

United States Senate
Committee on Finance

Testimony of Nell Minow
Editor, The Corporate Library
September 6, 2006

Thank you very much for inviting me to appear today. I am very pleased that this committee is looking into this vital area of concern.

The economist John Kenneth Galbraith said, "The salary of the chief executive of the large corporation is not a market award for achievement. It is frequently in the nature of a warm personal gesture by the individual to himself."

He said that in the 1950's. The primary change since then is the number of zeroes at the end of the figures.

My firm, The Corporate Library, maintains an extensive database on corporate governance in public companies, and that includes a great deal of information and analysis of executive compensation. The data show that the disparity between pay and performance is enormous and growing.

Backdating and spring-loading of options are only the latest in a series of abuses and dodges that have escalated CEO pay to levels that Marie Antoinette would have been embarrassed by. I am particularly outraged by those who suggest that there is nothing wrong with this manipulation. Everything is wrong with it.

The entire justification for options is to align the interests of management with those of the shareholders. The great challenge of capitalism is exactly this issue – how do you keep the managers as committed to creating shareholder value as those who are providing the capital? Options seemed like a good answer, and that was the theory behind 162-M. But, as you know, that well-intentioned provision has had unanticipated perverse consequences.

When the tax code was changed to prevent executive compensation of over \$1 million to be deducted unless it was tied to performance, two things happened. First, everyone got a raise to \$1 million. Second, everyone got boat-loads of options. The very definition of a "mega-grant" had to be changed, so it now can be as much as eight times the CEO's base pay and bonus.

Option grants only work when:

- 1) The executives make money based on how the company does, not on overall market gains,
- 2) The number of options is not so excessive that there is a mountain of

pay-out for a molehill of performance, and

3) All information relating to the options is promptly, clearly, accessibly, and comprehensibly disclosed.

The failure of 162-M shows how difficult it is for the federal government to address the issue of executive compensation. Ever since 1789, corporate governance has been a matter of state law. So, at the federal level, our only tools are the tax code and disclosure requirements. The result has been a sort of whack-a-mole game, as every time we slam down one abuse, others start popping up.

Back-dating and spring-loading have been among the most shocking, however, because they so fundamentally subvert the entire justification for option-based compensation. If options are supposed to align the interests of shareholders and executives, then it is monumentally unfair for executives to get a chance shareholders do not to retroactively change the starting of the clock. I can just imagine the reaction if an investor called his broker to say that he'd like to change his mind and move the date of his last purchase of stock to another time, when the share price was lower.

I am appalled by those who suggest there was nothing wrong here. If, in fact, it was not illegal, it is only because it is such an obvious outrage no one thought outlawing it was necessary. Apologists have suggested that it was just a clever way to grant executives more compensation in the pre-expensing days without having to take a hit to the income statement. If that is true, what did they have to hide? Why didn't they disclose it? And why would we want to give executives more compensation if it wasn't tied to performance?

I have also heard the argument that even pre-expensing investors could tell the cost of the options from the disclosures in the financials. This analysis completely ignores the other ways that investors use the information that executives have received in-the-money options. There's informational value in companies' compensation practices, so telling investors that all the options are at-the-money when they are not misleads investors, who could use the information to (1) make decisions about the management team's abilities, (2) decide how to vote the next time an equity compensation plan came up for a vote, (3) decide whether to withhold votes from members of the compensation committee and (4) evaluate whether to sell the stock. In January 2000, I wrote a report noting a problem at one company because it gave the CEO two million options at \$10 a share below market. It seemed clear that was a bet that the stock was going to decline in value. I got a lot of criticism; it was the fastest-growing stock in the history of the NYSE. But I was right. That company, Global Crossing, was soon to set another record as the fourth-largest bankruptcy in U.S. history.

If there is nothing wrong with the compensation arrangements, companies should be happy to provide full disclosure to encourage and reassure investors that their

interests are paramount.

Earlier this year, The Corporate Library conducted a special study for our latest CEO compensation survey, designed to test whether the highest compensation increases in the S&P 500 reflected significant long-term improvements in company performance. The results of the study showed that the largest percentage increases in total compensation had very little connection to long-term value creation. This table shows the examples of the greatest disparity between pay and performance:

Company Name	Ticker	Fortune Rank	Current CEO	Total CEO compensation in last two fiscal years	TCL Rating	5-Year TSR	Performance vs. Peers
AT&T Inc.	T	33	Edward E. Whitacre	\$34,435,596	D	-40.32	Underperformed
BellSouth Corporation	BLS	87	F. Duane Ackerman	\$22,747,700	D	-26.33	Underperformed
Hewlett-Packard Company	HPQ	11	Mark V. Hurd	\$27,056,129	D	-9.88	Underperformed
Home Depot, Inc. (The)	HD	13	Robert L. Nardelli	\$50,717,002	F	-19.05	Underperformed
Lucent Technologies Inc.	LU	247	Patricia F. Russo	\$17,317,113	F	-82.05	Underperformed
Merck & Co., Inc.	MRK	84	Richard T. Clark	\$40,754,311	D	-49.80	Underperformed
Pfizer Inc.	PFE	24	Henry A. McKinnell	\$26,365,439	D	-34.11	Underperformed
Safeway Inc.	SWY	46	Steven A. Burd	\$33,510,855	D	-54.99	Underperformed
Time Warner Inc.	TWX	32	Richard D. Parsons	\$26,058,130	D	-57.71	Underperformed
Verizon Communications Inc.	VZ	14	Ivan G. Seidenberg	\$26,580,200	D	-26.83	Underperformed
Wal-Mart Stores, Inc.	WMT	1	H. Lee Scott	\$27,961,065	D	-13.90	Underperformed

It's a very small group in the stratosphere of pay: rock stars, movie stars, athletes, investment bankers, and CEOs. Of that group, the first four are in the ultimate pay-for-performance category, with a tiny percentage at the very top making millions of dollars, and with deals that evaporate quickly if a movie, a CD, or a business deal tanks. Their pay is set through tough arms-length negotiations.

CEOs are the only ones who pick the people who set their pay, indeed they pay the people who set their pay. And no matter what "independence" standard we try to impose, the board room culture of congeniality and consensus is so powerful that it makes it very hard to object, especially when the compensation consultant helpfully provides an avalanche of numbers designed to justify pay increases. In the wonderful world of CEOs, like the children in Lake Woebegon, everyone is above average. Even Warren Buffett acknowledges his own failings as a director, particularly in approving excessive compensation: "Too often, collegiality trumped independence." If Warren Buffett, always a significant shareholder in any company on whose board he serves, does not feel able to oppose excessive pay, something is wrong.

In the 1990s, the cult of the CEO was based on the idea that vision and the ability to inspire were what made the CEOs worth the hundreds of millions of dollars they were paid. But a book by Harvard Business School professor Rakesh Khurana, *Searching for a Corporate Savior: The Irrational Quest for*

Charismatic CEOs, makes a compelling case that corporate boards err seriously when they pick chief executives based on "leadership" and "vision" or when they pay huge premium pay that is not sensitive to performance to attract a "superstar." Bringing in a CEO with a great record at another company may give the stock price a short-term boost. But high-profile transplants such as Al Dunlap at Sunbeam (which went into bankruptcy) and Gary Wendt at Consec (which went into bankruptcy), CEOs should have to make the same disclaimers that money managers do: "Past performance is no guarantee of future performance."

Disclosure is important. The SEC's new rules are a step in the right direction. But disclosure only matters if the people who absorb this information have the ability to act on it, and that is not currently the case. Executive compensation is a hydra-headed monster – every attempt to cut off one-head results in the growth of two more. Current abuses include these seven deadly sins of executive compensation:

1. Accelerated vesting of options
2. Manipulation of earnings to support bonuses
3. Imputed years of service
4. Setting the bar too low (guaranteed bonus)
5. Outrageous departure and retirement packages
6. Stock options that are not performance-based (including back-dating)
7. Perquisites and gross-ups

Until we remove the impediments to a market response from shareholders, we will never be able to address these problems.

I leave you with two key points. First, executive compensation must be looked at like any other allocation of corporate assets. Currently, the ROI for executive pay does not measure up to just about any other use of corporate capital.

Second, the pay-performance disparity is so outrageous, so atrocious that in my opinion it undermines the credibility our system of capitalism. In a global environment, information and the ability to trade in any market at any time will provide our system with the toughest market test in the history of our country. As we compete for capital, we must be able to show those inside and outside our country that we deserve their trust and will provide them with a competitive return instead of shoveling more money into the pockets of the top executives.

Ultimately, as long as the CEOs determine who sits on their board, and, in the overwhelming majority of cases, who sits on the compensation committee, the real mis-aligned incentive we have to worry about is the incentive of the compensation committee members to give the CEO whatever he wants.

We speak of the “election” of directors, but management picks the slate, no one runs against them in well over 99% of the cases, and management counts the votes. Even one vote for a candidate will insure his election. In my opinion, a requirement that board candidates get a majority of votes cast and, as in the UK, the ability of shareholders to vote on CEO compensation are meaningful changes that will be effective in addressing the abuses.

Many thanks, and I will be glad to answer any questions.