's shares, and he is fighting against Motorola. So the companies where there is a problem are exposed today, and there are votes on them. It is the companies that are doing a good job where this bill will impose costs that I believe are unnecessary.

Mr. BACHUS. Mr. Castellani, you mentioned the tenure of chief executives is going down, obviously, from 4.5 to—well, it was 8 years in 1985. It was 4.5 in the last year we know of. 15 percent of them were replaced in the last year we have statistics.

What does this indicate to you?

Mr. CASTELLANI. Well, it indicates two things to me. One, first and foremost, is that boards are being very responsive. The boards do control who are the management of a company. They have demonstrated that by the rapidity in which they have changed the management.

The second, unfortunately, is that it demonstrates something that Mr. Ferlauto talked about that is a problem, and that is an obsessiveness we have in this country with very short-term results, particularly where those results are expressed in the share price.

Mr. BACHUS. I've heard people say this. In fact, I have seen it, I think, in Birmingham. The last time when we have done something which we thought was just a given, and that was disclosure of executive pay, we at least heard a lot that CEO's looked at what other CEO's made, and they said they wanted raises. It has actually increased the number of wage increases, kind of, "He is making this, so I want it, too."

If it happened, and I think maybe it has, it is an unintended consequence of even the disclosures we have had. What would be some unintended consequences? I'm worried about that, too. Where does it go when you have CEO's leaving after 4 years? Mr. Castellani or Mr. Kaplan, would you all speak on some maybe unintended consequences?

Mr. KAPLAN. The primary unintended consequences, and this is something that I think is mixed about Sarbanes-Oxley. Sarbanes-Oxley has done some good things.

I think 404 has been overly invasive, and the unintended consequence of that, and the unintended consequence potentially of this bill is that you are driving CEO's and CFO's—generally the better ones—to private equity.

That is a good part of the reason. It is not all. Financial markets have helped, as was mentioned earlier. But a good part of the reason for all this private equity activity is that good CEO's and CFO's say, "I would rather be doing something else."

And John Calhoun, who was one of the top people at GE, ran a quarter of GE's business, and was well-regarded there, presumably would have been a desirable public company CEO at many public companies.

What did he do recently? He left GE and a $47 billion business to run a company that was funded by private equity, a $5 billion business, and he is no longer working for GE.

Mr. BACHUS. And now shareholders cannot buy shares in the company he runs even though he is one of the most efficient—

Mr. KAPLAN. Well, they do, actually. Mr. Ferlauto can maybe answer that. At least the pension funds can invest in the private equity funds, but individuals cannot.

Mr. BACHUS. So if we drive the best executives into private equity firms and hedge funds, then the average middle class individual can't walk up and invest in a company they run?

Mr. KAPLAN. That would be correct.

Mr. BACHUS. All right. Mr. Castellani.

Mr. CASTELLANI. Another unintended consequence is not really on the executives themselves, but really on the board of directors.

I don't want the conversation here to be misleading members of this committee that boards only spend their time on suspension. In fact, the preponderance of their time, and this is one of the concerns with Sarbanes-Oxley, should be spent on what is the company's strategic plan? What are their investment plans? How are they developing new products?

What markets are they going into? Who are the management of the company now? How are they performing, and who will be the management of the future? And how do we develop them for the sake of shareholders and increasing shareholder values?

One of the concerns we have is this proxy process is becoming very politicized. We see that with majority voting which is, quite frankly, something that we have been supportive of. But we also see that the politics of the campaigns become diverting of the attention of the board of directors.

Just as I think we can make an arrangement that we have to be very careful that our boards don't overreact to Sarbanes-Oxley to become compliance officers, we're also very concerned that boards don't overreact to become, I am sorry to say this to the people in this room, professional politicians, because what they are there to do is to oversee the shareholder's investment and ensure that all aspects of the company contribute to increasing it.

Mr. BACHUS. I am going to make one comment, if I could, just in response to Mr. Castellani. The last thing you said recalls a quote of Adam Smith where he said, "It is the highest impertinence and presumption therefore in kings and ministers to pretend to watch over the economy of private people and to restrain their expense. They are themselves always and without any exception the greatest spendthrifts in the society."

Having politicians run corporations is a scary thought indeed.

The CHAIRMAN. I recognize the gentleman from North Carolina. I will just take 10 seconds from his time to say that I thought shareholders were private citizens. I agree that private citizens should run the corporations. That is what this bill is about. The gentleman from North Carolina.

Mr. WATT. Thank you, Mr. Chairman. Thank you for holding this hearing. I have to say I have tried to come to these things and sort through the real differences between the people who are testifying and identify some issues that still remain.

Mr. Kaplan, it is true that you answered a number of questions many of which, in my estimation, kind of beg the question. Whether the system is broken or not doesn't answer for me whether it can be improved.

Whether CEO's are being lured into private equity companies might suggest that we ought to be looking at private equity compensation, but that doesn't necessarily mean that CEO's are not being overpaid.

Whether we should speculate about the private capital markets becoming democratic I don't think really is a subject that any of us ought to worry about. They never have been, and I doubt they ever will be.

The one question that you asked and answered in a way that I think is probably not in accord with what would be the case is whether the proposal would reduce the number of abuses.

It seems to me that having this kind of advisory capacity that makes this process more transparent is likely to get at some of those very, very serious abuses.

The question that you didn't pay much attention to that I want to ask Mr. Davis to enlighten us on a little bit, since he studied a system that is really in effect, is I keep wondering what is the cost benefit analysis if we assume that there are some benefits that could be derived from this bill?

What are the actual costs of implementation? I am not talking about speculative cost, the unintended consequences. I'm talking about the actual dollar amount, the extra amount in a shareholder disclosure, or whatever would be required.

Dr. Davis, did you do any study in England about what the actual cost of implementing this kind of advisory system would be?

Mr. DAVIS. Thank you, Congressman. What we did do was to ask boards and executives, "What extra did you have to undertake when the advisory vote process came into effect?"

And there are a series of things, but, essentially, it boils down to consultation, arranging some meetings, having some more phone calls than you would otherwise have in the course of a year, and having a few more sit-down sessions with your major shareholders, so the costs were minimal.

Mr. WATT. Are there actual paper costs associated with the additional disclosures? Are we talking about increasing the cost of the proxy process? Are there actual dollar amounts that we can put on these things?

Mr. DAVIS. Well, the cost of disclosure is one separate matter in some ways, and we have already because of the new CD&A regulations are a pretty serious set of disclosure requirements on companies.

In the United Kingdom, they have something less than that, actually. If we are to try to figure out whether there was any specific cost to it given a context of advisory votes, it is really just being able to frame those reports so that they appeal to the shareholders

and not just to lawyers. It is not a compliance exercise, in other words, it is a persuasion exercise.

Mr. WATT. Let me try to get in one other question really quick since my time is running out. The difference, it seemed to me, between the second and third witnesses, both of whom have difficult names to pronounce, so I won't try to do the that, seems to me to be whether there would be any accountability after this advisory process.

Under this proposal, there is no real accountability after the advisory process takes place. Aside from that, Mr. Castellani, I didn't hear a lot of difference. Maybe you were being collegial like Mr. Buffet said folks were being in the boardroom.

You did not seem to be really going after this proposal in a negative way. There seemed to be not much difference between you and the gentleman from AFSCME.

Mr. CASTELLANI. Well, there is a fair amount of difference between us and our positions. We did not support this proposal.

Mr. WATT. You do not support it as much as you do not support the one in the Senate?

Mr. CASTELLANI. Well, the one in the Senate, I think, we can all agree on is that the best pay systems are ones that are driven by—

Mr. WATT. No. Do you support this one less than you do not support the one—I'm asking the question as a relative matter—is the one in the Senate worse?

Mr. CASTELLANI. Both have serious negative consequences, in our view.

Mr. WATT. You are being collegial again. Maybe you are being collegial to Senators who are not here today. If you had to make a choice between the Senate proposal and this proposal, which one would you choose?

Mr. CASTELLANI. I would oppose both.

Mr. WATT. If you had to make a choice between the Senate proposal and this proposal, which one would you choose? That is the question. It would be nice if you would answer the question.

Mr. CASTELLANI. Both have serious problems, and both have potential to cause—

Mr. WATT. I hope you don't approach me in conference and try to move us toward this system, as opposed to the Senate one with that response.

The CHAIRMAN. I do take it that the Business Roundtable would be indifferent, then, if, as we moved it, instead of doing this bill we decided to substitute the Bachus bill, they would be indifferent as to that. I would not myself be, but I will acknowledge that.

That was the question that was asked, and I am taking the answer is that you are indifferent as to which of the two we would do if we were to do one. I am surprised at that, but you are entitled to your answer. The gentleman from New Jersey

Mr. GARRETT. Thank you, Mr. Chairman. What we are talking about today is whether salaries are excessive or abusive. Actually, I learned yesterday we can't really clearly define what abusive is; I am not sure whether we can define what excessive is, either.

Going to the issue that some of you on the panel say that pay should be tied to performance, I can, sort of, agree with that if we

can agree what performance is. You are all shareholders in this great republic of ours in one way, shape, or form.

And I wonder if anyone would hazard to give an advisory opinion on the level of performance and therefore of pay of Congress or the CEO of this committee and whether you would want to advise us in the correct direction. Are we excessive, or maybe should we be raising salaries? No. Okay.

Ms. MINOW. I think it is a mistake to draw too many analogies between any government office and a public corporation or any private enterprise. The same issue of defining performance is pervasive no matter what organization you are looking at.

Had you ever, I believe that there is no accountability standard that is higher than the one that is presented to each of you every other year. And therefore, I think that is adequate.

Mr. GARRETT. Thank you. A follow-up question for you. If we go this way with the advisory opinion or even go, as some suggest, even further than that, as far as not requiring any sort of, and I don't know how you would do it, liability on the very shareholders who are making that decision?

Because right now all of the liability is on the compensation committees or on the directors, and if this decision is advisory or even further than that, does that limit my liability now? Because I am taking this and going in a different direction than previously I had taken in my fiduciary responsibility, I said this was the best way to go.

Ms. MINOW. Congressman, I am really happy that you asked that question, because it, I think, is a very important one. I believe that the liability the shareholders have is expressed in the value of their stock price, which can go down to nothing if they did that wrong.

Mr. GARRETT. But clearly there is a lot more liability on a CEO who violates his fiduciary responsibility. He has a share price, too, but he can go to jail if he violates that.

Ms. MINOW. If he violates the criminal law, he can go to jail. If he violates a civil law, I think the record shows that in almost no case has a director or an officer had to pay out of his own pocket. It always comes out of the shareholder's pocket.

I also want to say that one point that we have noted is that excessive CEO compensation is the single best predictor of litigation and liability risk for the corporation, so shareholders have a very strong motive in terms of what is going to be coming out of their own pocket already in addressing this issue.

Mr. GARRETT. Okay. Thank you. I think, Dr. Davis, you made some sort of reference about saying that for those companies that have already begun to adopt some sort of advisory capacity or interplay with their shareholders that there has been a positive effect of that. Am I hearing you right?

Mr. DAVIS. That's correct.

Mr. GARRETT. Well, if that case is true, it is a positive effect as far as the overall performance of that company and overall performance of their stock as well? Is that the up-tick of what has occurred?

Mr. DAVIS. Well, the positive aspects are multiple. It is much too early to decide if this specific thing has made a big difference in

performance or stock price. It is very hard to, I'm sure my colleagues would agree, segregate out one aspect.

But the fact is that the boards see it as a real positive in terms of their relationship with the owners, and the shareholders feel it gives them much lower risk when they are investing.

Mr. GARRETT. Well, that brings up two comments. First, my opening comment saying that maybe we should just wait before we take any legislative action on this to see how it all shakes down.

And second, if what you are saying actually comes to pass to be true that it does have a positive effect, wouldn't then other companies look at that and say, well, those companies have done it. It has had a positive effect. Our company better go down the same road as well with or without this legislation. Wouldn't the market sort of dictate that?

Mr. DAVIS. The experience in the United Kingdom, in fact, and most markets could show that the good companies will do it, and the companies where there are real problems will stay well away from that.

The other point about waiting is that Britain sees this, for instance, as a way to keep their company in fighting trim, to keep London markets strong. If we wait, we are giving them the lead.

Mr. GARRETT. Okay. And that brings me to my last question. Dr. Kaplan, can you just give us some indications economically speaking—how is the United States doing versus the United Kingdom economically?

If they are doing all of these great things, I assume their unemployment is lower than ours, that their GDP is going up faster than ours. Everything must be going better in the United Kingdom, in essence, versus where we are in the United States. Is that the case?

Mr. KAPLAN. I am not perfectly certain of the U.K. numbers versus the U.S. numbers. However, it is certainly the case that the United States has done extremely well in terms of productivity growth since the early 1990's when CEO pay took off, and I would gather at least as well as the United Kingdom. But I don't have those figures at my fingertips.

The CHAIRMAN. I recognize the gentleman from North Carolina. He will be the last one, and then we will break. I would ask the gentleman for 15 seconds to say that I do think that we are hearing, apparently, a refutation of the McKenzie Report.

When we talk about Sarbanes-Oxley, we are told how much better it is to be in England. Now, apparently, it is better to be here. There is a lot of transatlantic travel here depending on which issue comes up. The gentleman from North Carolina.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman. I actually want to ask questions similar to what Mr. Garrett just asked.

It appears that we are in a distinct minority, the United States, in a distinct minority of developed market economies in that we do not have something similar to this.

In fact, England has an advisory vote, as Mr. Ferlauto points out, with a consequence of a negative vote that is not taken to heart by the directors.

Mr. Kaplan said that we risk driving CEO's from American public companies if we make compliance with legal requirements too annoying.

Mr. Davis, is there any evidence that there has been an exodus of CEO's from European companies because of this requirement?

Mr. DAVIS. There is no evidence that this particular requirement has done that. In fact, I think what I would argue is if we are concerned about private equity taking over more companies, the advisory vote system is exactly the right thing we ought to be looking at, because what we want to do is to equip our public shareholders with the kinds of tools that private equity investors already have; in other words, to act as real owners.

Right now our laws, essentially, tie the hands of public shareholders so they can't act like owners.

Mr. MILLER OF NORTH CAROLINA. Ms. Minow.

Ms. MINOW. I agree with Dr. Davis on that. I think that it is important to find out that if CEO's feel that they are going to be less accountable to, say, Henry Kravis through private equity than they are to the public markets, then they have another thing coming.

Mr. MILLER OF NORTH CAROLINA. In an earlier hearing in this committee, I asked the question of whether there is any evidence that European companies were in fact better led, better managed, more efficient, more profitable, perform better or less well, rather, because there were some restrictions, this modest restriction on corporate compensation, executive compensation. And the answer that I got was "no." Mr. Kaplan?

Mr. KAPLAN. This is where I can answer. The U.K. economy, I think, has done reasonably well, as has the U.S. economy. In terms of productivity growth, continental Europe has been far behind.

Mr. MILLER OF NORTH CAROLINA. Well, that is not actually the question. The question was corporate performance.

Mr. KAPLAN. Corporate performance, I believe, has been behind as well. In addition, the private equity question, it is the case in continental Europe and, I believe, in the United Kingdom that you've seen an exodus of good executives to private equity partially for the reason that the compensation packages are more attractive in the private equity arena.

Mr. MILLER OF NORTH CAROLINA. Does anyone else have an opinion on that question, whether there is any real evidence that European companies are less well managed, less well-led, or perform less well because they aren't getting the very best managers, because the very best managers don't make as much as American managers make or CEO's? Mr. Davis? Ms. Minow?

Ms. MINOW. I would like to mention that earlier in my testimony, I said that in only one case in the United Kingdom was there a vote against the pay plan.

And I'd like to point out that the company's justification for that pay plan was they said that because they did so much business in America that they had to compete with American CEO levels, and they were really trying to imitate us, and they were able to arrive at some kind of a compromise.

What I do see is that some of our worst ideas in terms of CEO pay are being imported, and I think the reason that it hasn't gotten

out of hand is that the other economies do have these very modest controls in place.

Mr. MILLER OF NORTH CAROLINA. Is there any evidence that the management of European companies is not as good as the management of American companies? Mr. Davis.

Mr. DAVIS. American companies, if we look at the individual skills of an American CEO against a European CEO, yes. They are going to be good. I mean, if they are top companies, there are, presumably, good folks running the companies.

The issue here is about whether there is an alignment. After all, this really isn't about, I think, in Britain or here, a crabbiness about how much money a CEO is making.

It is about alignment, whether the structure is such that what the CEO does, how he or she uses those skills, whether those uses are put to the uses of the shareholders or the interests of management.

And here is where we have a real problem with our structure, and this is not the panacea. It is one piece of the puzzle. Other pieces can be done by the marketplace. But this is an important light touch way in which we, effectively, make capitalism work.

The CHAIRMAN. Mr. Bebchuk.

Mr. BEBCHUK. I think there is really no evidence that the management of European companies is doing worse because of this requirement.

I think the good performance of the U.S. stock market in the last 15 years doesn't really speak to this issue, because the main drivers of the comparative performance of Europe and the United States are not just difference in corporate governance but major macro economic differences.

The Chinese stock market has done extremely well recently, and it is not because they have better corporate governance.

The CHAIRMAN. The committee will recess, and then we will come back and keep working. Members can come and go for lunch, but it wouldn't be fair to the witnesses to hold them. I will say that, depending on how quickly we move, we might even have a chance for a second round of questions.

We will be gone probably for another 15 or 20 minutes, because there is a second vote following this one, so we will be in recess until then.

[Brief recess]

The CHAIRMAN. The hearing will reconvene. Please, witnesses, take your seats. Going by the list that was presented to me by the ranking member, the next member to be recognized will be the gentleman from Florida, Mr. Feeney. Please, people take your seats.

Mr. FEENEY. Thank you, Mr. Chairman. I want to thank all of our guests and witnesses for being patient. I had a colleague earlier from Wharton who quoted Edmund Burke, who happens to be one of my favorite philosophers of all time: "The only thing necessary for the triumph of evil is for good men to do nothing."

As a great fan of Edmund Burke, who I think was the greatest conservative philosophy since Plato, I would say that of the many things that he was known for, probably the most important was his ability to distinguish the potential for the democratic impulse and how it can undermine legitimate governance.

Burke was one of the few people who supported in the parliament the American Revolution, but he opposed the French Revolution on the grounds that the American Revolution was designed to preserve traditions and successes and the rights of man, and the French Revolution was likely to lead to excesses of the democratic impulse. And that is exactly what happened. He was certainly prescient in that regard.

I am concerned in the same way that a democratic vote is what we are in for if we are not careful. Ms. Minow seems to be the only person on the panel who thinks that this bill strikes the exact correct balance.

The first couple of witnesses testified that they thought that this was a start, but that we needed more in order to correct the problem.

Two of the witnesses have said that this is unnecessary and would be counterproductive. Ms. Minow does come from the University of Chicago, and I am big fan of their views, including that asset allocation ought to be the juxt of every decision.

But we may know a little bit more about the way politics tends to unravel than the way economists would like things in an ideal world, and I would suggest that some of us do have a fear that the "camel's toe" problem is going to be a real and a significant one.

Nobody seems to call for a democratic vote on what the appropriate level of Steven Jobs' compensation or Bill Gates' would have been, say, in 1975 or 1980 or 1985. One witness, Dr. Kaplan, has talked to us about the fact that given today's rules under Sarbanes-Oxley, and if we would adopt some of these advisory opinions or even mandatory pay votes by a democratic electorate of the shareholders, very likely Bill Gates would have stayed private.

Steven Jobs would have stayed private, and hundreds of other successful entrepreneurs who have taken their companies public would have stayed private.

The unintended consequences, some of them unforeseeable, and some foreseeable, are what concern me. Now, we have had talk about trusting the SEC, and I think Christopher Cox has done a great job.

I would note that the chairman has defended the SOX initiative today. I am a big fan of Mike Oxley. It was not the House that included the nefarious Section 404 in the House bill. I wasn't here at the time. It was the Senate who insisted on Section 404.

And if we had stuck to House principles, I would tell the chairman, we would probably not be debating.

The CHAIRMAN. Would the gentleman yield?

Mr. FEENEY. I would be happy to.

The CHAIRMAN. Was the gentleman under the impression that somehow that bill passed without the House concurring in Section 404?

Mr. FEENEY. Ultimately, the full House did. And by the way, I was not here for either the vote in the—I was not a Member at the time.

But having said that, it is always fun to blame the Senate. And I think, in this case, we have a legitimate reason; nobody foresaw the consequences of 404.

But even if SOX has been some wonderful reason for the success in the London markets, the truth of the matter is that if there is pay excess in the American economy it should have shown up for the last 15 or 20 years with very little governance.

In fact, America was the premier capital market until roughly the time that we passed SOX. We are rapidly losing our preeminence in world capital market formation. Part of that is because the London market and others are advertising themselves as a SOX-free zone. They surely think it is a problem.

Also part of it is because of the private equity issue. I would like to ask Dr. Kaplan and Mr. Castellani if they have any opinions. In the United Kingdom, while there are advisory opinions for compensation, so far there have not been advisory opinions required of shareholders for other forms of corporate governance.

Should companies be forced to adopt pro environmental policies or pro labor policies? And we have a representative from AFSCME here who talked about investing for social and moral consciousness reasons. Personally, I want to make investments for my retirement that will guarantee a successful retirement.

Dr. Kaplan and Mr. Castellani, do you see any reasons why the United Kingdom did not adopt advisory opinions for other issues, and are there any other unintended consequences we ought to be worried about in this proposal before us?

Mr. CASTELLANI. Yes. Thank you. I think one of the things that underlies the discussion that we have been having about the U.S. system versus the U.K. system is the fact that there are some very substantial differences in U.S. and U.K. law.

One that is the most significant is their system of civil justice and litigation. In the U.K. system, you have a system where the loser pays when they bring lawsuits, and the environment is not as conducive for lawsuits.

So directors and boards are not as subjected to shareholder lawsuits as you see in the United States, for whatever reason. The rationale or the result is that boards in the United Kingdom can operate with less of a concern that they will find their actions being tested in court through civil litigation.

In just a recent trip over there in London, and in a discussion in a forum with the Chartered Accountants Institute, that has been something that was pointed out very strongly, that even the fear of that caused them to change recent legislation to ensure that they were not increasing the opening for that because of their concern that board actions would be second-guessed by potential litigants.

The second thing that is very different is that shareholders within the United Kingdom to be less activists where you see in our proxy process proxy proposals that range everything from ethical treatment of animals in research to whether or not a company supports nuclear power or is engaged in or supporting one aspect through the remediation of global warming. It is how the boards are structured.

That is typically not something that is done by the U.K. shareholder—very different.

The CHAIRMAN. Ms. Minow.

Ms. MINOW. Thank you very much, Mr. Chairman. It is important to point out that shareholders have very much more robust

rights in the United Kingdom and therefore don't need to resort to shareholder proposals; 10 percent of the shareholders can call a special meeting; and 50 percent can throw the board out, so it's hard to make comparisons there.

If I may, I would just like to correct the Congressman on something that he said about IPO's. If you look at the statistics on IPO's, and you take out the fact that most companies prefer to have their IPO in their country of origin, the fact is that we continue to be the same primary place for IPO's that we have always been.

I think we should be indifferent about whether a company is private or public. Steve Jobs and Bill Gates both were in private companies, and, at the point where they felt they needed access to public capital, they went public. Hurray for capitalism. It worked very, very well. Shareholders have the opportunity to invest in private or public companies.

Mr. FEENEY. I'd ask unanimous consent for 30 seconds to respond. Number one, with respect to the SOX issue about IPO's abroad, I'd invite you look at the study by AEI and Brookings that, basically, called this a 1.4 regulatory tax, $1.4 trillion.

And secondly, with respect to private equity has worked well, it did for Bill Gates and Steve Jobs, and it might even for AFSCME, who has access to private capital.

But I represent some of the 53 percent of Americans who are individual shareholders, and we don't get to participate in the next Microsoft—

Ms. MINOW. Do they have pensions? Do they have pension funds? Do they have 401(k)s?

The CHAIRMAN. The gentleman will suspend. I will say to the gentleman that we do plan to have a series of hearings on hedge funds and private equity.

The committee does plan to address the question about whether or not there are public policy concerns about private equity, etc. This is a subject I would note that we do intend to explore.

The gentleman from Georgia.

Mr. SCOTT. Thank you, Mr. Chairman. First of all, let me just remark to Ms. Minow, I believe, that you are absolutely right about the University of Chicago being the premier free market institution and so legendarily embodied with your legendary leader, Milton Freedman, who was just a great example of the free market.

Ms. MINOW. Thank you.

Mr. SCOTT. Mr. Castellani—

Mr. CASTELLANI. We could change it to Smith.

Mr. SCOTT. Did I mess it up?

The CHAIRMAN. Just for the record, I know there are not a lot of Italian Americans in some parts of the country. It is Castellani.

Mr. CASTELLANI. Thank you.

The CHAIRMAN. The gentleman is not alone.

Mr. SCOTT. Absolutely. I apologize for butchering your name, Mr. Castellani.

Mr. CASTELLANI. It is quite all right. It is done often.

Mr. SCOTT. I want to respond to something you said. First of all, you made the statement that what we were up here doing as far as the corporate executive pay and this bill is tantamount to every

time Congress makes a decision, they have to go get a referendum on it.

I might just point out to you that we get that referendum every other year in terms of decisions that we make.

You tend to support the status quo of where we are. Here is the status quo. The status quo is lavish compensation for executives that is totally unrelated to their performance.

The status quo is a losing degree of confidence in our most cherished aspect of our free enterprise system, which is the stock market, which is investor confidence. It is lavish pay packages that not only don't relate to performance, but even are given while their companies are struggling.

While companies are going down, executives are making hundreds of millions of dollars. While they are laying off employees, corporate executives are getting these outlandish packages, when these same executives are reneging on billions of dollars in pension packages for their retiring workers that they're not fulfilling.

They are losing confidence. That is the status quo. What we are doing here is nothing draconian. There is nothing draconian about doing and giving the owners of the company, the shareholders, just a simple say in what they are paying the top employee who work for them.

For us not to do this is a great threat under these circumstances to the future of all of this. There is no mandate here. There is no regulatory arm here. It is just simply saying the stockholders, the shareholders will have a say in these packages.

As I mention one company that has done a very superb job, I want to read to you what this executive said, this CEO. This is from the Aflac chairman, CEO Dan Amos. He said these words:

"Our shareholders, as owners of the company, have the right to know how executive compensation works. My board's action is in keeping with Aflac's long-standing pay for performance compensation policy and our commitment to transparency at all levels.

"We believe that providing an opportunity for an advisory vote on our compensation report is a helpful avenue for our shareholders to provide feedback on our pay-for-performance compensation philosophy and pay package."

Now, if that makes sense, which I think you will agree certainly makes sense, then the question I would like to ask you, and certainly Ms. Minow and Dr. Davis especially to comment, I think you come from different points of view on this, what is holding back these other companies?

If what CEO Amos is saying is correct, and it is, this transparency is going, what is holding back these other companies from doing this?

And particularly in the face of what we are doing is nothing more with our bill, not draconian, but it is just encouragement for them to bring about transparency through the proper way of providing the people that own the company.

When they pass out these $200- and $300 million packages, who has to stand for that? Shareholders should have a say. I think that this will make our economy much healthier and much stronger and certainly will build up the confidence in it.

I would like for you to just comment on what is holding back the other companies. What is it that they fear, particularly in light of what this chief executive has said? Ms. Minow, Mr. Davis, and certainly Mr. Castellani and any of you others who would like to comment.

The CHAIRMAN. We won't have time for everybody. We can take a couple.

Ms. MINOW. I think they fear having shareholders tell them they are making too much money.

Mr. DAVIS. I think as soon as corporations learn more about this process, any fears and anxieties will go away, because this strengthens boards at the end of the day.

The CHAIRMAN. Mr. Castellani.

Mr. CASTELLANI. Ultimately, what the CEO of Aflac said in the beginning of his letter is absolutely something that all the members of the Roundtable subscribe to. It should be transparent. It should be tied to performance.

If an individual company thinks that it should be voted on by shareholders, then that is a legitimate decision of the board of directors who are elected by the shareholders to make.

The CHAIRMAN. Would the gentleman yield to me for a second? Mr. Castellani, if you are a member of a board, would you vote to allow a shareholder to vote in an advisory capacity?

Mr. CASTELLANI. I would not.

The CHAIRMAN. Thank you. I thank the gentleman for yielding. Mr. Kaplan.

Mr. KAPLAN. I think the issue with the bill is that—

The CHAIRMAN. Could you confine yourself to the particular question? We don't have a lot of time.

Mr. KAPLAN. For good companies, this is an annoyance, so there is a cost. They are doing things well, and by having this mandated, it will take time, it will take energy, and it will have no benefit.

Bad companies today are already under siege and more so than ever with the hedge funds and the greater disclosure and shareholder advisory votes.

So that is the sense in which on a cost/benefit basis there are costs. I don't see big benefits. I would not do it.

The CHAIRMAN. The gentleman's time has expired. The gentleman from Illinois.

Mr. ROSKAM. Thank you, Mr. Chairman. In listening to the testimony today, it seems to me that what we are dealing with is really a continuum of a response.

The first response is, essentially, to do nothing, and that would be to allow the SEC rule to be promulgated and put into place, which would maintain transparency.

The next step would be to put it in statute the exact same SEC rule, take away the SEC's discretion but to move to that next step.

The chairman's bill moves to a step beyond that which requires a non-binding referendum, and then we would move to a binding referendum presumably would be the next step after that.

It just seems to me like there is wisdom in, sort of, going back to the admonition from old to creep, crawl, walk, and then run. Congress doesn't really have that great of a reputation for coming in and fixing a whole lot of things, if you look in the totality of

things and that there might be wisdom, Mr. Chairman, to slowing that down, essentially.

And that is, obviously, the subject of this whole debate. I think that we have to be a little bit careful. The word "transparent," which one of my colleagues on the other side of the aisle—I think the nature of his question made it seem like the system wasn't going to be transparent.

Well, it is going to be transparent. The question then is what do you do with that transparency? There was the comment on paying for failure in some of the earlier testimony, and I don't think anybody wants to pay for failure.

But isn't it inherent in a system that we sometimes pay people to go away? Isn't that the nature of, for example, litigation where you say, "Look, we are not admitting. We are not denying. We are not doing anything, but we will pay you a certain sum of money if you will go away."

And I would assume that a failed CEO is, sort of, in that place, that in exchange for their willingness to go away—bad leadership, bad stewardship, poor judgment—they are giving up certain rights that they may have had.

I don't think there is anything in this bill that makes that payment for failure that takes that away.

I do have a question, and that is what I perceive to be the de minimis nature of a $2,000 ownership requirement. Am I right, Mr. Chairman? And I will yield to you. Is that the amount of money that a shareholder would have to have? Is it $2,000, or is it a percentage?

The CHAIRMAN. It is an automatic vote. Any shareholder can vote in the percentage of his shares. There is no qualification. It is a shareholder vote. The way it works, as the gentleman knows, if you own so many shares, you get so many votes.

Mr. ROSKAM. I get that. What does it take, though, to initiate the petition or to initiate the referendum?

The CHAIRMAN. The way the bill works, and there have been earlier versions that the gentleman may be looking at, this takes what the SEC has required to be sent out and allows all shareholders to vote on it. It is an automatic advisory vote. The SEC has set the rules about what is in that form.

Mr. ROSKAM. So you have, basically, turned the high beams on. You are between walking and running already, but it is, sort of, in the walk category. It is walking fast.

The CHAIRMAN. I guess the gentleman would prefer that we stay in the creep stage, and I wasn't too content there.

Mr. ROSKAM. Touche. And I would be interested in maybe hearing from a proponent and an opponent. You know what? That is actually kind of surprising to me.

I am more troubled than I was before, actually. I thought that somebody had to actually take the initiative to get this out before—

The CHAIRMAN. Would the gentleman yield?

Mr. ROSKAM. Yes.

The CHAIRMAN. Because right now there is a great deal of uncertainty, frankly, with regard to SEC policy as to what happens with those initiatives. I think there is a certain amount of advantage in setting that.

The SEC just ordered AT&T to do it. Others don't know. It is a question of State law, etc. This notion that the government is involved is, of course, nonsensical.

The government is involved when you set up corporations. The government decides that you can have a corporation. The government sets the rules for governing corporations. This notion that it is purely market without government is fantasy land.

There is a debate going on. There are conflicting circuit court decisions, as I understand it, and the SEC has to decide on the whole proxy access question. The SEC just ordered AT&T to put such a referendum on the ballot and, obviously, under some statutory authority.

Right now there is uncertainty in the law as to whether or not the SEC can or can't order this petition to put this on the ballot. The board says no. People go to the SEC. And I think maybe others here who know more about this than I can answer it.

It seems to me there is a certain lack of clarity at this stage in the law as to when they do or don't have to go on the ballot.

Mr. ROSKAM. Okay. Reclaiming my time, I thank the chairman for answering.

The CHAIRMAN. That won't come out of the gentleman's time.

Mr. ROSKAM. Are there other analogous organizations? For example, are labor unions required to disclose their compensation levels?

Mr. FERLAUTO. Absolutely. The requirement for labor compensation is the most rigorous of any organization that I know of.

Mr. ROSKAM. Is it an NLRB rule?

Mr. FERLAUTO. Yes, it is.

Mr. ROSKAM. Are changes done by referendum?

Mr. FERLAUTO. Well, the salary levels are established democratically through votes of the union membership.

Mr. ROSKAM. Okay. So the actual question of compensation comes before each union member?

Mr. FERLAUTO. Each union operates differently.

Mr. ROSKAM. AFSCME, for example.

Mr. FERLAUTO. In AFSCME, we elect an executive committee that sets those.

Mr. ROSKAM. Well, the executive committee is like the board of directors. Is that fair?

Mr. FERLAUTO. That's correct. Again, everybody is using analogies that are just significantly—

Mr. ROSKAM. Anything with running and walking I am open to.

Ms. MINOW. I have a hobbling example.

Mr. ROSKAM. Hold up. I just want to finish this. So, basically, you're saying, look, don't trouble me with analogies about union compensation levels, because I don't like the answer?

Mr. FERLAUTO. No, because we don't have money at risk. This is all about ownership of a corporation and about how the assets of that corporation will be best allocated to achieve long-term shareholder value.

Mr. ROSKAM. Don't you think union dues are at risk, and union members have an expectation that they will be used wisely?

Mr. FERLAUTO. Union dues are established by democratic votes of all the union members.

Mr. ROSKAM. Okay. But the point is, I don't think that this is an unfair characterization. Let me just make this point, and then I will yield to the chairman.

Isn't there merit to the argument that there is symmetry between a company and a union in that the union members are analogous to shareholders, the executive committee is analogous to the board of directors, and the leadership is analogous to the leadership?

Mr. FERLAUTO. We could get into a long, long debate which I don't think would be worth the committee's time.

Mr. ROSKAM. I already have a couple more minutes from the chairman, so go ahead.

The CHAIRMAN. Will the gentleman yield to me?

Mr. ROSKAM. Yes, sir.

The CHAIRMAN. The analogy fails in the critical point of this hearing, salaries. I will ask the staff to prepare for me a comparative chart of salaries paid to the heads of unions and CEO's.

I think most unions would be delighted to settle for the requirement of this bill if they could get, like, about 10 percent of the CEO salary, most union heads. Of fact is that we are talking, in my judgment, about very different numbers. And that is one of the reasons why I think the analogy—

Mr. ROSKAM. No question about it, reclaiming my time. No question about it that the numbers are different, but the governing principle is the same. And you have largely been arguing that it is that democratic principle—

Mr. FERLAUTO. The governing principle that has been neglected to be discussed here is board accountability. The leadership of unions are democratically accountable to a democratically elected board.

There is no accountability mechanism in a corporate board where the ability to nominate independently candidates to be members of the board is only controlled by the board itself, wherefore the vast majority of companies there is nothing that resembles an election.

You can't vote no. You can only withhold a vote. And still, despite some movement to that effect, there are still a minuscule number of publicly-traded companies where more than one person would be required to elect a member of the board of directors.

Mr. ROSKAM. But the other situation is the shareholder in this case has the ultimate vote, don't they? I mean, the ultimate vote is—

Mr. FERLAUTO. Not our shareholders. Fiduciary—

Mr. ROSKAM. Well, let me finish.

Mr. FERLAUTO.—responsibility for institutional—

The CHAIRMAN. Suspended. The gentleman from Illinois.

Mr. ROSKAM. The ultimate vote is the sale of the share. The ultimate vote is to say we're done. We're not doing business with you.

Mr. FERLAUTO. Let me explain to you the fiduciary responsibility of large institutional investors that are required by fiduciary responsibility to hold the market. And when you hold the market, when you have $20- or $30- or $100 billion to invest, it means that you cannot trade in and out of a company. My funds are highly, highly indexed. 75 percent of their assets are indexed.

Mr. ROSKAM. Cannot go in and out of the marketplace?

Mr. FERLAUTO. For 75 percent of our asset allocation within public companies are indexed to the market.

The CHAIRMAN. Would the gentleman yield for one more—

Mr. FERLAUTO. Yes.

The CHAIRMAN. I have to say this, though. The analogy of saying to the shareholder, if you don't like it, then sell your share, would be in the union situation, if you don't like it, then quit your job. I don't think either one ought to be the object.

Mr. ROSKAM. Clearly. Look, I am not advocating that. I don't think you are implying that.

The CHAIRMAN. But, give me 30 more seconds and we'll move on. The gentleman from Texas.

Mr. GREEN. Thank you, Mr. Chairman, and I am most appreciative for your hosting these hearings and I thank the persons who are witnesses for giving us your time and your information. It has been most edifying.

On the question of salaries, while I do not have the specific information that the chairman referenced with reference to CEO's versus union officials, I do have something that I think merits consideration.

According to the AFL–CIO, the average CEO in the United States makes more than 260 times the pay of an average worker, and other studies in 2003 indicate that the average, large company CEO made 500 times the amount of the average worker.

I do not think that Congress, and I think most people agree, should determine how much compensation is too much compensation. I do not think Congress should do this, which is why Congress would never cap what lawyers make. Congress wouldn't do it, because, we do not think that we should determine how much is too much. We want the market to set how much folk ought to receive as compensation. Thank God for Congress.

Friends, and I will move specifically, if I may, to Mr. Davis. Mr. Davis you spoke of alignment and I would like to juxtapose, if I may, after the fact alignment with before the fact alignment. And I would like to with you, if you would, give me some indication as to whether it costs more to align after there has been a colossal mistake, or does it cost more to align before.

It seems to me that what Chairman Frank is proposing is before the fact alignment. Give the people who have a vested interest in the business an opportunity to give an opinion as to what alignment is. Now, we can wait until after the compensation has been accorded, discover that it was inappropriate, and then align.

The question becomes for me, which is more cost efficient?

Mr. Davis, if you would?

Mr. DAVIS. Well, thank you, Congressman. That's a great question. And I would like to first, if I might, endorse your earlier point which is that Congress really does not have the job, as the gentleman said earlier, of determining what is pay for failure. In effect, what this bill does and what the legislation does in the United Kingdom is to empower the shareholders to make that judgment as to what is failure and what is success. Congress is stepping out.

Mr. GREEN. In respect to your question, I entirely agree, and this is I think one of the reasons why, in the United Kingdom, they feel that the advisory vote is a boost to the marketplace, gives U.K.

companies a competitive advantage, because you do not wait for the failure to happen. You don't wait for the company to tumble off a cliff. You don't wait for companies to have problems and then as we have in this country, lots of litigation occurring after the fact.

So, if you can be proactive, and that's what this bill does, this bill incentivizes the dialogue between investors and boards, so that boards can find out where the problems are early and so can investors, work them out, and do that before there is a catastrophe.

My final comment, Mr. Chairman, is this. I heard talk of unintended consequences. We also have something in this world known as intended consequences. Intended consequences can consume a Board and place the Board at the mercy sometimes of the CEO. That sometimes is an intended consequence that will cause a CEO to have leverage above and beyond what may be in the best interest of the corporate personality.

Mr. Chairman, I thank you for the time and I yield back.

The CHAIRMAN. Thank you. The gentleman from California.

Mr. CAMPBELL. Thank you, Mr. Chairman. There seems to be consensus on the panel, and I believe on the dais, which agree by the way that we are not talking about the absolute level of compensation here, whether it is executives, lawyers, baseball players, or whomever. But talking about the alignment between shareholder returns and executive compensation, I also believe there is consensus both in the panel and on the dais that there have been instances where that alignment has not occurred, where certainly in retrospect, at least, compensation has not been at all aligned with shareholder returns.

That being said now, there is not consensus on the panel about the bill that is kind of before us or may be before us and we discussed in this committee. So I have questions for each side, if you will, on that. Where Mr. Ferlauto, Dr. Davis, and Ms. Minow, what we are talking about here is basically legislative issue-specific corporate direct democracy.

Do you support that concept?

Ms. MINOW. Mr. Congressman, we already have that concept. There are a number of issues put to a direct shareholder vote, including, for example, stock options, which are put to a binding shareholder vote, and so given that we currently have that structure, it seems to me that this is a legitimate item to add.

Mr. CAMPBELL. Okay, then do you believe there are other items that ought to be added to that list? Because one could say, certainly make an argument that although excessive, and out of alignment, executive compensation can get you upset as a percentage of the overall expenses of any corporation or the overall debt, or whatever, of any corporation, it is probably a fairly small number, it is probably unlikely to bring the company down.

So should there be other things that should have this kind of prescribed, direct democracy?

Ms. MINOW. I am aware of the "camel's nose" analogy and I am not interested in pushing the camel's eyes, or eyebrows, or hump into their tent at this time. I have nothing else to add.

Mr. CAMPBELL. This is the only thing. There is nothing else that you or Dr. Davis in an interview can stick in that you think deserves similar shareholder, direct democracy scrutiny than this.

Ms. MINOW. I am a supporter of strengthening the ability of shareholders to nominate their own directors.

Mr. DAVIS. That's separate issues. That's not being prescriptive as to the expenses and operations of a company, which is what this is doing.

Ms. MINOW. I have nothing to add to that list. Yes.

Mr. DAVIS. Either of the rest of you. Or, do you support the concept generally of corporate, direct democracy?

Look, I think we call it private enterprise when you own a piece of your property, you should have some say over how it works and that is, in effect, what this bill is trying to return to our market.

That's the principle that this bill tries to address. I think in terms of legislation there is a lot of other work that could be done by shareholders and boards in the private sector. But in terms of legislation, this is the only thing we need to work on right now.

And I think in the United Kingdom, and that's where I am coming from in my findings, this has been the area where there has been the most egregious misalignment between how a board operates and how shareholders operate.

Mr. CAMPBELL. Right, but there have been companies that have been brought down by too much debt, too much marketing, and by poor product allocation.

Should we be putting those things?

I am not aware of a company. Maybe you all are. You know more than I do on this subject, that has actually been brought down, in other words, gone bankrupt or whatever, because of excessive executive compensation. But I am aware of ones that have been brought down by a number of other expenses and factors.

Yes, Mr. Ferlauto?

Mr. FERLAUTO. If I may, other than again the proxy access right to nominate directors, the compensation issue stands of particular importance, because it flags and it creates incentive structures that impact widely on the way the company operates.

Particularly, I can talk about succession planning issues and a whole variety of incentives that get misaligned. So I think that the only place where democracy—democracy is not the word—it is accountability, you have to hold boards accountable only on the pay issue.

Mr. CAMPBELL. One question that you said if compensation then, should we go down the chain, should we include collective bargaining agreements? Should we include employee benefits to make sure they are aligned with the corporate objective?

Mr. FERLAUTO. I am a strong believer in the business judgment world, John, so that only the five most highly compensated as required within the SEC disclosures.

Mr. CAMPBELL. I am not sure why five is the magic number and why we should stop there and not go all the way through, but we will discuss it.

Let me ask Mr. Castellani and Dr. Kaplan a question in my last couple of seconds. Only I would suspect that you guys do not believe in prescribed corporate direct democracy, whether it is for this subject or anything else. If you don't, however, do you?

Mr. Castellani, you talked about majoritarian voting. There is potential cumulative voting. Do either of you support other methods

that where shareholders came through a board of directors express their displeasure with a company's operations executive compensation, whatever.

Mr. CASTELLANI. Absolutely.

Mr. CAMPBELL. Could you tell me what those are?

Mr. CASTELLANI. We have been very supportive and the SEC has promulgated regulations that enhance shareholder communication vehicles and mechanisms between the board of directors and the shareholders. There has to be input from the shareholders to the board of directors and that communication is something that we very much support.

Mr. CAMPBELL. Dr. Kaplan?

Dr. Kaplan. I would agree, I think, with everyone on this panel in supporting director majority votes, which seem to be happening through the market.

And greater shareholder access to the proxy, which is something that I think is a much more complicated issue. But I would, just in general, repeat what I have said. The market and the scrutiny are working. You already, which had not been mentioned before but just came up, you already have shareholders having a required vote on stock options.

So, there is already some binding vote on shares, and so putting this in again is going to have very little benefit and will add costs.

Mr. CAMPBELL. Thank you.

The CHAIRMAN. I am going to ask for just 20 seconds. I would just ask Mr. Castellani and Ms. Kaplan in particular, the SEC just ordered AT&T to let the shareholders vote on pay.

Mr. Castellani, do you think the SEC decided that wrongly?

Mr. CASTELLANI. I am not aware of that.

The CHAIRMAN. Well, you don't think I made it up. I mean the SEC told AT&T that they had to have a shareholder vote on compensation.

Mr. CASTELLANI. Well within the context of the SEC decision-making process, no, that's fine.

The CHAIRMAN. So, the SEC can order them to do this.

Mr. CASTELLANI. They can.

The CHAIRMAN. Okay. The last I time I checked, the SEC was a government entity. Is that not the government ordering them to do that?

So, in other words, Dr. Kaplan, what do you think about the SEC's decision ordering AT&T to do what the board of directors did not want to do?

Mr. KAPLAN. This is again something I said earlier. If shareholders identify company—

The CHAIRMAN. No. I am asking not what the shareholders said, but what the SEC is ordering them to do.

Mr. KAPLAN. The SEC must have looked at the situation and said a shareholder vote was in order.

The CHAIRMAN. That was okay?

Mr. KAPLAN. If you are identifying the bad guys, so this is the whole point where you want to go after the bad guys.

The CHAIRMAN. AT&T are the bad guys?

Mr. KAPLAN. They may be, but presumably, they may not be. I don't know.

The CHAIRMAN. I am sorry.

Mr. KAPLAN. Could I clarify something? I believe the SEC ordered AT&T or directed AT&T to put a shareholder proposal on the proxy to allow—

The CHAIRMAN. AT&T ordered them to do it.

Mr. KAPLAN. Not to vote itself.

The CHAIRMAN. But as a result, if the shareholders vote for that, they will then have that right. And, again, this is the government ordering the board of directors to do something. I am just wondering whether the objection is to Congress doing it rather than the SEC doing it.

It is the gentlewoman from Wisconsin's time.

Ms. CARSON. Thank you so much, Mr. Chairman, and I want to thank this very distinguished panel for being patient with us through our votes and so on.

I would love to ask each of you questions, but I know that my time is short. So I really want to direct my questions, I think, to Dr. Kaplan and to Ms. Minow. I want to start out with you, Dr. Kaplan.

You had some very compelling testimony. You talked about our economy having grown over the last 15 years, but the executive compensation has risen, and how hedge fund managers, basketball players, and other compensation has grown as well.

I guess I first of all would like you to juxtapose that particular observation against other testimony that we've heard in this committee from I guess, the great Wizard of Oz, Federal Reserve Chairman Bernanke, who really has sort of agreed that the growing inequity in compensation is very troubling, because he points to two indicators, consumption and productivity, as really blowing up our economy.

And when you stop and think about a CEO making $84 million, he probably still only has one Rolex watch versus our ability to have thousands of people buy Rolex watches, which would keep the economy going.

I see you are taking notes, so I guess I want you to respond to your long-term projection of where our economy will go, if we just have this little island of folks making a lot of money: basketball players, CEO's, and everybody else being too poor to consume, while they are continuing to be more and more productive.

You also made a couple of points that I would like to elaborate on, because they are a little bit underwhelming to me. You say that this bill will have costs, and you did not specify what those would be. Well, yes, there are costs to implementing new regulations. And then you seem to suggest that General Mills and other sort of public held companies would have no takers for CFO's and CEO's if we were to pass this legislation.

They would all run to the private equity firms and, you know, that they would somehow just shrink away from these $40- and $50 million packages. And I guess I want you to respond to that.

And then I want to ask Ms. Minow a question. She made a very, very provocative point that this legislation is necessary, because if we continue to have these kinds of disparities, people will not invest anymore. They will invest elsewhere. And I want you to expand on that and clarify that for me.

Thank you, so much.

Mr. KAPLAN. Thank you. There is a whole lot to talk about and I think those are very important issues. And I think the increase in inequality is a fact and it is a very difficult issue. I think that Federal Reserve Chairman Bernanke described what was going on. I don't know that he had any prescriptions other than to say that it was a difficult issue.

He did say that it was important to maintain equality of opportunity and that really means making sure that the less fortunate have access to opportunity and education. He also stressed that—

Ms. MOORE OF WISCONSIN. He needed the opportunity to consume.

Mr. KAPLAN. Well, he stressed that he said it did not mean equality of outcomes.

Ms. MOORE OF WISCONSIN. But they have to be able to consume, though, to keep the economy going.

Mr. KAPLAN. That's correct. And again I can point to the economy over the last 15 years that has done very well. Incomes for everyone have gone up. But there is no doubt that they have gone up more at the high end.

Now, the University of Chicago answer to give you is that competition will drive some of the extremes down. My preference is to allow competition to work. Over time, when people see a lot of money, that attracts entry which drives any excess profit down.

Now, coming to your question about finding CFO's and CEO's, the numbers that have been bandied about with hundreds of millions of dollars are really the exception. This was in my testimony. It points out the median salary for the CEO of an S&P 500 company—who is managing over 20,000 people—is $8 million a year. So that's a lot of money, but it is not $100 million, it is $8 million. And that CEO will make more money if the company does well. If the company doesn't do well, then that CEO makes less money. There is a lot of pay for performance in the current system.

Now, will CFO's and CEO's leave at that amount of money? And this is something that I know sounds very strange, and I hesitate to say it, but you see it in private equity deals, and you hear it in talking to CFO's and CEO's. With all the scrutiny, all the pressure, and all the regulation, CEO's and CFO's are thinking of doing other things. And it is the best ones. So, it is not my preference to say that, but that is how it is.

Now, the last thing about the costs versus the benefits, I think there are very small or no benefits from this bill. I think the costs are not earth-shattering, so it is not as if the world is going to be destroyed if you put this in, but I think there are costs in terms of extra time, extra angst, dealing with political interest.

And those costs actually hit the good companies, because the good companies are doing the right thing now, those are the ones that actually create the most value in this economy, and you will be imposing more costs on the good ones. So I hope that's helpful.

The CHAIRMAN. The gentlewoman has a minute left if she wishes to use it.

Ms. MOORE OF WISCONSIN. I would love an opportunity for Ms. Minow to respond.

The CHAIRMAN. Go ahead.

Ms. MOORE OF WISCONSIN. Thank you.

Ms. MINOW. This relates also to Mr. Campbell's question of a moment ago. When Gary Wendt took a job, he insisted on a $45 million signing bonus and a lot of other protections against the consequences of poor performance. And later, when a very good offer to buy the company came in, he turned it down because he was doing just fine.

It really didn't matter how the shareholders did, and the company ultimately went into bankruptcy. People do not want to invest if the CEO is going to do fine, whether or not they do fine. People want an alignment of interest, and we will send investment dollars abroad.

I am meeting a week from Monday with a group of international investors in American companies who are deeply concerned about this issue and who will take their money out of America if we do not solve it.

The CHAIRMAN. I thank you. Let me thank the panel. If you can stay with us another half hour so we can get everybody, I appreciate your indulgence.

The gentleman from North Carolina.

Mr. MCHENRY. Thank you, Mr. Chairman.

I think this is a fascinating subject for us to discuss and the panel has been fantastic. I have watched it on TV.

We have had the votes. We have been running around today, but I have caught most of your testimony. I wanted to follow-up for my colleague from Illinois, Mr. Roskam what his questions were earlier.

Some of you on the panel actually have special, well, corporations in America have a special privilege granted to them by the government. In essence, they are dealt with as individuals and that is a special notion that the States have given them and our government has respected. Unions also have a special place, as well as universities, tax status and so forth.

And, so, Mr. Ferlauto, I believe I am stating your name correctly or close enough. Who do you work with?

Mr. FERLAUTO. I do not understand.

Mr. MCHENRY. What is your business that you are employed by? Oh, it is AFSCME, the largest public employment service union in the country.

Are you one of the top five paid individuals at AFSCME?

Mr. FERLAUTO. No. I am not.

Mr. MCHENRY. You are not?

Do the top five most highly compensated individuals at your union, do you members vote on their salary and their compensation?

Mr. FERLAUTO. Our members do not vote directly on their salary.

Mr. MCHENRY. Do they have some sort of shareholder democracy by which they can state that?

Mr. FERLAUTO. Our members directly elect those officers and if those officers actually use the union treasury to buy $15,000 dollar bottles of wine, to have huge birthday parties for their wives, to buy country club memberships, or to get loans other than for giving, those officers would be out on their ear in less than 30 seconds.

Mr. MCHENRY. They might be in jail along with the corporate CEO's that you are referencing. They might be in jail.

Mr. FERLAUTO. Many of those things that we are referencing were actually not illegal to do. It was just immoral to use your treasury for those things.

Mr. MCHENRY. So, your shareholders, your employers, if you will let me continue, they do not have an advisory vote of any sort on compensation packages. Yes or no.

Mr. FERLAUTO. Not directly when there are compensation packages.

Mr. MCHENRY. The answer is no. So, you know, I am trying to follow this and I also know that as a union, you have large investments that you invest for your members, do you not?

Mr. FERLAUTO. We do through our pension funds.

Mr. MCHENRY. Now, do your pension funds, where do they invest?

Mr. FERLAUTO. They invest in the public markets and the private markets.

Mr. MCHENRY. Okay. So, also in private equity funds as well.

Mr. FERLAUTO. Sometimes, yes.

Mr. MCHENRY. Sometimes, yes.

And are you aware of the compensation packages in the private equity firms?

Mr. FERLAUTO. As much as they are disclosed.

Mr. MCHENRY. Does the union not have a policy about investing with these private equity funds?

Mr. FERLAUTO. Actually, the direct AFSCME fund that I represent does not invest in private equity because of the disclosure and the fee issues and the high risk issues involved.

There are other funds that involve our members that do, because they have the sophistication. They also invest and engage with those private equity principles around fee issues and other types of issues.

Mr. MCHENRY. Okay. Certainly, I appreciate that.

And so you are aware that CEO's in these private equity funds make far in excess of what the publicly held company CEO's make, adn yet, your union still invests with them.

So what your testimony here before Congress is very much—

Mr. FERLAUTO. My union does not directly invest. It is our members' money invested in some.

Mr. MCHENRY. Members' money which you as a union are investing for them through your pension funds, correct?

Mr. FERLAUTO. There are a number of different ways our members' money gets invested: directly through our pension fund and then directly through the public pension systems that sometimes have all our members represented on their boards, so there is some slight difference.

Mr. MCHENRY. Okay, Dr. Bebchuk, going to you, are you one of the top five most highly compensated individuals at Harvard?

Mr. BEBCHUK. No. And I do not get to vote on the President's compensation either.

Mr. MCHENRY. Okay, and as a non-profit in a very elite school, your interest of course. I hope that one day you would be the most five highly compensated members at Harvard.

But, nonetheless, do you think if you look at publicly traded companies, they also pay very high salaries and fees to entertainers, news anchors, and athletes, through endorsement deals, and some of these packages are far larger than what the CEO's are making. Do you think these decisions should receive shareholder approval, since they are so large?

Mr. BEBCHUK. I think not. And I think the key distinctions are the following. I do not have any problem about transactions—arms-length contracting. When you have arms-length contracting, we can count on the market to produce good outcomes.

Other examples about basketball players, private equity managers, and so forth, those are arms-length contracting market outcomes. The problem with executive compensation is that we do not have arms-length contracting and that is why you need some accountability mechanism, and the standard accountability mechanism is to have the owners have a say.

Mr. MCHENRY. Okay. Mr. Chairman, just two very brief questions to wrap up here so we can keep the panel moving.

To follow up with you Mr. Bebchuk, what you are saying is that the marketplace does not work with CEO compensation, and, bad CEO's are not thrown out. Well, as it turns out the marketplace seems to be continuing to turn over CEO's, and getting rid of CEO's in the marketplace as Dr. Kaplan has referenced in some respects is very functional.

My final question to Mr. Castellani and Dr. Kaplan concerns options versus salary. If you all could touch very briefly on the difference in compensation packages of straight salary that CEO's receive versus the options, in essence saying that the growth and the benefits accrued to shareholders will also accrue to the CEO of the company.

Therefore, if the CEO is successful, he will receive greater compensation. If he is not successful with the corporation, he will not receive greater compensation.

The CHAIRMAN. We will have to get to the answers.

Mr. KAPLAN. The options versus salary—that's a very important point. Part of what has happened in the last 25 years was a big move from cash-based compensation to options and those options do tie the CEO's wealth to shareholders and the data I gave you earlier—that said there was pay for performance—is driven by those options.

The options are not worth anything if the stock price goes down. They are only worth something if the stock price goes up. If CEO's performed well, their options are worth a lot, and if they performed badly, their options were worth little.

The CHAIRMAN. Mr. Castellani?

Mr. CASTELLANI. Only to add to that answer is that compensation should be balanced. Salaries should reflect an appropriate level for the basic job that the person is hired to do. Stock options should be a method or could be performance shares to tie a portion of that performance to the housing stock performance.

But those systems should be balanced so that it is both tied to the stock, but also tied to other parameters that are important for corporate value creations such as sales, revenues, margins, cash flow, and the like.

The CHAIRMAN. The gentleman from Missouri.

Mr. CLEAVER. Thank you, Mr. Chairman. My colleague was raising a lot of questions about labor unions that I was trying to find the reference in the bill. What I would like to do, Mr. Kaplan, is if you could just give me the "Readers Digest" answer. You mentioned earlier that you believe that some CEO's were in fact underpaid.

Can you name one? We do not have a lot of time because the chairman wants to stop, so can you name one CEO who is underpaid?

Mr. KAPLAN. David Calhoun was at GE. He ran a $45- to $55 billion business, and, he left GE to run a private equity funded company with only $5 million in sales.

Mr. CLEAVER. Okay. Can you tell me how much he had before he left?

Mr. KAPLAN. I do not know.

Mr. CLEAVER. Is it about $5 million?

Mr. KAPLAN. I do not know, exactly.

Mr. CLEAVER. Well then how do you know that he was underpaid?

Mr. KAPLAN. Well, if he were overpaid there, why would he have left?

Mr. CLEAVER. That is really bad theology.

Ms. MINOW. Thank you, University of Chicago.

[Laughter]

Mr. KAPLAN. I can give these other examples, if you want a few.

Ms. MINOW. So you are overpaid at the University of Chicago because you have not left?

Mr. CLEAVER. I asked for one. You have not given me one, yet.

Mr. KAPLAN. I did give you one—David Calhoun. Can I give you another?

Mr. CLEAVER. No. You cannot just throw out names. I mean, if they are underpaid, tell it.

Mr. KAPLAN. The CEO of SunGard. I can give you some details.

Mr. CLEAVER. If they are underpaid, you need to say how much and you at least need to know how much they make, or you are incapable of saying that they are underpaid.

That's not hard. Now, I mean, you cannot answer the question, and that is fine. Someone mentioned earlier that it was a bad analogy. They said it is okay to give people large compensation packages, because it is like the settlement in a lawsuit to just get it to go away.

Mr. Ferlauto, do you know a man or have heard of a man named Lee Raymond?

Mr. FERLAUTO. Yes, he is quite well known, actually.

Mr. CLEAVER. I would like to ask Mr. Ferlauto or Mr. Kaplan here, do you know Mr. Lee Raymond? Do you know who he is?

Mr. KAPLAN. Yes.

Mr. CLEAVER. Mr. Castellani?

Mr. CASTELLANI. He is the former CEO of Exxon-Mobil.

Mr. CLEAVER. Do you know how much money he was making a year?

Mr. CASTELLANI. I do not know exactly.

Mr. CLEAVER. I know, exactly—$38.1 million per year, and his retirement package was $400 million. Are you all right with that?

Mr. CASTELLANI. Yes, sir, I am.

Mr. CLEAVER. On top of the fact that we gave them a $10 billion tax break, which means they are siphoning off taxpayer money, and giving it to the CEO.

The CHAIRMAN. If the gentleman was really good, that is what they were rewarding him for.

Mr. CLEAVER. Are you all right with that—taking this taxpayer money?

Mr. CASTELLANI. Yes, I am. Yes, sir.

Mr. CLEAVER. Are you all right with it, Mr. Kaplan?

Mr. KAPLAN. Yes. Now, I say that one thing that is an issue is the pensions. And to the extent that some of these pensions have been given on CEO's pay that is not performance based, and in some cases the Board did not quite understand how big those pensions were, I think those should change and what will happen.

My prediction is with the new SEC disclosure, where this is going to be disclosed more carefully and where boards will be looking at this more carefully.

Mr. CLEAVER. And, if you do not have a problem with it.

Mr. KAPLAN. You will see fewer of those kinds of CEO's.

The CHAIRMAN. The gentleman from Missouri?

Mr. CLEAVER. If you do not have a problem with it, I mean, you cannot have a partial problem. You are saying you think it is going to be okay.

Earlier, you said you did not have a problem with it, which means it does not need to change. It is already okay. And so, you are saying that these "walk on the water CEO's" and "boardroom disciples" can manipulate even the taxpayer money in order to pay the CEO an exorbitant amount of salary because he or she is worth it, no matter what. And, so, my reservation is that this legislation is not enough of the "last supper."

I yield back the balance of my time.

The CHAIRMAN. Well, I would point out—and this is one of the problems you have in the case of Mr. Raymond—his $400 million settlement in that year. I believe Exxon-Mobil failed to fully fund its pension, so we are not just talking about a lot of money in one place, but money that should have gone to another place.

The gentleman from New Mexico.

Mr. CAMPBELL. Mr. Chairman, I would like to ask unanimous consent to submit a prepared statement by WorldatWork for the record.

The CHAIRMAN. Yes. It would be good and the Chair asks in that extent to apologize. I will probably get that. I put into the record something that was presented to me by the minority from the H.R. Policy Association, and I mistakenly stated that they were supportive, but I put it in the wrong pile. They oppose the bill. And this will also go in the record.

Mr. CAMPBELL. Thank you,

Chairman Frank. The gentleman from New Mexico.

Mr. PEARCE. Thank you. This was an interesting panel. I appreciate all of your participation here.

Mr. Castellani, how long does it take capital to flee?

Mr. CASTELLANI. It can flee very quickly.

Mr. PEARCE. Hours, days, months, years?

Mr. CASTELLANI. If you look at the volatility of the market, it flees on an hourly basis.

Mr. PEARCE. On when?

Mr. CASTELLANI. An hourly basis.

Mr. PEARCE. So, Ms. Minow, and also Mr. Davis, raised strong arguments that frankly it is—we are going to undermine the credibility, I think Ms. Minow said—that people will invest elsewhere. So a strong piece of the argument Mr. Davis declares in his item 3 that it is actually an item of competitiveness.

Tell me about the outflow of capital. And we will flee at a moment's notice, within minutes literally, we saw the collapse of the Mexican economy, and we saw the collapse of the Thai economy.

Tell me about the evacuation of capital because we are losing competitive edge. We are undermining the credibility. This process has been going on. I have been listening here. This process has been going on for 15 years, 20 years, overpay.

Tell me about the evacuation of capital that can happen at a moment's notice. Mr. Kaplan, if you would address, please, very briefly, the evacuation of capital. What are we seeing?

Mr. KAPLAN. I am not sure I have a quick answer, other than you have to look at the economy, the stock markets.

Mr. PEARCE. Our stock market is fairly solid.

It is the British, we are led to believe, and according to Mr. Ferlauto's testimony, the Netherlands, Australia, and Sweden, are doing it better. The United Kingdom is doing it better. Is capital evacuating to those markets? Are they seeing tremendous increases in their stock market, Mr. Kaplan?

Mr. KAPLAN. Not over the long run. The United States has done quite well.

Mr. PEARCE. Okay, and those markets, you are saying with respect to relative size that those markets are not significantly better?

Mr. KAPLAN. No.

Mr. PEARCE. Mr. Ferlauto, in your testimony you have on Page 2 a discussion that many people have mentioned—relative pay, relative amounts—and, you do not really draw the conclusion about what is wrong with that. But, let's say your union wants to bring in a keynote speaker for your national gathering. That happens. I have heard the number for Mr. Clinton, who has retired from the office down the street, $250,000 for a 1-hour speech. Is that something? Does your association bring in speakers that you pay anywhere from $30- to $40- or $50,000 per hour?

Mr. KAPLAN. I do not believe so.

Mr. PEARCE. Oh? I suspect I would like to see if you could provide me the programs of your last 10 annual meetings where you do bring speakers in. I suspect that we do have people who are very highly compensated and they are engaged or embraced by the hour.

Ms. Minow, you have mentioned that the real frustration comes when pay is not linked with performance. Now as we are looking at competitiveness and we have testimony in front of the Transportation Committee that of the seven airlines that sat in front of us

a couple of years ago, we are going to give a very large bailout, because all of the companies, all of the airline companies were not performing.

Now, my question to them was at 100 percent utilization, you fill every seat, every day, every month, in every year, will you make a profit? Only Southwest is making a profit every month in a competitive environment. They all fly airplanes and look alike, made out of the same sheet metal, use the same sort of diesel, about the same amount. The only difference was the amount of days worked. Southwest pilots get about the same, $200,000 per year.

But the six or seven airlines that are right at the fringe of bankruptcy, they work 3 days a month for their pay—$200,000 a year for 3 days a month. And if they work at the end of the month, they can get 3-day trips. And Southwest—they get 15 days a month.

Now, I would agree they pay for performance, but we are not concentrating on the real competitive disadvantage that we are putting our companies up against. Because, if you take the 8,800 pilots of American Airlines, and you put $100,000, that's $880 million versus, we are talking these little $20 million or $30 million packages. But if you run them up, and I do not know what everybody gets paid, but I assume 100,000 pilots at $200,000 is $1.6 billion. And so I think we are grabbing at it by limiting it, we want to talk about competitiveness, but we really do not want to talk about competitiveness.

We do not want to talk about the union structure that has that pay in place, and if we are really talking about competitiveness, Ms. Minow, I think that somewhere in your conversation you would have talked about frivolous lawsuits. Because that is where American Express told us 4 years ago in New York, that if we do not cure frivolous lawsuits, every major corporation in America is going to leave.

I thank the chairman for his indulgence and appreciate the opportunity to make the points. Thank you. If anyone wants to respond, they are welcome to if the chairman—

The CHAIRMAN. Well, if the gentleman has no objection, we will move on to the gentleman from California.

Mr. SHERMAN. Thank you, Mr. Chairman, I have a number of observations.

The gentleman from New Mexico may not fully understand Democratic Party politics. Ask me. Ask any Democrat, including a former President to go speak, we speak for free, including former Presidents.

Mr. Ferlauto, I think, has made an eloquent argument in favor of the bill by pointing out that General Electric suffered terribly by the decision of its Board to underpay its CEO, and of course a shareholder vote giving advice to the Board might very well have resulted in the appropriate level of compensation, which you have argued would be higher. It is unprecedented in history that the bulk of the world's capital is typically invested by giving it, putting it in the hands of strangers in faraway places. This has worked because corporate governments align shareholder interest with two strong pillars that control the money.

The first of those pillars is management. The second is the board. Those are the twin pillars that assure what we are calling align-

ment. But in the area of management compensation, those pillars are a little shaky. In the area of the pillar of management, obviously, you are at cross purposes with shareholders. So, you lose one pillar right away. The second pillar, the pillar of the Board, will keep in mind many people on the Board are there because in practice, management put them there.

And, second, the inside directors form a large caucus that influences the compensation level and options of the outside directors. So, you are missing one pillar. As a matter of fact, it is at cross purposes. And the other pillar is pretty shaky as well. Perhaps you need to shore up alignment with a shareholder vote.

I want to take a minute before I get to questions, though, to talk about this performance-based compensation. CEO's are not rock stars. They are not sports superstars. When the Lakers win, they only put five guys on the court and Kobe can dominate the game.

When General Motors wins, they put 100-, 200-, or 300,000 workers on the court. And to say that any one individual is the reason why they win begs the question: if you were to take out the CEO of many companies and put in just a journeyman CEO, they might do just as well. Different people could argue it one way or the other, yet no one who is a basketball fan would argue that you could take Kobe out, put in a journeyman or shooting guard, and the Lakers would do just as well.

So, the idea that a huge percentage of corporate performance is related to the CEO misconstrues basketball business. Second, we could end up with short term thinking, the CEO doing something just in the short term, because I think many of our corporate decisions are too short term. And, finally, CEO's may take wild risks in the last year of their career. Heads he wins; tails the shareholders lose. Mr. Davis, we have seen the Secretary of the Treasury join government where he gets paid as little as we do, which is still quite sufficient for us, but little in the world of corporate finance.

So, maybe he was being overpaid by his previous employer, but are British corporations able to get competent leadership?

Has there been a sell-off in British stocks because they have this advisory vote?

Has Aflac's stock tanked because they are going to have an advisory vote?

Mr. DAVIS. Congressman, there is no evidence of any of that occurring.

Mr. SHERMAN. So, we could institute this measure and we could probably find people willing to work for the $5-, $10-, or $20 million they are able to get running major, public companies, and there would not be a shortage of talent.

Mr. DAVIS. Yes, I think that's correct. As a matter of fact, even if you look at BP, we were talking about Lee Raymond, earlier. BP's CEO is just leaving office, and after many years of successful performance, and the last couple of years a very poor performance, he is leaving with a total retirement package of approximately $29 million, which is, you know, significant, but it is nothing like the $400 million that Lee Raymond left with.

Mr. SHERMAN. And do we see many top European business leaders coming across to the United States to be employed as CEO's of Fortune 100 companies?

Mr. DAVIS. I think there has been a good flow, actually, back and forth. There is no one.

Mr. SHERMAN. But it is not a one-way flow.

Mr. DAVIS. No.

Mr. SHERMAN. So, we pay our CEO's a lot more. We do not have an advisory vote, and we lose as many CEO's to Europe as we are able to recruit from Europe.

Mr. DAVIS. There are a lot of Americans going abroad and running companies in Europe and Asia, everywhere.

Mr. SHERMAN. I yield back.

The CHAIRMAN. The gentleman from Colorado.

Mr. PERLMUTTER. Thank you, Mr. Chairman, and I really thank the panelists for having the patience to be here with us all day. I am sorry I missed some of the early testimony, but quite frankly, I agree with a lot of what everybody is saying and I disagree with some of the things you have said and I disagree with my colleague, Mr. Cleaver, who was very upset about the compensation to the gentleman from Exxon.

I mean, if that is what the company is prepared to pay, then they are prepared to pay it. I think that this bill has an elegance, and, Mr. Kaplan, I would have to disagree with you on this, Professor. There is an elegance here where you have, as Mr. Sherman was saying, you have management. You have the directors. You have the shareholders. And I think you said you thought there would be a lot of costs attached to this without much benefit in return and I guess my feeling is just having. I have represented management. I have represented boards of directors. I have represented shareholders in all sorts of contexts.

Shareholders, if they take the time to read 10K's and 10Q's and different kinds of disclosures, are not ignorant people. They are smart. And they will, if given the opportunity, thinking management's performance does not fit with the performance of the company, they will shoot a shot across the bow, which the directors better take seriously.

If the directors take it seriously, they are going to talk to management and they are going to say, you guys are out of line. So, but then, on the other hand, if they have a high performing company, you know, and Exxon was making zillions of dollars, they are going to reward their executives because they do not want to lose them.

So, the shareholders are not going to act in a way that is contrary to their financial interest. At the end of the day, I think that the Federal Government also has an interest in this, not the Securities and Exchange, but I would come at it from the Pension Benefit Guaranty Corporation, because PBGC has so many pensions that it backs up that I have seen where the companies failed where the officers were getting tremendous salaries, and all of a sudden then the pensions that have invested it, you know, they turn out upside down and we are bailing them out.

So, I mean, there is at the end of the day a role for the Federal Government. If you could, Mr. Kaplan, just again, because you really did get to the point. You thought the costs of this outweighed the benefits. And, you know, that is where we differ. If the shareholders are prepared to pay a fortune to their execs, God bless

them. Go for it. But I think the shareholders should have an opportunity to say something.

Mr. KAPLAN. I think it is a legitimate issue and there are legitimate disagreements, so I very much appreciate that. I think the view I have taken is under the current system when the company is not doing a good job, shareholders have lots of ways to go after the company. There have been a number of compensation proposals that are on the proxies. When the company resists, they get a lot of publicity. So, that's a lot of advice to the directors that there is a lot of publicity.

So, in addition, shareholders do have to approve increases and option plans. Actually, it is a binding vote on checking some of the compensation. So under the current system the companies that are bad do get attacked, and with hedge funds now and activist shareholders, they really do get attacked.

The firms that are doing a good job are left alone, and I think this bill will not do very much different to the bad companies, but it will affect the good companies. And I would prefer to wait and see what the new SEC disclosure does and let the market work.

Mr. PERLMUTTER. So, I mean, really to summarize, you think, and I might not disagree with this. On a company-by-company you know annual shareholder meeting, the shareholders do have an opportunity to say, whoa. Let's throw these bums out. Let's cut their salaries in half, you know, speak up at the shareholder meeting.

Do they really have that kind of opportunity?

Mr. KAPLAN. They have the opportunity to speak up and to propose shareholder amendments or shareholder votes, yes.

Mr. PERLMUTTER. Last question. There was all that conversation about capital fleeing. If I understand correctly, England already has a similar kind of process, but I just had some people in from the investment community yesterday concerned that all of a sudden a lot of companies are moving to the London Exchange, because they feel like they are treated in a better fashion.

What is that all about?

Mr. DAVIS. If that is directed to me.

Mr. PERLMUTTER. To anyone.

Mr. DAVIS. It was one of the points that I made. I think what has occurred in Britain is something of a grand bargain, if you will. And the bargain is we won't put a lot of red tape on the corporations, but at the same time we are going to give shareholders significant authority.

I would disagree with my colleague. I do not think shareholders have anywhere near the authority that they should have in this country, and in Britain they have given shareholders more authority at the cost of lower regulation.

So, in effect, the advisory vote bill that we are talking about here is providing shareholders with the kind of tools they need to make the market work.

The CHAIRMAN. One more round of questions. You mentioned, Mr. Kaplan, that there has to be a binding vote on options. By whose authority?

Mr. KAPLAN. Yes, and again.

The CHAIRMAN. No. It is a very straightforward question.

Mr. KAPLAN. You want to increase?

The CHAIRMAN. Whose authority?

Mr. KAPLAN. It is a New York Stock Exchange listing requirement.

The CHAIRMAN. Thank you. Sometimes when we are asking questions, we want factual answers. It is a New York Stock Exchange listing requirement. Did you oppose that New York Stock Exchange listing requirement?

Mr. KAPLAN. I think that has been there for a long time.

The CHAIRMAN. Well, I understand that. I have been here for a long time. That does not mean people do not oppose me when I run again. What does one thing have to do with the other? Please answer directly. We are not playing games with you. Do you think that should be revoked?

Mr. KAPLAN. I honestly have not thought of that.

The CHAIRMAN. Dr. Kaplan, you lose credibility with me here, because you cite something, frankly, which contradicts the principles you have stated. This is an exterior imposition on the corporation's board of directors. It falls on the good and the bad companies alike. And I must say, you have more ability to distinguish those clearly than most of us do.

But, it rains on the good and the bad alike. It would appear to violate many of your principles. It is there because the stock exchange has the power and you say you do not answer it. And I think that is because if you were consistent to your principles, you would be opposed to it, but then you could not cite it.

I just want to elaborate on Dr. Bebchuk's point and ask others. People have said, "Well, you know the question was whether we want to get Mr. Campbell's nose under the tent", to mispronounce the metaphor.

Mr. CAMPBELL. No one will get my nose under that tent, thank you.

The CHAIRMAN. First of all, I just want to deal briefly with this notion of this is going to lead to that. Anyone who says that has never seen the Congress in action. Let us be very clear. Around here, Tuesday does not invariably lead to Wednesday. The notion that because we pass the bill that does one thing that is somehow going to lead to something else.

That just does not make sense. It is an argument given by people who were opposed to something on its merits but do not want to say so. So they say, well it might lead to something else. And then the question is, well, how do you separate it? And Mr. Bebchuk gave the argument.

I do not want to see stockholders voting on everything. But I do believe, and this is where I would differ with Mr. Castellani, he said, well, the boards of directors are getting better. But I do not remember a clear-cut admission that they were not very good before they started getting better from the corporate world.

And I think it continues to be, and this is Warren Buffett as of 2006 saying it is still the case that the relationship between boards of directors and CEO's is so close that it justifies an exception, that you do not get the arms-length relationship there.

The boards of directors do not have a relationship with the workers. We do not need shareholder votes on union contracts with suppliers, with others, but the CEO's still, to a great extent, pick the

directors. They have this very close relationship and what many of us are saying is that you can single out the CEO-board of directors relationship.

The other question I would ask you is this. Because people have said, well, you have analogized it to those of us in Congress. As I recall, there were companies—I remember when Mr. Eisner paid Mr. Ovitz $150 million to make him go away quietly, and there was frustration, but there was no way to nominate opponents.

Let me tell you this, enact a Constitutional amendment so that it is impossible to nominate anyone to ever run against me, and enact a rule that if I get any votes I win, and I will be the most independent-minded Member of Congress you have ever seen.

So let me ask the panelists. Do you believe there is a justification for some shareholder votes in this case only on compensation in those cases where there is not any realistic shareholder democracy on the board?

Let me ask Mr. Castellani and Mr. Kaplan.

In cases where, under various State laws and corporate rules, there is no way to nominate an alternative member of the board of directors and board of directors members can be reelected even if they don't get a majority vote. Do you still think that's enough and that we don't need to do anything else, Mr. Castellani?

Mr. CASTELLANI. I'm not sure that I completely understand the question.

The CHAIRMAN. Well, then I'll restate it. I apologize. There are corporations, as I understand it, where the way in which the board is elected does not allow for outside nomination and does not require a majority vote. What's the argument there for not allowing shareholders to have an advisory vote on the compensation?

Mr. CAMPBELL. Will the gentleman yield?

The CHAIRMAN. I'll yield.

Mr. CAMPBELL. I guess I would then ask the question why does—

The CHAIRMAN. I'll get my answer first and then you can ask yours.

Mr. CAMPBELL. All right. We'll do that.

The CHAIRMAN. Yes.

Mr. CASTELLANI. Mr. Chairman, it really is an issue of who decides and what they decide. In this case, we are talking about directors who are elected by the majority.

The CHAIRMAN. Excuse me, Mr. Castellani. That just so directly distorts my question. There are corporations where they were not elected by a majority of directors necessarily and where no one could nominate a competitive director. In those cases, how does the justification work?

Mr. CASTELLANI. If the board operates correctly, this is not necessary.

The CHAIRMAN. So that we don't—if you think that whatever the board of directors does, however it's constituted it's okay, then say so, but don't invoke, oh, there's accountability, because there are boards where we know there is no practical way for dissatisfied shareholders to do anything.

Mr. CASTELLANI. There's a very practical way.

The CHAIRMAN. What's that?

Mr. CASTELLANI. They can not own the shares.

The CHAIRMAN. Okay. Then that's the point that Mr. Ferlauto made. That's the point that says if you don't like the union, you can quit your job. The notion that you can "not own the shares", I think that's a pretty inhospitable answer for the business community to be giving shareholders. If you don't like it, sell your shares.

Ms. Minow, do you have a comment on that?

Ms. MINOW. I agree with you. The only thing that I know about investing is that you're supposed to buy low and sell high. And when you are concerned that the stock is at a low because it's depressed because of these various factors, it seems to me not just inhospitable, but it seems to me disingenuous to say just sell the shares when it should be easier for you to stay in the company and make a change.

The CHAIRMAN. I'll yield to the gentleman from California.

Mr. KAPLAN. Can I ask a question? It depends under what circumstances the shareholders bought the shares. For example, the New York Times is, I think, closely held by the family, and so that is exactly one company.

The CHAIRMAN. And you knew that going in?

Mr. KAPLAN. You knew that going in. So if you knew it going in, I think it's different. If you didn't know it going in, that's different. I think having the director require a majority vote and if the director doesn't get it, he or she is thrown out, that's a good thing.

The CHAIRMAN. That's a good thing, but you don't think any government should impose it? Should a government impose it? I mean do you think that's a good result; would it be okay for the government to impose it?

Mr. KAPLAN. You know, my preference, again, is to see if the market—

The CHAIRMAN. I understand that's your preference. I understand. We all have our preferences, as in my case well known. Do you think—

Mr. KAPLAN. I would prefer right now, given all the circumstances—I think the system is working.

The CHAIRMAN. I understand that, Mr. Kaplan. But you have to give straight answers in my business sometimes. Is there a principle that would be violated? Do you have something you think would be a good result, and some people do it and some people don't?

You know, you said you'd talk about angst. Here's where I disagree and then I'm going to yield to the gentleman from California. You talk about angst. Saying that the best way to do it is to let the bad companies be subjected to all that Sturm und Drang and all that—oh, there will be bad publicity, etc.

If it's a good result, why isn't the transaction costs of going through it by this public campaign, and Ms. Minow yelling at people, and Mr. Felanto bringing a picket line, and all these people doing that, wouldn't it be better if it's a good result to have a government agency just clearly say, here's what you should do?

That was addressed to Mr. Kaplan.

Mr. KAPLAN. I would just say Section 404, and I'm going to then—there are unintended consequences.

The CHAIRMAN. Section 404 is very different than a clear cut thing that says you have a majority vote. Section 404 was broadly worded. I agree with Mr. Castellani; it should be changed by regulation. I think it's being done. I yield to the gentleman from California.

Mr. CAMPBELL. Mr. Chairman, on the argument that you just made, if an issue is that corporations do not—that people do not have the ability to nominate alternate directors and there's not majoritarian voting, then why does this bill, why is not the proposal to have majority votes and the ability to nominate directors which would continue the path of allowing shareholders to—

The CHAIRMAN. Does the gentleman want an answer?

Mr. CAMPBELL. I do.

The CHAIRMAN. It would be even more intrusive, and I think that's the ultimate goal. I would say this; I hope that's not where we go to. I don't think it is where we will go to. If we were to have a series of advisory votes I would ignore it; people would build up to that. But this is less inclusive and it tries to—in general, my view is that the boards of directors, even those that have not been—were democratically elected, in most cases can be trusted at least not to have a conflict.

I make an exception here because of what Mr. Bebchuk talked about, the mutually supportive relationship of the CEO and the board of directors. So if the gentleman is complaining that this is not more intrusive in the corporate governance, I'll be glad to listen to his amendment at this juncture.

Mr. CAMPBELL. And you're very likely to hear it. I'd be curious to see—

Mr. FERLAUTO. Mr. Chairman, I mean, to be quite frank, I would trade this for real shareholder empowerment through a vote that could replace directors. Unfortunately, the Congress does not have that power. It's a State right that's also regulated by the SEC. But we believe that ultimately proxy access, the ability for shareholders to nominate a director, will be a solution.

But you don't want to use that willy nilly, so that the way this really operates most effectively is to have an advisory vote that is a warning signal to directors that if they don't change practice then the option is to be voted out.

Mr. CAMPBELL. Mr. Castellani, you seem anxious.

Mr. CASTELLANI. Well, I just wanted to make a point to the committee, and I hope that it's not lost here because it is common within this panel, and I think within the business community, and with the Congress.

Nobody is forced to own or invest in U.S. or foreign corporations. It is in the mutual interest of boards, of management, and of shareholders to be an attractive place for people to invest their money for return. All of this is about being responsible.

The CHAIRMAN. I appreciate that, Mr. Castellani. That's what Ms. Minow was saying, and what I'm saying. Please don't tell us that the answer is to sell the shares. Please, short of that, let's give them an alternative. An advisory vote on compensation seems to me to be far less of an intrusive way to deal with it than to tell people to sell their shares.

And now that I stand accused of being insufficiently intrusive into the affairs of corporate America, this hearing is adjourned.

[Whereupon, at 1:43 p.m., the hearing was adjourned.]

A P P E N D I X

March 8, 2007

Ranking Member Spencer Bachus (AL)
Opening Statement
March 8th Full Committee Hearing
"Empowering Shareholders on Executive Compensation"

Good morning and thank you, Chairman Frank, for calling this hearing today to review executive compensation.

As we begin this hearing, I want to express my willingness to keep an open mind concerning this issue. Like many of my constituents, I am troubled by news media reports of enormous compensation packages for corporate executives, especially when they seem to reward incompetence. Nonetheless, I approach this subject with abundant caution. Our system of corporate governance has evolved over decades, even centuries and we should make changes with great care. The admonition to "first, do no harm" should guide us. We should also remember the law of unintended consequences and seek as much advice as possible before changing a system that has served us well.

Lavish executive compensation packages for CEOs have contributed to the growing public perception – justified or not – that the rules in corporate America are rigged in favor of well-insulated insiders, often aided and abetted by boards of directors that have failed in their fiduciary obligations to shareholders. While I believe our overall system of corporate governance is sound, it is difficult to understand how some boards could have approved extravagant payments to executives who clearly failed to lead their companies successfully and deliver shareholder value. In fact, some recent examples seem to show outrageous rewards for rank incompetence.

While I firmly believe executive compensation should reflect performance, I believe we should consider whether it is the proper role of Congress to substitute our judgment for that of the owners expressed through their representatives on corporate boards of directors. I also question whether very large compensation packages are wrong if the executive clearly contributes to great success and substantial rewards for the stockholders. What was appropriate compensation for Jack Welch? Warren Buffett? Bill Gates? Is it misguided to reward exceptional vision, management skill and leadership with extraordinary compensation?

The bill the Chairman has introduced makes my decisions on this issue more difficult than some previous proposals that have taken a more prescriptive approach. It is crafted to require only an advisory expression by stockholders and not a vote that would bind the corporation or set compensation levels. The proposition that stockholders should have an opportunity to express their approval, or more importantly, disapproval of executive pay proposed by the board of directors is at first blush, a reasonable one.

Government intervention should be questioned in part because the system seems to be self-correcting even as we take up this issue. Indeed, at least one major U.S. corporation,

AFLAC, has already adopted this practice voluntarily, and I understand a number of others have it under consideration. If this is the direction stockholders want corporate management to take, they will reward those companies who adopt this practice and discountenance those who do not.

In other words, stockholders will exercise the right they already have and vote with their investment dollars.

The contributions of our regulatory community should also be acknowledged as we examine this issue. One example of constructive regulatory intervention is Chairman Cox's recent initiative at the SEC to require proxy statements to include comprehensive summaries of executive compensation, presented in a scorecard format that is easy for shareholders to understand. Whether we need to go beyond this robust, newly-adopted disclosure regime remains to be seen.

Transparency is one of the elements that I believe is essential to good corporate governance. The new SEC regulations seek to provide this. It should be recognized, however, that governmental actions often do have unintended consequences. Previous attempts to require companies to divulge executive compensation resulted in annual statement disclosures that compared a company's CEO pay to that of others at similar companies. Most companies try to place their CEO at the mid-point, or if they think their CEO is doing a good job, a little above the average on this scale. The result has been a perpetual pay escalator with each company moving its pay higher as each round of annual reports is issued.

This should engender caution as we address an equally well-intentioned proposal in this bill that could have outcomes we do not now contemplate.

What we do not want to do is to intervene in this issue in a way that creates additional problems. If the pendulum swings too far in the other direction, and publicly traded companies face artificial impediments to rewarding top executive talent, we could witness an exodus of qualified corporate officers to far more lucrative positions at hedge funds and private equity firms. I am always concerned about the effect of this kind of change on our global competitiveness.

Mr. Chairman, the great Scottish philosopher Adam Smith is known more for his concept of the "invisible hand" than his views on ethics. However, he believed that the concepts of fairness, trust, and reciprocity played essential roles in the functioning of the free market.

For the free enterprise system to work, shareholders need to have confidence that the businesses they invest in will engage in ethical, above-board behavior. Similarly, for the corporate system to work, shareholders must have confidence that corporate managers and boards of directors are acting in an ethical, above-board manner as well.

I look forward to the testimony of the witnesses. As the hearing proceeds, I will be listening carefully to the arguments for and against the legislation. Frankly, these

presentations will help me make up my mind on this issue. I believe it is vitally important that we get this right.

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7th District, Indiana

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Financial Services Committee
Hearing on Executive Compensation
Opening Statement of Congresswoman Julia Carson
March 8, 2007

Thank you Chairman Frank and Ranking Member Bachus for holding this hearing. I welcome the witnesses and thank them for taking the time to testify before us today.

I would like to start out by addressing some troubling trends that have become increasingly evident in the business community. News stories on corporate corruption and deceit are rampant. Executive compensation packages are created with shareholder interest as an afterthought. Public companies should be subject to shareholder scrutiny; and yet, in many of these companies, compensation packages are boosted while profits plummet.

Compensation packages disregard traditional and rational outcome-based incentives. This can be seen in companies like Blockbuster where the CEO received a 7.65 million dollar bonus while quarterly profits dropped 28 percent. Recently, Home Depot made national news as the former CEO left the company with a $210 million dollar severance package in addition to the millions he earned during his six years with the company while Home Depot suffered a stock price loss of 7.9 percent.

These packages have become extremely costly for companies, often accounting for nearly 10 percent of company profits. Further, the disparity between incomes at base levels and executive levels within corporations has grown exponentially. Rank and file employees made 140 times less than the average CEO in 1991, now that margin has grown to over 500 times. This margin is not representative of company success necessarily, rather it reflects corporate greed.

I congratulate the Chairman on his bill, HR 1257 which seeks to bolster accountability without imposing undue or unnecessary government regulation. Providing a non-binding vote has proven successful in other nations in increasing transparency in corporate operation, therefore improving trust between shareholders and CEOs.

Again, I thank the Chairman, the Ranking Member and all of the witnesses for holding and participating in this important hearing today.

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Opening Statement

Congressman Paul E. Gillmor (R-OH)

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

March 8, 2007

Hearing entitled: *"Empowering Shareholders on Executive Compensation: H.R. 1257, The Shareholder Vote on Executive Compensation Act."*

I would like to thank the Chairman for calling this hearing today. This is a public policy which deserves consideration. Far too often these days, there is kleptocracy in America's boardrooms. We have recently seen an increase in news reports of top executives who produce poor performance and are then approved excessive compensation packages by their board, often at the expense of the shareholder.

While I do not believe we are to the point of requiring legislative action to manage or advise compensation levels, this is an issue I would like to see addressed internally by all public companies. I look forward to hearing from today's panel and yield back my time.

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Written Testimony Submitted by
Professor Lucian A. Bebchuk
William J. Friedman and Alicia Townsend Friedman Professor
of Law, Economics, and Finance and
Director of the Corporate Governance Program
Harvard Law School
Before the
Committee on Financial Services
United States House of Representatives
Hearing on Empowering Shareholders on Executive Compensation
March 8, 2007

Mr. Chairman and distinguished members of the Committee, thank you very much for inviting me to testify today.[1]

Below I begin by first discussing the importance of executive compensation decisions to investors. I will then discuss the potential benefits of introducing "say on pay" arrangements – annual advisory votes on executive pay in public companies – as the U.K. and Australia did. I will next explain the reasons why, relative to the U.K. and Australia, having such votes would be especially fitting for the U.S. I will then examine possible arguments against say on pay arrangements and conclude that these arguments do not provide a good basis for opposing such arrangements. Throughout, my focus will be on the general question of whether introducing such advisory votes would be beneficial. I will conclude by noting that, although introducing such votes would be beneficial, additional reforms would be necessary to fully address concerns about executive pay.

THE IMPORTANCE OF EXECUTIVE PAY

Warren Buffet famously said that "in judging whether Corporate America is serious about reforming itself, CEO pay remains the acid test."[2] I support the introduction of "say on pay" arrangements because they will annually provide

[1]The views expressed herein are solely my own and should not be attributed to Harvard Law School or any other institution with which I am affiliated. My affiliation is noted for identification purposes only.
[2] Letter to the Shareholders of Berkshire Hathaway, Inc., February 2004

companies with valuable information about how their shareholders view company performance in this critical test.

Buffet's view about the importance of executive pay is one that is widely shared among researchers and practitioners of corporate governance, as well as among investors. During the 2006 proxy season, 23.9% of shareholder proposals focused on executive compensation (up from 15.8% in 2002).

I attach as an appendix an article co-authored with Jesse Fried that provides an overview of the flaws in existing pay arrangements, as well as the underlying governance processes that produce them. This article outlines the main elements of a detailed account of these problems we provided in an earlier book. [3]

Why does executive compensation raise serous concerns for investors? The issue is not merely symbolic but rather of practical significance. To begin, the amounts received by top executives are far from small change. They do affect investors' bottom line.[4]

Furthermore, and perhaps more importantly, flaws in pay arrangements have costs beyond the excess amounts paid to shareholders. Such flaws can dilute and distort the incentives of top executives. Among other things, there are reasons to be concerned about the following:

- The prevalence of arrangements that provide executives pushed out for failure with a "soft landing" that dilutes incentives to perform;
- Firms' failure to adopt termination arrangements that do not limit for-fault termination to extremely narrow circumstances;
- Firms' failure to adopt "claw-back" provisions enabling the recouping of compensation paid on the basis of results that are subsequently found to be incorrect;
- The design of equity-based compensation and bonus compensation in ways that enables executives to make large gains from industry-wide and market-wide movements that have nothing to do with their own performance;

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[3] A critical account of executive pay that focuses on the structure of pay arrangements and their failure to provide optimal incentives is offered in my book with Jesse Fried, Pay without Performance: The Unfulfilled Promise of Executive Compensation (Harvard University Press, 2004).

[4] For a study estimating the large amounts paid by public firms to their top-five executives, see Bebchuk & Grinstein, "The Growth of Executive Pay, " 21 *Oxford Review of Economic Policy* 283-303 (2005).

• Bonus plan practices that operate to decouple bonus compensation from performance such as lowering the goal posts after lower ones are not reached, and minimum bonus levels which provide bonus compensation in name only.
• Firms' failure to separate the vesting date of options from the date on which they may be freely exercised; and
• Firms' failure to adopt contractual limitations that prevent executives from engaging in hedging or derivative transactions that undo the incentive effects that equity-based compensation is supposed to produce.

There are additional aspects of the executive compensation landscape that in my view raise significant concerns. One of them is that public companies have consistently and persistently provided compensation in forms designed to make the amount of compensation, and the extent to which is was decoupled from performance, hidden or less transparent. While the recent disclosure reform might ensure that compensation would be more transparent in the future, past camouflage practices do raise concerns about the extent to which the design of pay arrangements can be counted on to be guided solely by shareholder interests. Another noteworthy aspect is the large body of empirical evidence that finds correlation between high pay, or performance-insensitivity pay, with factors associated with poor governance or lack of board accountability. And while past backdating practices are not expected to continue in the future, they again reveal problems about internal pay-setting processes that should be taken into account as we go forward.

To be sure, there are many who have come to the defense of existing pay arrangements.[5] But no matter how one comes out on the assessment of existing pay arrangements, there is little room for disagreement that the subject is an important one and that much turns on getting pay arrangements set in optimal ways. Executive pay matters.

Recognizing the importance of executive pay and investors' strong interest in it, last year the SEC adopted rules requiring public companies to expand their disclosures concerning executive pay. Following the adoption of these rules, a major fraction of the pages of proxy statements of public companies will be devoted to executive pay.[6] This

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[5] See, e.g., John E. Core, Wayne R. Guay, and Randall S. Thomas, Is U.S. CEO Compensation Inefficient Pay Without Performance? 103 *Michigan Law Review* 1142-1185 (2005); 26 *Oxford Journal of Legal Studies* 219-233 (2006); Bengt Holmstrom, Pay without Performance and the Managerial Power Hypothesis: A Comment, *Journal of Corporation Law* (2005).
[6] For example, in the 2007 proxy statement of the Walt Disney Company, whose annual meeting takes place on the date of this hearing, out of the statement's 54 pages (excluding cover pages,

expansive treatment of the subject in the proxy statements sent to investors prior to the annual meeting is yet another sign of the important place that executive pay now has in our corporate governance system.

THE VALUE OF SAY ON PAY

The SEC's disclosure reforms will provide additional information to the marketplace but will not, by themselves, improve pay arrangements. For the provision of this information to improve executive compensation, investors must have the ability to use such information.[7] As I will stress below, shareholders' rights in the U.S. are weak and significantly weaker than in other common law countries with dispersed ownership.

Introducing advisory votes on compensation at the annual meeting, as the U.K. and Australia did, would help shareholders influence pay arrangements and would move pay arrangements toward those that best serve shareholder interests. Such votes would express the collective judgment of the shareholders about the quality of the company's pay arrangements. An expression of widespread shareholder dissatisfaction would provide a valuable signal to the board.

Furthermore, the fact that the outcome of the vote would be publicly known would apply some pressure on the board to take the shareholders' preferences into account. Public companies have often been responsive to large votes in favor of precatory shareholder resolutions. Although they sometimes elect to ignore resolutions that attract strong shareholder support,[8] companies also sometimes elect to implement them and sometimes elect to address the concerns reflected in them in some other way. Overall, precatory resolutions have induced boards to move in directions for which there is strong support among shareholders. I expect that advisory votes on executive pay would similarly induce boards to give greater weight to shareholder views and preferences on this subject and would discourage practices and decisions that are strongly opposed by shareholders.

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table of content, and appendices), 23 pages are devoted to reporting about the company's compensation of top executives another 11 pages are devoted to the description of stock incentive and executive performance plan brought for shareholder approval.

[7]See Bebchuk, Op-Ed: Investors Must Have Power, Not Just Figures on Pay *Financial Times*, July 27, 2006; Bebchuk, Beyond Disclosure, *Forbes*, January 19, 2006.

[8] For evidence that boards sometimes elect to ignore majority-passed precatory resolutions, see Bebchuk, "The Case for Increasing Shareholder Power," 118 *Harvard Law Review* 833-914 (2005).

WHY SAY ON PAY IS ESPECIALLY FITTING FOR THE U.S.

While say on pay exists in both the U.K. and Australia, two countries with similar public companies, there are two aspects of the U.S. which make the case for such advisory votes even stronger than it is for these other countries.

The Weakness of Shareholder Rights in the U.S.

To begin, shareholder rights in the U.S. are weaker than they are in the U.K. and Australia. Given how much shareholders' hands are tied by U.S. rules, providing some means of influencing firm policy is especially needed.

The ways in which shareholder rights in the U.S. are weaker than in the U.K. include the following:

• While U.K. shareholders always have the power to remove directors, shareholders of many U.S. companies cannot remove directors during the term to which they were elected; terms can be as long as three years, as is the case in companies that have staggered boards (roughly half of all public companies).

• While U.K. shareholders always have the power to call a special meeting, shareholders of many public companies in the U.S. do not have such power and cannot initiate shareholder action between annual meetings.

• U.K. shareholders, but not U.S. shareholders, have the power to place director candidates on the corporate ballot.

• While mandatory U.K. laws provide shareholders with the power to amend the articles of incorporation by special resolution, in the U.S. mandatory rules deny shareholders the power to initiate changes in the corporate charter and reserve such initiation power for the board.

• Whereas U.K. boards may not use defensive tactics that block unsolicited takeover bids, U.S. boards are permitted to use powerful defensive tactics that insulate them from the discipline of the market for corporate control.

The U.S. Experience with Advisory Votes

The adoption of advisory votes on executive compensation was accompanied in the U.S. and the U.K. by objections that advisory votes on matters outside shareholders' constitutional powers in the company should not become an element of these countries'

corporate law structures.[9] In the U.S., however, advisory votes on many issues have long been a standard practice with which both boards and investors are familiar. Introducing advisory votes on compensation would be a natural extension of existing practices.

POSSIBLE OBJECTIONS TO SAY ON PAY

Below I discuss several possible objections that are likely to be raised against introduction of say on pay arrangements. Some (but not all) of these objections are ones that are commonly raised against any proposals to increase shareholder power or involvement. My conclusion is that none of these objections provide a good basis for opposing the proposed arrangements.

Companies Already Get Input from Shareholders

Many boards, it might be argued, solicit or obtain shareholders' views about various matters including the company's executive pay arrangements, and such "informal" channels of communications make a "formal" advisory vote unnecessary. While some boards communicate regularly with shareholders, others – which might be disproportionately ones that prefer not to hear what shareholders might have to say -- do not. Furthermore, because the fraction of shareholders participating in an advisory vote is likely to exceed the fraction of shareholders participating in informal communications with the company, having an advisory vote in addition to informal communications would help the board gain a fuller picture of shareholders' collective view. Finally, as explained earlier, an advisory vote would provide information about shareholders' views concerning the board's performance not only to the board but also to the marketplace. When substantial shareholder dissatisfaction exists, informal communications between shareholders and the board would not make public in a clear way the extent of shareholder dissatisfaction and thus might not have the same ability as an advisory vote to induce the board to improve executive pay.

Difficulty of Interpreting a Negative Shareholder Vote

In the event that many shareholders would vote against the company's pay arrangements in an advisory vote, it might be argued, the board might have difficulty knowing which elements of the compensation arrangement the investors oppose. I doubt, however, that in cases of a strong negative vote, the board would be in the dark

[9] See Larelle Chapple & Blake Christensen, "The Non-Binding Vote on Executive Pay: A Review of the CLERP 9 Reform" (2005) 18 Australian J Corp L 263.

about the reasons for shareholder dissatisfaction. Most likely, the board would know the reasons for shareholder opposition – from informal communications with investors, explanations accompanying the recommendations of shareholder advisory firms, and the directors' own sense of the ways in which the company's pay arrangements stand out – and would learn from the advisory vote the extent to which the objections are widely shared among the company's shareholders. Furthermore, getting a "noisy" signal that shareholder dissatisfaction about the company's pay arrangements is widespread would still make the board more informed, even if the signal is somewhat difficult to interpret, compared with not getting the signal at all.

Finally, note that, in the many public companies that still do not have majority voting, withhold votes now perform a communicative role similar to an advisory vote on compensation. In these companies, a large number of withhold votes would not affect the results of director elections but rather would send the board a signal of shareholder dissatisfaction. Given that shareholders casting a withhold vote might be concerned not only about compensation but also about other issues, the signals sent by withhold votes might be more difficult to interpret, and are unlikely to be easier to interpret, than the signals that advisory votes on compensation would send. Nonetheless, the number of withhold votes cast is viewed as providing information to boards, and the ability of shareholders to cast withhold votes is generally not questioned.

Shareholders' Imperfect Information

Advisory votes would not be useful, it might be argued, because shareholders have less information than boards and thus are in relatively worse position to assess the merits of the company's compensation decisions. However, although shareholders might be less well-informed about the subject than directors, shareholders might well have the strongest incentives to act in the way best for shareholders. Furthermore, while institutional investors might be less informed about company-specific facts, they are likely to recognize whatever information disadvantage they have. Such recognition at least partly underlies the tendency of many institutional investors to display considerable deference to boards' judgments on many issues. Thus, it can be expected that such institutional investors participating in advisory votes on compensation would commonly display some deference to the board's decisions and would cast a "no" vote only when they see some good reasons that warrant such a vote.

Use by Shareholders with Special Interests

An argument regularly made against any proposed reforms to increase shareholders' role is that the reform would be used by shareholders with special interests to advance their interests (e.g., to advance the interests of employees or some environmental causes) at the expense of shareholders' long-term value. However, the outcome of advisory votes on compensation would primarily be determined by the views of the majority of shareholders, not by the views of small minorities motivated by special interests. Furthermore, one concern commonly raised about the use of shareholder proposals by special interest shareholders – that such shareholders would not be able to determine the outcome of votes on proposals but would be able to extract concessions from the company by threatening to initiate proposals – is completely inapplicable for legislation introducing advisory votes on compensation. Because such legislation would introduce advisory votes as the standard arrangement for public companies without the need for shareholder initiation, it could not provide shareholders with blackmail power based on the threat to initiate votes that management prefers not to have.

Shareholders Should Limit Themselves to Electing and Replacing Directors

The corporation, it might be argued, should be a purely representative democracy in which shareholders are able to affect outcomes only through their choice of directors. On this view, as long as directors are in office, shareholders should not engage in "back-seat driving" by second-guessing directors' decisions and expressing views on particular issues from their back seats. Shareholders, so the argument goes, are free to replace the incumbent directors with another team, but as long as they refrain from doing so, it would be counter-productive for shareholders not to let the directors completely run the show. This argument, however, overlooks the significant existing impediments to director replacement. Moreover, it is entirely possible for shareholders to view as adequate the overall performance of incumbent directors, and thus to prefer to keep them in office, and at the same time critically view the directors' compensation decisions. In such a case, it would be desirable to enable the shareholders to seek changes in the board's compensation strategy while keeping the directors in office, and an advisory vote on compensation could be useful in shareholders' effort to secure such an outcome.

Congress Should be Wary of Imposing Mandatory Requirements

While the securities laws impose a wide range of mandatory rules on public companies, it might be argued that Congress should, at least going forward, be wary of adding any additional mandatory arrangements on public companies and should leave the introduction of governance arrangements to private ordering in the marketplace. This argument, however, overlooks the significant existing impediments to adoption of new governance arrangements by shareholders. Furthermore, in assessing this consideration, it is important to keep in mind that the proposed legislation would not impose any outcomes on firms, and would not even impose any process that could produce binding outcomes, but would only introduce an advisory vote.

In any event, to the extent that one is still concerned about the imposition of a requirement of holding a vote on public companies whose shareholders might prefer not to hold such a vote, this concern can be addressed by allowing companies to opt out of the requirement with shareholder approval. For example, the requirement could be designed to be inapplicable to any public companies that have a shareholder-adopted bylaw that prohibits such a vote.

BEYOND SAY ON PAY

Before concluding, I would like to stress that reform based on introducing advisory votes on compensation would not do too much but rather would do too little to address the problems of executive pay as well as corporate governance more generally. Although advisory votes would have a beneficial effect, as discussed above, introducing them would still leave shareholders with far weaker rights that they should have and than they have in other common law countries. It would be desirable to dismantle existing impediments to shareholders' ability to replace directors and to shape companies' corporate governance arrangements.[10] This broader point should be kept in mind as the Committee proceeds to consider the subject of say on pay.

[10] I put forward a detailed program for such reforms in Bebchuk, "The Case for Increasing Shareholder Power," 118 *Harvard Law Review* 833-914 (2005); Bebchuk, "The Myth of the Shareholder Franchise," Harvard Law School Olin Discussion Paper No. 565 (2006), forthcoming, *Virginia Law Review* _ (2007), available at http://ssrn.com/abstract=829804.

Pay Without Performance: Overview of the Issues

by Lucian A. Bebchuk, Harvard Law School, and Jesse M. Fried, University of California at Berkeley*

In judging whether Corporate America is serious about reforming itself, CEO pay remains the acid test. To date, the results aren't encouraging.
—Warren Buffett, letter to shareholders of Berkshire Hathaway Inc. (February 2004)

In our recent book, *Pay Without Performance*,[1] and in several accompanying and subsequent papers,[2] we seek to provide a full account of how managerial power and influence have shaped executive compensation in publicly traded U.S. companies. Financial economists studying executive compensation have typically assumed that pay arrangements are produced by *arm's-length contracting*—contracting between executives attempting to get the best possible deal for themselves and boards trying to get the best deal for shareholders. This assumption has also been the basis for the corporate law rules governing the subject. We aim to show, however, that the pay-setting process in U.S. public companies has strayed far from the arm's-length model.

Our analysis indicates that managerial power has played a key role in shaping executive pay. The pervasive role of managerial power can explain much of the contemporary landscape of executive compensation, including practices and patterns that have long puzzled financial economists. We also show that managerial influence over the design of pay arrangements has produced considerable distortions in these arrangements, resulting in costs to investors and the economy. This influence has led to compensation schemes that weaken managers' incentives to increase firm value and even create incentives to take actions that *reduce* long-term firm value.

The dramatic rise in CEO pay during the last two decades has been the subject of much public criticism, which intensified following the corporate governance scandals that began erupting in late 2001. The wave of corporate scandals shook confidence in the performance of public company boards and drew attention to possible flaws in their executive compensation practices. As a result, there is now widespread recognition that many boards have employed compensation arrangements that do not serve shareholders' interests. But there is still substantial disagreement about the scope and source of such problems and, not surprisingly, about how to address them.

Many take the view that concerns about executive compensation have been exaggerated. Some maintain that flawed compensation arrangements have been limited to a relatively small number of firms, and that most boards have effectively carried out their role of setting executive pay. Others concede that flaws in compensation arrangements have been widespread, but maintain that these flaws have resulted from honest mistakes and misperceptions on the part of boards seeking to serve shareholders. According to this view, now that the problems have been recognized, corporate boards can be expected to fix them on their own. Still others argue that, even though regulatory intervention was necessary, recent reforms that strengthen director independence will fully address past problems; once these

* This paper is a revision of an article prepared for the summer 2005 issue of the *Journal of Corporation Law*. For financial support, we would like to thank the John M. Olin Center for Law, Economics, and Business and the Guggenheim, Lens, and Nathan Cummins Foundations (Bebchuk); and the Boalt Hall Fund and the U.C. Berkeley Committee on Research (Fried).

1. Lucian A. Bebchuk and Jesse M. Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Cambridge, MA: Harvard University Press, 2004). Earlier articles by us on which the book draws include Lucian A. Bebchuk, Jesse M. Fried, and David I. Walker, "Managerial Power and Rent Extraction in the Design of Executive Compensation," *University of Chicago Law Review*, Vol. 69 (2002), pp. 751-846; and Lucian A. Bebchuk and Jesse M. Fried, "Executive Compensation as an Agency Problem," *Journal of Economic Perspectives*, Vol. 17 (2003), pp. 71-92.

2. These studies include Lucian A. Bebchuk and Jesse M. Fried, "Stealth Compensation via Retirement Benefits," *Berkeley Business Law Journal*, Vol. 2 (2004), pp. 291-325; Lucian A Bebchuk and Jesse M. Fried, "Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives, Nonperformance Pay, and Camouflage," forthcoming in *Journal of Corporation Law* (2005); Lucian A. Bebchuk and Yaniv Grinstein, "The Growth of Executive Pay," *Oxford Review of Economic Policy*, Vol. 21 (2005), pp. 282-303; Lucian A. Bebchuk and Robert Jackson, Jr., "Putting Executive Pensions on the Radar Screen," Harvard Olin Paper No. 507, forthcoming in *Journal of Corporation Law* (2005); and Lucian A. Bebchuk and Yaniv Grinstein, "Firm Expansion and CEO Pay," Working Paper, Harvard Law School and NBER (2005).

reforms are implemented, boards can be expected to adopt shareholder-serving pay policies.

Our work seeks to persuade readers that such complacency is unwarranted. To begin with, flawed compensation arrangements have not been limited to a small number of "bad apples"; they have been widespread, persistent, and systemic. Furthermore, the problems have not resulted from temporary mistakes or lapses of judgment that boards can be expected to correct on their own; rather they have stemmed from structural defects in the underlying governance structure that enable executives to exert considerable influence over their boards. The absence of effective arm's-length dealing under today's system of corporate governance has been the primary source of problematic compensation arrangements. Finally, while recent reforms that seek to increase board independence will likely improve matters, they will not be sufficient to make boards adequately accountable; much more needs to be done.

Another, broader aim of our work has been to contribute to a better understanding of some basic problems with the U.S. corporate governance system. The study of executive compensation opens a window through which we can examine our current reliance on boards to act as guardians of shareholders' interests. Our corporate governance system gives boards substantial power and counts on them to monitor and supervise company managers. As long as corporate directors are believed to carry out their tasks for the benefit of shareholders, current governance arrangements—which insulate boards from intervention by shareholders—appear acceptable. Our analysis of the executive pay landscape casts doubt on the validity of this belief and on the wisdom of insulating boards from shareholders.

A full understanding of the flaws in current compensation arrangements, and in the governance processes that have produced them, is necessary to address these problems. After providing a full account of the existing problems, our work also puts forward a set of proposals for improving both executive pay and corporate governance. We provide detailed suggestions for making both the amount of pay and its performance-sensitivity more transparent. Such transparency will provide a better check on managers' power to influence their own pay. It will also eliminate existing incentives to choose compensation arrangements that are less efficient but more effective in camouflaging either the amount of pay or its insensitivity to managers' own performance.

Furthermore, our analysis of the many ways in which pay schemes weaken or distort managerial incentives provides a basis for recommending how corporate boards could strengthen the link between pay and performance and thereby improve incentives. Finally, we propose a number of reforms that would make directors not only more independent of insiders but also more dependent on shareholders, thus improving board accountability to shareholders. Such reforms may well offer the most promising route for improving executive compensation and corporate governance more generally.

In this paper, we outline some of the main elements of our critique of contemporary executive compensation and corporate governance arrangements, as well as our proposals and suggested reforms. We start by describing the limitations of the official arm's-length model of executive compensation. We then turn to the managerial power perspective. We show that managerial influence can explain many features of the compensation landscape, and explain how this influence has led to opaque and distorted pay arrangements. We conclude with a discussion of our proposals for making pay more transparent, improving the design of pay arrangements, and increasing board accountability.

Before proceeding, we want to emphasize that our critique of existing pay arrangements and pay-setting processes does not imply that most directors and executives have acted less ethically than others would have in their place. Our problem is not with the moral caliber of directors and executives, but rather with *the system* of arrangements and incentives within which directors and executives operate. As currently structured, our corporate governance system unavoidably creates incentives and psychological and social forces that distort pay choices. Such incentives and forces can be expected to lead most people to go along with arrangements that favor their colleagues or individuals who can in turn favor them, as long as these arrangements are consistent with prevailing practices and conventions and thus not difficult to justify to themselves and to others. If we were to maintain the basic structure of the system and merely replace current directors and executives with a different set of individuals, the new directors and executives would be exposed to the same incentives and forces as their predecessors and, by and large, we would not expect them to act any differently. To address the flaws in the pay-setting process, we need to change the governance arrangements that produce these distortions.

The Stakes

What is at stake in the debate over executive pay? Some might question whether executive compensation has a significant economic impact on shareholders and the economy. The problems with executive compensation, it might be argued, do not much affect shareholders' bottom line, but instead are mainly symbolic. However, the question of whether and to what extent pay arrangements are flawed is important for shareholders and policymakers because defects in these arrangements can impose substantial costs on shareholders.

Let's start with the excess pay that managers receive as a result of their power—that is, the difference between what managers' influence enables them to obtain and what they would get under arm's-length contracting. As a recent study

Table 1 **Aggregate Top-Five Compensation, 1993-2003 (in billions of 2002 dollars)**

	Period	All ExecuComp Firms	Non-ExecuComp Firms	All Firms
Full period:	1993-2003	212	139	351
First five years:	1993-1997	68	55	123
Last five years:	1999-2003	122	70	192

Notes: The table shows aggregate compensation paid by a large set of public firms to their top five executives. The sample includes all ExecuComp firms and Compustat firms with market cap larger than $50 million except for REITs, mutual funds, other investment funds (SIC codes 67xx), and firms with missing Compustat data. The compensation paid to executives of non-ExecuComp firms is estimated using the coefficients from annual regressions of compensation on firm characteristics in ExecuComp firms.
Source: Bebchuk and Grinstein, "The Growth of Executive Pay."

Table 2 **Compensation and Corporate Earnings**

	Period	Aggregate Top-Five Compensation to Aggregate Earnings
Three-year periods:	1993-1995	5.0%
	1994-1996	4.9%
	1995-1997	5.2%
	1996-1998	5.5%
	1997-1999	6.0%
	1998-2000	6.5%
	1999-2001	8.6%
	2000-2002	12.8%
	2001-2003	9.8%
Five-year periods:	1993-1997	5.2%
	1999-2003	8.1%
Full period:	1993-2003	6.6%

Notes: The table shows, for a large set of public firms, the ratio of the aggregate compensation of these firms' top-five executives to the aggregate earnings (net income) of these firms. The set of firms includes all ExecuComp firms and Compustat firms with market cap larger than $50 million except for REITs, mutual funds, other investment funds, and firms with missing Compustat data. Income information is from Compustat, and the estimates of aggregate top-five compensation are calculated in the same way as in Table 1.
Source: Bebchuk and Grinstein, "The Growth of Executive Pay."

by Yaniv Grinstein and one of us documents in detail,[3] the amounts involved are hardly pocket change for shareholders. Among other things, this study provides figures for the aggregate compensation of the top five executives of publicly traded U.S. firms. According to the study's estimates, which are shown in Table 1, these companies paid their top five executives a total of $351 billion during the eleven-year period 1993-2003, with about $192 billion paid during the five-year period 1999-2003. Note that the aggregate compensation figures reported by the study reflect only those amounts reported in each firm's annual summary compensation table. As will be discussed later, standard executive compensation datasets (like the ExecuComp dataset used in the study) omit many significant forms of compensation, such as the substantial amounts of retirement benefits received by executives. Thus, the aggregate compensation figures may significantly understate the actual compensation received by top executives during this period.

Table 2 displays the ratio of aggregate top-five compensation to aggregate corporate earnings for publicly traded U.S. firms. Such aggregate compensation accounted for 6.6% of the aggregate earnings (net income) of publicly traded U.S. firms during the period 1993-2003. Moreover, during the most recent three-year period examined by the study (2001-2003), aggregate top-five compensation jumped to 9.8% of aggregate earnings, up from 5% during the period 1993-1995.

These figures indicate that if compensation levels could be cut without weakening managerial incentives, the gain to investors would not be merely symbolic; it would have a discernible effect on corporate earnings. But excess pay is unlikely to be the only or even the main cost of current

3. Bebchuk and Grinstein, "The Growth of Executive Pay," cited earlier.

compensation practices. Managers' influence over their compensation arrangements can result in the weakening and distortion of managerial incentives. In our view, the dilution and distortion of incentives could well impose a larger cost on shareholders than excessive compensation per se.

Existing pay arrangements have been producing two types of incentive problems. First, compensation arrangements have provided weaker incentives to increase shareholder value than would have been provided under arm's-length contracting. Both the non-equity and equity components of managerial compensation have been more sharply decoupled from managers' contribution to company performance than appearances might suggest. Making pay more sensitive to performance could therefore have substantial benefits for shareholders.

Second, prevailing practices not only fail to provide cost-effective incentives to increase value but also create perverse incentives. For example, managers' broad freedom to unload company options and stock can lead them to act in ways that reduce shareholder value. Executives who expect to unload shares have incentives to report misleading results, suppress bad news, and choose projects and strategies that are less transparent to the market. The efficiency costs of such distortions may well exceed—possibly by a large margin—whatever liquidity or risk-bearing benefits executives obtain from being able to unload their options and shares at will. Similarly, because existing pay practices often reward managers for increasing firm size, they provide executives with incentives to pursue expansion through acquisitions or other means, even when that strategy is value-reducing.

The Arm's-Length Contracting View

According to the "official" view of executive compensation, corporate boards setting pay arrangements are guided solely by shareholder interests and operate at arm's length from the executives whose pay they set. The premise that boards contract at arm's length with executives has long been and remains a central tenet in the corporate world and in most research on executive compensation by financial economists. In the corporate world, the official view serves as the practical basis for legal rules and public policy. It is used to justify directors' compensation decisions to shareholders, policymakers, and courts. These decisions are portrayed as being made largely with shareholders' interests at heart and therefore deserving of deference.

The premise of arm's-length contracting has also been shared by most of the research on executive compensation. Managers' influence over directors has been recognized by those writing on the subject from legal, organizational, and sociological perspectives, as well as by media commentary on executive pay. But the vast majority of research on executive pay has been done by financial economists, and most of their work assumes that corporate boards adopt pay arrangements that serve shareholders by providing managers with cost-effective incentives to maximize value. Because boards and executives operating at arm's length have incentives to avoid inefficient provisions, the arm's-length contracting view has led researchers to assume that executive compensation arrangements will tend to increase value.[4] Some financial economists, whose studies we discuss at length in our book, have reported findings they viewed as inconsistent with the arm's-length model.[5] However, most work in the field has started from the premise of arm's-length contracting between boards and executives.

Financial economists, both theorists and empiricists, have largely worked within the arm's-length model in attempting to explain common compensation arrangements as well as differences in compensation practices among companies.[6] In fact, upon discovering practices that appear inconsistent with the cost-effective provision of incentives, financial economists have labored to come up with clever explanations for how such practices might be consistent with arm's-length contracting after all. Practices for which no explanation has been found have been described as "anomalies" or "puzzles" that will ultimately either be explained within the paradigm or disappear.

In our book, we identified many compensation practices that are difficult to understand under the arm's-length contracting view but can readily be explained by managerial influence over the pay-setting process. In response, critics suggested reasons why some of these practices could still have an explanation within an arm's-length contracting framework and argued that we have therefore not succeeded in ruling out completely the possibility of arm's-length dealing. For example, in response to our account of the significant extent to which pay is decoupled from performance, John Core, Wayne Guay, and Randall Thomas argue that there are circumstances in which large amounts of non-performance pay might be desirable.[7] Similarly, in response to our criticism of the widespread failure of firms

4. The link between arm's-length contracting and efficient arrangements has led us to label arm's-length contracting as "efficient contracting" or "optimal contracting" in some of our earlier work. See Bebchuk, Fried, and Walker, (2002), cited earlier; Bebchuk and Fried (2003), cited earlier.

5. See, e.g., Olivier Jean Blanchard, Florencio Lopez-de-Silanes and Andrei Shleifer, "What Do Firms Do with Cash Windfalls?," *Journal of Financial Economics*, Vol. 36 (1994), pp. 337-360; David Yermack, "Good Timing: CEO Stock Option Awards and Company News Announcements," *Journal of Finance*, Vol. 52 (1997), pp. 449-476; and Marianne Bertrand and S. Mullainathan, "Are CEOs Rewarded for Luck? The Ones without Principals Are," *Quarterly Journal of Economics*, Vol. 116 (2001), pp. 901-932.

6. For surveys from this perspective in the finance and economics literature, see, for example, John M. Abowd and David S. Kaplan, "Executive Compensation: Six Questions That Need Answering," *Journal of Economic Perspectives*, Vol. 13 (1999), pp. 145-168; and John E. Core, Wayne Guay, and David F. Larcker, "Executive Equity Compensation and Incentives: A Survey," *Economic Policy Review*, Vol. 9 (2003), pp. 27-50.

7. See, e.g., John E. Core, Wayne R. Guay, and Randall S. Thomas, "Is U.S. CEO Compensation Inefficient?," *Michigan Law Review*, Vol. 103 (2005), pp. 1142-1185.

to adopt option plans that filter out windfalls, both Jeff Gordon and Bengt Holmstrom argue that our analysis has not completely ruled out the possibility of explaining such failure within the arm's-length contracting model.[8]

These arguments reflect an implicit presumption in favor of arm's-length contracting: pay arrangements are assumed to be the product of arm's-length contracting unless one can prove otherwise. The presumption of arm's-length contracting, however, does not seem warranted. As we discuss below, an examination of the pay-setting process suggests that managerial influence seems likely to play a key role. Thus, given the *a priori* likelihood of managerial influence, the burden of proof should be on those arguing that executive pay arrangements are not significantly shaped by such influence. In any event, the fact that financial economists continue implicitly or explicitly to use arm's-length contracting as their baseline presumption indicates the dominance and power of this long-held view.

Limits of the Arm's-Length View

The official arm's-length story is neat, tractable, and reassuring. But it fails to account for the realities of executive compensation.

The arm's-length contracting view recognizes that managers are subject to an agency problem and do not automatically seek to maximize shareholder value. The potential divergence between managers' and shareholders' interests makes it important to provide managers with adequate incentives. Under the arm's-length view, the board attempts to provide such incentives cost-effectively through managers' compensation packages. But just as there is no reason to assume that managers automatically seek to maximize shareholder value, there is no reason to expect that directors will either. Indeed, an analysis of directors' incentives and circumstances suggests that director behavior is also subject to an agency problem.

Directors have had and continue to have various economic incentives to support, or at least go along with, arrangements that favor the company's top executives. A variety of social and psychological factors—collegiality, team spirit, a natural desire to avoid conflict within the board, friendship and loyalty, and cognitive dissonance—exert additional pull in that direction. Although many directors own some stock in their companies, their ownership positions are too small to give them a financial incentive to take the personally costly, or at the very least unpleasant, route of resisting compensation arrangements sought by executives. In addition, limitations on time and resources have made it difficult for even well-intentioned directors to do their pay-setting job properly. Finally, the market constraints within which directors operate are far from tight and do not prevent deviations from arm's-length contracting outcomes in favor of executives. Below we briefly discuss each of these factors.

Incentives to be Re-Elected

Besides an attractive salary, a directorship is also likely to provide prestige and valuable business and social connections. The financial and nonfinancial benefits of holding a board seat naturally give directors an interest in keeping their positions.

In a world where shareholders select individual directors, board members might have an incentive to develop reputations as shareholder-serving. Typically, however, the director slate proposed by management is the only one offered. The key to retaining a board position is thus being placed on the company's slate. And because the CEO has had significant influence over the nomination process, displeasing the CEO has been likely to hurt one's chances of being put on the company slate. Directors have thus had an incentive to go along with the CEO's pay arrangement as long as the compensation package remains within the range of what can plausibly be defended and justified. In addition, developing a reputation as a director who blocks compensation arrangements sought by executives can only hurt a director's chances of being invited to join other boards.

The new stock exchange listing requirements, which attempt to give independent directors a greater role in director nominations, weaken but do not eliminate executives' influence over director nominations. The CEO's wishes can be expected to continue to influence the decisions of the nominating committee; after all, the directors appointed to the board are expected to work closely with the CEO. As a practical matter, director candidates who are opposed by the CEO are not expected to be offered board nomination and would likely decline the nomination if it were offered.[9] Even if the CEO had no influence over nominations, members of the nominating committee would be unlikely to look favorably on an individual who has taken a tough position on the CEO's pay. They might wish to avoid the friction and unpleasantness accompanying disputes over the CEO's pay, or might simply side with the CEO for other reasons discussed below.

CEOs' Power to Benefit Directors

There are a variety of ways in which CEOs can benefit individual directors or board members as a group. For one thing, CEOs have influence over director compensation. As the company leader, usually as a board member, and often as

8. See Bengt Holmstrom, "Comments on Bebchuk and Fried's book 'Pay Without Performance: The Unfulfilled Promise of Executive Compensation'," forthcoming in *Journal of Corporation Law* (2005); Jeffrey Gordon, "Executive Compensation: If There's a Problem, What's the Remedy? The Case for 'Compensation Disclosure and Analysis'," *Journal of Applied Corporate Finance* (this issue).

9. Daniel Nasaw, "Opening the Board: The Fight Is On to Determine Who Will Guide the Selection of Directors in the Future," *Wall Street Journal* (October 27, 2003), p. R8.

board chairman, the CEO can choose either to discourage or encourage increases in director pay. Independent directors who are generous toward the CEO might reasonably expect the CEO to use his or her bully pulpit to support higher director compensation. At a minimum, generous treatment of the CEO contributes to an atmosphere that is conducive to generous treatment of directors. And in fact, a study finds that companies with higher CEO compensation have higher director compensation as well—and that such high pay levels appear to reflect insider "cooperation" rather than superior corporate performance.[10]

CEOs also have often used their power over corporate resources to reward individual directors who were particularly cooperative. The new stock exchange listing standards place some limits on CEOs' ability to reward independent directors, but they do leave CEOs with substantial power in this area. For example, these requirements allow the company to pay $100,000 in additional compensation to an independent director. And there is no limit to how much the firm can pay an independent director's immediate family members, as long as they are non-executive employees.

Similarly, the requirements limit but do not prohibit business dealings between a company and an independent director's firm, and they place no limit on the company's dealings with the director's firm before or after the director qualifies for independent director status. The standards also permit unlimited contributions to charitable organizations that independent directors run, are affiliated with, or simply favor. In sum, executives' control over corporate resources continues to enable them to provide many directors with rewards—rewards that generally outweigh the small direct personal cost to most directors of approving pay arrangements that fail to serve shareholder interests.

Friendship and Loyalty

Many independent directors have some prior social connection to the company's CEO or other senior executives. Even directors who did not know the CEO before their appointment may well have begun their service with a sense of obligation and loyalty to the CEO. The CEO often will have been involved in recruiting the director to the board. As a result, directors often start serving with a reservoir of good will toward the CEO, which will contribute to a tendency to favor the CEO on compensation matters. This kind of reciprocity is expected and observed in many social and professional contexts. Not surprisingly, studies find that compensation committees whose chairs have been appointed after the CEO takes office have tended to award higher CEO compensation.[11]

Collegiality and Authority

In addition to friendship and loyalty considerations, there are other social and psychological forces that make it difficult for directors to resist executive-serving compensation arrangements. The CEO is the directors' colleague, and directors are generally expected to treat their fellow directors collegially. The CEO is also the company's leader, the person whose decisions and visions have the most influence on the firm's future direction. In most circumstances, directors treat the CEO with respect and substantial deference. Switching hats to contract at arm's length with one's colleague and leader is naturally difficult.

Cognitive Dissonance and Solidarity

Many members of compensation committees are current and former executives of other companies. Because individuals have a tendency to develop views that are consistent with their self-interest, executives and former executives are likely to have formed beliefs that support the type of pay arrangements from which they themselves have benefited. An executive who has benefited from a conventional option plan, for example, is more likely to resist the view that such plans provide executives with excessive windfalls.

Further reinforcing such cognitive dissonance, an executive who serves as a director in another firm might identify and feel some solidarity or sympathy with that firm's executives and naturally would be inclined to treat these executives the same way he or she would like to be treated. Not surprisingly, there is evidence that CEO pay is correlated with the pay levels of the outside directors serving on the compensation committee.[12]

The Small Cost of Favoring Executives

Directors typically own only a small fraction of the firm's shares. As a result, the direct personal cost to board members of approving compensation arrangements that are too favorable to executives—the reduction in the value of their shareholdings—is small. This cost is therefore unlikely to outweigh the economic incentives and social and psychological factors that induce directors to go along with pay schemes that favor executives.

Ratcheting

It is now widely recognized that the rise in executive compensation has in part been driven by many boards seeking to pay their CEO more than the industry average; this widespread practice has led to an ever-increasing average and a continuous escalation of executive pay.[13] A review

10. Ivan E. Brick, Oded Palmon, and John K. Wald, "CEO Compensation, Director Compensation, and Firm Performance: Evidence of Cronyism," forthcoming in *Journal of Corporate Finance* (2005).

11. Brian G. M. Main, Charles A. O'Reilly III, and James Wade, "The CEO, the Board of Directors, and Executive Compensation: Economic and Psychological Perspectives," *Industrial and Corporate Change*, Vol. 11 (1995), pp. 292-332.

12. Main, O'Reilly III, and Wade (1995), cited earlier.

13. Kevin J. Murphy, "Executive Compensation," in *Handbook of Labor Economics*, edited by Orley Ashenfelter and David Card (New York: Elsevier, 1999).

of reports of compensation committees in large companies indicates that a large majority of them used peer groups in determining pay and set compensation at or above the 50th percentile of the peer group.[14] Such ratcheting is consistent with a picture of boards that do not seek to get the best deal for their shareholders, but are happy to go along with whatever can be justified as consistent with prevailing practices.

Limits of Market Forces

Some writers have argued that even if directors are under the considerable influence of corporate executives, market forces will force boards and executives to adopt the compensation arrangements that arm's-length contracting would produce. Our analysis, however, finds that market forces are neither sufficiently fine-tuned nor sufficiently powerful to compel such outcomes. The markets for capital, corporate control, and managerial labor do impose *some* constraints on executive compensation. But these constraints are by no means stringent and they permit substantial deviations from arm's-length contracting.

Consider, for example, the market for corporate control—the threat of a takeover. Most companies have substantial defenses against takeovers. For example, a majority of companies have a staggered board, which prevents a hostile acquirer from gaining control before two annual elections are held, and often enables incumbent managers to block hostile bids that are attractive to shareholders. To overcome incumbent opposition, a hostile bidder must be prepared to pay a substantial premium.[15] The disciplinary force of the market for corporate control is further weakened by the prevalence of golden parachute provisions, as well as by payoffs made by acquirers to target managers to facilitate the acquisition. The market for corporate control thus exerts little disciplining force on managers and boards, leaving them with considerable slack and the ability to negotiate manager-favoring pay arrangements.

New CEOs

Some critics of our work have assumed that our analysis of managerial influence does not apply when boards negotiate pay with a CEO candidate from outside the firm.[16] However, while such negotiations might be closer to the arm's-length model than negotiations with an incumbent CEO, they still fall quite short of this benchmark.

Among other things, directors negotiating with an outside CEO candidate know that, after the candidate becomes CEO, he or she will have influence over their renomination to the board and over their compensation and perks. The directors will also wish to have good personal and working relationships with the individual who is expected to become the firm's leader and a fellow board member. And while agreeing to a pay package that favors the outside CEO imposes little financial cost on directors, a breakdown in the negotiations, which might embarrass the directors and force them to re-open the CEO selection process, would be personally costly to them. Finally, directors' limited time forces them to rely on information shaped and presented by the company's human resources staff and compensation consultants, all of whom have incentives to please the incoming CEO.

Firing of Executives

Some have suggested that the increased willingness of directors to force out CEOs over the past decade, especially in recent years, provides evidence that boards do in fact deal with CEOs at arm's length.[17] However, firings or resignations under fire are still limited to unusual situations in which the CEO is accused of legal or ethical violations (such as Fannie Mae, AIG, Boeing, and Marsh) or is viewed by revolting shareholders as having a record of terrible performance (such as Morgan Stanley and HP). Without strong outside pressure to fire the CEO, mere mediocrity is far from enough to get a CEO pushed out. Furthermore, in the rare cases in which boards fire executives, boards often provide the departing executives with benefits beyond those required by the contract to sweeten the CEO's departure and alleviate the directors' guilt and discomfort. All in all, boards' record of dealing with failed executives does not support the view that boards treat CEOs at arm's length.

In sum, a realistic picture of the incentives and circumstances of board members reveals many incentives and tendencies that lead directors to behave very differently than boards contracting at arm's length with their executives over pay. Recent reforms, such as the new stock exchange listing requirements, may weaken some of these factors but will not eliminate them. Without additional reforms, the pay-setting process will continue to deviate substantially from arm's-length contracting.

Power and Pay

The same factors that limit the usefulness of the arm's-length model in explaining executive compensation suggest that executives have had substantial influence over their own pay. Compensation arrangements have often deviated from arm's-length contracting because directors have been influenced by management, insufficiently motivated

14. John M. Bizjak, Michael L. Lemmon, and Lalitha Naveen, "Has the Use of Peer Groups Contributed to Higher Levels of Executive Compensation?," Working paper (2003).

15. Lucian Bebchuk, John Coates IV, and Guhan Subramanian, "The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy," *Stanford Law Review*, Vol. 54 (2002).

16. Kevin J. Murphy, "Explaining Executive Compensation: Managerial Power vs. the Perceived Cost of Stock Options," *University of Chicago Law Review*, Vol. 69 (2002), pp. 847-869.

17. See, e.g., Holman W. Jenkins, "Outrageous CEO Pay Revisited," *Wall Street Journal* (October 2, 2002), p. A17.

to insist on shareholder-serving compensation, or simply ineffectual. Executives' influence over directors has enabled them to obtain "rents"—benefits greater than those obtainable under true arm's-length contracting.

In our work, we find that the role of managerial power can explain many aspects of the executive compensation landscape. It is worth emphasizing that our conclusion is not based on the amount of compensation received by executives. In our view, high absolute levels of pay do not by themselves imply that compensation arrangements deviate from arm's-length contracting. Our finding that such deviations have been common is based primarily on an analysis of the process by which pay is set and an examination of the inefficient, distorted, and nontransparent structure of pay arrangements that emerge from this process. For us, the "smoking gun" of managerial influence over pay is not high levels of pay, but rather such things as the correlation between power and pay, the systematic use of compensation practices that obscure the amount and performance insensitivity of pay, and the showering of gratuitous benefits on departing executives.

Power-Pay Relationships

Although top executives generally have some degree of influence over their boards, the extent of their influence depends on various features of the company's governance structure. The managerial power approach predicts that executives who have more power should receive higher pay—or pay that is less sensitive to performance—than their less powerful counterparts. A substantial body of evidence does indeed indicate that pay is higher, and less sensitive to performance, when executives have more power.

First, there is evidence that executive compensation is higher *when the board is relatively weak or ineffectual* vis-à-vis the CEO. In particular, CEO compensation is higher when the board is large, which makes it more difficult for directors to organize in opposition to the CEO; when more of the outside directors have been appointed by the CEO, which could cause them to feel gratitude or obligation to the CEO; and when outside directors serve on three or more boards, and thus are more likely to be distracted.[18] Also, CEO pay is 20% to 40% higher if the CEO is the chairman of the board, and it is negatively correlated with the stock ownership of compensation committee members.[19]

Second, studies find a negative correlation between the *presence of a large outside shareholder* and pay arrangements that favor executives. A large outside shareholder might engage in closer monitoring and thereby reduce managers' influence over their compensation. One study finds a negative correlation between the equity ownership of the largest shareholder and the amount of CEO compensation; more specifically, doubling the percentage ownership of a large outside shareholder is associated with a 12% to 14% reduction in a CEO's non-salary compensation.[20] Another study finds that CEOs in companies without a 5% (or larger) outside shareholder tend to receive more "luck-based" pay—that is, pay associated with profit increases that are generated entirely by external factors (such as changes in oil prices and exchange rates) rather than by managers' own efforts.[21] This study also finds that, in companies lacking large outside shareholders, boards make smaller reductions in cash compensation when they increase CEOs' option-based compensation.

Third, there is evidence linking executive pay to the *concentration of institutional shareholders*, which are more likely to monitor the CEO and the board. One study finds that more concentrated institutional ownership leads to lower and more performance-sensitive compensation.[22] Another study finds that the effect of institutional shareholders on CEO pay depends on the nature of their relationships with the firm.[23] This study reports that CEO pay is negatively correlated with the presence of "pressure-resistant" institutions—institutions that have no other business relationship with the firm and thus presumably are concerned only with the firm's share value. But CEO pay is positively correlated with the presence of "pressure sensitive" institutions—those having business relationships with the firm (such as managing its pension funds) and thus more vulnerable to management pressure.

Finally, studies find a connection between pay and *anti-takeover provisions*, arrangements that make CEOs and their boards less vulnerable to a hostile takeover. One study finds that CEOs of companies adopting anti-takeover provisions enjoy above-market compensation before adoption of the provisions and that adoption is followed by further significant increases in pay.[24] This pattern is not readily explainable by arm's-length contracting; indeed, if risk-averse managers' jobs are more secure, shareholders should be able to pay the managers less. Another study finds that CEOs of companies that became protected by state anti-takeover legislation enacted during the period of 1984-1991 reduced their holdings of shares (which became less impor-

18. John Core, Robert Holthausen, and David Larcker, "Corporate Governance, Chief Executive Compensation, and Firm Performance," *Journal of Financial Economics*, Vol. 51 (1999), pp. 371-406.

19. Core, Holthausen, and Larcker (1999), cited earlier; Richard Cyert, Sok-Hyon Kang, and Praveen Kumar, "Corporate Governance, Takeovers, and Top-Management Compensation: Theory and Evidence," *Management Science*, Vol. 48 (2002), pp. 453-469.

20. Cyert, Kang, and Kumar (2002), cited earlier.

21. Marianne Bertrand and Sendhil Mullainathan, "Agents With and Without Principals," *American Economic Review*, Vol. 90 (2000), pp. 203-208.

22. Jay C. Hartzell and Laura T. Starks, "Institutional Investors and Executive Compensation," *Journal of Finance*, Vol. 58 (2003), pp. 2351-2374.

23. David Parthiban, Rahul Kochar, and Edward Levitas, "The Effect of Institutional Investors on the Level and Mix of CEO Compensation," *Academy of Management Journal*, Vol. 41 (1998), pp. 200-208.

24. Kenneth A. Borokhovich, Kelly R. Brunarski, and Robert Parrino, "CEO Contracting and Anti-Takeover Amendments," *Journal of Finance*, Vol. 52 (1997), pp. 1503-1513.

tant for the purpose of maintaining control) by an average of 15%.[25] Arm's-length contracting, by contrast, might predict that CEOs protected by anti-takeover legislation would be *required by their boards* to increase their shareholdings to restore their incentive to generate shareholder value.

Limits of Managerial Influence

There are, of course, limits to the arrangements that directors will approve and executives will seek. Although market forces are not sufficiently powerful to prevent significant deviations from arm's-length outcomes, they do impose *some* constraints on executive compensation. If a board were to approve a pay arrangement viewed as egregious, for example, shareholders would be less willing to support incumbents in a hostile takeover or a proxy fight.

In addition, directors and executives adopting such an arrangement might bear social costs. Directors approving a clearly inflated and distorted pay package might be subject to ridicule or scorn in the media or in their social and business circles. Most directors would wish to avoid such treatment, even if their board positions were not at risk, and these potential social costs reinforce the constraints imposed by market forces. Like market forces, these potential costs cannot preclude significant deviations from shareholder-serving arrangements, but they may discourage the adoption of arrangements that are patently abusive and indefensible.

One important building block of the managerial power approach is therefore "outrage" costs. When a board approves a compensation arrangement favorable to managers, the extent to which directors and executives bear economic costs (such as heightened risk of takeover) and social costs (such as embarrassment) will depend on how the arrangement is perceived by outsiders whose views matter to the directors and executives. The more outrage a compensation arrangement is expected to generate, the larger will be the potential economic and social costs, and thus the more reluctant directors will be to approve it and the more hesitant managers will be to propose it in the first place.

There is evidence that the design of compensation arrangements is indeed influenced by how outsiders perceive them. One study finds that, during the 1990s, CEOs who were the target of shareholder resolutions criticizing executive pay had their annual (industry-adjusted) compensation reduced over the following two years.[26]

Camouflage and Stealth Compensation

The critical role of outsiders' perception of executives' compensation and the significance of outrage costs explain the importance of yet another component of the managerial power approach: "camouflage." The desire to minimize outrage gives designers of compensation arrangements a strong incentive to try to legitimize, justify, or obscure—or, more generally, to camouflage—the amount and performance-insensitivity of executive compensation.

The desire to camouflage has an important effect on pay structures. We show that compensation designers' attempts to obscure the amount and performance-insensitivity of compensation have led to arrangements that undermine and distort managerial incentives, thereby weakening firm performance. Overall, the camouflage motive turns out to be quite useful in explaining many otherwise puzzling features of the executive compensation landscape.

Among the arrangements that disguise or downplay the amount and performance-insensitivity of compensation are executive pension plans, deferred compensation arrangements, and post-retirement perks. Most executive pensions and deferred compensation arrangements do not enjoy the large tax subsidy granted to the standard retirement arrangements provided to other employees. In the case of executives, such arrangements merely shift tax liability from the executive to the firm. The efficiency grounds for providing compensation through in-kind retirement perks are also far from clear.

All of these arrangements, however, make executives' compensation less visible to investors, regulators, and the general public. Among other things, existing disclosure rules do not require companies to place a dollar value on—or include in their publicly filed summary compensation tables—the amounts provided to executives after they retire. Although the existence and terms of executives' retirement arrangements must be disclosed in various places throughout the firm's public filings, this disclosure is less visible because outsiders, including compensation researchers and the media, focus on the dollar amounts reported in the compensation tables.

In a recent empirical study, Robert Jackson and one of us used information provided in proxy statements to estimate the value of the executive pension plans of S&P 500 CEOs.[27] About two-thirds of CEOs have such plans, and the study estimated the value of these plans for all the CEOs who recently left their firms or are close to retirement age. For the median CEO in the study's sample, the actuarial value of the CEO's pension was $15 million, which made up about one-third of the total compensation (both equity-based and non-equity) they had received during their service as CEOs.

Furthermore, the study indicates that, when pension value is included in calculating executive pay, compensa-

25. Shijun Cheng, Venky Nagar, and Madhar V. Rajan, "Identifying Control Motives in Managerial Ownership: Evidence from Antitakeover Legislation," *Review of Financial Studies*, Vol. 8 (2005), pp. 637-672.

26. Randall S. Thomas and Kenneth J. Martin, "The Effect of Shareholder Proposals on Executive Compensation," *University of Cincinnati Law Review*, Vol. 67 (1999), pp. 1021-1065.

27. See Bebchuk and Jackson (2005), cited earlier.

tion is much less linked to performance than commonly perceived. After pension value is included, the percentage of a CEO's total compensation that is "salary-like" (i.e., the portion that consists of fixed annual payments, such as basic salary during the CEO's service and pension payments afterwards), increases from 16% to 39%. The study documents that the current omission of retirement benefits from standard compensation datasets has distorted investors' picture of pay arrangements. In particular, this omission has led to: 1) significant underestimations of the total amount of pay; 2) considerable distortions in comparisons among executive pay packages; and 3) substantial overestimations of the extent to which executive pay is linked to performance.

While companies do not make the value of executive pensions transparent, they are required to disclose enough information to enable diligent researchers to estimate the value of these pensions. In contrast, the information provided about deferred compensation arrangements does not allow even the most careful analyst to estimate with any precision the value conferred on executives through these arrangements. Thus, this form of compensation is especially effective in camouflaging potentially large amounts of non-performance pay.

Gratuitous Goodbye Payments

In many cases, boards give departing CEOs payments and benefits that are not required under the terms of a CEO's compensation contract. Such gratuitous "goodbye payments" are common even when CEOs perform so poorly that their boards feel compelled to replace them. For example, when Mattel CEO Jill Barad resigned under fire, the board forgave a $4.2 million loan, gave her an additional $3.3 million in cash to cover the taxes for forgiveness of another loan, and allowed her unvested options to vest prematurely. These gratuitous benefits were offered in addition to the considerable benefits that she received under her employment agreement, which included a termination payment of $26.4 million and a stream of retirement benefits exceeding $700,000 per year.

It is not easy to reconcile such gratuitous payments with the arm's-length contracting model. The board has the authority to fire the CEO and pay no more than the CEO's contractual severance benefits. There should be no need to "bribe" a poorly performing CEO to step down. In addition, the signal sent by the gratuitous goodbye payment will, if anything, only weaken the incentive of the next CEO to perform.

The making of such gratuitous payments, however, is quite consistent with the existence of managerial influence over the board. Because of their relationship with the CEO, some directors might be unwilling to replace the existing CEO unless he or she is very generously treated. Other directors might be willing to replace the CEO even without a gratuitous goodbye payment but prefer to give it either to reduce their personal discomfort in forcing out the CEO or to make the separation process less personally unpleasant. In all of these cases, directors' willingness to make such payments stems from their relationships with the CEO.

Of course, taking managerial power *as given*, providing gratuitous payments to fired CEOs could be beneficial to shareholders in some instances. If many directors are loyal to the CEO, such payments might be necessary to assemble a board majority in favor of replacing the executive. In this case, the practice helps shareholders when the CEO's departure yields a benefit larger than the cost of the goodbye payment. For our purposes, however, what is important is that these gratuitous payments, whether or not they are beneficial to shareholders (given managers' power), reflect the existence and significance of managerial influence.

The Decoupling of Pay from Performance

In the early 1990s, prominent financial economists such as Michael Jensen and Kevin Murphy urged shareholders to be more accepting of large pay packages that would provide high-powered incentives.[28] Shareholders, it was argued, should care much more about providing managers with sufficiently strong incentives than about the amounts spent on executive pay. Defenders of current pay arrangements view the rise in pay over the past 15 years as the necessary price—and one well worth paying—for improving executives' incentives.

The problem, however, is that executives' large compensation packages have been much less sensitive to their own performance than has been commonly recognized. Shareholders have not received the most bang for their buck. Companies could have generated the same increase in incentives at a much lower cost to their shareholders, or they could have used the amount spent to obtain more powerful incentives.

Non-Equity Compensation

Although the equity-based fraction of managers' compensation has increased considerably during the past decade and has therefore received more attention, non-equity compensation continues to be substantial. In 2003, non-equity compensation represented on average about half the total compensation of both the CEO and the top five executives of S&P 1500 companies not classified as new economy firms.[29]

Although significant non-equity compensation comes in the form of base salary and sign-up "golden hello"

28. Michael C. Jensen and Kevin J. Murphy, "Performance Pay and Top-Management Incentives," *Journal of Political Economy*, Vol. 98 (1990), pp. 225-264; and Michael C. Jensen and Kevin J. Murphy, "CEO Incentives: It's Not How Much You Pay, but How," *Harvard Business Review*, Vol. 68 (1990), pp. 138-153.

29. Bebchuk and Grinstein, "The Growth of Executive Pay," cited earlier.

payments that do not purport to be performance-related, much non-equity compensation comes in the form of bonus compensation that does purport to be performance-based. Nonetheless, empirical studies have failed to find any significant correlation between non-equity compensation and managers' own performance during the 1990s.[30]

A close examination of compensation practices suggests why non-equity compensation is not tightly connected to managers' own performance. First of all, many companies use subjective criteria for at least some of their bonus payments. Such criteria could play a useful role in the hands of boards guided solely by shareholder interests. However, boards favoring their top executives can use the discretion provided by these plans to ensure that executives are well paid even when their performance is substandard.

Furthermore, when companies do use objective criteria, these criteria and their implementation are usually not designed to reward managers for *their own contribution* to the firm's performance. Bonuses are typically based not on how the firm's operating performance or earnings increased relative to its peers but rather on other metrics. And when companies fail to meet the established targets, the board can reset the target (as happened at Coca-Cola in 2001 and at AT&T Wireless in 2002) or compensate the executives by setting even lower figures going forward.

Finally, many boards award bonuses to managers simply for buying other companies. In about 40% of large acquisitions during the period 1993-1999, the acquiring-firm CEO received a multi-million dollar bonus for completing the deal.[31] But making acquisitions hardly appears to be something for which managers should receive a special reward—that is, a payment above and beyond whatever benefit they get from the effect of the acquisition on the value of the managers' options, shares, and earnings-based bonuses. Executives do not lack incentives to make value-increasing acquisitions. If anything, investors' concern is that executives may engage in empire-building and make too many acquisitions. Thus, although the making of a large acquisition might provide a convenient excuse for a large bonus, acquisition bonuses are not called for by incentive considerations.

Windfalls in Equity-Based Compensation

In light of the historically weak link between non-equity compensation and managerial performance, shareholders and regulators wishing to make pay more sensitive to performance have increasingly encouraged the use of equity-based compensation, often in the form of stock options. We strongly support equity-based compensation, which in principle can provide managers with desirable incentives. In practice, however, the design of executives' stock options has enabled executives to reap substantial rewards even when their own performance was merely passable or even poor.

Rewards for Market-Wide and Industry-Wide Movements. Conventional stock options enable executives to gain from any increase in the nominal stock price above the grant-date market value. This in turn means that executives can profit even when their companies' performance significantly lags that of their peers, as long as market-wide and industry-wide movements provide sufficient lift for the stock price. A substantial fraction of stock price increases is due to such movements, rather than to firm-specific factors that might reflect the manager's own performance.

Although there is a variety of ways in which market- and industry-driven windfalls could be filtered out, very few companies have adopted equity-based plans that even attempt to filter out such windfalls. Unfortunately, most of the boards now changing their equity-based compensation plans in response to outside pressure are still choosing to avoid plans that would effectively eliminate such windfalls. Instead, they are moving to plans based on restricted stock that fail to eliminate, and sometimes even increase, these windfalls.

Rewards for Short-Term Spikes. Option plans have been designed, and largely continue to be designed, in ways that enable executives to make considerable gains from temporary spikes in the company's stock price, even when long-term stock performance is poor. Companies have given executives broad freedom to unwind equity incentives, a practice that has been beneficial to executives but costly to shareholders. In addition to being granted the freedom to exercise their options as soon as they vest and sell the underlying stock, executives often have considerable control over the timing of sales, enabling them to benefit from their inside information. Compounding the problem, many firms have adopted reload plans that make it easier for executives to lock in profits from short-term spikes. The features of option plans that reward managers for short-term spikes not only decouple pay from managers' own performance, but also provide incentives to manipulate earnings. There is in fact significant evidence linking executives' freedom to unload options with earnings manipulation and financial misreporting.[32]

Compensation At and After Departure

As already noted, the dollar value of a substantial portion of executive compensation is not reported in firms' publicly filed summary compensation tables and is therefore not included in standard compensation datasets. This "stealth compen-

30. See Murphy (1999), cited earlier.

31. Yaniv Grinstein and Paul Hribar, "CEO Compensation and Incentives: Evidence from M&A Bonuses," *Journal of Financial Economics*, Vol. 71 (2004), pp. 119-143.

32. Daniel Bergstresser and Thomas Philippon, "CEO Incentives and Earnings Management: Evidence from the 1990s," forthcoming in *Journal of Financial Economics* (2005); Scott L. Summers and John T. Sweeney, "Fraudulently Misstated Financial Statements and Insider Trading: An Empirical Analysis," *Accounting Review*, Vol. 73 (1998), pp. 131-146.

sation" includes executive pensions, deferred compensation arrangements, and post-retirement consulting contracts and perks. These less visible forms of compensation have tended to be insensitive to managerial performance, thus further contributing to a decoupling of pay from performance.

Take, for example, Franklin Raines, who was forced to retire as Fannie Mae's CEO in late 2004. Upon departure, Fannie owed him (and his surviving spouse after his death) an annual pension of approximately $1.4 million, an amount specified without any connection to the firm's stock performance under Raines. In a case study of his compensation, we estimated the value of this non-performance element of pay at about $25 million.[33]

Further decoupling pay from performance are severance payments given to departing executives. Executives pushed out by their boards are typically paid a severance amounting to two or three years' worth of annual compensation. These payments are not reduced even when the executive's performance has been clearly and objectively dismal. Furthermore, standard severance provisions do not reduce the severance payment even if the executive quickly finds other employment.

It is doubtful that these severance arrangements reflect efficient, arm's-length contracting. Non-executive employees are both more likely to be terminated than executives and less financially capable of bearing this risk. But they are not protected from having to bear a substantial monetary loss in the event of termination. If executive severance provisions were driven by risk-bearing considerations, one would expect non-executive employees to have such provisions as well.

More importantly, if executives' high pay is justified by the importance of providing them with incentives, one would expect their compensation arrangements to be *more* sensitive to performance than non-executive pay and to provide *less* protection in the event of dismal failure. Current corporate severance practices not only fail to strengthen the link between pay and performance, they undermine it by diminishing the difference between payoffs for good and bad performance.

Improving Transparency

We now turn to our proposals for improving pay arrangements and the governance processes that produce those arrangements. We start with a reform that we view as a "no-brainer," one for which we see no reasonable basis for opposition. In particular, the SEC should require public companies to make the amount and structure of their executive pay packages more transparent.

Financial economists have paid little attention to transparency. They tend to focus on stock price behavior and assume that any publicly available information, even if understood by only a small number of professionals, becomes incorporated into stock prices. Thus, economists are typically interested in *whether* certain information is publicly available, not *how* it is disclosed. As we have discussed, SEC regulations already require detailed disclosure of the compensation of a company's CEO and its four other most highly paid executives. Thus, from economists' stock-pricing perspective, there is already a significant amount of information available about executive compensation.

In our view, however, is it critical to recognize the importance of making such disclosures transparent. The purpose of executive compensation disclosure is not merely to enable accurate pricing of corporate securities, but to provide some check on arrangements that are too favorable to executives. This goal is not well served by disseminating information in a way that makes the information understandable to a small number of market professionals but opaque to others.

Public officials, governance reformers, and investors should work to ensure that compensation arrangements are and remain transparent. Transparency would provide shareholders with a more accurate picture of total pay and its relationship to performance and thereby provide some check on departures from arrangements that serve shareholder interests. Furthermore, transparency would eliminate the distortions that currently arise when pay designers choose particular forms of compensation for their camouflage value rather than for their efficiency. Finally, transparency would impose little cost on companies because it would simply require them to disclose clearly information they have or can obtain at negligible cost.

Although we support improved mandatory disclosure requirements, nothing prevents companies in the meantime from voluntarily making pay more transparent. Investors should demand more openness, and companies should not continue to follow a "lawyerly" approach of not disclosing more than is legally required. The measures described below could substantially increase the transparency of pay arrangements:

Recommendation 1: Place a Dollar Value on All Forms of Compensation

Companies should be required to place a dollar value on all forms of compensation and to include these amounts in the summary compensation tables contained in company SEC filings. Executives routinely receive substantial "stealth compensation" in the form of pensions, deferred compensation, and post-retirement perks and consulting contracts. Although certain details of these benefits appear in various SEC filings, companies have not been required to place a dollar value on any of these forms of benefits and to include

33. Bebchuk and Fried (2005), cited earlier.

this value in the summary tables that receive the most attention from investors and the media. These benefits have not even been included in the standard database used by financial economists to study executive compensation.

In our view, companies should be required to place a monetary value on each benefit provided or promised to an executive, and to include this value in the summary compensation table in the year the executive becomes entitled to it. Thus, for example, the compensation tables should include the amount by which the expected value of an executive's promised pension payments increases during the year. In addition, it might be desirable to require companies to place a dollar value on and report any tax benefit that accrues to the executive at the company's expense (for example, under deferred compensation).

Recommendation 2: Disclose All Non-Deductible Compensation

The tax code permits companies to deduct certain payments to executives but not others. Companies routinely include in their disclosure boilerplate language notifying shareholders that some of the arrangements may result in the firm being unable to deduct a portion of an executive's compensation. But they do not provide details about what particular amounts end up not being deductible. Companies should provide full details about the components of pay that are not deductible, place a monetary value on the costs of this non-deductibility to the firm, and disclose this dollar cost to investors.

Recommendation 3: Expense Options

Options should be expensed. From an accountant's perspective, expensing is desirable because it leads to a more accurate reflection of the company's financial situation. In our view, expensing is beneficial because it makes the costs imposed by option-based compensation more visible to investors on an ongoing basis.

Rationalizing the accounting treatment of option plans would also level the playing field among different types of options. It would eliminate a major excuse used to avoid indexed and other reduced-windfall options. The fact that such options must be expensed while conventional options need not has long been a convenient excuse for using conventional options that reward managers for general market or sector rises.

Recommendation 4: Report the Relationship between Pay and Performance

Companies should report to their shareholders how much of their executives' profits from equity and non-equity compensation is attributable to general market and industry movements. This could be done by requiring firms to calculate and report the gains made by managers from the exercise of options (or the vesting of restricted shares, in the case of restricted share grants) and to report what fraction, if any, reflects the company's success in outperforming its industry peers. Such disclosure would help clarify the extent to which the company's equity-based plans reward the managers for good relative performance.

Recommendation 5: Disclose Option and Share Unloading

Companies should be required to make transparent to shareholders on a regular basis the extent to which their top five executives have unloaded any equity instruments received as part of their compensation. Although a diligent and dedicated researcher can obtain this information by sifting through stacks of executive trading reports filed with the SEC, requiring the firm to compile and report such information would highlight for all investors the extent to which managers have used their freedom to unwind incentives.

Improving Pay Arrangements

Well-designed executive compensation can provide executives with cost-effective incentives to generate shareholder value. We have argued, however, that the promise of such arrangements has not yet been realized. Below we note various changes that companies should consider, and investors should urge companies to adopt, in order to strengthen the link between pay and performance and thereby improve executives' incentives.

Recommendation 1: Reduce Windfalls in Equity-Based Compensation

Investors should encourage firms to adopt equity compensation plans that filter out at least some of the gains in the stock price that are due to general market or industry movements. With such filtering, the same amount of incentives can be provided at a lower cost, or stronger incentives can be provided at the same cost. This can be done not only by indexing the exercise price of stock options, but in other ways as well. For example, by linking the exercise price of options to changes in the stock price of the worst-performing firms in the industry, market-wide movement can be filtered out without imposing excessive risk on executives. It is also important to note that moving to restricted stock is not a good way to address the windfalls problem. In fact, grants of restricted stock provide even larger windfalls than conventional options.

Recommendation 2: Reduce Windfalls in Bonus Plans

For similar reasons, companies should design bonus plans that filter out improvements in financial performance due to economy- or industry-wide movements. Even assuming that it is desirable to focus on accounting rather than stock price performance, as most bonus plans seek to do, reward-

ing executives for improvements in accounting measures enjoyed by all companies in the industry is not a cost-effective way to provide incentives. Thus, bonus plans should not be based on absolute increases in earnings, sales, revenues, and so forth, but rather on such increases relative to peer companies.

Recommendation 3: Limit the Unwinding of Equity Incentives

Investors should also seek to curtail executives' broad freedom to unwind the equity-based incentives provided by their compensation plans. It may be desirable to separate the vesting of options and managers' ability to unwind them. By requiring that executives hold vested options (or the shares resulting from the exercise of such options) for a given period after vesting, boards would ensure that options already belonging to executives will remain in their hands for some time, continuing to provide incentives to increase shareholder value. Furthermore, such restrictions would eliminate the significant distortions that can result from rewarding executives for short-term spikes in the stock price that do not subsequently hold. To prevent circumvention, such restrictions should be backed by contractual prohibitions on executives' hedging or using any other scheme that effectively eliminates some of their exposure to declines in the firm's stock price.

In addition, it might be desirable, as one of us proposed some time ago, to require executives to disclose *in advance* their intention to sell shares, providing detailed information about the intended trade, including the number of shares to be sold.[34] Providing executives with opportunities to sell their shares when their inside information indicates the stock price is about to decline can dilute and distort their incentives.

Recommendation 4: Tie Bonuses to Long-Term Performance

Even assuming it were desirable to reward managers for improvements in accounting results, such rewards should not be given for short-term results but only for improvements that are sustained over a considerable period of time. Rewarding executives for short-term improvements is not an effective way to provide beneficial incentives and indeed might create incentives to manipulate short-term accounting results.

Compensation contracts should also generally include "clawback" provisions that require managers to return payments based on accounting numbers that are subsequently restated. Such return of payments is warranted, regardless of whether the executive was in any way responsible for the misreporting. When the board believes it is desirable to tie executive payoffs to a formula involving a metric whose value turns out to have been inflated, correctly applying the formula requires reversing payments that were based on erroneous values. The governing principle should be: "What wasn't earned must be returned."

Recommendation 5: Be Wary of Paying for Expansion

Because running a larger company increases managers' power, prestige, and perquisites, executives might have an incentive to expand the company at the expense of shareholder value. Executive compensation arrangements should seek to counter rather than reinforce this incentive.

A recent study by Yaniv Grinstein and one of us finds that executives' decisions to expand company size—by issuing new equity to finance acquisitions or investments or by avoiding distributions—are associated with increases in subsequent executive pay.[35] Controlling for past performance, the compensation of continuing CEOs is positively and substantially correlated with firm expansion during their service. While a larger firm size might lead the board to raise executive pay, boards should keep in mind that an expectation that expansion will result in higher pay can provide executives with incentives to expand even when doing so would not be value-maximizing.

Recommendation 6: Restore Dividend-Neutrality

Under current option plans, terms are not updated to reflect the payment of dividends and, as a result, executives' payoffs are reduced when they decide to pay a dividend. There is evidence that companies run by executives whose pay has a large option component tend to pay lower dividends and instead distribute cash through share repurchases,[36] which have a less adverse effect on the value of managers' options but may not be the most efficient form of payout.[37] To reduce distortions in managers' payout decisions, all equity-based compensation should be designed in such a way that it neither encourages nor discourages the payment of dividends. In particular, in the case of option plans, the exercise price of options should be adjusted downward to reflect a dividend payment.

Recommendation 7: Rethink Executive Pensions

There are reasons to doubt the efficiency of the widespread practice of using Supplemental Executive Retirement Plans (SERPs) to provide executives with a major component of their career compensation. Unlike pension plans used

34. See Jesse M. Fried, "Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure," *Southern California Law Review*, Vol. 71 (1998), pp. 303-392.

35. Lucian A. Bebchuk and Yaniv Grinstein, "Firm Expansion and CEO Pay," cited earlier.

36. Christine Jolls, "Stock Repurchases and Incentive Compensation," NBER Working Paper No. 6467 (1998). Jolls' findings were subsequently confirmed by George Fenn and Nellie Liang, "Corporate Payout Policy and Managerial Stock Incentives," *Journal of Financial Economics*, Vol. 60 (2001), pp. 45-72.

37. See Jesse M. Fried, "Informed Trading and False Signaling with Open Market Repurchases," forthcoming in *California Law Review* (2005).

for non-executive employees, SERPs do not enjoy a tax subsidy. And given that companies have been moving away from defined benefit plans to defined contribution plans for non-executive employees, it is far from clear that providing executives with defined benefit plans is required by risk-bearing considerations. Unlike defined contribution plans, which force the employee to bear the risk of poor investment performance, defined benefit plans shift the risk of investment performance to the firm. However, executives do not seem less able to bear such risk than other employees. While the efficiency benefits of SERPs are far from clear, SERPs impose incentive costs. They provide executives with pay that is largely independent of performance, thereby weakening the overall link between total pay and performance. Boards would thus do well to reconsider their heavy use of SERPs.

Recommendation 8: Avoid Soft-Landing Arrangements

Soft-landing arrangements, which provide managers with a generous exit package when they are pushed out due to failure, dilute executives' incentives. While companies spend large amounts on producing a payoff gap between good and poor performance, the money spent on soft-landing arrangements works in the opposite direction, narrowing the payoff gap between good and poor performance.

At present, executives are commonly promised generous severance arrangements in the event of termination, unless the termination is triggered by an extremely narrow set of circumstances (such as criminal indictment or "malfeasance"). Boards should consider provisions that make the termination payoff depend on the reasons for the executive's termination and the terminated executive's record. Even if companies stick to the existing, broad definition of termination without cause, the payoff in such a termination should depend in part on the firm's performance relative to its peers during the executive's service. An executive who is terminated against a background of extremely poor stock performance should get less than an executive who is terminated when the company's performance is reasonable.

Improving Board Accountability

Past and current flaws in executive pay arrangements have resulted from underlying problems within the corporate governance system: specifically, directors' lack of sufficient incentives to focus solely on shareholder interests when setting pay. If directors could be relied on to focus on shareholder interests, the pay-setting process, and board oversight of executives more generally, would be greatly improved. The most promising route to improving pay arrangements is thus to make boards more accountable to shareholders and more focused on shareholder interests. Such increased accountability would transform the arm's-length contracting model into a reality. It would improve both pay arrangements and board performance more generally.

Recent reforms require most companies listed on the major stock exchanges (the New York Stock Exchange, NASDAQ, and the American Stock Exchange) to have a majority of independent directors—directors who are not otherwise employed by the firm or in a business relationship with it. These companies must also staff compensation and nominating committees entirely with independent directors. Although such reforms are likely to reduce managers' power over the board and improve directors' incentives somewhat, they fall far short of what is necessary.

Our analysis shows that the new listing requirements weaken executives' influence over directors but do not eliminate it. More importantly, there are limits to what independence can do by itself. Independence does not ensure that directors have incentives to focus on shareholder interests or that the best directors will be chosen. In addition to becoming more independent of insiders, directors also must become more *dependent on shareholders*. To this end, we should eliminate the arrangements that currently entrench directors and insulate them from shareholders.

To begin with, shareholders' power to replace directors should be turned from myth into reality. Even in the wake of poor performance and shareholder dissatisfaction, directors now face very little risk of being ousted. Shareholders' ability to replace directors is extremely limited. A recent study by one of us provides evidence that, outside the hostile takeover context, the incidence of electoral challenges to directors has been practically negligible in the past decade.[38] This state of affairs should not continue.

To improve the performance of corporate boards, impediments to director removal should be reduced.[39] As a first step, shareholders should be given the power to place director candidates on the corporate ballot. In addition, proxy contest challengers that attract sufficient support should receive reimbursement of their expenses from the company. Furthermore, it would be desirable to limit the use of staggered boards, a feature of most public companies, to impede director removal. Staggered boards provide powerful protection from removal in either a proxy fight or a hostile takeover. And a recent study by Alma Cohen and one of us finds that staggered boards are associated with economically significant reductions in firm value. Share-

38. Lucian Bebchuk, "The Case for Shareholder Access to the Ballot," *The Business Lawyer*, Vol. 59 (2003), pp. 43-66.

39. For a fuller analysis of the ways in which shareholder power to remove directors could be made viable, see Lucian Bebchuk, "The Myth of the Shareholder Franchise," Working paper, Harvard Law School (2005).

holders should be able to replace all the directors each year or at least every other year.[40]

In addition to making shareholder power to remove directors viable, boards should not have veto power—which current corporate law grants them—over proposed changes to governance arrangements in the company's charter. Shareholders should have the power, which they now lack, to initiate and adopt changes in the corporate charter. Under current rules, shareholders can pass only nonbinding resolutions. And, as documented in a recent empirical study by one of us, boards often choose not to follow resolutions that receive majority support from shareholders, even if these resolutions have passed two or three times.[41] This state of affairs should change.

Allowing shareholders to amend the corporate charter would over time improve the entire range of corporate governance arrangements without outside regulatory intervention. If there is concern that shareholders are influenced by short-term considerations, shareholder-initiated changes could require approval by majority vote in two successive annual shareholder meetings. But we should not continue denying shareholders the power to change the corporate charter, no matter how widespread and long-lasting the shareholder support for such a change. Allowing shareholders to set governance arrangements would help make boards more accountable to shareholders.

To fully address the existing problems in executive compensation and corporate governance, structural reforms in the allocation of power between boards and shareholders are necessary. Given political realities, such reforms will not be easy to pass. But the corporate governance flaws that we have discussed—and have shown to be pervasive, systemic, and costly—call for such reforms.

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40. Lucian Bebchuk and Alma Cohen, "The Costs of Entrenched Boards," *Journal of Financial Economics*, Vol. 78 (2005), pp. 409-433.

41. Lucian Bebchuk, "The Case for Increasing Shareholder Power," *Harvard Law Review*, Vol. 18 (2005), pp. 833-914.

Business Roundtable

Testimony for the Record

Of

John J. Castellani
President, Business Roundtable

On

Empowering Shareholders on Executive Compensation: H.R. 1257,

The Shareholder Vote on Executive Compensation Act

Before the U.S. House of Representatives
Committee on Financial Services

On

Thursday, March 8, 2007

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Dear Chairman Frank, Ranking Member Bachus, members of the committee:

Business Roundtable is pleased to provide testimony based upon our experience and perspective representing the chief executive officers of leading corporations.

We share with you the common goal of promoting public policies that foster economic growth, job creation, investor confidence, and the creation of long term shareholder value. We are committed to policies that ensure that U.S. based companies remain the economic engine of the global economy and our markets retain their competitive advantage over foreign exchanges.

Introduction

U.S. companies and their systems of corporate governance are the most transparent, efficient and accountable in the world. A wave of reforms over the past five years has resulted in improved investor confidence in our corporations, growth in the stock market, and continued shareholder returns.

Business Roundtable (www.businessroundtable.org) is an association of chief executive officers of leading U.S. companies with $4.5 trillion in annual revenues and more than 10 million employees. Member companies comprise nearly a third of the total value of the U.S. stock markets and represent over 40 percent of all corporate income taxes paid. Collectively, they returned $112 billion in dividends to shareholders and the economy in 2005.

Recent Reforms and Accountability

The Roundtable has a strong record of leadership in corporate governance that includes supporting the Sarbanes-Oxley reform legislation (2002); issuing *Principles of Corporate Governance* (2002 and updated in 2005); publishing *Principles of Executive Compensation* (2003 and updated in 2007)); creating the Business Roundtable Institute for Corporate Ethics (2004); and supporting the new Securities and Exchange Commission (SEC) compensation disclosure rules (2006). Going back to the late 1970s, Business Roundtable has issued a series of statements on corporate governance best practices, including specific statements relating to executive compensation.

Our *Principles of Executive Compensation,* which we recently updated to reflect developments in best practices and the new SEC executive compensation disclosure rules, recommend that executive compensation reflect the core principle of pay-for-results, including significant performance-based criteria. Additionally, we believe executive pay should be closely aligned with the long-term interests of shareholders and corporate goals and strategies.

The Roundtable supports complete, understandable and timely disclosure of compensation packages and, in keeping with this, supported the new rules issued by the SEC in 2006 that make it easier for investors to better understand exactly what CEOs are being paid. The new Compensation Disclosure and Analysis Section required in proxy statements under the SEC rules will provide important information about not only the objectives of a company's executive compensation program, but also why the company has chosen to pay each element of

compensation (e.g. salary, bonus and long-term compensation) and the specific items of corporate performance that are taken into account in making compensation decisions. We believe that this increased transparency about compensation will benefit the marketplace as it will give investors more information on which to make decisions. These new disclosure requirements could have a significant impact on executive compensation practices.

Furthermore, Business Roundtable believes that the best people to set executive compensation and hold CEOs accountable for company performance are the independent members of a company's board of directors, acting upon the recommendations of their compensation committees. These committees are subject to strict independence requirements, and all directors are strictly accountable to all shareholders.

In recent years, corporations have made dramatic reforms to their systems of corporate governance. In order to ensure meaningful director elections, many companies have voluntarily shifted to a system of majority voting for directors. Currently 52% of the S&P 500 have adopted some form of majority voting, up from 20% last year.[1] This trend will continue, and it provides for enhanced accountability of board members to shareholders.

In addition, it is clear that corporate governance reforms are working and that corporate board directors have become more independent. The results of a 2006 corporate governance survey of Roundtable members reported that 85% of our company boards are composed of at least 80% independent directors. The Roundtable's *Principles of Corporate Governance* define an independent director as not having business, employment, charitable or personal relationship with the corporation or its management.

Directors are also more active, as they should be. In the Roundtable's 2006 survey, 75% of companies reported that their independent directors meet in executive session *at every meeting*, which is an increase from 55% in 2003. Our survey also showed that 91% of Audit Committees increased the number and length of their meetings, the same being true for 67% of Governance Committees and 76% of Compensation Committees.

It is also interesting to note that CEO turnover is increasing. The average tenure of a Business Roundtable CEO today is 4.5 years, nearly half of the eight-year average tenure in 1985. In addition, a 2005 study showed that CEO turnover was over 15%, the highest level in a decade.[2]

Role of Boards and Shareholders

In addressing any additional reforms, it is important to recognize that corporations are private entities designed to generate value for their shareholders. Company organization and structure is governed by state law, while federal securities laws generally govern the disclosure of information to investors.

As detailed in our *Principles of Corporate Governance*, the business of a corporation is managed under the direction of the Board of Directors. Making decisions regarding the selection,

compensation and evaluation of a well-qualified CEO is the single most important responsibility of the board.

Directors, who are shareholders themselves, have a legal obligation to act in the best interests of *all* shareholders, and not represent the interests of particular constituencies. While cooperation and consensus is critical for a board to function, effective directors maintain an attitude of constructive skepticism, asking incisive questions requiring accurate and honest answers.

The role of shareholders is equally important. Shareholders provide capital, elect directors, approve mergers and other significant actions, and are recognized as the "owners" of the corporation. However, shareholders do not run companies and have no legal liability should something go wrong.

Shareholders come in different shapes and sizes with different motivations and goals. Some seek immediate gains on their investment and others look for long-term growth. There are small individual investors, large institutional investors, mutual funds, union pension funds and privately held hedge funds, all of whom invest for different reasons and for varying lengths of time. Investing in a corporation is voluntary and shareholders are free to invest elsewhere for any reason. Unlike democracies, shareholder rights vary based upon the size of their investment, and by definition corporate decision making is not a democratic process.

Considerations on Shareholder Participation

When considering shareholder approval for compensation decisions, we are concerned with several underlying issues.

First and foremost, we believe that requiring a shareholder vote on compensation – even an advisory vote – would seriously erode critical board responsibility. Determining compensation involves several factors: company goals, specific performance metrics, and amounts negotiated under the terms of an employment contract. It would be difficult to effectively subject some or all of these elements to a voting process.

Secondly, there are significant irregularities with the current voting process that have been identified by academics and more recently discussed at length in the *Wall Street Journal*. This article highlights the problems with hedge funds using their short term holdings for so called "empty voting".[3] Moreover, unregulated proxy advisory firms often vote on behalf of investors. Proxy materials are distributed by paper and electronically, and the distribution involves third parties who in some instances cast votes themselves on behalf of the actual shareholders.

In 2004, Business Roundtable petitioned the SEC to reform the shareholder communications process. We have been joined in this effort by the National Association of Corporate Directors, the National Investor Relations Institute, the Securities Transfer Association and the Society of Corporate Secretaries.[4]

While our petition remains under consideration at the SEC, we believe these issues are far more pressing than considering fundamental changes to the existing balance of responsibility that has produced so much economic growth.

We also believe that if we moved to a referendum system, fractured shareholder groups would subsequently campaign for or against ballot questions. Boards and CEOs would spend less time on planning, product development and oversight and more time meeting with advocacy groups and lobbyists.

Adversarial shareholder groups with divergent interests would form coalitions in an effort to influence proxy outcomes and then dictate policies and operational decisions to boards and management.

Furthermore, it would be naïve to think that once shareholders had the right to vote on compensation, special interests would have no interest in expanding the right to other major decisions.

For example, there are a number of other significant board decisions involving more resources than compensation, including capital investments, strategic plans, and marketing and endorsement deals. Subjecting these to shareholder approval would politicize the decision making process, slow company growth, and shareholder return would suffer.

The U.K. System

The U.K. system of shareholder advisory votes on compensation is not automatically applicable in the U.S., as some have suggested. There are key differences between the U.K. and U.S. corporate governance systems, making adoption of such a system in the United States unwise.

Briefly, a federally mandated shareholder advisory vote is counter to federalism principles. As noted earlier, in the U.S., state law remains the prominent source relating to the governance of corporations. The determination of what topics shareholders are required to vote on is generally left to the states. Even the sweeping Sarbanes-Oxley reforms of 2002 did not override this structure—its provisions relating to boards of directors were limited to audit committees and the Congress deferred to the stock exchanges rather than calling for direct SEC rulemaking.

Secondly, U.S. boards of directors are substantially more independent than in the U.K. In the U.S., boards are required to have a majority of independent directors and must comply with the NYSE's rigorous definition of independence. In the U.K., boards include many more company executives and are subject to a "comply or explain" regime rather than subject to a mandatory definition of independence. An independent 2006 survey of leading companies found that the percentage of independent board members was 81% in the U.S., and only 61% in the U.K.[5]

Because boards in the U.K. are less independent of management, the shareholder vote on compensation may be necessary to resolve the conflicts of interest present in executives and non-independent directors determining executive compensation. In contrast, in the U.S., exclusively independent directors make compensation decisions and therefore a shareholder vote on

executive compensation is less necessary. NYSE companies also are required to have a mechanism for shareholders to communicate with directors, which provides shareholders a means of sharing their views with respect to executive compensation.

Third, there is a fundamental difference between the U.S. & U.K. legal systems. In the United States, directors are subject to potentially significant litigation and personal liability as result of their board duties. In the U.K., directors may be protected against legal actions brought against them where board decisions have been put to a shareholder vote; this means that directors may be essentially immunized against litigation.

And finally, unlike the U.S., the U.K. has a "loser pays" system which discourages lawsuits. We have large scale securities class actions in the U.S., while the U.K. does not allow such cases. Indeed, their shareholder advisory vote is, in part, a substitute for such class actions. Thus, their system includes a balance between the two, not a piling on of one on top of the other.

Conclusion

The U.S. system of corporate governance has had more reform in the past five years than in the previous 50 years, and those reforms are working. Boards are more independent, have taken significant steps to increase performance metrics, align CEO pay with shareholder interests, and replace CEOs that fail to produce results.

The recent reforms have led to greater accountability of CEOs and Boards to shareholders. At the same time, individual and institutional shareholders have enjoyed enormous returns by participating in the market.

In the past 15 years, the market has dramatically grown, from $5 trillion to $19 trillion. During the same period, participation in the market by U.S. households has increased 156% - from $3.89 trillion in 1992 to $9.98 trillion in 2006. In the same timeframe, the average annual return on the S&P 500 index was 11.98% per year[(6)].

We therefore need to be careful before we erode critical Board responsibilities and alter the underlying model and record of success.

We thank you for your consideration and look forward to working with you. I am available to answer any questions and provide additional information.

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The Washington Post
washingtonpost.com

Job Security Wanes in Executive Suites; CEO Turnover at Top Companies Was 15.3% in 2005, Highest in a Decade

Brooke A. Masters
The Washington Post
05/18/2006
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It's getting shaky at the top.

More than 15 percent of the world's 2,500 biggest companies lost their chief executives last year, and only half of the departures were voluntary, according to a study that will be released by the consulting firm Booz Allen &Hamilton today.

The number of chief executives who left -- 383 -- was up slightly from last year and the 15.3 percent turnover rate was the highest recorded in the 10 years Booz Allen has studied the matter. Turnover was highest in Japan, with 19 percent, and in North America, where the 16.2 percent turnover rate was the highest since 2000.

"We think this level of turnover is here to stay," said Paul Kocourek, a Booz Allen senior vice president and an author of the study. "Boards are much more activist, and they are not going to tolerate poor performance. . . . If your [company is] performing at 2.5 percent below the Standard &Poor's 500 index, you are at risk."

The statistics from North America tend to bear that out. Thirty-five percent of chief executives who departed in 2005 were forced out -- the most ever recorded in the survey -- compared with 44 percent who left voluntarily and 25 percent who lost their jobs because of mergers. Among the high-profile departures last year were Harry C. Stonecipher, forced out at Boeing Co. after a scandal; Hewlett-Packard Co.'s Carly Fiorina; Walt Disney Co.'s Michael D. Eisner, and Morgan Stanley's Philip J. Purcell.

Retirements and other voluntary departures have not changed significantly since 1995, but the number of chief executives forced out for performance-related reasons has more than quadrupled, Kocourek said.

Much of the change seems to stem from regulatory changes that have emphasized director independence and made them feel more personally responsible for company performance, as well as the growing willingness of large investors to challenge company strategies when share prices are lagging.

High chief-executive turnover can have both good and bad consequences.

"It's very good. It creates a culture of accountability," said Charles M. Elson, who directs the Center for Corporate Responsibility at the University of Delaware. "Boards who remove CEOs are to be congratulated. They're doing their job. . . . In the old days, there were lots of reasons to remove [corporate leaders], but boards dominated by CEOs didn't do it."

For employees, change can create uncertainty. "CEO turnover is often coupled with broader organizational change along the lines of layoffs and selling businesses and changing strategies," said Paul Oyer, an associate professor of economics at Stanford University's business school. "When CEOs turn over, that's both a problem and an opportunity."

On the other hand, high turnover could make chief-executive jobs less attractive. "If you ask CEOs to take the risk of having to resign in a fairly public manner . . . people might be less willing to take the job and want higher compensation, which means you shrink the pool," said Constance E. Helfat, a strategy professor at Dartmouth's Tuck School of Business who studies chief-executive turnover.

Some analysts wondered whether the problem will be exacerbated if the Securities and Exchange Commission adopts a proposal to require more disclosure of executive perks. If it does, they said, top business executives might decide to work for a privately held company or a venture capital firm rather than a publicly traded firm, to avoid the risk of public scrutiny.

The Booz Allen study also looked at the succession process and concluded that over the short term, companies that brought in new chief executives from the outside did better than those that promoted someone from the inside. But insider chiefs tended to serve longer and provided better shareholder return over the long haul.

Others who have studied the matter said the Booz Allen study may overstate the benefits of outsiders, even in the short term, because outsiders are more likely to inherit companies that are in bad shape where investors are primed to respond positively to any kind of change. Helfat said that in her study of chief executives during the first three years of their tenure, she found that once she adjusted for the company's previous performance, outsiders and insiders performed, on average, equally well. Outsider chiefs were more of a gamble, she said, because

they were more likely to do spectacularly badly or spectacularly well, while insiders tended to stick closer to average.

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OUTSIDE INFLUENCE

How Borrowed Shares Swing Company Votes

SEC and Others Fear Hedge-Fund Strategy May Subvert Elections

By KARA SCANNELL

Private investment firms have found a simple way to profit from the workings of public companies: Borrow their shares, and then swing the outcomes of their votes.

In some cases, the strategy has allowed speculators to gamble that a company's stock will drop, and then vote for decisions that will ensure that it does—without their ever having to own any stock themselves. Some outside interests have used the strategy to hide their voting power within a company until the last moment. Often, individual shareholders don't realize their own stocks, and their voting rights, have been borrowed from their brokerage accounts, until it's too late.

Fueling the practice—dubbed "empty voting" in a study by two University of Texas professors—is a booming business in lending shares. That business has nearly doubled in the past five years, according to one report, and now earns $8 billion a year for big brokerages and banks plus an unknown amount for institutional investors. Voting rights are lent along with the shares, and increasingly, that is leading to unintended consequences.

Vote counters often fail to keep track accurately and let the borrowers and owners of the same shares both cast votes. Four big banks paid the New York Stock Exchange $2.35 million last year to settle charges in this area. Meanwhile, other shareholders often are unaware that a big voting bloc has no real ownership stake in the company—and that it may vote directly opposite the wishes of the

Please turn to page A9

Taking Stock

How hedge funds can borrow shares to sway shareholder votes

Company announces the "record date" on which investors must hold stock to vote at the next shareholder meeting.

Hedge fund seeks to borrow stock in the company before that date.

Broker taps shares from institutional lender or an individual's account for the hedge fund.

Broker transfers the shares, along with voting rights, to the **hedge fund** in exchange for collateral and a fee.

Hedge fund votes with the borrowed stock. Institutions or individuals who own the shares lose their votes. **Hedge fund** can return the shares at any time after the record date.

Continued from Page One
stock's actual owners.

This phenomenon has gotten the attention of regulators, who fear it is escalating just as shareholder voting is gaining importance as a way to improve corporate governance and keep management excesses in check. If elections can be too easily gamed, critics fear, a basic foundation of public companies—that shareholders vote in the company's best interest—will be undermined.

The practice "is almost certainly going to force further regulatory response to ensure that investors' interests are protected," Securities and Exchange Commission Chairman Christopher Cox said in an interview. "This is already a serious issue and it is showing all signs of growing."

THE SEC HAS NO firm plans yet. Britain's securities regulator, the Financial Services Authority, has begun a study into whether to force greater disclosure of large investors' stakes in companies, regardless of whether they own stocks or are just borrowing them. One of the largest pension-fund managers there, Hermes, has called for regulators to outlaw voting altogether by borrowers of shares. In Hong Kong, the Securities and Futures Commission said it is studying "issues relating to borrowed shares and voting."

The concern arises just as more companies are moving toward requiring a majority of all shares to elect directors, instead of simply a plurality of those casting votes. A recent U.S. federal appeals court decision opened the door to giving shareholders a greater say in the election and nomination of directors, and the SEC recently approved a rule to make it easier for investors to put up their own slates of directors. But the vulnerability of the voting system could set back such efforts.

"It seems in trying to perfect corporate governance, we were polishing an apple that had a lot of worms inside, and we didn't know it," says Carol Hayes, corporate secretary of Coca-Cola Co., and a member of the Society of Corporate Secretaries and Governance Professionals.

The opportunity for "empty voting" arises when brokerage firms or institutional fund managers lend the shares they manage to hedge funds or other firms, for a fee that can rise with how difficult the shares are to get. The value of securities borrowed on any given day has reached $1.6 trillion after several years of double-digit growth, according to Astec Marketing Research Group Inc., a New York capital-markets research firm.

When it comes times for a shareholder vote, it's the borrowers that hold the voting rights. Under Delaware law, where most large companies are incorporated, voting rights belong to whoever holds the stock on a date the company chooses in advance of its stockholder meeting. It's as if in the U.S. electoral system, someone could borrow your voting rights and use them to vote in your place without your knowing it. Individual share owners often are unaware that contracts with brokerages normally allow the brokerages to make money by lending out stock if it's held in margin accounts, just as banks profit from lending their cash deposits.

The owners must ask for their stock to be recalled if they want to vote—which means they would have to know the stock was lent and that the vote was coming. If their stocks are lent, the borrowers of the shares, not the owners, are supposed to receive invitations to vote. Stocks in cash accounts aren't affected.

No one knows how widespread "empty voting" is. Law professors Henry Hu and Bernard Black at the University of Texas at Austin have studied 22 instances world-wide from 2001 through 2006 in which either borrowed stock or hedging strategies, or both, were used. Consider one example:

On Borrowed Time

- **The Issue:** Hedge funds can vote shares they don't own by borrowing them.
- **The Stakes:** Critics say shareholder elections are skewed if investors who don't have an economic stake can vote.
- **The Bottom Line:** Regulators are circumspect about the practice.

HENDERSON LAND Development Co., Hong Kong's third-largest property developer, owned 73% of a subsidiary called Henderson Investment. It offered a rich premium in November 2005 to buy the rest. It had failed in a similar effort three years earlier, but this time it came back with a better offer. Under Hong Kong law, the deal would go through unless 10% of all the shares opposed it. Since the parent owned such a large stake and large institutions backed the deal, passage was considered a foregone conclusion.

Yet the acquisition was voted down early last year by a slim margin. Several market participants were quoted in news reports saying there was a surge in borrowed shares by at least one hedge fund ahead of the vote, compared with little if any lending in Henderson shares over the previous seven months.

By borrowing the shares and simultaneously shorting the underlying stock, the hedge funds gained the voting rights to squash the deal and stood to profit when the stock dropped 18% the next day. After the Henderson vote, the Hong Kong regulator said it was examining voting practices.

"It appears that one or more hedge funds borrowed Henderson Investment shares before the record date, voted against the buyout, and then sold those shares short, thus profiting from its private knowledge that the buyout would be defeated," the Texas professors wrote in the May 2006 Southern California Law Review. A Henderson spokeswoman declined to comment.

Altogether the professors analyzed 12 instances in which it appeared that hedge funds or other large shareholders voted to try to swing public-company contests in their favor without much ownership stake. In 10 others, they said investors just hid their stake in the company until a vote.

THE SHAREHOLDER VOTE is rooted firmly in corporate law, which is based on the notion that shareholders vote in the best interests of the company in which they own stock. The effects of short-selling and other sophisticated instruments that can separate a vote from economic interest were never considered. "You have this whole superstructure built on this notion that there is this coupling of economic interest and voting power," says Mr. Hu. "With these financial innovations, you're screwing around with the foundation."

Hedge funds say their actions are legitimate, lawful and many times in the best interest of their investors. Often they borrow stock or use a hedging strategy to minimize the risk of their stake without any intention to affect the votes of the companies. They also say that if institutions can make money by lending shares, there shouldn't be a judgment against those who borrow.

"You should be able to vote your shares irrationally if you want," says Marc Weingarten, a partner in New York with law firm Schulte Roth & Zabel who advises hedge funds. He adds, "The rules and state law simply haven't caught up with the marketplace for sophisticated trading techniques. They never contemplated the slicing and dicing of ownership and voting power that's done in the marketplace."

It's routine for hedge funds and other investors to borrow shares to vote them. Many individual investors hold their shares in margin accounts with their brokers. Brokers lend those shares out, often when they are requested by short-sellers, who borrow shares in the expectation the price will fall, sell them and hope to profit by buying them back at a lower price.

The California Public Employees' Retirement System reported in October that it made $129.4 million in net income from lending securities for the year ending March 31, 2006. Critics say investors like Calpers shouldn't lend their shares if borrowers will use them in ways to undermine corporate governance. Proponents of securities lending say Calpers and other institutional investors have a fiduciary duty to make the most money for their constituents.

Not everyone agrees where the fiduciary duty lies. Lord, Abbett & Co., a mutual-fund company, has scaled back its stock lending program recently, saying it sometimes didn't get securities back in time to vote and decided that the money it was earning from lending out stocks wasn't worth it. "It was impeding our corporate governance efforts in a troubling number of circumstances," says Robert Morris, chief investment officer at Lord Abbett.

Calpers says it prohibits lending its 30 largest equity investments to make sure they will be available for voting, and on a second list monitors 300 of its largest so that if Calpers wants to vote the shares, it can try to get them back. A Calpers spokesman called those measures "a sufficient safeguard for our interests, for the time being."

Brokerage firms keep records of which shares are lent out when, and which holders of stocks are supposed to have the votes. But shares can be lent and re-lent and the records don't always keep up. Sometimes proxies are sent to both owners and borrowers, leading to "overvoting."

The New York Stock Exchange, which says tracking of votes has become inadequate, found overvotes in almost all the shareholder votes it tested at Deutsche Bank in 2002 and 2003: 23 of 27 instances. "There shouldn't be overvoting," John Thain, chief executive of NYSE Group Inc., said in a speech last year. "The question is, 'How do we prevent that from happening?' "

The phenomenon has gotten the attention of regulators.

Last February, Deutsche Bank agreed to pay $1 million, without admitting or denying wrongdoing, to settle NYSE allegations that the brokerage firm didn't have proper systems in place. In June, UBS Securities, Goldman Sachs Group Inc. and Credit Suisse Securities agreed to pay a total of $1.35 million, without admitting or denying wrongdoing, to settle similar NYSE charges.

JAMES MORPHY, the head of mergers and acquisitions at New York-based law firm Sullivan & Cromwell, says because the votes haven't yet affected many outcomes in general corporate elections, companies haven't spent the time or money to dig deeply into who actually owns and votes their stocks. "To the extent there are a lot more voting contests, these issues are going to come to the fore," he said. As shareholders are getting more power in the wake of management scandals, votes are narrowing, which forces companies to pay more attention to who their shareholders are—as have the growth and increased combativeness of hedge funds.

One way "empty voting" occurs is by borrowing stock ahead of the date that companies use to determine which stockholders can vote at a particular meeting. Record dates are usually set 30 days before a vote, designed to give companies adequate time to print and mail information to its shareholders of record.

In 2002, activist British hedge fund Laxey Partners, which owned a 1% stake in British Land, a major British property owner, sought to break up the company and oust its chairman John Ritblat. With a key proxy vote approaching, Laxey boosted its voting stake in British Land to 9% by borrowing more than 40 million shares days before the record date. By being shareholders of record on the record date, Laxey was entitled to vote at the next meeting.

IN THE END, Laxey's proposals were defeated. But Mr. Ritblat criticized Laxey for borrowing the shares, saying it wasn't good corporate governance. The three institutions that lent out shares—Hermes, Barclays Global Investors and Scottish Widows, a life insurance and investment arm of Lloyds TSB—apologized to British Land. Hermes says it didn't lend shares to Laxey but apologized to British Land for not recalling its shares and voting its full strength in support of management.

Since then, several large pension funds have taken notice and established internal systems to allow them to recall shares ahead of a vote and better monitor which shares are lent.

Because corporate voting is mostly governed by state law, the SEC's main tool in voting issues is requiring more disclosure. "Empty voting" usually doesn't trigger current disclosure rules because they don't cover borrowed stock or derivative holdings unless an investor owns more than 5%. Many hedge funds own just shy of 5%, Mr. Hu says—and then use empty-voting strategies to enlarge or hide their stake.

Paul Atkins, a Republican SEC commissioner, expressed concern in a speech this week that empty-voting and other techniques should be considered as the SEC looks to tackle other shareholder proposals. That could delay the SEC from moving forward in resolving whether shareholders are permitted to nominate their own directors on corporate ballots.

One potential solution is to give institutional investors better notice of important proxy votes so they can know to recall shares—and the attached voting rights—that they've lent. Some investors already write recall options into their lending contracts, but brokerage firms have advised it could make borrowing those shares less attractive.

Professors Hu and Black recommend regulators require disclosure of an investor's complete stake, however it is held. Disclosure now "is so patchwork, you almost never see it," says Mr. Hu. "We need to get a better grip on just how extensive these practices are."

Regulators, however, don't want to disrupt the stock-lending market, and also have to be careful that any fix doesn't have the reverse effect that they intend. For instance, weighing votes by how long the stock has been held could curtail empty voting but disenfranchise individual investors, too.

—Tom Lauricella contributed to this article.

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Testimony of
Stephen M. Davis

On

"Empowering Shareholders on Executive Compensation: H.R. 1257, the 'Shareholder Vote on Executive Compensation Act'"

Before the Committee on Financial Services
United States House of Representatives

March 8, 2007

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Chairman Frank, Ranking Member Bachus and Members of the Committee, the Millstein Center for Corporate Governance and Performance at the Yale School of Management is in the process of producing a white paper on the practice of annual advisory votes on compensation policy. The aim of *Does 'Say on Pay' Work? Lessons on Making CEO Compensation Accountable* is to assess the track record in Britain and provide analysis on whether the advisory vote tool may be adapted to the United States environment. While we expect to issue draft and final versions later this spring, as director of the project I wanted to provide the Committee herewith a preliminary summary of principal findings for the record, as members deliberate on H.R. 1257. Note that conclusions are those of the author and do not reflect the opinion of the Millstein Center as an institution.

First, a word of background on the Millstein Center. The Center is an international resource providing active support for research in corporate governance. It disseminates its work to the world's academic, policy-making and professional communities. We produce and sponsor scholarly research, policy-oriented white papers and a unique online platform of databases on global corporate governance. The Center's affiliated faculty and fellows comprise leading scholars and practitioners from a variety of disciplines. Our advisory board includes leaders in the business and financial communities. A forum for interdisciplinary research, the Millstein Center for Corporate Governance and Performance brings together scholars from the School of Management, the Yale Law School, the Yale Economics Department, and other graduate and professional programs within Yale University to study governance mechanisms in a global context. For this white paper project, the Center sourced information and conducted roundtables and interviews in London in February 2007 with cooperation from the Association of British Insurers, Institute of Chartered Secretaries and Administrators, Institute of Directors, International Corporate Governance Network, Deloitte and others.

The overall conclusion of the *Does 'Say on Pay' Work?* white paper is as follows.

Advisory votes on executive pay policies are rational, timely, road-tested and practical for use in the United States. Based on reviews of the UK track record, we find that advisory votes represent an important lever that could strengthen both boards and shareholders in the quest to better align top corporate pay with performance. A surprisingly broad consensus of corporate directors, shareholders and government in Britain sees 'say on pay' acting as a driver of corporate value, making public corporations more competitive and, by raising confidence in governance integrity, lowering risks for investors. Experience shows that advisory votes on compensation are likely to serve as a potent stimulus

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to dialogue between boards and shareholders. Moreover, advisory votes can go hand-in-hand with new SEC-mandated rules on pay disclosure. The tool is no panacea on its own. While constructive in and of themselves, advisory votes on compensation policy generate best outcomes when fitted with other measures, such as majority-rule director elections. Further, to best tether pay to performance, boards, shareholders and service providers face the challenge of hard-wiring material changes in their operations to handle advisory votes. In this respect, market players in the United States have an opportunity to take steps to avoid shortfalls evident in Britain.

Underpinning the summary conclusions above are seven principal findings from the UK which can inform the process of adapting 'say on pay' to the United States environment. They are as follows.

1. *Votes on compensation policy resulted in a marked rise in dialogue between corporate boards and management, on the one hand, and institutional investors on the other. This transformed the way compensation policies are constructed.* The introduction of 'say on pay,' and in particular the GlaxoSmithKline board's jolting defeat in 2003, produced a virtual overnight increase in the level of dialogue between companies and funds. Directors have shown a strong interest in avoiding the prospect of individual and collective reputational damage resulting from significant shareholder opposition. "Beforehand, we paid the CEOs what we wanted to and told investors who objected 'too bad,'" recalled one former board member. But the Glaxo loss "concentrated the mind wonderfully. Now the board must base remuneration on performance and be scrupulous about it." The Association of British Insurers (ABI) estimates that contacts initiated by companies before they finalize compensation plans tripled. And an arm of the National Association of Pension Funds (NAPF), which had recorded an average 20 such outreach efforts by companies each year prior to 'say on pay,' engaged in 150 instances of dialogue in 2005 and 130 in 2006. These consultations ranged from a simple phone call to multiple high-level meetings. In many cases such dialogue resulted in boards changing corporate plans to strengthen performance triggers in ways that met shareholder objections. Critics have raised concerns about minority shareholders abusing a 'say on pay' system to enhance their sway over boards of directors. In Britain, anxiety over a tide of investor uprisings proved misplaced. In four years only Glaxo, among major companies, has seen its remuneration report rejected in a non-binding vote. Proxy advisors have exercised restraint. Between 2004 and 2006 RREV, the UK arm of Institutional Shareholder Services (ISS), urged votes against at less than 13% of 1,817 annual meetings. Investors have come to view a vote against board pay policies as an option of near-last resort. Just 64

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companies out of 596 reporting voting results between 2002 and 2007 experienced combined dissent ('no' votes plus abstentions) of more than 20%, according to Deloitte.

2. *While top executive pay in the UK continues to exceed inflation and average workforce wage increases, advisory votes have been an important contributing factor in taming the rate of increase, curbing opportunities for 'pay for failure', and linking compensation dramatically closer to performance.* As elsewhere, fuller disclosure of compensation in Britain has proven a contributing factor in rising pay levels among top executives. Advisory votes do not appear to have reversed that trend. Absolute numbers continue to climb, though at a more measured pace (the average annual increase has slowed in the last four years to between 5 and 10%, say various sources). However, advisory votes are credited by virtually all parties with producing "dramatically better alignment between incentive pay and shareholder value." For instance, the latest Deloitte study concluded that the level of variable pay has increased significantly with meaningful performance conditions attached to incentive compensation. Stock option plans are being replaced by share grants tied to significant performance triggers advocated by shareholder bodies. Payouts for average performance have dropped significantly in response to investor pressure. New limits cap the amount of options any one executive may be granted. Golden parachute packages, swelled to three times final salary before a drive to curb them began in 1999, have steadily shrunk to the equivalent of one year's wage. The quality of reporting on pay has improved substantially. In short, "the level of transparency and disclosure and explanation today can't be compared to before," contends one service provider.

3. *Advisory votes are seen by government as having succeeded not only in handing investors a voice on compensation, but in contributing to the competitiveness of the British economy and the attraction of London as an international capital market.* British lawmakers may have initiated advisory votes "as a negative push to correct scandals on pay," asserted a key official the UK Department of Trade and Industry (DTI), the agency which crafted and now oversees 'say on pay' legislation. But London now perceives them as part of strategic measures that "enhance the competitiveness of the UK economy." The DTI has concluded that advisory votes result in "better planning by corporations, fewer surprises, better dialogue with investors." They are "a prophylactic against poor management," the official said in an interview, keeping UK companies in fighting trim. Advisory votes are among "appropriate steps to reduce risk...and we have had no big scandals among quoted companies" in recent years. Public authorities and the London Stock Exchange have touted the UK corporate governance regime, including

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'say on pay' voting rights, as equipping the City with a competitive edge for attracting capital, especially in comparison to New York. Echoing that perspective, four of the world's largest funds recently wrote to the Securities and Exchange Commission asking for advisory votes to expand shareholder rights and, thereby, to improve the attraction of the US for foreign capital.

4. *Corporate board compensation committees have retooled the way they design and communicate about executive pay plans so as to draw support from institutional shareholders.* Before advisory votes came into force, the typical compensation committee had to produce a package aimed at persuading the board. After advisory votes, the board compensation committee had to design packages capable of persuading shareholders. The difference has proven significant. Pay panels now meet more frequently; engage in design-stage consultation with key investors, investor trade organizations and/or proxy service advisors; utilize more information; and hire more independent outside advice. Directors "demonstrate more awareness that their work will be subject to broad scrutiny" and are "more diligent" about crafting policies that allow them "to defend decisions taken," according to corporate secretaries at a Yale roundtable in London. Moreover, compensation committees "are much more constrained" in shaping generous severance terms, since UK shareholder guidelines on CEO employment contracts are prescriptive and relatively strict. Chairs of compensation committee, in particular, have welcomed advisory votes as they supply leverage in standing up to potential insider pressure. However, corporations are on a learning curve. Some initiate early, high-level dialogue with investors and produce fulsome disclosure documents considered best in class. Others make only token efforts at consultation and rely on boilerplate in reporting.

5. *Institutional investors have stepped up scrutiny of executive pay packages but continue to search for effective methods of monitoring compensation.* "There is no question that investors changed dramatically after introduction" of advisory votes, observed one market player in Britain. Before them, institutions generally devoted fewer resources to systematic analysis of compensation structures except in egregious cases brought to special attention through media or other circumstances. The onset of universal voting on pay at FTSE All-Share companies generated fresh demands on both the time and skills of fund professionals as corporate boards sought input on plans, and as complex incentive policies required analysis for ballot decision-making. Funds have experienced mixed success in facing challenges posed by the introduction of advisory votes. Some funds responded by relying almost entirely on outsourced agents, the proxy advisory services, to conduct

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such analysis and consultation. Leading funds, however, sought to participate directly in engagement with companies over pay practices. They report having had striking success in persuading boards to tie incentive pay directly to performance. However, institutional investors also worry that they have entered into something of an arms race, where they are struggling to match expertise with corporations' remuneration consultants who produce ever more complex arrangements. Said one investor: "we risk getting lured into tweaking; of thinking we've achieved objectives when we might be missing the big picture." UK funds are only beginning debate about whether to ease their own prescriptive guidance on pay practices in favor of broader principles that can be adapted to individual companies. They are also assessing at what level of detail they must engage when reviewing compensation plans.

6. *Advisory votes have proven particularly effective in a context of measures that provide for substantial board accountability.* Advisory ballots on compensation appear to carry particular weight in the UK because of a related power. Investors retain authority under corporate law to oust directors by majority vote. If members of a remuneration committee fail to be responsive to shareholder concerns over pay policies, investors have the real, but rarely exercised, option in an annual meeting—or by a mid-term special meeting—of supporting their ejection from a board. Therefore, directors choosing to ignore significant dissent in an advisory ballot face the risk of practical consequences. The 'teeth' of majority rule may be seen as another reason why both corporations and investors in Britain have come to endorse the concept of advisory votes on pay. Boards see the measure as a way of channeling dissent away from elections so that members can isolate and resolve a specific problem over pay rather than risk stinging levels of opposition, or outright defeat, for a director candidate. For their part, investors back votes of confidence on remuneration because the tool allows them to register dissent over pay without exercising their power to overthrow board members they might otherwise support.

7. *Providers of proxy analysis and recommendation services have found their role enhanced.* Investment funds in Britain expect proxy service providers affiliated with their trade associations to vet remuneration plans with companies and to engage in dialogue with boards in search of improvements before plans are finalized. Other funds appear to rely on service providers solely for guidance in voting. Either way, market concerns center on two questions: First, whether too many investors follow service provider voting advice automatically and, second, whether such providers apply a "one-size-fits-all" framework instead of evaluating compensation plans according to a company's specific circumstances. The services themselves have

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confronted other challenges. They experienced intense new demands on internal resources in the wake of advisory votes on compensation. Ventures providing recommendations had to re-examine guidelines on pay as such best-practice advice now related directly to a voting item. The two most influential UK services (ABI's IVIS and the NAPF's RREV, owned by Institutional Shareholder Services) reported a substantial rise in outreach by corporate boards and representatives, such as compensation consultants. Services faced needs to improve the sophistication of their analysis of compensation packages.

It follows from the observations above that 'say on pay' is a demonstrated propellant of healthier corporate-shareholder relations with a meaningful record of strengthening performance links to CEO compensation. Further, insights from the UK experience illuminate variables US players should address in the course of Americanizing advisory votes on pay. Some involve legislation; others adaptation of market practices. Among them:

- Advisory votes on pay are best introduced on a legislative basis. The history of UK experience before votes on pay became law makes clear that companies already engaged in market-leading pay practices tended to be early voluntary adopters. But companies deemed most in need of greater accountability shunned the tool, despite significant government and investor pressure.

- Advisory votes are constructive in and of themselves. However, they can reach their full potential when operating at companies which conduct director elections according to the majority vote standard. Ongoing efforts to install majority voting as the electoral standard at US companies can be an important parallel development in the drive to better align executive pay with performance.

- Corporate boards can readily develop effective proactive strategies to secure investor loyalty in advisory votes. New SEC disclosure rules on pay are more comprehensive than those in Britain. Compensation committees can oversee design-stage consultation exercises with investors and/or their agents, and road shows on pay policies in advance of the annual meeting.

- Investors can prompt entities such as the Council of Institutional Investors to develop advanced collective guidance on best-practice compensation principles.

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Thank you for the opportunity of contributing to the debate over advisory votes. Please do not hesitate to contact me should you have any questions or comments, or if the Millstein Center can be of any further assistance. We will of course provide the Committee with the full white paper report when it is completed. I look forward to answering your questions.

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Testimony of

Richard Ferlauto
Director of Pension and Benefit Policy

American Federation of State, County and Municipal Employees

Before the
Committee on Financial Services
U.S. House of Representatives

On

H.R. 1257
The Shareholder Vote on Executive Compensation Act

March 8, 2007

Testimony of Richard Ferlauto, Director of Pension and Benefit Policy
American Federation of State, County and Municipal Employees
Before the Committee on Financial Services, U.S. House of Representatives on
H.R. 1257, The Shareholder Vote on Executive Compensation Act
March 8, 2007

Good morning, Chairman Frank and members of the Committee on Financial Services. My name is Richard Ferlauto. I am the Director of Pension and Benefit Policy at the American Federation of State, County and Municipal Employees. AFSCME is the largest union in the AFL-CIO with 1.4 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. We believe that both are required to align the compensation of the most highly paid executive officers with the long-term performance objectives of public fund shareholders.

Executive compensation that is not aligned with long-term value creation has been a problem for shareholders for years. Inappropriate compensation arrangements can distort the incentive structure for implementing strategic planning and can waste corporate assets that could be distributed to shareholders or reinvested in the company and its employees, making companies less competitive. And, when so much money is at stake, inappropriately structured compensation can generate the motivations to manage earnings, obfuscate financial statements or simply cook the books. The latest versions of this phenomenon are the "options back dating" and "spring loading" scandals that, according to statistical models, ultimately may implicate thousands of publicly listed companies.

In addition to the important issue that this is for corporate shareowners, there are compelling public policy reasons why concerns about spiraling and out of control CEO pay needs to be addressed through legislation. Social equity concerns should be heeded when internal corporate governance failures lead to the creation of a super-rich class, whose rise is not based on merit, but rather on ineffective corporate boards, crony relationships and financial manipulation. When failed CEOs walk away with hundreds of millions of dollars or when golden handshakes are given to the newest "rock star" executive with contract guarantees or when books are manipulated to meet payout thresholds, then the American ideal of working hard to get ahead rings hollow. This type of inequity may eventually tear at the fabric of our society.

The numbers tell the story. The average S&P 500 CEO took home $13.51 million in 2005, up by more than 16 percent over the year before.[1] The average pay for all CEOs comes to

$7.09 million in 2005.[2] Yet these numbers do not include the to-date "hidden" pensions, tax gross-ups, country club memberships, personal jet use and myriads of other CEO perquisites.

Looked at another way, the average CEO in the United States earned 262 times the pay of the average worker in 2005. In 2005 a CEO earned more in one workday than an average worker[3] earned in 52 weeks.[4] Put executive pay up against a minimum wage worker, and the CEO was paid 821 times as much as a minimum wage worker in 2005.[5]

A 2006 poll found that 80 percent of Americans thought executives were overpaid.[6] It is not just the public that is outraged over soaring pay for executives. Ninety percent of institutional investors think the current executive compensation system has dramatically overpaid executives.[7] Even a majority of directors realize there is a problem. Sixty-one percent of corporate directors think the current executive compensation system has overpaid executives.[8]

A study by Towers Perrin of top executive pay in 26 major countries found that American executives make an average of twice as much as their French, German and British counterparts and four times as much as the Japanese and Koreans.[9]

The argument that CEOs are paid handsomely because they are great generators of wealth for the US economy is not sustained by the facts. Much of the time CEO compensation has little relationship to performance. For example, the 60 companies at the performance bottom of the Russell 3000 index lost $769 billion in market value and destroyed $475 billion in economic value over the five years ending in 2004, while the top five executives at the companies were paid more than $12 billion dollars according to the consulting firm MVC Associates International.[10]

Out of control compensation many times is an indicator of other problems that are linked to failures of the board of directors. Too often, CEO pay is driven by outside consultant surveys and the fact that boards believe their CEO has to be in the top half, if not the top quartile of their peer group, regardless of performance. When pay is not performance-based or is an outlier to its peer group, it often indicates that appropriate CEO succession planning with the strategic objectives of the company in mind has not taken place. Rather than nurturing internal talent, boards which go outside the company need to make whole the current "hot" executive at an auction price. Boards have little discipline when shopping for executives and often get stuck with a non-performing CEO who then needs to be paid off to leave. Witness Carly Fiorina's $21.1 golden parachute at Hewlett Packard; the re-pricing of 1,100,000 stock options for Paul Pressler, the recently departed CEO at the Gap; and, Bob Nardelli's $257 million exit package at HomeDepot, just to highlight a few instances of board failure.

The root cause of these board failures is that directors are not accountable to shareowners. In fact, the American way of corporate governance is fundamentally flawed because the lack of ownership rights creates the classic problem of agency. American investors and companies deserve something better if we are to most efficiently create wealth as well as remain competitive with the global markets where director accountability and shareholder influence on pay is more advanced.

AFSCME supports H.R 1257, "The Shareholder Vote on Executive Compensation Act," because those who have been in a position to link pay to performance and give shareholders an

increased voice in the pay review process have not lived up to that responsibility. It would have been our preference that corporate boards, the Self Regulatory Organizations (SROs) or the SEC give increased power to shareholders to effect better pay models. However, they have had their chance to act in the shareholder's interest and failed to do so for years. Under the circumstances that exist today, where only one U.S. company has come forward and said it would voluntarily provide a shareholder advisory vote, we see no other alternative but to support congressional action and continued congressional oversight.

We remain hopeful that the SEC's new disclosure rules on executive pay will create substantially more transparency about general compensation, retirement benefits and perquisites for top executives. In establishing those rules, however, the SEC has given shareholders only half of what is needed. Better disclosure is necessary but not a sufficient tool to rein in compensation unaligned with value creation. The SEC-required disclosures give us more information, but not the ability to act on that information, although many institutional investors asked for such rights in the rulemaking comment period. In fact, it is not at all clear that market forces given this new information will not act to drive up pay levels even further as CEOs observe and demand the richer pay packages of their peers.

Similarly, U.S. stock exchange listing standards require shareholder approval of equity-based compensation plans. Those plans, however, only set general parameters and accord the compensation committee substantial discretion in making awards and establishing performance thresholds for a particular year. The SROs certainly have the ability to require advisory votes on pay as a requirement of their listing standards, but given the internally conflicted nature of regulatory control contained within the current for-profit SRO structure, we see little hope for action from these bodies. Even the investor outrage over Dick Grasso's $187 million pay package from the New York Stock Exchange has not resulted in listing standards that empower shareholders with the right to object to company pay packages.

Finally, we believe that shareholders do not have any mechanism for providing ongoing feedback on the application of those general listing standard requirements to individual pay packages. Withholding votes from compensation committee members who are standing for reelection is a blunt and insufficient instrument for registering dissatisfaction with the way in which the committee has administered compensation plans and policies in the previous year.

Most company director elections continue to be governed by plurality voting, so a vote withheld from directors is meaningless. Plurality voting ensures that a director will be elected even if the holders of a majority of shares voting decide to withhold support from a director. Ironically, with the increase in the number of companies moving to majority election standards--as they should, shareholders' ability to send messages to compensation committees may actually be reduced. Today, "no votes", which withhold support for directors, are used as part of the dance of shareholder messaging to directors. As votes become more meaningful, proxy voters and advisors may be less willing to send these messages on specific issues like pay, if the board is otherwise well-functioning or if corporate performance is high.

In contrast to U.S. practices, in the United Kingdom public companies are required to give shareholders an advisory vote on the "directors' remuneration report," which discloses executive compensation. Such a vote is not binding, but gives shareholders a clear voice that can

help shape senior executive compensation. In the U.K. and other markets we can observe the history and effectiveness of a shareholder advisory vote on pay.

Advisory shareholder votes are established in the U.K. by law in the Director's Remuneration Report regulations, which require a detailed annual remuneration report that is put to a shareholder vote at every annual general meeting of quoted companies with financial years ending on or after December 31, 2002. The purpose of the legislation as stated by the United Kingdom's Department of Trade and Industry (DTI) was to: 1) enhance transparency in setting director's pay; 2) improve accountability to shareholders and; 3) provide for a more effective performance linkage.[11] The first required votes of the remuneration reports took place at annual general meetings between March 2003 and March 2004. In addition to these newly legislated reporting and voting requirements the Association of British Insurers and the National Association of Pension Funds issued voluntary guidelines for shareholders engaging with companies over compensation issues.

The impact of the new advisory vote requirement was felt beginning in May 2003 at GlaxoSmithKline, the global pharmaceutical company, when shareholders rejected the remuneration report with 50.72 percent of votes cast against the report. The protest vote proved to be humiliating for the GSK board - the historic vote, although only advisory, made Glaxo the first, and to date, only British company to have its pay scheme rejected by shareholders. Shareholders were particularly angry about the "golden parachute" payment chief executive Jean-Pierre Garnier would have received if he lost his job.

When GlaxoSmithKline lost its vote, a sea change occurred with an almost immediate realization among boards that they now had to talk to their shareholders about pay packages. And not just talk *at* them, they actually had to explain the numbers, to justify the incentives, and to persuade their shareholders to accept them.

Paul Munn of Hermes describes the benefits of the vote in the U.K, "We see it as a useful means of engaging with companies on the issue of executive pay. Having an advisory vote sets up the basis for having a dialogue, and that is what is useful."[12]

With greater shareholder consultation on executive compensation packages in the United Kingdom last year, the growth of executive salaries is declining.[13] A study of Britain's 100 largest companies by New Bridge Street Consulting found that the rate of increase in executive salaries in 2006 was five to six percent, down from roughly 14 percent five years earlier.[14]

The DTI engaged the consulting firm Deloitte to issue the November 2004 Report on the impact of the Directors' Remuneration Report Regulations.[15] Among its most important findings, more than 70 percent of shareholders believed that the advisory vote on the remuneration report had significant impact on the "board attitudes and behaviours."

In 2004, the Netherlands took it a step further by requiring companies to submit remuneration reports to a binding vote. In 2005, both Sweden and Australia adopted requirements for non-binding shareholder votes on remuneration reports. An Australian survey in 2006 found that 40 percent of corporate officers believed that directors should take notice of shareholder concerns if a pay report receives a ten percent negative vote, while another 48 percent stated there should be a response if a pay report received a 20 percent negative vote.[16]

From discussions and consultations with the largest global institutional investors experienced with the advisory vote, AFSCME has drawn the following lessons about the use of advisory votes on executive compensation:

- Communication and consultation between shareholders and compensation committees would increase, become more substantative and take place earlier in the pay setting process.

  These communications would better align compensation packages with pay for performance practices that reflect shareholder interest in long-term value and wealth creation.

- With pay for performance in place, the pay practices better reflect individual company situations and better align CEOs with long-term strategic objectives because appropriate incentive structures are put in place.

- The vote is an effective antidote to the tendency of executive compensation to spiral up with enhanced disclosure requirements.

Based on this history and outcomes, in 2006 the AFSCME Employees Pension Plan imported the U.K. advisory vote model by filing "say on pay" shareholder proposals at seven companies, seeking to test the concept with institutional investors and the reaction of board compensation committees. The proposals averaged more than 41 percent support from shareholders, which according to Institutional Shareholder Services is the strongest showing ever for any first year shareholder proposal.

So far in 2007, more than 60 "say on pay" advisory vote proposals have been filed by a broad network of institutional investors, including public pension systems such as CalPERS, the New York City Employees' Retirement System, and Connecticut Retirement Plans and Trust Funds; international funds such as Hermes Investment Management Limited; and the mutual funds Walden Asset Management, Boston Common Asset Management, Calvert Group, and Trillium Asset Management. Labor funds in addition to the AFSCME Employees filing these proposals include the IBEW, SEIU Master Trust and the AFL-CIO Pension Fund Reserve.

The 2007 formulation of the proposals urges the adoption of a policy that company shareholders be given the opportunity at each annual general meeting to vote on an advisory resolution, to be proposed by company's management, to ratify the compensation of the named executive officers as set forth in the proxy statement's Summary Compensation Table and the accompanying narrative disclosure of material factors table. The management would make clear that the vote is non-binding and would not affect any compensation paid or awarded to any named officer.

Just two weeks ago in reaction to one of these shareholder proposals, Aflac became an early adopter of the process, perhaps opening the door for others to follow. Aflac CEO Dan Amos says a vote would make a difference even if it is non-binding. "We would go back to our big shareholders and ask: 'Why did you vote against? What was it you didn't like?' From there, we'd make adjustments."[17]

The shareholder proposals also have resulted in the formation of a working group composed of top U.S. corporations and major institutional investors. The working group is examining how the shareholder advisory might be adapted from the U.K. to the U.S. market. Company participants in the group believe that the concept has considerable merit, but have raised questions about differences between U.K. and U.S. governance systems that need to be explored. It is my hope that the output from this working group will lead to general principles and best practices about how to structure compensation committee/shareholder consultation and produce additional voluntary adopters of the advisory votes. I believe that this effort will bring about a trend of voluntary adoption by leading-edge corporate governance companies. What will not occur with this voluntary approach, however, is broad use of the advisory vote in the immediate future nor its acceptance by entrenched boards with the worst compensation practices.

We want to emphasize that the shareholder vote on pay should be structured only as an advisory vote and not a mandatory vote, which directly rejects or sets compensation levels. It is the responsibility of the compensation committee and the board to establish pay schemes and they are the ones who must ultimately be held accountable for the pay schemes they establish. An advisory vote would provide directors with additional information about shareowners' views on pay and generate the benefits I describe earlier in this testimony. Furthermore, to the extent that the SEC disclosure requirements in the Compensation, Disclosure and Analysis (CD&A) look back on compensation already awarded, and are not prospective, mandatory compensation votes on the CD&A would have large implications for how the terms of compensation agreements are negotiated.

Most importantly, in order for the shareholder advisory vote on compensation to be effective it must be paired with a shareholder proxy access right to nominate directors. Proxy access is the accountability tool that will drive a robust consultation process and focus directors on long-term value issues. Shareowners today have no meaningful way to hold accountable dysfunctional and entrenched boards that are unresponsive to votes on pay reform or other issues. Proxy access is a cost-effective and efficient safety valve for good corporate governance, director accountability and long-term value creation.

The advisory vote and proxy access are necessary complements in the modernization of shareholder rights in the United States. Shareowners will be allowed to evaluate whether or not the compensation committee has produced an appropriate compensation package. If an advisory vote fails to produce reform, then shareholders could withhold votes or replace members of compensation committees that overpay or do not properly link CEO pay to performance.

The experience in the United Kingdom offers instructive guidance for the situation we have today. In the U.K., which has both rights, these shareholder powers are viewed much like soccer's yellow and red card warning system. The advisory vote is the yellow card. A large shareholder vote against a pay report is the yellow card warning to the company board. If this warning is not heeded and pay practices are not reformed and better aligned with performance, then shareholders have the opportunity to use the red card by replacing failed directors.

Finally, I would urge one important clarifying amendment to the legislation, which is required to guarantee the ability of shareholders to continue to submit proposals on the specific elements of senior executive pay. We suggest that language be added to the effect that no

requirement imposed by this Act on companies shall be construed to permit a registrant to exclude shareholder proposals on specific elements of executive compensation. The current form of the legislation could be interpreted by companies as permitting them to omit specific pay-related proposals on the basis of SEC 14a-8(i)(9) and (i)(10) issues, which allow exclusion of proposals that directly conflict with one of the company's own proposals to be submitted to shareholders at the same meeting or proposals that have already been substantially implemented by the company, respectively.

Thank you Mr. Chairman for allowing me to share the views of AFSCME, and many institutional investors on H.R. 1275, and more generally on how enhancing shareholder rights through an advisory vote on pay and proxy access will lead to long-term shareholder value and create a more competitive capital market in the United States. I would be pleased to answer any questions from the Committee.

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[1] "2006 CEO Pay Survey," The Corporate Library, September 29, 2006, p. 8
[2] Ibid, p. 7.
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Testimony of
Steven N. Kaplan

on

"Empowering Shareholders on Executive Compensation"
and
H.R. 1257, the "Shareholder Vote on Executive Compensation Act"

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Are U.S. CEOs Overpaid?

by

Steven N. Kaplan*

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Abstract

Critics of U.S. corporate governance claim that public company (1) CEOs are overpaid; (2) CEOs are not paid for performance; and (3) public company boards do a poor job of compensating and monitoring CEOs. In this paper, I argue that the critics are wrong. While corporate governance and CEO pay are not perfect, a great deal of evidence suggests that CEO pay is largely determined by market forces. CEOs have been affected by the same forces that have increased income inequality. They have not done better than several similar groups. CEOs are strongly paid for performance. And boards do monitor CEOs. CEO tenures are lower than they have been since tenures have been measured in the 1970s; CEO turnover is more closely tied to stock performance than it has been since turnover has been studied in the 1970s. The increased transparency for CEO pay required by the new SEC disclosure rules should further reduce any remaining unwise compensation practices. The proposed bill to mandate a shareholder vote on executive compensation, H.R. 1257, is likely to impose costs while having little, if any, benefit.

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1. Introduction

I am the Neubauer Family Professor of Entrepreneurship and Finance at the University of Chicago Graduate School of Business. One focus of my career and my research has been to study corporate governance, and to understand what governance arrangements lead to the best corporate performance.

In the last several years, corporate governance in the United States has come under great scrutiny and attack. The scandals of Enron, Worldcom and others early in this decade led to the Sarbanes-Oxley legislation. Since that legislation, the criticism of corporate governance has continued. CEOs are routinely criticized for setting their pay, being overpaid and for stealing when they can. Boards of directors are routinely criticized for paying the CEOs too much, not paying for performance, and being too friendly to management.[1]

Are the critics right? Is it true that the typical CEO is overpaid? Is it true that the typical CEO is not paid for performance? Is it true that public company boards are doing such a bad job? In the rest of this submission, I will argue the answers to these questions are no, no, no and no. While CEO and top executive pay practices are by no means perfect, they are nowhere near broken.

First, it is important to put the United States economy in perspective. Over the last 15 years, the period in which corporate governance and CEO pay have been criticized, the U.S. economy has done extremely well – both on an absolute basis and relative to other developed countries. Productivity growth in the U.S. has been unexpectedly good and, despite the tech bust, the stock market has performed very well over that period.

Second, are CEOs overpaid? While there have clearly been abuses and unethical CEOs, pay for the typical CEO appears to be largely driven by market forces. As CEO pay has increased substantially since the early 1990s, the pay of other talented and fortunate groups has increased by at least as much. For example, hedge fund, private equity, and venture capital investors have seen fees increase from less

[1] Jensen, Murphy and Wruck (2004) document the increase in CEO pay since the 1970s. Bebchuk and Fried (2003) and Bebchuk and Grinstein (2005) document a substantial increase in CEO pay accelerated after 1995.

than $5 billion to roughly $35 billion from 1994 to 2004, an increase of 7 times. These increases have translated into very high pay for those groups. By one estimate, the top 25 hedge fund managers earned more in 2004 than all 500 CEOs in the S&P 500. The number of professional baseball, basketball, and football players earning more than $5 million a year increased by a factor of almost 10 times from 1994 to 2004. Even top lawyers saw their pay increase by more than 2.5 times. In line with these other groups, the pay of S&P 500 CEOs increased by roughly 3 times over the same period (although it has declined since 2000).

In other words, while CEOs earn a great deal, they are not unique. Other groups with similar backgrounds and talents have done at least equally well over the last ten or fifteen years. The increase in pay at the top appears to be systemic. Rising CEO pay, therefore, appears to be part of (not the cause of) the general increase in economic inequality that we have seen in the last several decades. The compensation of the other groups, undoubtedly, has been driven by market forces. It is difficult to imagine that the increase in CEO pay is not largely driven by market forces as well.

Third, are CEOs paid for good stock performance? Critics contend that CEOs are not paid for performance. That is just not true. In some cases, the critics confuse theoretical pay – what the boards give to the CEOs as estimated pay – and actual pay. The key question is whether CEOs who perform better earn more in actual pay.

And the answer is yes. My colleague Josh Rauh and I looked at actual CEO pay in a given year. Firms with CEOs in the top decile of actual pay earned stock returns that were 90% greater than those of other firms in their industries over the previous 5 years. Firms with CEOs in the bottom decile of actual pay underperformed their industries by almost 40% in the previous 5 years. The results are qualitatively similar if we look at performance over the previous three years or previous year. There can be absolutely no doubt that the typical CEO in the U.S. is paid for performance.

Fourth, are boards today dominated by their CEOs? The evidence suggests no. My colleague Bernadette Minton and I studied CEO turnover in Fortune 500 companies. Turnover levels since 1998 have been substantially higher than in previous work that has studied previous periods. In any given year,

one out of 6 Fortune 500 CEOs lose their jobs. This compares to one out of 10 in the 1970s. The CEO job is riskier today than it has been in the past. Second, CEO turnover is strongly related to poor firm stock performance – both poor performance relative to the industry and poor industry performance. These sensitivities have been stronger in the last eight years than in any other period since 1970.

Fifth, is there a market for CEOs? The critics contend that CEO pay is driven by consultants and board relationships, not by market forces. The factors I have just presented suggest that view is wrong. All of these factors suggest that the CEO job has become increasingly difficult and less pleasant. Although I hesitate to say it, one might argue that good CEOs are not overpaid, but underpaid. Fortunately, the New York Times has said it for me. In January, Andrew Ross Sorkin reported:

> "Chief executives are being lured by private equity-owned businesses, which offer higher pay and freedom from scrutiny of shareholders and regulators; executives at privately held firms secure ownership positions that can turn into bountiful riches when businesses are sold or go public again; private firms' willingness to pay big money may bolster the argument of defenders of corporate pay practices who contend that companies have been paying going rate in market to attract top talent ..."

Last year saw an unprecedented volume of private equity activity. It is unlikely that the CEOs who did those deals would have chosen to go private and work for private equity investors if they were so overpaid as public company CEOs.

It also is worth pointing out that in hiring the CEOs at higher pay, the private equity investors cannot have felt the CEOs were overpaid. This is true because private equity investors are strongly motivated to make profits. Any extra compensation to a CEO reduces the profit of a private equity investor. In addition, private equity investors control the boards of their firms, so the negotiations are arms-length.

A prominent and interesting example is David Calhoun. Mr. Calhoun was a well-regarded vice chairman at General Electric (GE). He ran a unit that generates $47 billion in sales – about 1/4 of GE's sales. Undoubtedly, he would have been an attractive CEO candidate to a host of other public companies. Instead, he agreed to become the CEO of a private equity-funded company with only $5 billion sales,

VNU Group (which owns A.C. Nielsen). If good public company CEOs were overpaid, it is difficult to understand why he would choose to run a much smaller private equity-funded company.

In addition to going to work for private equity funded companies, some of the more successful public company CEOs have gone to work for the private equity firms as investors or advisors. These include Lou Gerstner of IBM at Carlyle, Ed Artzt of P&G at KKR, Jack Welch of GE at Clayton Dubilier, and Jim Kilts of Gillette at Centerview. There is no doubt that many of these CEOs would be welcome as CEO by many public companies, yet they are choosing not to.

In other words, the regulation, criticism and hounding of public company CEOs may have a major cost. CEOs can and will leave public companies to do something else. And, it is the better CEOs who will tend to do so. The result may be more private companies that are less transparent and more public companies with less able CEOs.

Three other aspects of the current corporate governance system are worth commenting on. First, the SEC issued new rules for the disclosure of executive compensation that are in the process of being implemented. These new rules increase transparency for investors and for boards of directors. At the same time, board compensation committees have become increasingly independent. It is likely that this increased disclosure and independence will reduce any remaining inappropriate practices. And some companies will further increase the pay for performance they offer their CEOs. (If I am correct about the market for CEOs, however, the increased disclosure will not lead to reduced pay for the typical CEO.)

Second, if shareholders are or continue to be dissatisfied, they can withhold their votes from directors in elections for boards of directors. It appears that many companies will move to a majority-voting standard in which directors require a majority of votes cast to be elected. (This is a positive development that makes directors more accountable.)

Third, public company CEOs and boards face increased pressure today from activist shareholders and hedge funds.

Given all this, what do I make of the proposed H.R. 1257? Let's look at the current rules and what the proposed law will change. Under current rules, shareholders can ask a company to have a non-

binding vote on executive compensation in its annual proxy. In fact, more than 50 such proposals have been submitted this year. Because the proposals require shareholders to act, they are generally based on some evidence of poor compensation practices.

The company that receives such a proposal has two choices. It can agree to a vote – like AFLAC – in which case the vote occurs. Or the company can disagree, in which case the company is likely to attract adverse publicity and attention. So, under current rules, when shareholders believe a company has compensation problems, shareholders can generate a vote or adverse publicity for that company. When no one believes a company has problems, nothing happens.

In contrast, H.R. 1257 would mandate a non-binding shareholder vote to approve the compensation of executives for every company every year. Companies with problems will have a vote and, presumably, will receive a negative vote. But this is almost exactly what happens under the current system. So, it is not clear to me that the new bill would create any benefits.

At the same time, the bill would mandate a vote for companies that do not have a problem. This has the potential to impose costs on those companies and boards that they do not incur today. It potentially subjects these boards and companies to increased pressure from interest groups that they do not incur today. One can imagine politically oriented shareholders attempting to make political statements in their votes. A shareholder vote for every company also is likely to make it more difficult to hire a CEO from outside the company.

In summary, the evidence strongly supports the view that CEO and top executive pay is largely driven by market forces. While there have been pay abuses (and the press has focused on them), those examples are not typical and are likely to become less common. On the margin, the proposed bill does not create clear benefits over the current system. It does impose clear costs. Furthermore, the proposed bill is likely to further reduce the attractiveness of being a public company CEO, particularly for good CEOs. That is not good for U.S. companies; it is not good for U.S. workers; and it is not good for the U.S. economy.

The rest of this submission details and expands on the statements above.

2. How have public companies in the U.S. performed?

Before talking about top executive pay, it is worth noting that the U.S. economy and, particularly, the U.S. corporate sector, have performed extremely well in the last 15 years, the period in which corporate governance and CEO pay have been criticized. During that period, the productivity of the U.S. economy has increased substantially, both on an absolute basis and relative to other developed countries. Furthermore, the U.S. stock market has performed extremely well. About a year ago, Berkeley economist, Brad Delong, noted that since Alan Greenspan's famous "irrational exuberance" speech in 1996, the U.S. stock market has not declined, but, rather, increased by 6% per year above inflation.[2] Rather than being irrationally exuberant, the U.S. stock market and U.S. companies have benefited from unexpectedly good productivity growth.

So, as one considers CEO and top executive pay, remember that one should start from a perspective that U.S. companies and their executives have been very successful on average in delivering productivity growth and shareholder returns.

3. How is CEO pay measured?

There are two ways to measure CEO and top executive pay. Unfortunately, these two measures are often used and confused in misleading ways.

The first measure is the estimated or theoretical value of CEO pay. This includes the CEO's salary, bonus, the value of restricted stock issued, and the estimated or theoretical value of the options issued to the CEO that year (usually calculated with Black-Scholes). This is a good estimate of what the board expects to give the CEO that year. It is not a measure of what the CEO actually gets to take home. The CEO takes his or her salary and bonus, but does not get to cash in the options. This measure, therefore, is inappropriate for considering whether CEOs are paid for performance.

[2] http://www.j-bradford-delong.net/movable_type/2005-3_archives/001805.html

The second measure is realized or actual CEO pay. This includes the CEO's salary, bonus, the value of restricted stock, and the value of the options the CEO exercised that year. Because it uses actual option gains (not the theoretical values), this second measure is a good measure of the amount of money the CEO actually takes home in a given year. This measure, therefore, is more appropriate for considering whether CEOs are paid for performance.[3]

. What are the facts about CEO pay?

CEO pay increased significantly from 1993 to 2000. Since 2000, however, CEO pay has not increased. By some measures, it has declined. Exhibit 1 reports the average and median total pay (estimated / theoretical) of S&P 500 CEOs from 1993 to 2005 (in millions of 2005 $). The exhibit shows that average CEO pay peaked in 2000 and has declined by roughly 1/3 since then. Median CEO pay peaked in 2001 and has declined slightly since then. Exhibit 2 reports CEO pay relative to median household income. Again, average CEO pay peaked in 2000 while median CEO pay peaked in 2001.

Nevertheless, the exhibits indicate that boards expected to pay CEOs well. In 2005, the median S&P 500 CEO received estimated pay of just under $8 million, roughly 150 times the pay of the median household. Although these numbers are large, they have declined since 2000, and are lower than some of the figures suggested by critics. The ratio was 71 times in 1994, so from 1994 to 2004, the ratio has increased by slightly more than two times.

Exhibits 3 and 4 present the analogous figures for actual CEO pay. Recall that this includes exercised options that were issued in the past. Exhibit 3 shows that average actual pay also peaked in 2000. Median pay has continued to increase and peaked in 2005 at a value of just over $6 million. Exhibit 4 shows a similar pattern relative to median household income.

4. Are CEOs unique or unusual?

[3] Because it measures realized gains, it also includes any benefits from backdating that lowered the exercise price of the options.

Although estimated and actual CEO pay has declined since 2000, it is clear that CEOs are highly paid and have done very well since the 1990s. The important question is why they have done so well? Are the increases driven by market forces? Or, as the critics argue, is much of the increase due to unethical behavior and cozy arrangements between CEOs and their boards? While such behavior has occurred and undoubtedly will continue to occur in some instances, the preponderance of the evidence points toward market forces as the driver of high CEO pay.

For example, Gabaix and Landier (2006)[4] argue that the increase in CEO pay can be explained by market forces. In a simple competitive model, they show that as firms get bigger, CEOs will get paid more. A talented CEO creates more value as a firm becomes larger. In a competitive market, CEO pay will be bid up as firms become larger. In their model, CEO pay increases over time at exactly the same rate as the size of the average firm in the economy. In other words, the larger size increases the returns to hiring a more productive CEO. They then show empirically that the market values of large U.S. firms have increased by a factor of 4 to 7 times since 1980. As predicted by their model, CEO pay has increased by a similar factor over this period.

The argument for market forces also implies that other, similar individuals should have done very well over the same period. My colleague Josh Rauh and I studied this issue and find evidence consistent with this.[5] While CEOs have done well, so have several other fortunate and talented groups. Several of those groups have done better than the CEOs. In other words, the increase in CEO pay is a factor in the increase in income inequality at the very top end of the income distribution. It is not, however, the driver of that inequality.

Exhibit 5 provides a good example. It presents the top 10 incomes in 2004 for three groups. The first is the top 10 highest paid hedge fund managers. The second group is the top 10 highest paid S&P 500 CEOs using actual pay. The third group is the top 10 highest paid S&P 500 CEOs using estimated /

[4] Xavier Gabaix and Augustin Landier, 2006, "Why Has CEO Pay Increased So Much?" working paper, New York University. See also Carola Frydman and Raven Saks, 2005, "Historical Trends in Executive Compensation, 1936-2003," working paper, Harvard University.

[5] Steven Kaplan and Joshua Rauh, 2006, "Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?" working paper University of Chicago.

theoretical pay. As the exhibit makes clear, CEOs are not the only fortunate group. In fact, the top 25 hedge fund managers earned more in 2004 than all 500 S&P 500 CEOs combined.

By the measure of estimated pay, public company CEOs are no more fortunate relative to others in 2004 than they were in 1994. Exhibit 6 reports the fraction of the top AGI income brackets comprised by public company CEOs tracked by the ExecuComp database in 1994 and 2004. The ExecuComp database cover roughly 1700 companies in both years. The exhibit shows that the top bracket (top 0.01%) increased a great deal, from $3.1 million to $7.2 million in that period. The share of ExecuComp CEOs of that top bracket, however, remained constant with the CEOs representing roughly 2% of the very top income bracket (top 0.01%) in both 1994 and 2004. Again, CEOs are not the only ones who are earning more.

Exhibits 7 to 12 provide an indication of other groups that have done extremely well over this period – Hedge Fund, Private Equity, and Venture Capital investors, investment bankers, professional athletes, and lawyers. Exhibit 7 documents the estimated increase in hedge fund fees over time. They have grown from $2 billion in 1994 to $20 billion in 2005. (By comparison, the total pay of S&P 500 CEOs grew from $1.6 billion in 1994 to just under $5 billion in 2004 using estimated or theoretical pay.) Because of lack of transparency, it is impossible to know exactly how those fees are divided among individuals. But as Exhibit 5 indicates, much of that increase has gone to a few fortunate and talented individuals.

Exhibit 8 documents the increase in expected fees to private equity and venture capital investors. According to these estimates, the fees increased from $3 billion in 1994 to over $18 billion in 2005. And our calculations likely understate total fees. Again, a lack of transparency makes it impossible to calculate exactly how these increased fees are divided.

Exhibit 9 compares our estimates of top investment banker pay to the pay of all top executives in the ExecuComp database. That means that we compare roughly 7,500 top executives of non-financial public companies to our estimate of 10,000 managing directors and highly paid investment bankers in 2004. (We exclude CEOs of financial companies because a number of the highly paid ones run

investment banks.) Exhibit 9 indicates that the investment bankers comprise a greater fraction of the top 0.1% and top 0.01% of the income distribution.

Exhibit 10 provides a similar comparison of 1995 and 2004 for professional athletes in baseball, basketball, and football. In 1995, fewer than 40 professional athletes earned over $5 million. In 2004, over 350 did. Like the other groups, professional athletes increased their presence in the very top of the income distribution.

Finally, exhibits 11 and 12 show that lawyers also have done extremely well over the period from 1994 to 2004. According to the American Lawyer survey, the average partner at a top 50 law firm increased his or her income from $0.6 M in 1994 to over $1.2 million in 2004 (using $2004). And there were almost 50% more partners. As a result, we estimate that lawyers also increased their presence substantially in the top 0.1% of the income distribution.

The point of these exhibits is that while CEOs earn a great deal, they are not unique. Other groups with similar backgrounds and talents – particularly, hedge fund and private equity investors, investment bankers, and lawyers – have done at least equally well over the last ten or fifteen years. The increase in pay at the top appears to be systemic. Rising CEO pay, therefore, appears to be part of (not the cause of) the general increase in economic inequality that we have seen in the last several decades. The compensation of these other groups, undoubtedly, has been driven by market forces. Given those trends, it seems likely that the increase in CEO pay has been largely driven by market forces as well.

What are those market forces? Our best guess is that changes in technology have allowed the most fortunate and talented to increase their productivity relative to others. This seems likely to provide some, if not much of the explanation for the increase in pay of professional athletes (technology increases their value by allowing them to reach more consumers) as well as Wall Street investors and CEOs (technology allows them to acquire information and trade large amounts more efficiently). Ben Bernanke

discussed these issues and appeared sympathetic to this explanation in his recent remarks on economic inequality.[6]

5. What do boards do? Are they controlled by their CEOs?

According to the critics, boards are too friendly to management: they do not pay for performance and they do not fire CEOs for poor performance. The truth is, in fact, the opposite.

A. Are CEOs paid for performance?

Critics contend that CEOs are not paid for good stock performance. That is just not true. In some cases, the critics confuse theoretical pay – what the boards give to the CEOs as estimated pay – and actual pay. The key question is whether CEOs who perform better earn more in actual pay. And the answer is yes.

For each year from 1999 to 2004, my colleague Josh Rauh and I took all the firms in the ExecuComp database and sorted them into ten groups based on size. We did this because it is well-established that pay is tied to firm size. Bigger firms do pay more. Within each size group for each year, we sorted the CEOs into ten groups based on how much compensation they actually realized. We then looked at how the stocks of each group performed relative to their industry over the previous five years.

Exhibit 13 gives the results. Actual compensation is highly related to firm stock performance. Firms with CEOs in the top decile of actual pay outperform their industries by more than 90%. Firms with CEOs in the bottom decile of actual pay underperform their industries by almost 40%. The results are qualitatively the same if we look at performance over the previous three years or previous year.

There can be no doubt that the typical CEO in the U.S. is paid for performance.

B. Are CEOs fired for poor performance?

[6] Ben Bernanke, "The Level and Distribution of Economic Well-Being," Federal Reserve Board, February 6, 2007.

Critics contend that boards are too friendly to management. Is that true? Bernadette Minton and I study CEO turnover in Fortune 500 firms from 1992 to 2005.[7] We consider all turnover, both internal and turnover that occurs through takeover and bankruptcy. We then look at how turnover varies with firm performance.

Two patterns emerge. First, turnover levels since 1998 have been substantially higher than in previous work that has studied previous periods. The CEO job is riskier today than it has been in the past. Second, CEO turnover is strongly related to poor firm performance.

Exhibit 14 shows the likelihood a CEO loses his or her job in a given year from the 1970s through 2005. The exhibit does not include takeovers. The data for the 1970s and 1980s, are taken from Murphy and Zabonjik (2005). Not counting takeovers, 10% of CEOs turned over each year. We find a similar percentage through 1997. Since 1998, however, turnover has increased substantially. Not counting takeovers, 12.8% of CEOs turned over each year from 1998 to 2005.

When takeovers are included, the numbers are even greater. Exhibit 15 shows that since 1998, an average of 16.5% of CEOs of Fortune 500 companies lose their jobs each years. This means the average CEO can expect to have the job for only 6 years. Thirty years ago it was closer to ten years.

Next, we consider how CEO turnover is related to firm stock performance. We divide that performance into performance of the firm's industry and performance relative to the industry. We find that board-driven CEO turnover is strongly related to both. CEOs are more likely to lose their job when their firms perform poorly relative to the industry and when their industries perform poorly. And the relationships are meaningful. These relations have been particularly strong since 1998 – 2005. This result is not driven by the firms involved in scandals. I.e., the result is driven by boards, possibly pressured by institutional shareholders and hedge funds.

The bottom line. Since 1998, annual CEO turnover is higher than at any time since 1970. The job is riskier. And, turnover initiated by the board is significantly related to industry stock performance

[7] "How has CEO Turnover Changed? Increasingly Performance Sensitive Boards and Increasingly Uneasy CEOs," by Steven Kaplan and Bernadette Minton, working paper, Universtiy of Chicago, August 2006.

and firm stock performance relative to the industry. I.e., CEOs face significant performance pressure. This is consistent with corporate governance system / boards having performed better in their monitoring role from 1998 to 2005 than in any previous period.

6. What about pensions and severance payments?

Pensions received a great deal of attention last year when the large accumulated pension amounts of Hank McKinnell of Pfizer and Lee Raymond of Exxon were revealed. While the compensation numbers above do not include pensions, including pensions are unlikely to change the results appreciably for the typical CEO.

Sundaram and Yermack (2006)[8] study the value of CEO pensions for a sample of Fortune 500 companies. They find that the annual increment to pension value is less than 10% of total pay on average. The annual increment is smaller for the typical or median CEO. In other words, annual pension income increases the incomes estimated previous by a small amount for the typical CEO. In addition, it is not clear that these pensions have increased over time. Based on this evidence, McKinnell and Raymond appear to represent extremes on the distribution of pensions.

It also is likely that in the future, boards will make less use of these types of pension plans when they are not appropriate. The adverse shareholder reaction and the improved disclosure of top executive pay that the SEC now requires will likely lead to such a result.

The compensation numbers above also exclude severance agreements. The media and shareholder activists have focused on some of the more egregious examples of these agreements. Again, the average or median case is quite different from the extremes. Yermack (2005) looks at severance agreements in 179 instances of CEO turnover in Fortune 500 companies.[9] The mean separation payment is $5.4 million (compared to average pay of $8.1 million) while the median is $0.7 million (compared to

[8] Rangarajan Sundaram and David Yermack, "Pay Me Later: Inside Debt and Its Role in Managerial Compensation," working paper, New York University, 2006.
[9] David Yermack, "Golden Handshakes: Separation Pay for Retired and Dismissed CEOs," working paper, New York University, 2005.

median pay of $4.8 million). Most observers would be surprised that these numbers are not larger. The disparity between the mean and the median indicates that the mean is driven by a few large (and well-publicized) separation payments.

Furthermore, as is the case with pensions, it seems probable that boards will respond to adverse shareholder reaction and improved disclosure to make less use of severance when it is not appropriate.

7. Is it better in the UK?

The UK is sometimes cited as a model for CEO pay. Shareholders are supposed to be more active in the UK. And since 2003, UK shareholders have been allowed to cast advisory votes on executive compensation packages in public companies. It is not clear what difference this has made.

One academic study by Conyon, Core and Guay looked closely at similar sized UK and US companies in 1997 and 2003. They use the estimated or theoretical value of CEO pay – i.e., the pay the board expected to give in those years. They find that the pay of the US CEOs increased by less than 25%, from $3.6 million to $4.5 million in that period. At the same time, the pay of UK CEOs increased by almost 100% from $1.3 million to $2.5 million.[10] I.e., CEO pay increased by more in the UK than in the US. According to a recent Wall Street Journal article, the trend may have continued.[11] The article reported that from 2003 to 2005, CEO salary and bonus increased by 35% in the UK (ISS UK) versus 14% in the US (Mercer).

8. If public company CEOs are so overpaid, why are they leaving public companies?

At this point, I have presented the following facts:

- Average CEO pay has declined or been flat since 2000 / 2001.

[10] "How High Is US CEO Pay? A Comparison with UK CEO Pay," by Conyon, Core, and Guay, working paper, University of Pennsylvania, 2006.

[11] "Shareholders Push for Vote on Executive Pay," Erin White and Aaron Patrick, Wall Street Journal, February 26, 2007.

. While CEO pay has gone up a great deal since 1994, CEOs occupy roughly the same place in the overall income distribution as in 1994. Pay of other similarly fortunate and talented individuals has gone up at least as much since 1994.

. Actual CEO pay is strongly related to stock performance.

. CEO turnover is up substantially. The CEO job is less secure than it has been since at least 1970.

. CEOs face more performance pressure from their boards than they have in any period since 1970.

. U.S. CEO pay appears to have gone up by less than pay for U.K. CEOs since 1997.

At the same time, CEOs and boards have had to implement the new Sarbanes-Oxley regulations. A number of CEOs and directors have complained that the costs involved in some aspects of Sarbanes-Oxley exceed the benefits. According to some, Sarbanes-Oxley has lead to more bureaucracy and compliance at the expense of strategy and value creation.

All of these factors suggest that the CEO job has become increasingly difficult and less pleasant. Although I hesitate to do so, one might be tempted to argue that good CEOs are not overpaid, but underpaid. Fortunately, the New York Time presented exactly this argument in January. Andrew Ross Sorkin reported:

> "Chief executives are being lured by private equity-owned businesses, which offer higher pay and freedom from scrutiny of shareholders and regulators; executives at privately held firms secure ownership positions that can turn into bountiful riches when businesses are sold or go public again; private firms' willingness to pay big money may the bolster argument of defenders of corporate pay practices who contend that companies have been paying going rate in market to attract top talent … "[12]

Last year saw an unprecedented volume of private equity activity. With the recent deals for Equity Office Properties and TXU, that activity has not abated. While liquid financial markets are playing an important role, this activity would not be occurring without the active participation of public company CEOs. If they were so overpaid as public company CEOs, it is difficult to explain why so many

[12] New York Times, January 8, 2007

CEOs have chosen to go to work for private equity-funded companies – either by taking their own companies private or by leaving their companies to work for other ones.

It also is worth pointing out that in hiring the CEOs at higher pay, the private equity investors cannot have felt the CEOs were overpaid. This is true because private equity investors are strongly motivated to make profits. Any extra compensation to a CEO reduces the profit of a private equity investor. In addition, private equity investors control the boards of their firms, so the negotiations are arms-length.

A prominent and interesting example is David Calhoun. Mr. Calhoun was a well-regarded vice chairman at General Electric (GE). He ran a unit that generates $47 billion in sales – about 1/4 of GE's sales. Undoubtedly, he would have been an attractive candidate to become the CEO of GE or a host of other public companies. Instead, he agreed to become the CEO of a private equity-funded company with only $5 billion sales, VNU Group (which owns A.C. Nielsen). If good public company CEOs were overpaid, it is difficult to explain why he would choose to run a much smaller private equity-funded company.

And Calhoun is not the only example. Mark Frissora left CEO job at publicly traded Tenneco to run Hertz. The CFO of Circuit City left last month to become the CFO of a private equity funded retailer.

In addition to going to work for private equity funded companies, some of the more successful public company CEOs have gone to work for the private equity firms as investors or advisors. These include Lou Gerstner of IBM at Carlyle, Ed Artzt of P&G at KKR, Jack Welch of GE at Clayton Dubilier, Larry Bossidy of Honeywell at Aurora, and Jim Kilts of Gillette at Centerview. There is no doubt that many of these CEOs would be welcome as CEO by many public companies, yet they are choosing not to work for public companies.

In other words, the criticism and hounding of public company CEOs may have a major cost. CEOs can and will leave public companies to do something else. And, it is the better CEOs who will tend to do so. This leaves more private companies with less transparency and leaves public companies with less able CEOs.

9. Is a law to require a non-binding shareholder vote a good idea?

The facts reported call into question the claims that CEOs are overpaid, that CEOs are not paid for performance, and that boards are dominated by their CEOs. In fact, the evidence indicates that good CEOs in U.S. companies may be underpaid at this point. Furthermore, the performance of the U.S. economy and the U.S. stock market is consistent with a system that has performed well, not one that has performed badly.

Now, let's look at the current rules and what the proposed law will change. Under current rules, shareholders can ask a company to have a non-binding vote on executive compensation in its annual proxy. In fact, more than 50 such proposals have been submitted this year. Because the proposals require shareholders to act, they are generally based on some evidence of poor compensation practice.

The company that receives such a proposal has two choices. It can agree to the proposal in which case the vote occurs. Or the company can disagree, in which case the company is likely to attract adverse publicity and attention. So, under current rules, when shareholders believe a company has compensation problems, shareholders can generate a vote or adverse publicity for that company. When a company has no problems, nothing happens.

In contrast, H.R. 1257 would mandate a non-binding shareholder vote to approve the compensation of executives for every company every year. Companies with problems will have a vote and, presumably, will receive a negative vote. But this is almost exactly what happens under the current system. So, it is not clear what the benefits of the new bill would be.

At the same time, the bill would mandate a vote for companies that do not have a problem. This has the potential to impose costs on those companies and boards that they do not incur today. It potentially subjects these boards and companies to increased pressure from interest groups that they do not incur today. One can imagine politically oriented shareholders attempting to make political statements in their votes.

A shareholder vote for every company also is likely to make it more difficult to hire a CEO from outside the company. While the board and CEO candidate may agree that a compensation contract is at a market rate, the uncertainty about the shareholder vote and attendant publicity has the potential to scare off some candidates.

So, the proposed bill would impose clear costs without generating clear benefits.

Two other aspects of the current regime are worth commenting on. First, the SEC issued new rule for the disclosure of executive compensation that are in the process of being implemented. These new rules increase transparency for investors and for boards of directors. It is likely that this increased disclosure will reduce or eliminate inappropriate practices that remain. If I am correct about the market for CEOs, however, the increased disclosure will not lead to reduced pay for the typical CEO.

Second, if shareholders are or continue to be dissatisfied, they can withhold their votes from directors in elections for boards of directors. It appears that many companies will move to a majority-voting standard in which directors require a majority of votes cast to be elected. (This is a positive development that makes directors more accountable.)

So, in sum, I see that H.R. 1257 addresses a problem that is not the systemic problem that critics claim it is. In fact, it may be a greater problem that some of the best public company CEOs do not want to be public company CEOs any longer. The flight of top executives and companies to private equity (and hedge funds), both in the U.S. and in Europe, suggests that these kinds of concerns are real. CEOs and top executives appear to operate in and are paid by a market.

It is hard to see that H.R. 1257 will generate appreciable benefits over the current system. At the same time, H.R. 1257 will generate additional costs. On the margin, this bill also will further reduce the attractiveness of being a public company CEO, particularly for good CEOs. That is not good for U.S. companies; it is not good for U.S. workers; and it is not good for the U.S. economy.

Exhibit 1:

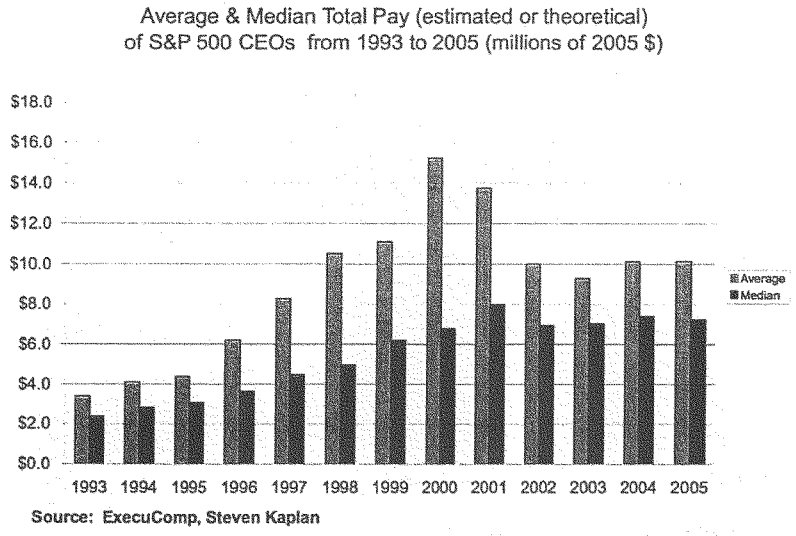
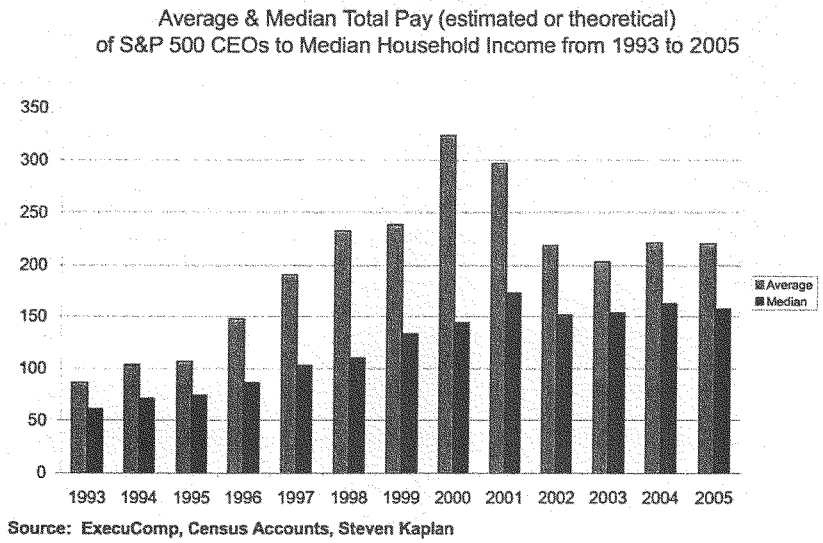


Exhibit 2:



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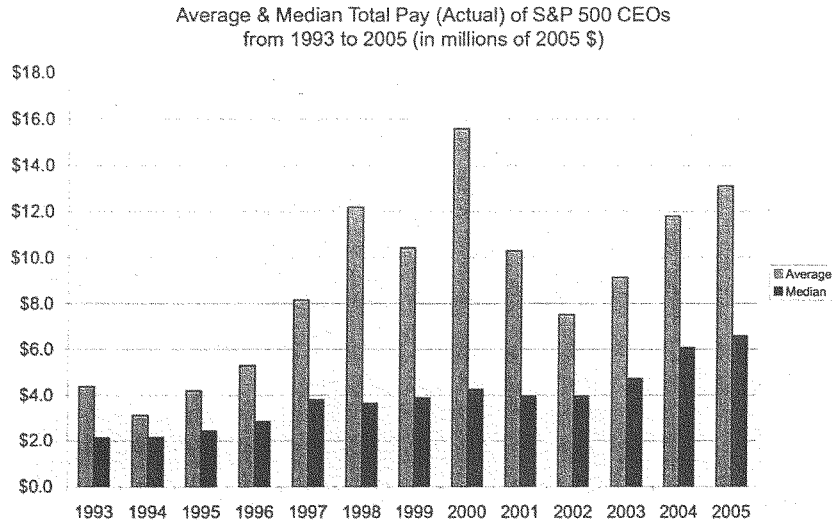
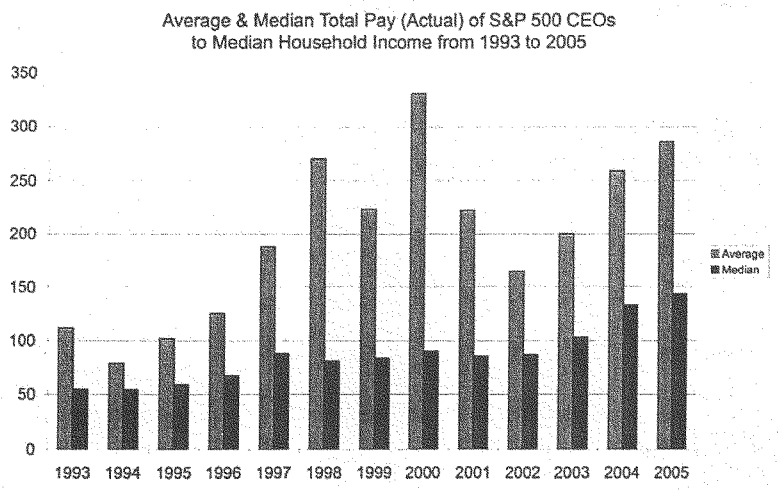


Source: ExecuComp, Steven Kaplan

Exhibit 4



Source: ExecuComp, Census Accounts, Steven Kaplan

Exhibit 5
2004 Pay of Top Hedge Fund Mangers and S&P 500 CEOs in $ millions

Top 10 Hedge Fund Managers	Top 10 S&P 500 CEOS Actual Pay	Top 10 S&P 500 CEOS Estimated / Theoretical Pay
$1,020	$231	$120
$670	$125	$88
$550	$110	$59
$450	$89	$55
$420	$89	$52
$305	$82	$47
$300	$79	$40
$240	$75	$39
$225	$75	$38
$205	$72	$38
Total Pay Top 25 Hedge Fund Managers	Total Actual Pay 500 S&P 500 CEOs	Total Estimated Pay 500 S&P 500 CEOs
$6,270	$5,743	$4,923

Source: Institutional Investor Alpha 25, ExecuComp

Exhibit 6

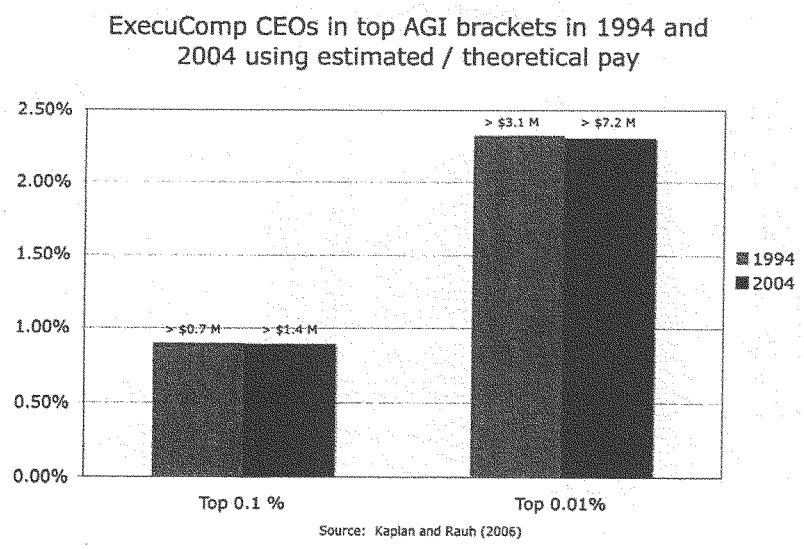
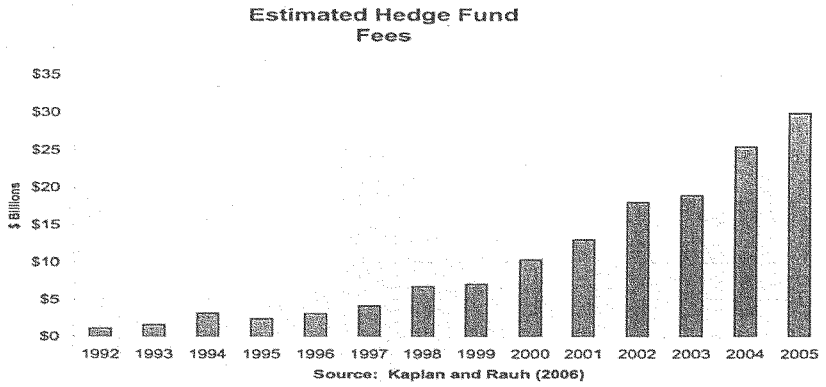


Exhibit 7



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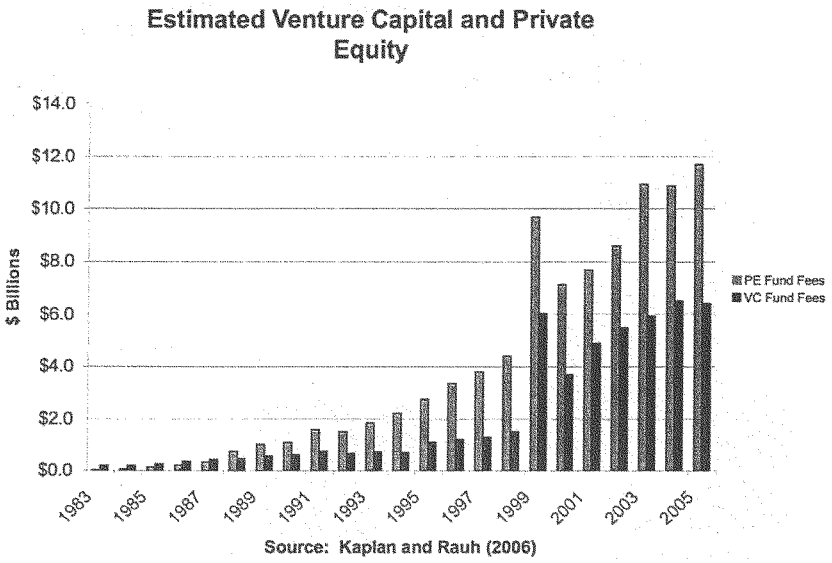

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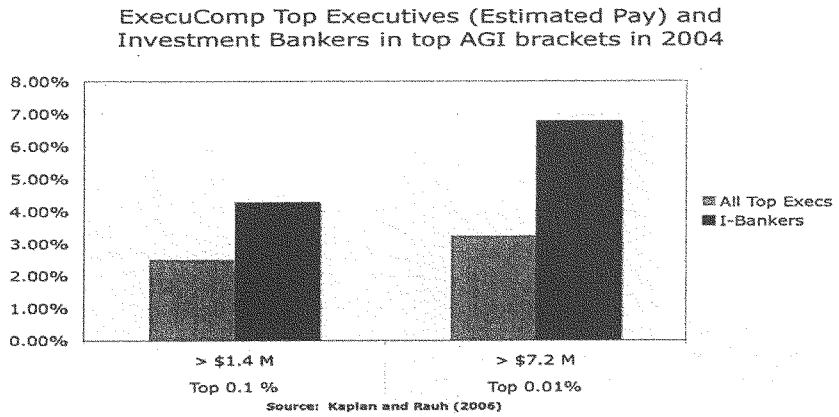


Exhibit 10

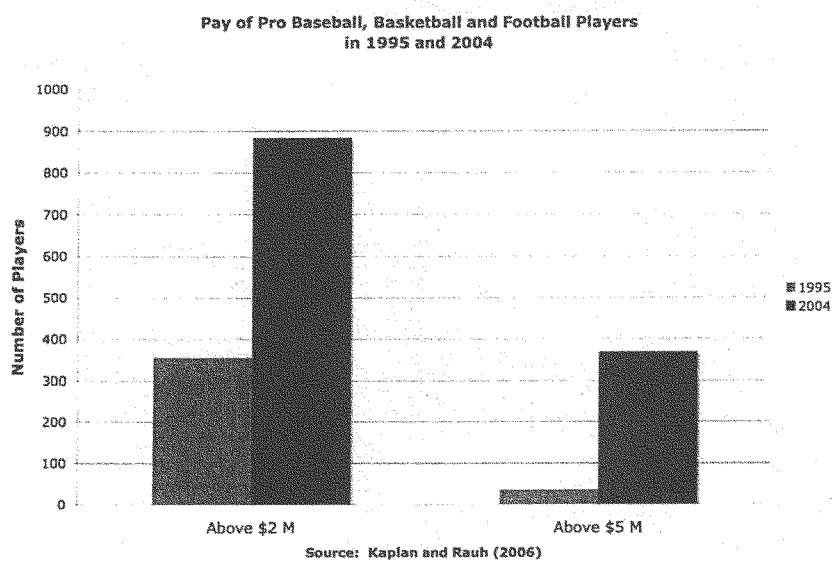


Exhibit 11

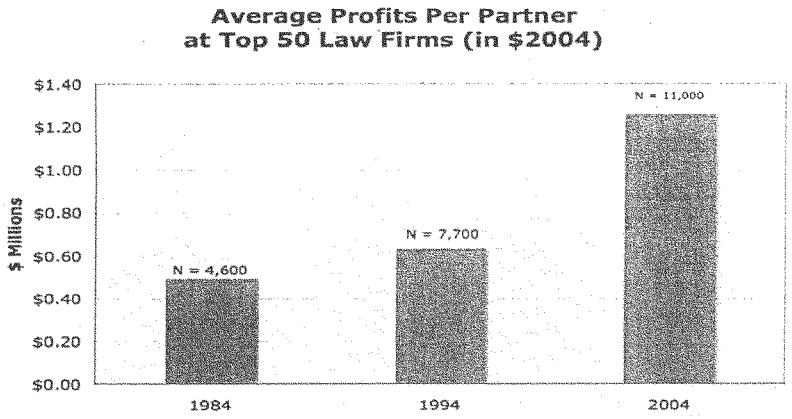


Exhibit 12

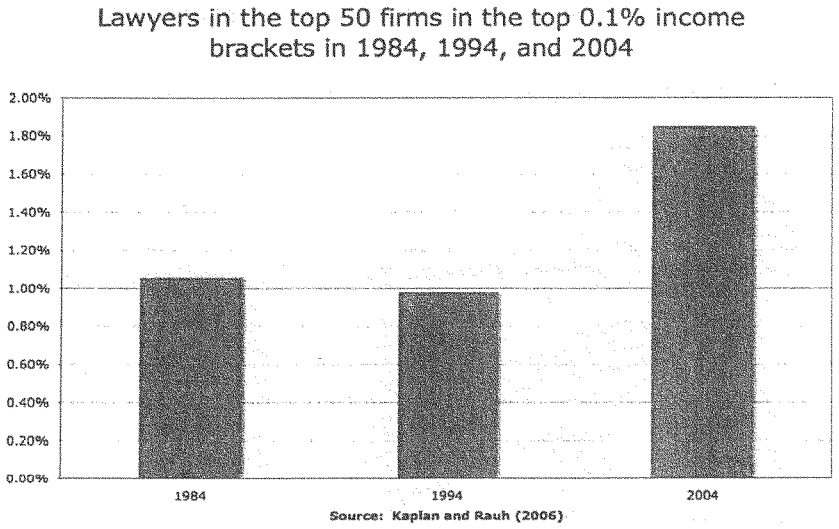


Exhibit 13

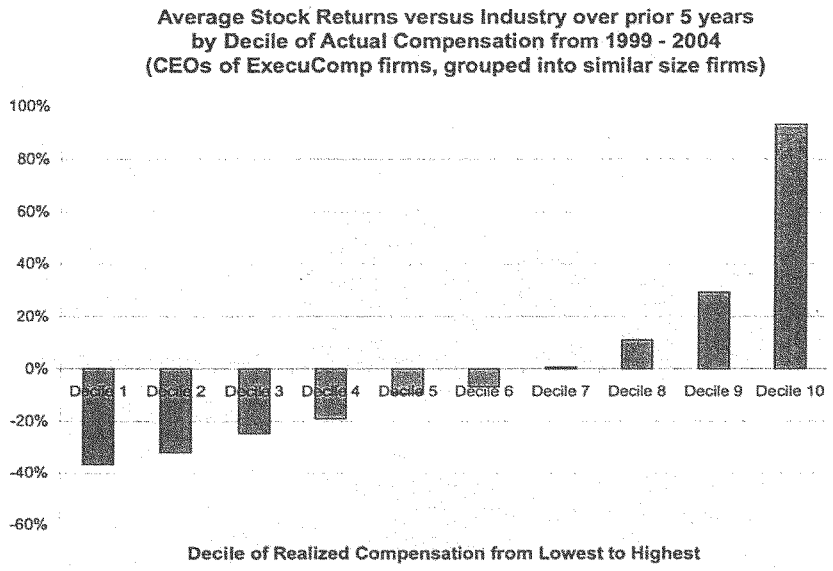


Exhibit 14

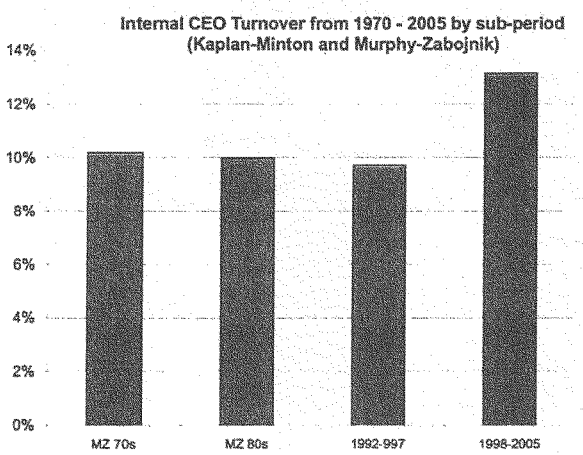
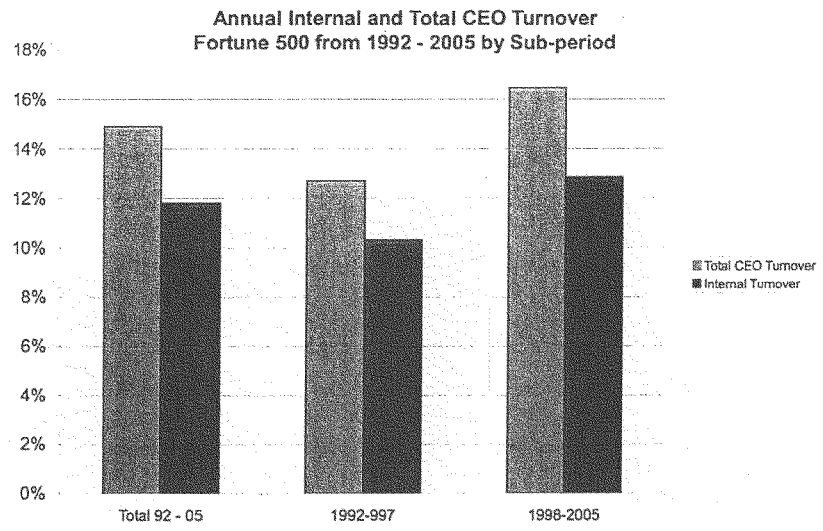


Exhibit 15


Annual Internal and Total CEO Turnover
Fortune 500 from 1992 - 2005 by Sub-period
18%
16%
14%
12%
10%
8%
6%
4%
2%
0%
Total 92 - 05
1992-997
1998-2005
Total CEO Turnover
Internal Turnover

United States House of Representatives
Committee on Financial Services

Testimony of Nell Minow
Editor, The Corporate Library
March 8, 2007

I am very grateful to the Committee for inviting me to participate in this hearing on a matter of vital importance to the credibility and sustainability of our capital markets.

Mr. Chairman and Members of the Committee, if our current system of executive compensation tied pay to performance, if it provided an effective incentive to create long-term shareholder value, if it met any possible market test, I would stand up and cheer. As I have said to this committee before, executive compensation must be looked at as any other asset allocation. And the return on investment for the expenditures on CEO pay is by any measure inadequate. We are not getting what we pay for.

That is because under our current system there is no consequence for excessive pay. The fundamental irony – and the fundamental hypocrisy -- is that the very same people who claim that the free market is the most efficient mechanism for assigning value are less enthusiastic when it comes to applying that test to their own pay packages.

The failure of 162-M shows how difficult it is for the federal government to address the issue of executive compensation. The result has been a sort of whack-a-mole game, as every time we slam down one abuse, others start popping up.

I do not think that the Senate Finance Committee's current proposal, again addressing the issue through the tax code, is the right solution. I am a strong supporter of the approach in Congressman Frank's bill, an advisory vote on executive compensation. This is a very modest step, but, as the experience in the UK shows, it is a significant one. Here is an excerpt from a report on the subject prepared by my company's top specialist on executive compensation, Paul Hodgson:

> [i]t was not until May 2003, after the remuneration report vote became mandatory, that a company felt the full force of shareholder disapproval. Pharmaceutical giant GlaxoSmithKline (GSK) suffered a defeat at its annual general meeting when shareholders voted against the remuneration report. The results indicated that 50.72 percent of votes were cast against.
>
> It is sometimes claimed that a vote against a remuneration report, or a CD&A, is a blunt instrument as it is not clear to what shareholders are objecting. However, in the GSK instance it was very clear what shareholders found objectionable. The item in questions was an employment agreement with its CEO Jean-Paul Garnier that would have been regarded as moderate in the US but which was considered excessive in the UK The company's response was to ask Deloitte & Touche, its compensation consultants, to conduct an independent review and report back for 2004.
>
> The proposed employment agreement contained provisions for salary and bonus continuation of two years, with all the normal US bells and whistles – outplacement counseling, excise tax reimbursement, immediate vesting of equity awards, etc., etc. By the time the agreement was signed in March 2004, this had been cut back to a plain one year's salary and bonus continuation with equity vesting governed by the respective incentive plans. The excise tax gross-up was maintained, but given that such severance is unlikely to trigger it, this was not much more than a sop.
>
> Much of this was disclosed in GSK's announcement of its annual meeting in 2004, when it described the prior year's fracas and its resolution thus: "The Remuneration Report, which is the subject of Resolution 2, embodies the results of the Board's thorough review of remuneration policy. The thrust of the revised policy is to reward performance and eliminate what might be deemed 'payment for failure'. This policy has resulted in significant voluntary changes to the contracts of the Executive Directors and the senior executive group; and I thank the executive, particularly Dr Garnier and John Coombe, for their help in

working with the Board's Non-Executive Directors to determine what was in the best interests of GSK, and acting accordingly.

"After the very full consultation with shareholders in June and July, the Board decided the changes in remuneration policy that would best bridge the gap between the views of shareholders and the competitive needs of the business. These were announced in December and are outlined in the Remuneration Report.

"Since then we have held further discussions with shareholders to ascertain if and where there still exist points of difference. We had always recognised that, due to GSK's transatlantic straddle, some would remain. However, the recent discussions have confirmed that we have moved substantially towards compliance with shareholders' guidelines. They have also, I hope, engendered trust that we will continue to listen to shareholders; and that we are committed to timely and appropriate consultation hereafter in order to avoid the differences of view which we have had to resolve in 2003."

This might have been the signal for a new contentious era in UK executive compensation but, while there have been a number of near misses and controversial rows – at telecommunications giant Cable & Wireless, major utility National Grid, and telecom company Vodafone for example – there have been no other majority votes against pay since the GSK meeting. The key to this outcome can actually be found in the extract from the GSK notice of meeting above: "further discussions with shareholders". In each of the cases where controversy has appeared to have been brewing, behind the scenes discussions with major institutional shareholders have averted protests.

Steve Tatton, editor of Executive Compensation Review, a UK journal specializing in the area, said that at the journal's recent conference on executive pay, a consistent story was told by senior human resource professionals who gave speeches. This was that companies now regularly work closely with shareholders to ensure that there is full agreement on pay issues prior to the annual meeting and that sometimes companies will have to incorporate changes in order to gain this support. Most of the issues have to do with equity incentive plans that create excessive dilution.

Perhaps because of the lack of continued controversy, the practice of submitting remuneration reports to shareholder vote has spread. A year after the UK made the practice mandatory, the Netherlands took it a step further by requiring companies to submit remuneration reports to a binding vote. And in 2005, Sweden and Australia both adopted requirements for non-binding share

Opponents of the practice claim that shareholders already vote on the largest parts of executive compensation – annual and long-term incentive plans. But recent announcements of outsized severance packages belie the assertion that incentives represent the largest element of compensation. Furthermore, a vote on a compensation plan is a vote on the theoretical application of a policy not on actual practice; it is a vote on inputs not outcomes. And the outcomes sometimes come as something of a surprise even to those shareholders who have approved them.

While some companies may be justified in fearing the implementation of such an advisory vote, there are surely many where the compensation paid is entirely reasonable and tied closely to performance. Such companies should welcome this vindication of the compensation committee's decision making.

As I have said above, I believe that requiring an advisory vote on pay strikes exactly the right balance in providing a mechanism that is meaningful but not disruptive. I ask the committee to consider three other points.

First, we want to make it clear that this new rule would not infringe on the current rights shareholders have to submit proposals related to specific elements of pay and other corporate governance matters permitted under 14(a)(8).

Second, while I do not believe that shareholders should have a binding vote on pay, I would like to see some consequences for companies that insist on imposing a pay plan that is objected to by a majority of shareholders. If the British example is any indicator, it would be extremely rare to have such a vote and almost unheard of to have a company proceed contrary to the expressed wishes of the shareholders. If such a case did occur, I would suggest that the board be required to replace a majority of the members of the compensation committee. If the committee then decided to go ahead with the compensation plan rejected by the shareholders, it would at least ensure an additional layer of review and it would at least encourage the new members of the committee to communicate with the shareholders more effectively.

Third, I ask this committee to consider asking the SEC and the Department of Labor to look into the conflicts of interest in proxy voting by mutual funds and pension funds. Last year, The Corporate Library and AFSCME issued a report on this subject. We found that with a few exceptions, the largest mutual fund families are complicit in runaway executive compensation because they have not used their voting power in ways that would constrain pay by tying it more closely to individual company performance. In the aggregate, the mutual funds voted to support management recommendations on compensation issues—both recommendations to vote in favor of management compensation proposals and recommendations to vote against shareholder proposals seeking executive pay reform—73.9 percent of the time and rejected the management position only 23.7 percent of the time.

Both mutual funds and pension funds are subject to legal standards requiring them to vote in the best interests of beneficial owners – investors and pension plan participants. But the agencies with oversight have failed to issue guidance or provide any enforcement when they cast proxy votes in favor of excessive pay and directors who approve it. It is just too easy to vote "yes" when there is no risk of enforcement and when that vote can enhance relationships with portfolio companies with whom they may have (or would like to have) other business relationships. It would be a shame to give investors this important opportunity to cast an advisory "no" vote without making sure that those votes are not compromised through negligence or conflicts of interest.

A couple of years ago, in a debate on CEO pay, my opponent said, "It's not fair. You have all the good examples." Mr. Chairman and members of the Committee, this is not a case of a couple of outrageous anecdotes. It is a systemic problem. And excessive CEO compensation is not just an immaterial aberration. It is the symptom of a fundamental disconnect and abuse that undermines the credibility of our capital markets and increases the cost of capital. We will lose critical investors to economies that tie pay to performance if we do not address this issue. I believe that Chairman Frank's proposal is the best possible way to begin.

Thank you again and I would be happy to answer your questions.

Jack Ehnes
Chief Executive Officer

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Bill Lockyer

Superintendent of Public Instruction
Jack O'Connell

March 6, 2007

The Honorable Barney Frank
Chairman, House Financial Services Committee
2129 Rayburn H.O.B
Washington, D.C. 20515-6050

Dear Chairman Frank:

This letter is sent on behalf of the members of the California State Teachers' Retirement System (CalSTRS). As you are aware, CalSTRS is the second largest public pension system in the United States, with over $158 billion in assets that are managed on behalf of over 794,812 members and beneficiaries. CalSTRS paid $6.3 billion in benefits to CalSTRS members and their families in 2006. Our domestic equity portfolio currently comprises $68 billion in investments; CalSTRS invests in over 2,800 stocks domestically. CalSTRS assets are professionally managed and invested on a long-term basis using sound investment policies that have produced strong investment returns averaging 11.74 percent annually since 1985.

Clearly, the fortunes of CalSTRS are inextricably linked with the domestic market. CalSTRS has been actively involved with the operation and oversight of the domestic market for well over twenty-five years, at both the federal and state level. We have taken the time to communicate and personally meet with the responsible regulatory, oversight and legislative bodies, including the SEC, in order to protect the assets that our beneficiaries and participants will have to depend upon in retirement, disability or death. We are long-term investors by necessity. We have been providing benefits to California's public school teachers since 1913. Because of the long-term nature of our liabilities, the majority of our assets are dependent upon the domestic market.

In December 2006, Fred Buenrostro of CalPERS and I met with you and discussed some of our concerns related to executive compensation and proxy access. CalSTRS has long believed that the pay-for-performance link that investors need is missing from the limited review of compensation plans that shareholders are allowed. We have always supported the idea that shareholders should have a meaningful voice in the way the boards of directors establish and approve executive pay. We applaud the SEC's efforts regarding increased transparency but we are aware that disclosure alone does not consider the whole problem associated with executive pay. We believe that advisory votes by shareholders on executive compensation, such as those that have been required in the UK since 2003, and

in Australia since 2005, and now introduced by you in the bill, H.R. 1257, on March 1, 2007, go a long way to giving shareholders a meaningful voice on this matter.

Your legislation takes a responsible, balanced approach. As written, the bill does not set pay or even any limits on pay, but allows necessary feedback from shareholders to the boards of directors of companies on the pay plans that they have offered to management. We are also in full support of the provision in the bill that allows for a separate advisory vote on change-in-control payments that become exercisable when negotiations begin involving the sale or purchase of a company. As you know, these so-called change-in-control payments often happen when executives negotiate employment deals that involve no true change in control or even work responsibilities. CalSTRS employs a calculation based on the percentage of the deal that shareholders will have to pay to effect these transactions and regards anything in excess of five percent as excessive. However, we are not currently able to vote on these agreements separately and must now consider this factor along with the investment merits of any deal presented.

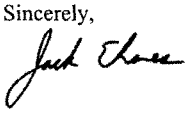
Shareholders were amenable to these payments when they were begun twenty years ago because we did not want management interest in opposing deals to negate investment transactions that made sense for shareholders. However, the bounties that are routinely paid today, even in friendly, negotiated transactions, represent a disavowal of the fairness and alignment of interest doctrines that motivated shareholders in the past. Our domestic portfolio is benchmarked against a customized version of the Russell 3000, however, even with this optimization, CalSTRS holds on average 2,800 stocks in its domestic portfolio. Because pension plans and other institutional investors such as CalSTRS are invested so broadly across the domestic equities market, we often are shareholders in both parties to the transaction. Accordingly, these fees are particularly pernicious because they transfer value from the shareholders' pockets without contributing any added value to the surviving corporate entity.

Advisory votes on matters like these would give shareholders and the boards of directors valuable input on these payouts: Often well-in-advance of the triggering event. At the moment, shareholders have to use a very big blunt instrument in order to register displeasure regarding executive pay; they can vote against members of the Compensation Committee. The advisory vote allows all parties an opportunity to address the concerns in the packages and head off the necessity for the hammer on the nail approach of voting against Compensation Committee directors. Despite having had the practice around since 2002, there have been very few negative votes in the UK advisory compensation plans. The most notable is still the GlaxoSmithKline vote, and that vote happened in 2003. The advisory vote allows boards to address shareholder concerns without forcing them to engage in micromanagement or present disruption to the board by allowing members to be voted off over items that, if properly handled, would result in an adjustment as opposed to a coup. This solution is better for all the parties in the corporate pyramid; shareholders are

well aware that distraction has a cost to the health of their investments. The more of these matters that are handled in a predictable governance setting, the less likely that untoward market impact will be visited on the stocks. The presence of legislation like this removes the need for shareholders to begin a foot-soldier campaign, submitting resolutions to one company at a time, experiencing delays on the issue because of possible director fears of being a first mover or any kind of outlier against their peer board members. H. R. 1257 puts all of the companies, their boards of directors and their shareholders, on the same plate, with the same equipment, and with the same information.

We believe that this feedback to the boards of directors would strengthen the accountability that shareholders require on this issue. The boards of directors would have a partner in its efforts to review executive compensation and the presence of a vote on a discrete issue leaves little room for confusion or argument on its meaning. We wanted to register our support for your actions and offer to help either by providing written testimony or by appearing before or meeting with the members of your Committee if you believe that such efforts would be helpful. Please feel free to contact me to discuss this letter or any other matter that you believe would benefit the public school teachers of California.

Sincerely,



Jack Ehnes
Chief Executive Officer

Statement Submitted for the Record

by

HR POLICY ASSOCIATION

Before the

House Committee on Financial Services

Hearing on

H.R. 1257, Shareholder Vote on Executive Compensation Act

MARCH 8, 2007

MR. CHAIRMAN AND DISTINGUISHED MEMBERS OF THE COMMITTEE:

Thank you for this opportunity to present the views of the HR Policy Association regarding the need for a shareholder vote on executive compensation arrangements and your proposed legislation, H.R. 1257, the Shareholder Vote on Executive Compensation Act. In sum, we believe that a shareholder vote – even a nonbinding one – will usher in an era of "management by shareholder referendum," turning our system of corporate governance on its head, but provide little clarity on the rationale for shareholders' opposition. In addition to the substantial changes in executive compensation we have witnessed in recent years – including the new SEC disclosure rules – shareholders can vote directors out of office, register their disapproval by offering a non-binding resolution on specific executive compensation issues, or communicate directly with the company. Because we believe there are more effective mechanisms of achieving the same ends, we urge the Committee not to pursue legislation to require a shareholder vote on executive compensation.

HR Policy Association is a public policy advocacy organization representing the chief human resource officers of over 250 leading employers doing business in the United States. Representing nearly every major industry sector, HR Policy members have a combined U.S. market capitalization of more than $7.5 trillion and employ more than 18 million employees world wide. Our members are particularly interested in sound executive compensation practices because they are responsible for assisting boards of directors and board compensation committees in developing compensation programs for executives. These programs seek to recruit, develop, motivate and retain the best talent in a competitive global marketplace, and thus improve shareholder value.

HR Policy Association is uniquely situated to provide its views on executive compensation issues because of the central supporting role senior human resource officers play in the executive compensation process. In 2005, we published our ten principles for responsible executive compensation to provide a set of best practice principles from the chief human resource officer perspective. These principles build upon the statutory, regulatory and stock exchange listing changes that sought to align executive compensation with shareholder value. The principles most relevant to today's hearing include:

- Performance-Based – Executive compensation programs should be designed to provide pay commensurate with company performance and positive shareholder returns;
- Market-Driven – The executive compensation programs should be awarded based on competition for talent;
- Analytically Rigorous – The Compensation Committee should review and understand all payout scenarios of executive compensation plans;
- Accountability – Boards of Directors should ensure that the process for setting and approving executive compensation are followed in practice;
- Transparency – Executive compensation should be clearly and fully disclosed in an understandable manner.

In addition, it is important to put the shareholder vote issue in context by recognizing that many changes have been made to the regulation and formulation of executive compensation since 2000, often at the behest of shareholders. These include:

- Requiring the independence of compensation committee members;
- Establishing written compensation committee charters;
- Setting annual goals and objectives used to evaluate the CEO's performance;
- Increasing the number of independent directors on the board;
- Increasing the number of executive sessions; and
- Substantially increasing the amount and type of information disclosed on the proxy statement regarding executive compensation.

The SEC's revision of its executive compensation disclosure rules deserves special mention. Starting in 2007, companies will disclose total compensation as well as additional details on equity and non-equity long-term incentive compensation, retirement plans, severance, and perquisites. In addition, companies will be required to explain the rationale for each element of their executive compensation programs in the new Compensation Discussion and Analysis (CD&A). As part of those changes, the CEO and CFO must sign off on the CD&A, and it is subject to SEC enforcement and shareholder derivative lawsuits. HR Policy strongly supports its goals of clearer and more meaningful disclosure, although we do not agree with every aspect of the SEC's release.

Changes in compensation plans demonstrate the priority that Boards place on this issue. One of the more notable changes is the increase in the use of performance-based equity compensation. Between 2004 and 2006 there was a 14 percent increase in the use of performance-based equity among the top 250 corporations.[1] There has similarly been a reduction in the use of nonqualified stock options. Further demonstrating a greater link between managers' compensation and shareholder return, the percentage of the top 250 companies with stock ownership guidelines has increased from 57 percent in 2004 to 71 percent in 2006.[2]

These are just a few of the indications that executive compensation has undergone real and substantial changes over the last several years. HR Policy recognizes that there is continued dissatisfaction with executive compensation but believes that practices will continue to improve without resorting to cumbersome and expansive measures such as a nonbinding shareholder vote.

HR Policy Opposed to a Shareholder Vote on Executive Compensation

HR Policy Association opposes the push for a mandatory nonbinding shareholder vote on many grounds. Fundamentally, it would alter the U.S. system of corporate governance as shareholders sought to ratify board decisions in a variety of areas. Unlike more specific nonbinding

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[1] Frederic W. Cook & Co, "The 2006 Top 250," at 4 *last accessed at* http://www.fwcook.com/alert_letters/Top_250_06.pdf.
[2] *Id.* at 20-21.

resolutions on compensation already offered by shareholders, the result of a shareholder vote would not meaningfully communicate shareholders' concerns. If viewed as a tool to encourage communications, the vote is redundant because large corporations already regularly meet with their largest institutional shareholders. Moreover, the vote concept is imported from the United Kingdom, which has a much different capital and corporate governance structure not easily translated in the U.S.. All of these concerns are addressed in the following sections.

A Shareholder Vote Would Fundamentally Alter the U.S. System of Corporate Governance

Mr. Chairman, HR Policy Association opposes a shareholder vote on executive compensation because it would turn our system of corporate governance on its head. Under corporation law, the Board of Directors has a duty and obligation to manage the corporation on behalf of shareholders. In turn, annually, shareholders have the right to replace those directors if they believe the corporation is not being managed in their best interests. Ultimate control rests with the shareholders, and this control is becoming more meaningful as companies adopt majority voting for directors.

The delegation of management authority to the Board is necessary because of the complex, voluminous, and often confidential information that directors must consider when deciding on corporate strategy. Providing shareholders with a vote, even a nonbinding one, to ratify the Board's decision on executive compensation could undermine its authority by effectively rendering its decisions null and void. The process of evaluating executive performance and setting compensation illustrate why substituting shareholder judgment in this area is a bad idea.

When determining executive development, compensation and succession, the Board Compensation Committee gathers a wide variety of information from different sources and considers a number of key factors. These include confidential assessments of individual and company performance, interviews with management personnel to assess an individual's future potential, and deliberations among members of the Committee on pay and incentive levels. In this process, the Committee also considers compensation levels of similarly situated, skilled, and experienced executives, and evaluates skills needs relative to retention concerns. For competitiveness reasons, this essential information cannot be widely shared. Acting through the compensation committee, the Board's role is to review and modify this information and approve compensation packages that are in the best interests of the shareholders and the company as a whole.

Shareholders have roles in approving the framework of certain elements of compensation, such as equity compensation plans and performance-based compensation plans. These approvals serve as procedural protections on the Board's authority. However, allowing a vote on a framework is fundamentally different from substituting shareholders' perspectives for that of a fully informed Compensation Committee or Board. For example, when the shareholders approve the general constructs of an equity compensation plan, the Board then must decide how that stock plan should be implemented based on the company's overall strategy and its reasoned judgment on how best to incentivize executives to achieve it. Shareholders could not fulfill this role because they would not have access to this information and thus are likely to come to other conclusions.

Shareholder Vote Would Result in Management by Referendum.

The costs of a shareholder vote aside, permitting a shareholder vote on executive compensation would result in management by referendum, because shareholders would seek to extend the ratification vote to other issues. For example, shareholders may seek an annual vote on accounting practices or means of defending, or settling, certain types of lawsuits. As it grew in popularity, the practice of advisory shareholder votes would undermine the system of Board management of corporations because major decisions would require shareholder vote.

Shareholder Vote Would Not Provide Meaningful Information to Boards Regarding Objectionable Practices

Proponents of a shareholder vote argue that under current rules, shareholders have insufficient means of "providing input to boards on senior executive compensation," and the best means of doing this is by way of an annual nonbinding vote. Yet, even if a majority of shareholders vote against a company's summary compensation table, the result provides no clear indication to a Board why the pay regime was rejected. For example, assuming the vote hinged on a single issue, which is doubtful, under H.R. 1257, a pay package could be rejected because of the size of compensation element or due to concerns over the explanation of compensation in the CD&A. However, the vote would not identify which of the two reasons triggered the rejection.

A mandated nonbinding vote is not needed because shareholders already have the ability to offer nonbinding resolutions on specific aspects of executive pay packages. These resolutions provide more meaningful information to Boards, which pay close attention to these resolutions. However, development of these resolutions requires shareholders to gain an understanding of the company's pay program. A shareholder vote is a shortcut to carefully considering a company's pay program. It allows shareholders to summarily "approve or reject" compensation plans, regardless of whether they understand the compensation programs and have a problem with a particular area.

A shareholder vote could also be manipulated to suit shareholders' parochial needs. U.S. shareholders have a variety of different interests in investing in a company. Some are short-term profit-takers, some are hedging other investments, some are long-term institutional investors, and others are individuals with differing objectives. Rarely, if ever, will there be shareholder consensus on executive pay. Certain shareholders will use the occasion to register a protest vote against executive compensation generally without considering particular issues. Others will simply against management to register disapproval on unrelated issues, such as social responsibility or labor relations. Thus, far from providing a clear message on executive compensation, the vote could be used by certain shareholders to champion a wide variety of parochial interests.

Companies Already Engage in Ongoing Discussions With Largest Shareholders

Beyond a lack of clarity, the shareholder vote mandate would be redundant with respect to major shareholders. The rationale for a shareholder vote is that it would provide a "mechanism for providing ongoing feedback" to the compensation committee. However, this argument makes it

appear as if companies do not routinely engage in discussions with their major shareholders. In fact, most large companies hold periodic meetings throughout the year with their largest shareholders on a variety of subjects, including compensation. If compensation is an issue for a major shareholder, companies listen and respond, but it is more effective to do so in a setting that encourages dialog.

Differences Between Capital Markets Render UK-Style Shareholder Vote Impractical, Ineffective in US

The shareholder vote concept in the U.S. has been adapted from the United Kingdom, which required a vote for publicly held companies in 2002. Under the U.K. approach, shareholders must have the chance to vote on the Board compensation report at the annual meeting. However, because the structure of the British capital and governance systems are substantially different, the U.K. approach does not serve as a reasonable model for governance in the US.

In the U.K., the two largest institutional investors, the Association of British Insurers and the National Association of Pension Funds, together control roughly 30 percent of total shares on the London Stock Exchange. As a practical matter, if a company has the support of these investors, the company's pay resolution is virtually guaranteed approval because other investors follow the giants' lead. By contrast, the U.S. stock market is more than twice as large as its U.K. counterpart, with many more large institutional investors, making the exercise akin to herding cats. In sum, the U.S. has a dynamic capital market and governance system that meets the dual goals of protecting shareholders and fostering corporate innovation and growth. Importing a shareholder vote mandate from a country with a much different system would do little to further protect shareholders.

Conclusion

For the reasons discussed above, we strongly urge the Committee not to adopt the provisions of H.R. 1257 or any similar shareholder vote mechanism on executive compensation. A shareholder vote is unneeded to ensure strong communications with major shareholders and potentially damaging to the U.S. system of corporate governance.

Thank you for the opportunity to express our views.

Statement of WorldatWork Regarding
Shareholder Vote on Executive Compensation

March 8, 2007

This commentary is in response to the U.S. House of Representatives Financial Services Committee hearing on March 8, 2007 and the recent introduction of legislation titled "The Shareholder Vote on Executive Compensation Act" by the Committee's Chairman, Rep. Barney Frank (D-MA).

For more than 50 years, WorldatWork has been the world's largest association of compensation and "total rewards" professionals – professionals that use various types of monetary and non-monetary rewards to attract, motivate and retain employees. Today, ninety-five percent of the *Fortune 1000* companies in North America employ a member of WorldatWork. WorldatWork is a not-for-profit, non-partisan, member-based organization with headquarters in Arizona.

Because our members are the day-to-day professionals in companies and other organizations designing and administering compensation plans, the perspectives below represent those of the practitioner.

There are already multiple mechanisms in place to prevent excessive executive compensation, if shareholders choose to exercise these mechanisms. Corporate compensation committees today, with the advice of their outside experts and professional staff, oversee the development, design and administration of executive compensation and benefit programs, generally within the parameters of the plans approved by shareholders. Shareholders have opportunities for input on many different fronts:

- Stockholder approval of equity incentive plans is required;
- Majority voting is increasingly being adopted by many companies, which allows for a greater voice for shareholders;
- Most committees and board already have in place processes for shareholder communications in which shareholders can write directly to the board of directors;
- Many companies now have processes in place whereby they discuss compensation and governance matters with their largest investors, and it is likely that the trend will continue and increase in prevalence;
- Shareholders currently have the ability to participate in binding votes for and against board members (including compensation committee members).

We do not believe that a non-binding vote adds anything to the numerous input processes already available through which shareholders may affect executive compensation.

In order to be effective, the design and implementation of executive compensation plans involves complexity, and is best served by a system that involves compensation professionals, independent consultants, and independent boards of directors. In 2007, perhaps more than ever before due to legislative and regulatory initiatives of the past five years, compensation decisions are being made by independent directors that engage the services of independent advisors (outside executive

compensation consultants). Executive compensation design today involves a complex calculation and calibration of base pay, short and long-term incentives using a variety of vehicles, perquisites, and other intangible rewards which must be structured specifically to support a companies unique business strategy. What's more, the long-term incentives that are included frequently as parts of the compensation package today are binding through legal arrangements (such as deferred compensation) that companies enter into through employment contracts. For example, the recent highly-visible separation payment at Home Depot was the result of an employment agreement that was entered into many years prior. In that situation, a non-binding shareholder vote would have had no effect on the compensation paid out.

In addition to the multitude of reward levers that may be deployed internally, there are external factors that go into the compensation design decision that include the current business environment, performance of the company and/or industry, the competitive landscape for talent, and the difficulty or duration of the incentive goals (to name a few). In this environment, it simply is not possible (nor is it in the shareholders best interest) to take a cookie-cutter approach to executive pay. To allow shareholders to exercise a voting opinion in this complex system is the equivalent of allowing shareholders to have a vote on the location of a company's next manufacturing facility, or have a say in decisions about new product introductions.

Finally, the Security and Exchange Commission's (SEC) 2006 executive compensation proxy disclosure rules are already changing the executive compensation landscape, and we are only at the beginning of this new disclosure process. Chairman Frank's proposed legislation comes at the beginning of the 2007 proxy season, a time in which most companies are grappling with the requirements of a newly complex CD&A, required by the SEC near the end of 2006. In order to comply with these new requirements, companies are engaging consultants and watching other companies closely before restructuring and amending their proxy statements. There is ample evidence that the new disclosure requirements are resulting in companies re-evaluating their executive compensation design and approval processes and it is having an impact on how companies are handling certain executive reward arrangements. For instance, there have been several highly visible changes in several companies' perquisites, severance arrangements, and the addition of features such as "clawback" policies. If the goal of a non-binding shareholder vote is to place additional focus on executive compensation, it would seem that the SEC's 2006 proxy disclosure changes go a great distance toward this goal, and we believe that it would be prudent to see the full impact of the SEC's new disclosures before creating additional new compliance requirements for companies.

About WorldatWork® - *The Total Rewards Association*

Founded in 1955 as the American Compensation Association (ACA), today's WorldatWork (www.worldatwork.org) is the non-partisan, not-for-profit association for human resources professionals focused on attracting, motivating and retaining employees. WorldatWork provides more than 24,000 practitioners worldwide with the knowledge and education they need to effectively implement "total rewards" in their organization. Total rewards integrates an organization's compensation, benefits, work-life, performance & recognition, and development & career opportunities systems. WorldatWork supports its members and customers in 30 countries with thought leadership, education, publications, research and professional certifications, including the Certified Compensation Professional (CCP), Certified Benefits Professional (CBP) and Global Remuneration Professional (GRP) designations.

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