

EXECUTIVE PAY: THE ROLE OF COMPENSATION CONSULTANTS

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BEFORE THE

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AND GOVERNMENT REFORM

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EXECUTIVE PAY: THE ROLE OF COMPENSATION CONSULTANTS

WEDNESDAY, DECEMBER 5, 2007

HOUSE OF REPRESENTATIVES,
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room 2154, Rayburn House Office Building, Hon. Henry A. Waxman (chairman of the committee) presiding.

Present: Representatives Waxman, Cummings, Kucinich, Davis of Illinois, Higgins, Yarmuth, Murphy, Welch, Davis of Virginia, Souder, Platts, Duncan, Westmoreland, McHenry, Foxx, Sali, and Jordan.

Staff present: Phil Schiliro, chief of staff; Phil Barnett, staff director and chief counsel; Karen Lightfoot, communications director and senior policy advisor; Roger Sherman, deputy chief counsel; John Williams, deputy chief investigative counsel; Brian Cohen, senior investigator and policy advisor; Michael Gordon, senior investigative counsel; Earley Green, chief clerk; Teresa Coufal, deputy clerk; Caren Auchman and Ella Hoffman, press assistants; Leneal Scott, information systems manager; Kerry Gutknecht, William Ragland, and Miriam Edelman, staff assistants; David Marin, minority staff director; Jennifer Safavian, minority chief counsel for oversight and investigations; Keith Ausbrook, minority general counsel; Ed Puccerella, minority professional staff member; Kristina Husar, minority counsel; Larry Brady, minority senior investigator and policy advisor; Patrick Lyden, minority parliamentarian and member services coordinator; Brian McNicoll, minority communications director; Benjamin Chance, minority clerk; and Ali Ahmad, minority deputy press secretary.

Chairman WAXMAN. The meeting of the committee will please come to order.

Today the committee will be considering the issue of executive compensation. Reports of astronomical payouts to corporate CEOs have lead many to question the fairness and effectiveness of the system for setting executive pay. We will be exploring these questions today.

In the 1980's, the CEOs of the Nation's largest companies were paid 40 times more than the average employee. Now they make over 600 times more. At a typical company, 10 percent of corporate profits—a staggering sum—goes into the pockets of the top executives. These huge pay packages raise a basic question: Are corporate CEOs working for the company who hire them or are the companies working for the CEOs?

Many academic experts, financial analysts and investors believe that soaring CEO paychecks are a symptom of a corporate governance system that is not working. As noted investor Warren Buffett has commented: In judging whether corporate America is serious about reforming itself, CEO pay remains the acid test.

Today's hearing examines a practice that may be fueling this dysfunctional pay system: the use of executive compensation consultants with conflicts of interest.

Executive compensation has become incredibly complex, CEOs don't just get salaries anymore. They get stock options, restricted stock units, deferred compensation, executive pension plans, lucrative severance packages and a vast array of perks from corporate jets to tax and financial planning services and country club memberships. These compensation packages can be worth hundreds of millions of dollars.

Many companies now rely on the services of professional executive compensation consultants to evaluate these complex pay arrangements. Last year, in fact, over three quarters of the Fortune 250 retained outside compensation consultants.

Most Americans have never heard of Towers Perrin, Mercer and the other influential compensation consultants, but these pay advisors can have an enormous impact on executive pay. When they do their job right, they can align the interest of the CEO with the interest of the shareholder. But when they do their job wrong, the result can be vast wealth for the CEO and a plundered company for the shareholders and the employees.

That's why it is so important that these pay consultants be independent and free of conflicts of interest. Consultants who are paid millions of dollars by a corporate CEO won't provide objective advice to the board. They know what the CEO wants to hear, and they know what will happen to their lucrative contracts if they don't say it.

For the last 7 months, the committee has been investigating conflicts of interest among compensation consultants; and today I'm releasing a report that summarizes what the majority staff has found. And, without objection, this report will be made part of the hearing record.

[The information referred to follows:]



UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
MAJORITY STAFF
DECEMBER 2007

**EXECUTIVE PAY:
CONFLICTS OF INTEREST AMONG
COMPENSATION CONSULTANTS**

PREPARED FOR
CHAIRMAN HENRY A. WAXMAN

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EXECUTIVE SUMMARY

Corporate consultants can have a financial conflict of interest if they provide both executive compensation advice and other services to the same company. According to experts on corporate governance, consultants hired by corporate executives to administer employee benefit plans or to provide other services to a company may not be able to provide objective advice about the compensation of the executives who hire them. These experts have recommended that corporate boards should retain a compensation consultant that performs no other work for the company.

At the request of Rep. Henry A. Waxman, this report examines whether the compensation consultants hired by large publicly traded companies meet this standard of independence. The report is based on nonpublic information provided to the Committee by the leading compensation consultants in the United States. For each consultant, the Committee requested and received data on the value of the executive compensation services and other services provided to the 250 largest publicly traded companies as determined by *Fortune* magazine.

The report finds that compensation consultant conflicts of interest are widespread. Over 100 large publicly traded companies hired compensation consultants with substantial conflicts of interest in 2006. In many cases, the consultants who are advising on executive pay are simultaneously receiving millions of dollars from the corporate executives whose compensation they are supposed to assess.

Key findings in the report are:

- **Compensation consultant conflicts of interest are pervasive.** In 2006, at least 113 of the Fortune 250 companies received executive pay advice from consultants that were providing other services to the company.
- **The fees earned by compensation consultants for providing other services often far exceed those earned for advising on executive compensation.** In 2006, the consultants providing both executive compensation advice and other services to Fortune 250 companies were paid almost 11 times more for providing other services than they were paid for providing executive compensation advice. On average, the companies paid these consultants over \$2.3 million for other services and less than \$220,000 for executive compensation advice.
- **Some compensation consultants received over \$10 million in 2006 to provide other services.** One Fortune 250 company paid a compensation consultant over \$11 million for other services in 2006, over 70 times more than the company paid the consultant for executive compensation services. Another Fortune 250 company also paid a compensation consultant over \$11 million for other services, over 50 times more than it paid the consultant for executive compensation advice.

- **Many Fortune 250 companies do not disclose their compensation consultants' conflicts of interest.** In 2006, over two-thirds of the Fortune 250 companies that hired compensation consultants with conflicts of interest did not disclose the conflicts in their SEC filings. In 30 instances, the companies informed shareholders that the compensation consultants were "independent" when in fact they were being paid to provide other services to the company.
- **There appears to be a correlation between the extent of a consultant's conflict of interest and the level of CEO pay.** In 2006, the median CEO salary of the Fortune 250 companies that hired compensation consultants with the largest conflicts of interest was 67% higher than the median CEO salary of the companies that did not use conflicted consultants. Over the period between 2002 and 2006, the Fortune 250 companies that hired compensation consultants with the largest conflicts increased CEO pay over twice as fast as the companies that did not use conflicted consultants.

The investigation also uncovered evidence that some Fortune 250 companies may not be disclosing the identity of all consultants hired to provide executive compensation advice. Securities and Exchange Commission rules require publicly traded companies to disclose "any role of compensation consultants" in determining executive pay and to identify all such consultants, whether they advise management or the board. The information obtained by the Committee from the compensation consultants indicates that in 2006, almost 100 Fortune 250 companies used executive compensation consultants that they did not disclose. In some cases, the companies paid hundreds of thousands of dollars to undisclosed consultants for executive compensation services. One explanation for these discrepancies may be that the compensation consultants used a different definition of executive compensation services in reporting to the Committee than the companies used in their SEC filings.

I. INTRODUCTION AND METHODOLOGY

Executive pay is rising rapidly. The chief executive officers (CEOs) of the 250 largest U.S. companies, as identified by *Fortune* magazine, received an average of \$18.8 million each in 2006, an increase of 38% in just one year.¹ A decade ago, the aggregate pay of the top five executives at large U.S. companies amounted to about 5% of corporate profits. By 2003, the share of corporate earnings paid to top executives had doubled to 10%.² Many experts believe there is a growing disconnect between CEO pay and performance, as increases in executive pay cannot be explained by factors such as changes in firm size, profits, and industry classification.³ Analysts have observed that poorly performing CEOs sometimes receive exceptionally large pay packages.⁴

Dramatic increases in executive compensation have widened the gulf between CEO pay and the pay of the average worker. In 1980, CEOs in the United States were paid 40 times the average worker.⁵ In 2006, the average Fortune 250 CEO was paid over 600 times the average worker.⁶ While CEO pay has soared, employees at the bottom of the pay scale have seen their real wages decline. In real terms, the value of the new federal minimum wage, \$5.85 per hour, is 13% below its value a decade ago.⁷

At the request of Rep. Henry A. Waxman, the Chairman of the Committee on Oversight and Government Reform, this report examines one possible cause of high CEO compensation: the use of compensation consultants with conflicts of interest.

Large companies routinely retain compensation consultants to provide advice on executive pay, such as developing compensation peer groups, designing equity compensation plans, conducting compensation surveys, and analyzing the tax, accounting, and legal implications of specific pay packages. These consultants can be retained by either the corporate board (typically, the compensation committee of the board) or management, and they may advise the board, management, or both on executive pay issues. Whether retained by the board or management, these consultants can have a major impact on executive pay decisions.

According to experts on executive compensation, compensation consultants can have a conflict of interest if they provide other services to a company at the same

¹ *Big Paychecks*, *Forbes* (May 3, 2007).

² Lucian Bebchuk and Yaniv Grinstein, "The Growth of Executive Pay," *Oxford Review of Economic Policy*, Vol. 21, pp. 283-303 (2005).

³ *Id.*

⁴ See, e.g., Lucian Bebchuk and Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (2004); The Corporate Library, *Pay for Failure: The Compensation Committees Responsible* (2006); The Corporate Library, *Pay for Failure II: The Compensation Committees Responsible* (2007).

⁵ Institute for Policy Studies and United for a Fair Economy, *Executive Excess 2007: The Staggering Social Cost of U.S. Business Leadership* (Aug. 2007).

⁶ In 2006, the average American worker earned \$29,544. *Id.*

⁷ The current minimum wage is \$5.85 — adjusted for inflation, \$4.49 in 1997 dollars. The actual minimum wage in 1997 was \$5.15.

time that they are providing executive compensation advice.⁸ The concern is that the ability of consultants to provide independent, unbiased advice to directors regarding the pay of senior executives can be compromised if the senior executives are at the same time paying the compensation consultants to provide other services to the company. These other services can include a wide range of activities, including employee benefit administration, human resource management, and actuarial services.

Little information is currently available to the investing public to assess compensation consultant conflicts of interest. In August 2006, the Securities and Exchange Commission (SEC) promulgated new rules on the disclosure of executive compensation that for the first time require publicly traded companies to disclose the identity of their compensation consultants and describe the nature of the consultant's assignment.⁹ These rules do not, however, require companies to disclose whether the consultant has other business relationships with the company or the fees received for providing executive pay advice and other services.

To assess the extent of consultant conflicts of interest, Chairman Waxman wrote to request nonpublic information from six leading compensation consultants: Frederick W. Cook & Company, Hewitt Associates, Mercer Human Resources Consulting, Pearl Meyer & Partners, Towers Perrin, and Watson Wyatt. For each consultant, the Committee requested data on the value of the executive compensation consulting services and any other services that the consultant provided to Fortune 250 companies from January 1, 2002, through December 31, 2006.¹⁰ The compensation consultants were asked to report to the Committee as executive compensation consulting fees any revenues earned for work related to the compensation of the most senior executives of the companies, including such services as devising equity compensation plans, designing compensation peer groups, and providing pay survey data. The consultants were asked to report fees earned for services related to compensating employees other than senior executives or for other work unrelated to compensation as "other" revenue.

Four of the consultants (Hewitt, Mercer, Towers Perrin, and Watson Wyatt) reported to the Committee that they are diversified firms offering a variety of services to their corporate clients. The data the Committee received from these four consultants disclosed how much they were paid in each year by each Fortune 250 company to provide executive compensation services and how much they were paid to provide other services for companies for whom the consultants provided both types of services between 2002 and 2006. Because of limitations in how the consultants maintained their records, the data did not indicate the precise nature of the financial arrangements between the

⁸ The Conference Board, *The Evolving Relationship Between Compensation Committees and Consultants*, 6, 15, (Jan. 2006).

⁹ SEC, *Final Rules on Executive Compensation and Related Party Disclosures*, Items 402 (b) and 407 (e) of Regulation S-K (August 29, 2006).

¹⁰ Letters from Chairman Henry A. Waxman to Frederick W. Cook & Company, Hewitt Associates, Mercer Human Resources Consulting, Pearl Meyer & Partners, Towers Perrin, and Watson Wyatt (May 8, 2007) [online at <http://oversight.house.gov/story.asp?ID=1302>].

consultants and the companies, such as who retained the consultants. It also did not indicate the precise services provided by the consultants.

Two of the consultants (Frederic W. Cook and Pearl Meyer) reported to the Committee that they are specialized firms that focus on executive and director compensation. Because they do not provide other services to their corporate clients, the data from these two consultants did not show conflicts of interest.

II. FINDINGS

Academic researchers and investors have raised concerns that the methods used by boards of directors to set CEO pay are flawed. In theory, executive pay should result from an arm's length negotiation in which executives bargain in their own self interest while corporate directors advocate the best interests of the company and its shareholders. In fact, studies suggest that rapidly rising executive pay results in part from management influence over the process by which executive pay is set.¹¹ Corporate directors themselves have recognized that executive compensation practices are problematic. In a recent survey of over 1,000 directors at large U.S. companies, 67% said that they believe boards are having difficulty controlling the size of CEO pay packages.¹²

One area of potential management influence on the executive pay process involves the use of compensation consultants that work for corporate management. Corporate governance experts recommend that corporate directors hire independent executive compensation consultants that are free of conflicts of interest and can provide objective advice regarding executive pay. A 2003 Blue Ribbon Panel of the National Association of Corporate Directors emphasized the importance of an independent compensation consultant and recommended that a truly independent consultant "should be hired by and report directly to the [compensation] committee, and should not be retained by the company in any other capacity."¹³ In January 2006, the Conference Board, a leading business think tank, advised:

When the compensation committee uses information and services from outside consultants, it must ensure that consultants are independent of management and provide objective, neutral advice to the committee. ... The economics of the consultants' engagement for services is very important as an insight into independence. Any imbalance in fees generated by management versus fees generated on behalf of the committee should receive intense scrutiny.¹⁴

¹¹ Lucian Bebchuk and Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (2004).

¹² Corporate Board Member and Pricewaterhouse Coopers, *What Directors Think: Annual Board of Directors Survey* (Oct. 2007).

¹³ National Association of Corporate Directors, *Executive Compensation and the Role of the Compensation Committee* (Dec. 2003).

¹⁴ The Conference Board, *The Evolving Relationship Between Compensation Committees and Consultants*, 6, 15. (Jan. 2006).

Similarly, the Business Roundtable states in its “Executive Compensation Principles” that “the compensation committee should have independent, experienced expertise available to provide advice on executive compensation arrangements and plans. The compensation committee should oversee consultants to ensure that they do not have conflicts that would limit their ability to provide independent advice.”¹⁵

Despite these recommendations, this report finds that large publicly traded companies often retain consultants with significant conflicts of interest. In 2006, over 100 Fortune 250 companies relied on compensation consultants that had been hired by corporate management to provide other services to the company. In most cases, the amount the consultants earned providing executive compensation advice was a fraction of the amount they were paid to provide the other services. Often, the consultants who were advising on executive pay were simultaneously being paid millions of dollars by the corporate executives whose compensation they were supposed to evaluate.

A. Extent of Compensation Consultant Conflicts of Interest

In their SEC filings for 2006, 194 of the Fortune 250 companies disclosed retaining a compensation consultant to help set executive pay. Of these 194 companies, 179 disclosed hiring at least one of the compensation consultants examined in this report.

Among the 179 Fortune 250 companies that disclosed hiring one of the compensation consultants examined in this report, the use of compensation consultants with conflicts of interest was common. In 2006, 113 of these companies (63%) paid the same consultant to provide other services for the company in 2006.¹⁶

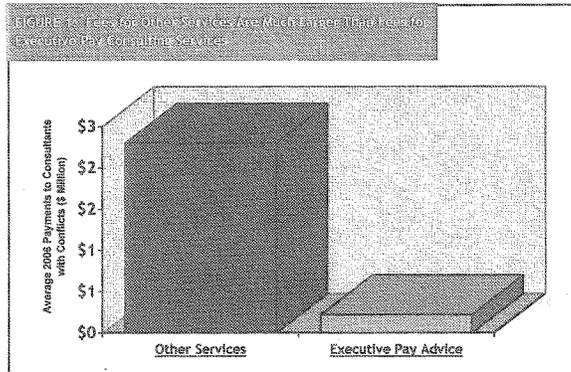
The fees these compensation consultants earned providing executive compensation advice were consistently small compared to the fees they received for providing other services. In 2006, the compensation consultants that provided both types of services to Fortune 250 companies received an average of \$220,000 for executive compensation advice and \$2.3 million for other services from each client company. For each dollar these consultants received for executive pay advice, they received almost \$11 in payments for other services. Figure 1.

A compensation consultant’s “fee ratio” is the ratio of the consultant’s fees for other services to the consultant’s fees for executive compensation advice. In 27 cases, these fee ratios exceeded 20 to 1 in 2006. In some cases, they were over 100 to 1.

One company, Johnson and Johnson, paid its compensation consultant over \$11 million for other services in 2006 compared to approximately \$160,000 for executive compensation advice, producing a fee ratio of over 70 to 1. Another company, Halliburton, also paid its compensation consultant over \$11 million compared to approximately \$210,000 for executive compensation advice, a fee ratio of over 50 to 1.

¹⁵ The Business Roundtable, *Executive Compensation Principles* (2007).

¹⁶ Companies that paid consultants a minimal fee — less than \$10,000 for either executive compensation or other services — were not considered to have hired a conflicted consultant for purposes of this report.



Twenty-five of the 113 Fortune 250 companies disclosed hiring multiple compensation consultants in 2006. In at least nine of these cases, the additional compensation consultant did not provide other services to the company. The retention of an independent compensation consultant in these cases could mitigate the influence of the conflicted consultant. In at least five cases, the additional compensation consultant also had a conflict of interest. The retention of a second consultant with a conflict of interest would not mitigate the conflict concern.¹⁷

B. Disclosure of Compensation Consultant Conflicts of Interest

Most of the 113 Fortune 250 companies that hired compensation consultants with conflicts of interest did not disclose these conflicts to public investors. The existence of multiple business relationships with the compensation consultants was revealed in the SEC filings of only 33 of the 113 companies. The remaining 80 companies did not disclose to investors that the executive pay advisor mentioned in its proxy statement did other work for the company.

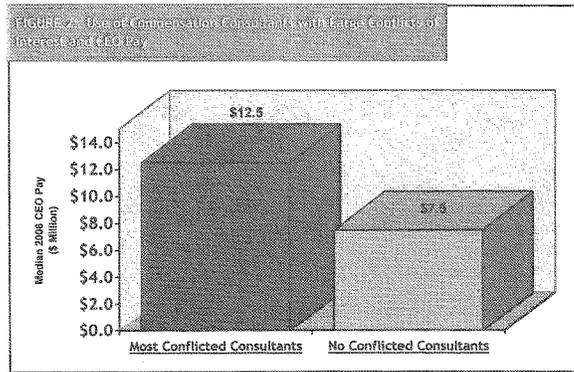
In fact, 30 of the 113 companies identified their compensation consultant as “independent” in their proxy statements even though the information provided to the Committee showed that the consultant had been hired by the company to provide other services. One company, Metlife, described its compensation consultant as “independent” in its SEC filings even though Metlife paid the consultant more than \$7 million to

¹⁷ In 11 cases, it could not be determined whether the additional consultant was independent or conflicted because the consultant was not one of the six consultants surveyed by the Committee.

provide other services to the company, according to the information received by the Committee. Another company, Pepsico described its consultant as "independent" in its SEC filings even though it paid the consultant over \$6 million to provide other services to the company, according to the information received by the Committee.

C. Relationship Between Compensation Consultant Conflicts of Interest and Levels of CEO Pay

There appears to be a correlation between the retention of compensation consultants with significant conflicts of interest and levels of CEO pay. The 25 Fortune 250 companies that used compensation consultants with the largest conflicts (as measured by fee ratios) paid their CEOs a median salary of \$12.5 million in 2006. This was 67% higher than the median salary of \$7.5 million paid by Fortune 250 companies that did not report using consultants with conflicts of interest.¹⁸ Figure 2.



A similar but less pronounced trend is observed when the CEO salaries of all Fortune 250 companies that used compensation consultants with conflicts of interest are compared to the CEO salaries of Fortune 250 companies that did not use compensation consultants with conflicts of interest. In 2006, the median CEO salary of the companies with conflicted consultants (\$8.7 million) was higher than the median CEO salary of the companies that did not use conflicted consultants (\$7.5 million).

¹⁸ CEO salary data was obtained from the Forbes magazine annual CEO compensation report. See, Forbes, *supra* note 1. Companies that did not use one of the six compensation consultants surveyed by the Committee, companies for which CEO salary data was unavailable for 2006, or companies that did not file a proxy statement in 2006 were not included in this analysis.

The Committee obtained information on fee ratios from the surveyed compensation consultants for a five-year period from January 1, 2002, through December 31, 2006. Over this period, the median CEO salary increase of the 25 Fortune 250 companies that used compensation consultants with the largest conflicts of interest was 226%. In comparison, the median CEO salary increase was less than half as much (105%) at the Fortune 250 companies that did not use conflicted compensation consultants.

These correlations between consultant conflicts of interest and levels of CEO pay suggest, but do not prove, a possible causal relationship. Numerous factors beyond the use of compensation consultants with conflicts may affect CEO pay at Fortune 250 companies. Among the companies included in this analysis, the companies that used compensation consultants with the highest fee ratios tended to be larger than the companies that did not use conflicted consultants, possibly explaining some of the pay differences. More investigation is needed to confirm whether the correlations are significant and to assess whether an unrelated factor could be responsible for the relationships observed in the data.

D. Compliance with SEC Disclosure Rules

The regulations promulgated by the SEC in 2006 require that companies disclose “any role of compensation consultants in determining or recommending the amount or form of executive and director compensation” and identify such consultants.¹⁹ According to SEC guidance, companies must disclose all consultants that played a role in determining executive pay, not just the consultant advising the board or its compensation committee.²⁰

The information the Committee received raises a question about whether the Fortune 250 companies are complying fully with this disclosure requirement. In their SEC filings, 194 of the Fortune 250 companies disclosed retaining executive compensation consultants in 2006. According to the information that the Committee received from the leading compensation consultants, however, an additional 13 Fortune 250 companies retained executive compensation consultants in 2006 but did not identify these consultants in their SEC filings. Moreover, among the 194 Fortune 250 companies that reported retaining an executive compensation consultant in 2006, not all of the retained consultants may have been disclosed. According to the information that the Committee received, almost 100 of the 194 companies failed to disclose a compensation consultant retained by the company.

Differences in definitions may be an explanation for discrepancies between the executive pay services reported to the SEC and those reported to the Committee. The executive compensation services reflected in the consultants’ submissions to the Committee could include a broader range of activities than those required by the SEC to be disclosed to shareholders. If a company hired a consultant only to provide survey data on executive pay, for example, this work could have been reported by the consultant to the Committee

¹⁹ SEC, Final Rules on Executive Compensation and Related Party Disclosures, Items 402 (b) and 407 (e) of Regulation S-K (August 29, 2006).

²⁰ *Id.*, see also, SEC, Staff Interpretation: Item 407 of Regulation S-K – Corporate Governance (March 13, 2007).

as executive compensation services, but the company may not have considered the consultant's work to involve "determining or recommending" the amount of executive pay under the SEC disclosure rules. Alternatively, although it appears inconsistent with the SEC guidance, a company may have disclosed in its SEC filings only the compensation consultants that provided services to the company board.

In some cases the compensation consultants that were not disclosed in SEC filings were paid large amounts for executive compensation services, according to the information reported to the Committee. In dozens of cases, compensation consultants reported to the Committee that they were paid over \$100,000 in 2006 for executive compensation services that were not disclosed in SEC filings.

E. The Position of the Compensation Consultants

The four diversified compensation consultants surveyed by the Committee maintain that a consulting firm's ability to provide objective, independent advice regarding executive pay is not compromised simply because it provides other services to the company. The consultants have described a variety of policies and practices they have instituted to ensure that executive compensation consultants deliver unbiased advice.

Towers Perrin, in a letter to Chairman Waxman, listed several policies and procedures for ensuring the soundness and objectivity of its consulting advice. These include: (a) a code of conduct that articulates a commitment to providing impartial and objective services; (b) the designation of a senior consultant to review and resolve all potential conflicts of interest before an engagement proceeds; (c) review of significant executive pay recommendations by a senior consultant not on the consulting team performing the work; and (d) a policy precluding an individual who advises a company's board on executive pay from serving as the firm's relationship manager with the company, where the firm provides other services to the same company.²¹

Similarly, Hewitt stated:

In the area of executive compensation counseling, Hewitt employs a number of safeguards and procedures to ensure independence. Over the last several years we have increasingly separated our executive compensation engagements from the engagements for our other services. These safeguards have evolved over time, and we adopt new ones as corporate governance and regulatory standards continue to change.²²

The Committee did not investigate the internal practices in place within compensation consulting firms, such as efforts to separate executive pay consultants from the firm's other engagements with a client company. However, there is evidence to suggest that the lines between those providing executive compensation advice and those providing other services may not be as bright as the consultants described. Employment advertisements

²¹ Letter from Mark V. Mactas, Towers Perrin, to Chairman Henry A. Waxman (June 26, 2007).

²² Letter from Ilene S. Grant, Hewitt Associates, LLC, to Chairman Henry A. Waxman (May 25, 2007).

posted by some of the compensation consultants indicate that one responsibility of individuals hired to perform executive compensation services is "cross selling" other services to client companies.

For example, Towers Perrin, in a recent job posting for an executive compensation consultant, listed the following as job responsibilities:

- Cross selling consulting and other Towers Perrin services to existing and new clients
- Minimum revenue generation from all sources (i.e., not just executive compensation services) goal of \$750 thousand in the first 12 months would be expected²³

Similarly, a recent Mercer job posting for a senior executive compensation consultant identified the following as a job responsibility: "generating revenue through development of new client relationships, cross-selling to current clients and extension of current client engagements."²⁴

CONCLUSION

The information provided to the Committee represents the best — and only — comprehensive information currently available on the extent of conflicts of interest among executive compensation consultants. An analysis of this information shows that in 2006, over 100 Fortune 250 companies used compensation consultants that provided both executive compensation advice and other services to the company at the same. In many cases, the consultants hired to provide executive compensation advice were paid millions of dollars by the executives whose pay they were supposed to assess. The information provided to the Committee also shows that many of these conflicts of interest were not disclosed to the investing public in company SEC filings.

²³ Towers Perrin, Job Description for Executive Compensation Consultant, accessed from Towers Perrin web site on October 31, 2007 (available at http://careers.towersperrin.com/towers_career/).

²⁴ Mercer Human Resources Consulting, Job Description for Senior Executive Compensation Consultant, accessed from Mercer web site on October 30, 2007 (available at <http://www.mercer.com/joiningmercer/home.html?ri=&geographyid=-1>).

Mr. DAVIS OF VIRGINIA. Mr. Chairman, I would also ask that the minority staff response be included in the record as well.

Chairman WAXMAN. Without objection, both requests will be granted.

[The information referred to follows:]

Minority Staff Response

To the Majority Staff Report: “Executive Pay: Conflicts of Interest Among Compensation Consultants”

The Majority staff report, “Executive Pay: Conflicts of Interest Among Compensation Consultants,” concludes that “compensation consultant’s conflicts of interest are widespread” and that “there appears to be a correlation between the extent of a consultant’s conflict of interest and the level of CEO pay.” This conclusion is based on the assumption there is a fundamental flaw in the way corporate executives are paid and assumes that everyone in the process is a potential bad actor. It presumes corporate boards are wholly beholden to management interest, and so are third party compensation consultants.

However, the Majority merely asserts, without substantiation, that these agents have been “captured” by management. The only supporting argument offered is the assertion that compensation consultants are similar to auditors who certify financial accounting statements of public companies. However, this analogy was rejected by the SEC during deliberations on the 2006 Executive Compensation rules. But to read the Majority’s report is to think that the SEC did not institute sweeping reforms, as the new SEC reporting requirements and their impact on executive compensation are wholly ignored.

Moreover, without providing evidence, the Majority assumes that anytime a firm provides executive compensation advice, and has another business contact with a public company, a conflict of interest automatically arises. However, this overly broad definition fails to account for measures that the firm or the company has instituted to preserve independence and provide unbiased advice. For example, in testimony before the Oversight and Government Reform Committee today, Towers Perrin outlines policies and procedures specifically designed to avoid conflicts of interest. Hewitt Associates provides similar information about their business practices to protect client interests and prevent conflicts and tainted advice. However, the Majority simply ignores the existence of these policies designed to avoid conflicts of interest in their analysis. This deliberate omission is irresponsible. So is the failure to note that the ultimate responsibility for determining executive compensation lies solely with the Board of Directors and/or their Compensation Committee. These individuals are free to accept or reject the advice given to them by compensation consultants just as they are free to seek a second opinion.

The Majority’s report ignores other factors that economists agree have led to a growth in executive compensation. For example, there is no discussion of the risk premium that must be paid to executives to compensate for the personal liability that the CEO must accept every time he or she certifies the company’s financial statements. There is also no acknowledgement that as CEO tenure becomes less certain, their contracts may be all they have to hang on to, so they negotiate the best deal possible going in.

The Majority spent the last six months investigating the six largest compensation consultants that advise the largest 250 publicly traded companies in America. Yet, despite access to nonpublic confidential information, billing records and multiple staff interviews, they concede, "The correlations between consultant conflicts of interest and the levels of CEO pay suggest, **but do not prove**, a possible causal relationship. Numerous factors beyond the use of compensation consultants with conflicts of interest may affect CEO pay." (emphasis added) To concede this point defeats the central premise of the report and renders the entire analysis specious and unreliable.

Public companies are the backbone of American entrepreneurial success and play an important role in distributing new wealth to a variety of investors and workers. Moreover, despite some troubling headlines, the underlying health of the American system is evidenced by the fact there are currently 15,000 public companies based in the United States, which are owned by 84 million investors. The value of these companies is an astounding \$37 trillion dollars. Over the last 15 years, 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. Domestic investment in public companies comes in the form of pension funds, 401Ks, and individual investments.

Moreover, there is evidence that company boards are acting as good agents of the shareholders, and getting rid of underperforming CEOs. According to a recent survey by Booz, Allen, and Hamilton, since 1995 annual CEO turnover has grown 59% and performance-related turnover has increased by 318%. While in 1995, only one in eight departing CEOs were forced from office - in 2006, nearly one in three left involuntarily. Similarly, in 1995, underperforming CEOs stayed in office as long as high performers, but by 2006, a CEO who delivered above-average returns was almost twice as likely as one delivering sub-par returns to remain CEO for more than seven years. What this means is that CEOs who deliver below-average investor returns don't remain in office long. Corporate America does not need Congress's "wisdom" in this regard.

Taken together, this empirical evidence suggests that the current market for executive talent is fully functioning and American investors and workers are benefiting. Moreover, the U.S. system of corporate governance has had more reform in the past five years than in the previous 50, and those reforms are working. Boards are more independent, have taken significant steps to increase performance metrics, align CEO pay with shareholder interests, and replacing CEOs that fail to produce results. Congress should not act hastily to intervene in a functioning marketplace when there is little evidence of a market failure and before the dust has had a chance to settle on previous reforms. The evidence offered by the Majority's report simply doesn't rise to the level necessary to justify further intervention.

Finally, the Minority staff is very concerned with the decision of the Majority to release proprietary information that the consulting companies provided in an effort to be cooperative with the investigation. While these disclosures might make the report more newsworthy, this is not sufficient justification for the disclosure of such closely held information.

Chairman WAXMAN. The results of our investigation should concern everyone who cares about corporate governance. Over 100 of the biggest companies in America are using compensation consultants with significant conflicts of interest to set CEO pay.

Last year, 113 Fortune 250 companies retained conflicted consultants. These consultants typically received \$200,000 to advise the company about executive pay and over \$2 million to provide other services, like benefit administration, to the company.

In fact, the consultants are being asked to evaluate the worth of the executives who hire them and pay them millions of dollars. Like the auditors who signed off on Enron's books, they have an inherent conflict of interest. For every dollar the consultants are paid to advise on CEO pay, they are being paid \$11 by the CEO to perform other services to the company.

What's more, few of these conflicts are being disclosed to shareholders. We found that some companies call the consultants "independent" in their proxy statements when in fact the consultants were being paid millions of dollars to provide other services. And when we looked closely at the conflicts, we found that the Fortune 250 companies that use consultants with the most extreme conflicts of interest paid their CEOs more and raised their pay faster than other companies.

Today's hearing will give us additional insights on this issue. Our first panel includes corporate governance experts and institutional investors that have experience identifying, assessing and addressing potential conflicts of interest; and I thank them for being here today.

Our second panel consists of the consultants themselves. We will hear their side of the story: how they handle conflicts of interest and what they do to mitigate their impact. I appreciate their cooperation in the committee's inquiry and their willingness to appear before the committee today.

I am disappointed, however, that two leading compensation consultants, Watson Wyatt Worldwide and Pearl Meyer & Partners, declined our invitation to testify today.

At bottom, the issue we are examining goes to the heart of the executive compensation process. Are soaring CEO pay packages earned or are they the result of a rigged process? Today's hearing will give us a new perspective on this important question.

[The prepared statement of Chairman Henry A. Waxman follows:]

HENRY A. WAXMAN, CALIFORNIA,
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Opening Statement of Rep. Henry A. Waxman
Chairman, Committee on Oversight and Government Reform
Hearing on Executive Pay and the Role of
Compensation Consultants
December 5, 2007

Today the Committee will be considering the issue of executive compensation. Reports of astronomical payouts to corporate CEOs have led many to question the fairness and effectiveness of the system for setting executive pay. We will be exploring these questions today.

In the 1980s, the CEOs of the nation's largest companies were paid 40 times more than the average employee. Now they make over 600 times more. At a typical company, 10% of corporate profits — a staggering sum — goes into the pockets of top executives.

These huge pay packages raise a basic question: Are corporate CEOs working for the companies who hire them or are the companies working for the CEOs?

Many academic experts, financial analysts, and investors believe that soaring CEO paychecks are a symptom of a corporate governance system that is not working. As noted, investor Warren Buffett has commented: "In judging whether Corporate America is serious about reforming itself, CEO pay remains the acid test."

Today's hearing examines a practice that may be fueling this dysfunctional pay system: the use of executive compensation consultants with conflicts of interest.

Executive compensation has become incredibly complex. CEOs don't just get salaries any more. They get stock options, restricted stock units, deferred compensation, executive pension plans, lucrative severance packages, and a vast array of perks from corporate jets to tax and financial planning services and country club memberships. These compensation packages can be worth hundreds of millions of dollars.

Many companies now rely on the services of professional executive compensation consultants to evaluate these complex pay arrangements. Last year, in fact, over three-quarters of the Fortune 250 retained outside compensation consultants.

Most Americans have never heard of Towers Perrin, Mercer, and the other influential compensation consultants. But these pay advisors can have an enormous impact on executive pay. When they do their job right, they can align the interests of the CEO with the interests of the shareholder. But when they do their job wrong, the result can be vast wealth for the CEO and a plundered company for the shareholders and employees.

That's why it's so important that these pay consultants be independent and free of conflicts of interest. Consultants who are paid millions of dollars by a corporate CEO won't provide objective advice to the board. They know what the CEO wants to hear and they know what will happen to their lucrative contracts if they don't say it.

For the last seven months, the Committee has been investigating conflicts of interest among compensation consultants. Today I am releasing a report that summarizes what the majority staff has found.

The results of our investigation should concern everyone who cares about corporate governance: over 100 of the biggest companies in America are using compensation consultants with significant conflicts of interests to set CEO pay.

Last year, 113 Fortune 250 companies retained conflicted consultants. These consultants typically receive \$200,000 to advise the company about executive pay — and over \$2 million to provide other services, like benefit administration, to the company.

In effect, the consultants are being asked to evaluate the worth of the executives who hire them and pay them millions of dollars.

Like the auditors who signed off on Enron's books, they have an inherent conflict of interest. For every dollar the consultants are paid to advise on CEO pay, they are being paid \$11 dollars by the CEO to perform other services to the company.

What's more, few of these conflicts are being disclosed to shareholders. We found that some companies called the consultants "independent" in their proxy statements when in fact the consultants were being paid millions of dollars to provide other services.

And when we looked closely at the conflicts, we found that the Fortune 250 companies that use consultants with the most extreme conflicts of interest paid their CEOs more — and raised their pay faster — than other companies.

Today's hearing will give us additional insights on this issue. Our first panel includes corporate governance experts and institutional investors that have experience identifying, assessing, and addressing potential conflicts of interest. I thank them for being here.

And our second panel consists of the consultants themselves. We'll hear their side of the story: how they handle conflicts of interest and what they do to mitigate their impact. I appreciate their cooperation in the Committee's inquiry and their willingness to appear before the Committee today. I am disappointed, however, that two leading compensation consultants — Watson Wyatt Worldwide and Pearl Meyer & Partners — declined our invitation to testify today.

At bottom, the issue we are examining today goes to the heart of the executive compensation process: Are soaring CEO pay packages earned or are they the result of a rigged process? Today's hearing will give us a new perspective on this important question.

Chairman WAXMAN. I would like to now recognize the ranking member of this committee, Mr. Davis.

Mr. DAVIS OF VIRGINIA. Well, thank you, Mr. Chairman.

The Enron fiasco reminded us all that corporate responsibility and transparency are critical components of a healthy capitalist system. Shareholders should have confidence in the soundness and independence of key decisions by company directors, including decisions on executive salaries, bonuses, stock options and benefits. But even after a majority staff report issued today I am just not ready to join them in the logical leap that presumes a causal connection between the services of compensation consultants and any kind of corporate malfeasance. It seems we were called here to discuss a problem that may not exist and one this committee can't solve, in any event.

The theory goes something like this: Pliant and corrupt consultants working both sides of the fiduciary street take huge fees for management and recommend unreasonably high compensation for those same managers. Company directors, unaware of the consultant's conflict of loyalties, blindly take the advice; and that's why executive pay has risen so high even while company's performance and stock prices fall.

It is an interesting theory, one steeped in anti-corporate populism, but there is little proof that it is true. Instead, in a dizzying whirl of fallacious reasoning, the majority first presumes an incurable conflict of interest whenever a compensation consultant provides advisory services to both the directors and the management of the same company. Having thus conjured this conflict into existence, it is easy to jump to the conclusion that any decision based on such tainted advice lacks the requisite independence and fiduciary care.

It is true the undue influence of compensation consultants, like the self-serving opinions rendered by some accounting firms, posed a threat to corporate integrity in the past. But post-Enron reforms like the Sarbanes-Oxley law put in place substantial new safeguards and stiff penalties to induce greater transparency and accountability in publicly traded companies. Those additional protections and liabilities short-circuit the majority's theory that consultants cause corporate misbehavior and that only additional regulation can fix the problem.

If there is a problem with the amounts or methodologies of executive pay, it is the legal and fiduciary duty of corporate directors to solve it. No amount of additional disclosure by compensation consultants would alter or abrogate the fundamental responsibility of corporate directors to make timely and informed decisions in the best interest of shareholders.

As Mr. Shadab in his testimony today from George Mason University in my district notes, that to be able to capture a board, a manager would have actually be employed by the corporation to establish the close ties, but CEOs promoted from within the company earn about 15 percent less than CEOs hired from the outside and that this premium for external hires actually grew throughout the 1970's, 1980's and 1990's. But if entrenched managers are unduly influencing compensation decisions of the board, then why do CEOs without the ability to capture directors earn more? Good question.

If there is a problem with the amounts of methodologies, it is the legal and fiduciary duty of the corporate boards of directors to solve it, as we noted before.

Last year, the Securities and Exchange Commission considered and rejected the compensation consultants' disclosures abrogated here today by the majority and some of our witnesses. Why did they do this? Because the Commission found the attempt to regulate consultants like accountants inept and unworkable. The SEC concluded the proposed disclosure could do more harm than good if the information betrayed corporate strategy or otherwise caused competitive harm in the public realm.

Ironically, the Commission's concerns about irresponsible disclosures were borne out this morning. Sensitive, company-specific information provided this committee by compensation consultants is included in the majority staff report. Shareholders in those companies have cause to be concerned about the gratuitous, potentially damaging revelation of corporate policy in regulatory compliance practices.

Demonizing executive pay won't cure corporate ills or strengthen the performance of company stocks held by pension funds covering millions of Americans. Nor should envy or false egalitarianism be allowed to repeal the laws of supply and demand.

Recent evidence suggests corporate executive compensation levels reflect market forces and correlate with company growth and increase stock volume. High turnover in America's top executive suites also seems to prove that those who abuse the system or fail to perform are replaced with or without a consultant's help.

Mr. Chairman, I agreed when you said management of Federal Government funds and programs demanded our full attention, so while I appreciate the information our witnesses will provide today, I hope we can take the lessons that the private sector has to teach and refocus our oversight on that important work.

Thank you.

[The prepared statement of Hon. Tom Davis follows.]

HENRY A. WAXMAN, CALIFORNIA
CHAIRMAN

TOM DAVIS, VIRGINIA
RANKING MINORITY MEMBER

ONE HUNDRED TENTH CONGRESS

Congress of the United States

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Statement of Rep. Tom Davis
Ranking Republican Member
Committee on Oversight and Government Reform
“Executive Pay: The Role of Compensation Consultants”
December 5, 2007

Mr. Chairman, the Enron fiasco reminded us all that corporate responsibility and transparency are critical components of a healthy capitalist system. Shareholders should have confidence in the soundness and independence of key decisions by company directors, including decisions on executive salaries, bonuses, stock options and benefits. But even after reading the majority staff report issued today, I’m just not ready to join them in the logical leap that presumes a causal connection between the services of compensation consultants and corporate malfeasance. It seems we were called here to discuss a problem that may not exist, and one this Committee cannot solve in any event.

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If there is a problem with the amounts or methodologies of executive pay, it's the legal and fiduciary duty of corporate directors to solve it. No amount of additional disclosure by compensation consultants would alter or abrogate the fundamental responsibility of corporate directors to make timely and informed decisions in the best interests of shareholders. Last year, the Securities and Exchange Commission considered, and rejected, the compensation consultant disclosures advocated here today by the majority and some of our witnesses. Why? Because the Commission found the attempt to regulate consultants like accountants inapt and unworkable. And the SEC concluded the proposed disclosures could do more harm than good if the information betrayed corporate strategy or otherwise caused competitive harm in the public realm.

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Mr. Chairman, I agreed when you said management of federal government funds and programs demanded our full attention. So, while I appreciate the information our witnesses will provide today, I hope we can take the lessons the private sector has to teach and refocus our oversight on that important work.

Chairman WAXMAN. Thank you, very much, Mr. Davis.

I do want to call on other colleagues that are here today. Ordinarily, just the two of us make opening statements, but if either of the other Members that are here wish to make opening statements I will recognize them.

Mr. DAVIS OF ILLINOIS. I have no statement.

Chairman WAXMAN. I want to introduce our first panel:

Charles Elson, Edgar S. Woolard, Jr., Chair in Corporate Governance and director of the John L. Weinberg Center For Corporate Governance at the University of Delaware's Lerner College of Business and Economics. Meredith Miller is the assistant treasurer for policy for the State of Connecticut Treasurer's Office. Daniel F. Pedrotty is the director of the AFL-CIO Office of Investment. Houman Shadab is a senior research fellow in the Mercatus Center's Regulatory Studies Program.

We are pleased to have each of you here today, and I thank you for being here.

It is the practice of this committee that all witnesses testify under oath, so I would like to ask if you would stand and please raise your right hands.

[Witnesses sworn.]

Chairman WAXMAN. Thank you.

The record will indicate that each of the witnesses answered in the affirmative.

And what we'd like to now do is hear from you. Your written statements will be made part of the record in full. We'd like to ask each of you to try to limit the oral presentation to 5 minutes. We will have a clock, and it will be green, and the last minute it will be yellow and then red when the 5 minutes are up. When you see red, I hope you will conclude.

Mr. Elson, why don't we start with you. There is a button at the base of the mic. Be sure to press it in so we can hear.

STATEMENTS OF CHARLES ELSON, JOHN L. WEINBERG CENTER FOR CORPORATE GOVERNANCE, UNIVERSITY OF DELAWARE; MEREDITH MILLER, ASSISTANT TREASURER FOR POLICY, CONNECTICUT STATE TREASURER'S OFFICE; DANIEL PEDROTTY, DIRECTOR, OFFICE OF INVESTMENT, AFL-CIO; AND HOUMAN SHADAB, SENIOR RESEARCH FELLOW, MERCATUS CENTER, GEORGE MASON UNIVERSITY

STATEMENT OF CHARLES ELSON

Mr. ELSON. Thank you.

The problem with executive overcompensation is quite simple in its origins and solution. You see, high compensation leaves me totally voiceless.

Pay unrelated to performance is the result of the failure of effective bargaining between the corporate board and management. The elements leading to this failure are, first of all, overreaching management and, second, passive, management-dominated directors often advised by sometimes compromised compensation consultants.

The key to the solution is to stimulate better bargaining between the board and management. I think this can be accomplished by in-

sisting that the board, and particularly the members of the board's compensation committee, negotiate with executive on pay, be comprised of individuals who are completely independent of management and hold personally meaningful equity stakes in the business itself. This will ensure that they have the objectivity and incentive to effectively negotiate pay.

Additionally important to the solution and I think the subject of the hearing today are reforms in the ways in which compensation consultants aid in the pay compensation process.

Traditionally, the consultant was hired by management to aid in the design and review of the executive pay package. Often, the consultant's firm was also engaged to do a significant amount of other work for the company. Additionally, it was believed that the presence of the consultant provided some legal protection to the board who ultimately approved the compensation package.

As a third-party, non-company employee, the consultant was supposed to add some objectivity to the process that could be effectively relied upon by the board in the review of the compensation package. However, because the consultants were hired by management and often did other highly compensated work for the company, their objectivity as to their review for the board of the compensation package was either factually or certainly optically compromised. That's why corporate governance advocates have long suggested that the best practice in this case would be that the consultant who advises the compensation committee be hired exclusively by the committee and perform no other tasks for the company or its management. The idea was that directors who negotiate pay must receive completely unfettered and objective advice from outsiders solely responsible to the committee and full board, uncompromised by managerial relationships.

This advice presented to independent and motivated directors I think would ultimately result in effective incentive pay for the company's executives. At minimum, certainly the optics of such a process would be much more appealing to the shareholders, aiding in the restoration of public confidence in the integrity of our business institutions.

Now this approach, similar to that taken with regard to outside company auditors under Sarbanes-Oxley, has been endorsed by numerous business and investor organizations, including the National Association of Corporate Directors, and is supported by many in the financial community. In fact, Chief Justice Veasey of the Delaware Supreme Court, the Nation's leading appellate business court, in widely quoted remarks made at the University of Delaware a couple of years ago stated, that compensation committees should have their own advisers and lawyers. Directors who are supposed to be independent should have the guts to be a pain in the neck and act independently—suggesting judicial support for this theory.

Now, the trend today, given the obvious logical appeal of this approach and widespread shareholder support, the trend of which I have been familiar as a director and academic specializing in the area, has clearly been for board compensation committees to engage their own compensation consultants who provide no other work for the enterprise. From a Federal regulatory standpoint, I think to further board adherence to this best practice, better disclosure on

compensation consultant conflicts of interest needs to be provided to the investors.

While at present the Securities and Exchange Commission mandates disclosure to investors of the identity of a company's comp consultant and certain other retention details, there must also be disclosure of any other services the consultant provides to the organization, as well as the amount of fees paid to that consultant, similar to the required disclosure regarding the company's outside auditors. This disclosure, I think combined with public pressure and the resulting trend toward the use of non-conflicted consultants, I believe will lead to improved pay practices and a greater confidence by the investing public in the integrity of our public corporations.

Chairman WAXMAN. Thank you very much, Mr. Elson.
[The prepared statement of Mr. Elson follows:]

Congress of the United States
House of Representatives
One Hundred Tenth Congress
Committee on Oversight and Government Reform

Executive Pay: The Role of Compensation Consultants Hearing
December 5, 2007

Charles M. Elson
Edgar S. Woolard Jr., Chair in Corporate Governance &
Director, John L. Weinberg Center for Corporate Governance
University of Delaware

The problem of executive over-compensation is quite simple in its origins and solution. Pay unrelated to performance is the result of the failure of effective bargaining between the corporate board and management. The elements leading to this failure are: 1. overreaching management; and 2. passive, management-dominated directors often advised by sometimes compromised compensation consultants. The key to the solution is to stimulate better bargaining between the board and management. This can be accomplished by insisting that the board, and particularly the members of the board's compensation committee who negotiate with executives on pay, be comprised of individuals who are completely independent of management and hold personally meaningful equity stakes in the organization. This will ensure that they have the objectivity and incentive to effectively negotiate pay. Additionally important to the solution, and the subject of this hearing, are reforms in the ways in which compensation consultants aid in the pay negotiation process.

Traditionally, the consultant was hired by management to aid in the design and review of the executive pay package. Often the consultant's firm was also engaged to do a significant amount of other work for the company. Additionally, it was believed that the presence of a consultant provided some legal protection to the board who ultimately approved the compensation agreement. As a third party, non-company employee, the consultant was supposed to add some objectivity to the process that could be effectively relied upon by the board in the review of the compensation package. However, because the consultants were hired by management and often did other highly compensated work for the company, their objectivity as to their review for the board of the executive compensation agreement was either factually or certainly optically compromised. This is why corporate governance advocates have long suggested that the best practice in this case would be that the consultant who advises the compensation committee be hired exclusively by the committee and perform no other tasks for the company or its management. The idea was that the directors who negotiate pay must receive completely unfettered and objective advice from outsiders solely responsible to the committee and full board, un-compromised by managerial relationships. This advice presented to independent and

motivated directors would ultimately result in the most effective incentive pay for the company's executives.

At minimum, certainly the optics of such a process would be much more appealing to the shareholders, aiding in the restoration of public confidence in the integrity of our business institutions. This approach, similar to that taken with regard to outside company auditors under the Sarbanes-Oxley Act, has been endorsed by numerous business and investor organizations, including the National Association of Corporate Directors, and is supported by many in the financial community. In fact, Chief Justice E. Norman Veasey of the Delaware Supreme Court, the nation's leading appellate business court, in widely quoted remarks made at the University of Delaware in 2002 stated, "Compensation committees should have their own advisers and lawyers. Directors who are supposed to be independent should have the guts to be a pain in the neck and act independently"¹ – suggesting judicial support for the theory.

Given the obvious logical appeal to this approach and widespread shareholder support, the trend

¹"What's Wrong with Executive Compensation? A roundtable moderated by Charles Elson," HARVARD BUSINESS REVIEW, January 2003, Volume 81, Number 1, p. 68

of which I have been familiar as a director and academic specializing in the area, has clearly been for board compensation committees to engage their own compensation consultants who provide no other services for the enterprise. From a federal regulatory standpoint, to further board adherence to this best practice, better disclosure on compensation consultant conflicts of interest needs to be provided to shareholders. While at present the Securities and Exchange Commission mandates disclosure to investors of the identity of a company's compensation consultant and certain other retention details, there must also be disclosure of any other services the consultant provides to the organization as well as the amount of fees paid to that consultant, similar to the required disclosure regarding the company's outside auditors. This disclosure, combined with public pressure and the resulting trend toward the use of non-conflicted consultants, should lead to improved pay practices and greater confidence by the investing public in the integrity of our public corporations.

Chairman WAXMAN. Ms. Miller.

STATEMENT OF MEREDITH MILLER

Ms. MILLER. Good morning, Chairman Waxman, Ranking Member Davis and committee members. Thank you, Mr. Chairman, and your staff for your leadership on this important issue.

My remarks this morning cover the findings of an investor initiative led by Treasurer Denise Nappier on compensation consultant independence. This initiative was launched in response to the SEC's failure to require in its new disclosure rules that companies disclose whether a compensation consultant worked for both the board and the management of the same company. The results of the investor initiative showed that compensation committees were willing to exceed SEC's reporting requirements and address the issue of independence of consultants in the proxy statements, with many adopting formal policies.

With these findings, we urged the SEC to revisit this issue and to take steps that a best practice cannot do, that is, issue new rules that require companies to disclose all compensation consultant business relationships and the fees paid by the company for these engagements.

The independence of compensation consultants is important to investors because of the influential role consultants play in advising boards on executive compensation. And, in turn, executive compensation is important to investors because of the ability to serve as a window into board accountability. It can show the quality of the decisions and the dynamics of the board, and it can show whether those decisions align the company interests with shareholders to create long-term, sustainable value.

Unfortunately, we continue to see executive levels of pay rising and rewards for poor company performance. Investors have responded with various strategies, including 60 shareholders proposals filed last year calling for an investor advisory vote on pay packages known as "say on pay." The House responded as well by passing legislation this year that would give investors this right.

With these trends and events, it follows that, whether it be perception or real, investors are concerned that consultants who earn more from providing services to management while at the same time providing services to the board's compensation committee may be biased in decisions related to executive pay in order not to lose the lucrative engagements.

We can agree that management would have a conflict of interest if it decided its own compensation. That's why shareholders seek to meet with the compensation committee members and not management of the company.

Executive compensation is one issue that comes before a board where such a conflict needs to be avoided, and the same principle applies if you can consider consultants paid by management as an agent of management. In 2006, when the SEC announced its intentions to propose new rules for executive compensation disclosure, Treasurer Nappier immediately issued an open letter to compensation committee members cautioning them about the need to be prepared for the increased scrutiny such disclosure would bring. The

Treasurer highlighted the need for this disclosure, harkening back to the auditor consulting controversy pre-Enron.

When the SEC issued its final rules, it acknowledged comments from investors urging this disclosure, but ultimately it deferred to the consulting community that investors should rely on the business judgment of the competition committees and that would suffice.

The Treasurer then embarked on the compensation consultant initiative in October 2006. Along with a coalition of investors representing \$850 billion, the Treasurer wrote to the top 25 companies in the S&P to ask whether compensation consultants did work for both the board and the company and to ask if the company would consider adopting a formal policy on compensation and consultant independence that prohibited work for management in the 2007 CDNA.

In response to the October letter, we received 18 replies and identified the top 10 best practices and sent those practices back to the companies so that the compensation committees could learn from each other and set a best practice for 2007 CDNA. When we examined the 2007 CDNAs of the top 25, we found that the vast majority, 23 out of 25, addressed the issue of independence, thereby exceeding the SEC's requirement. Out of the 25, 12 implemented formal policies that promoted the fundamental principles of independence, and 11 did no work for management. And we learned of several innovative approaches to this issue.

Elements of a best practice included a formal policy adopted by the compensation committee which ideally would bar work from management, but if management needed survey work data on compensation a de minimus test existed. This initiative showed that companies were willing and able to exceed the SEC reporting standards, but that without clear and uniform rules the definitions of independence varied, who made the determination varied, and even the decision to disclose on the issue varied.

We urged the SEC to recognize what investors, consultants and compensation committees recognize, that investors have a right to know if the advice their company receives on executive compensation could potentially be compromised by monetary ties to the management of that same company.

Thank you.

Chairman WAXMAN. Thank you very much, Ms. Miller.

[The prepared statement of Ms. Miller follows:]

**Testimony of Meredith Miller, Assistant Treasurer for Policy
Office of the Connecticut State Treasurer Denise L. Nappier
Before the Committee on Oversight and Government Reform, U.S. House of Representatives
Hearing on Executive Pay: The Role of Compensation Consultants
December 5, 2007**

Good morning, Chairman Waxman, Ranking Member Davis, and Members of the Committee on Oversight and Government Reform. My name is Meredith Miller. I am Assistant Treasurer for Policy in the Office of Connecticut State Treasurer Denise L. Nappier. Treasurer Nappier is the principal fiduciary of the \$26 billion Connecticut Retirement Plans and Trust Funds (CRPTF).

I applaud the committee and its staff for bringing attention to the potential conflicts of interest that may arise when compensation consultants perform work for both board committees and the management of the same company. My testimony will comment on the willingness of top U.S. companies to grant investor requests to adopt policies that promote compensation consultant independence and to exceed U.S. Securities and Exchange Commission (SEC) reporting requirements by addressing the issue of independence in the 2007 proxy statement. In present-day corporate governance, there should be no tolerance for potential conflicts of interests that arise from a lack of adequate disclosure on items that can be easily provided by companies. Compensation consultant independence has been the subject of shareholder resolutions, policy formulation by investor trade associations, comment letters to the SEC, and is now the focus of today's hearing. The SEC should no longer view this issue as a best practice, and should require uniform and detailed disclosure about all of the business relationships an outside advisor may have with a company. Without this information, investors cannot hold compensation committees accountable for the management of potential conflicts of interest, regardless of whether those conflicts are perceived or actual.

Corporate Governance, Executive Compensation and Compensation Consultant Independence

Since taking office in January 1999, the Treasurer has been actively involved in corporate governance issues through engagement with companies and in the public policy arena. Key among these issues is executive compensation, of which compensation consultant independence is an important element.

The Treasurer's interest in executive compensation as a priority corporate governance issue stems from her belief that executive compensation is a "window" into board accountability; that is, executive compensation sheds light on the quality of board decision-making and the implications of those decisions for strategically positioning the company for long-term sustainable growth and increased shareholder wealth. One of the ways in which executive compensation aligns management's interests with those of the shareholders is by linking pay to company performance.

Executive compensation that is not linked to performance can result in distorted pay practices and the kind of misplaced incentives that have become all too familiar in the governance scandals epitomized by Enron. Despite the attention paid to corporate governance in the wake of the scandals, there has been a persistent and blatant ratcheting up of CEO pay, even in the face of poor

company performance. A recent study by The Corporate Library, "Pay for Failure II: The Compensation Committees Responsible,"¹ found that over a five-year period, compensation committees of twelve of the largest U.S. companies authorized payouts to CEOs of \$1.26 billion, while shareholder value dropped by \$330 billion. The companies chosen for the most pronounced gap between pay and performance realized negative shareholder returns over the last five years and underperformed their peer groups over the same period. More poignant for investors are severance packages like the one recently paid to ousted Merrill Lynch CEO Stanley O'Neal: \$161.5 million worth of parting gifts, and an office and an executive assistant in the wake of \$8.4 billion in losses following the sub-prime fallout.

Institutional investors, including the CRPTF, have been active on many fronts in their efforts to reign in excessive executive pay. Shareholder resolutions asking for an advisory vote on the pay package, referred to as "Say on Pay," have resulted in several high votes and some companies' voluntary adoptions. Congress has also taken the issue up with the House passage of a "Say on Pay" bill and similar legislation pending in the Senate. Like other activist institutional investors, the CRPTF has filed shareholder resolutions dealing with pay for performance, "Say on Pay," and backdating of options.

Fundamental to the success of initiatives such as "Say on Pay" is the ability of investors to make informed decisions about pay packages. To facilitate better reporting on compensation, the SEC issued disclosure rules effective for the 2007 proxy season that require companies to report details of the compensation program as part of a new section of the proxy, the Compensation Discussion and Analysis (CD&A). In promulgating the new rules for the CD&A, the SEC required limited disclosure on the issue of compensation consultant independence by only mandating disclosure of the point of hire, scope of work and identification of the consultant. Noticeably lacking is disclosure as to whether the consultant performs other kinds of work for the management of the same company and the respective fees associated with the board and management engagements.

It was the SEC's announcement of the new CD&A that prompted Treasurer Nappier in 2006 to urge compensation committees to be prepared for the enhanced scrutiny the new disclosure requirements would bring to committee decisions and policies. Treasurer Nappier was mindful of investors' requests to the SEC to require disclosure of auditor consulting work that fell on deaf ears even before Enron. With this history in mind, key among the list of issues about which the Treasurer cautioned committees was the issue of compensation consultant independence.

The Implications of Compensation Consultant Independence for Compensation Committees

The Treasurer's focus on the compensation committee reflects the potentially influential role a consultant may play in decisions on key elements of the compensation package. Consultants may provide input on important pieces of the compensation program, including the philosophy and the structure of the compensation program, types of pay, percentages of pay at risk, the choice of performance metrics and goals along with the identification of the peer group companies used to measure performance. Consultants with more lucrative engagements on the management side may be precluded from providing impartial data or advice than those with no monetary ties.

¹ The Corporate Library, "Pay for Failure II: The Compensation Committees Responsible," May 2007.

Harvard Professor Lucian Bebchuk and U.C. Berkeley Professor Jesse Fried addressed the potential conflict compensation consultants may encounter in recommending pay levels for the management that oversees them in a study, "Executive Compensation as an Agency Problem."² The authors noted,

*Compensation consultants have strong incentives to use their discretion to benefit the CEO. The firm's human resources department usually hires the consultant, which is subordinate to the CEO. Providing advice that hurts the CEO's pocketbook is hardly a way to enhance the consultant's chances of being hired in the future by this firm or, indeed, by any other firm. Moreover, consulting firms often have other, larger assignments with the hiring company, which further increases their incentive to please the CEO.*³

Unfortunately, as the authors note, directors often rely on the recommendations presented by the compensation consultants due to time constraints in fulfilling their own commitments to the company.⁴

The Treasurer conveyed her concern about the importance of compensation consultant independence in a June 5, 2006, comment letter to the SEC on proposed rules for executive compensation and related party disclosure. Treasurer Nappier stated,

*[M]ultiple business relationships within a company may compromise the independence of a consultant's recommendations and/or advice to the compensation committee, and such information is fundamental to any assessment by investors as to the independence of the advice and guidance provided by the consultant.*⁵

Other investor groups have joined the call for compensation consultant independence. The Council of Institutional Investors (CII) this year adopted language in its Corporate Governance Policies asking the compensation committee to construct a formal policy on the independence of compensation consultants, and to review and report on the nature of the consultant's engagement with management:

Individual compensation advisors and their firms should be independent of the client company, its executives and directors and should report solely to the compensation committee. The compensation committee should develop and disclose a formal policy on compensation adviser independence. In addition, the committee should annually disclose an assessment of its advisers' independence, along with a description of the nature and dollar

² Lucian Arye Bebchuk and Jessie M. Fried, "Executive Compensation as an Agency Problem," *Journal of Economic Perspectives* 17 (Summer 2003). Available at <http://ssrn.com/abstract=364220>. Dr. Bebchuk is the William J. Friedman and Alicia Townsend Friedman Professor of Law, Economics, and Finance and Director of the Program on Corporate Governance at Harvard Law School. Dr. Fried is a Professor of Law at the University of California, Berkeley, and Faculty Co-Director of the Berkeley Center for Law, Business and the Economy (BCLBE).

³ *Ibid.* 10.

⁴ *Ibid.* 5.

⁵ Comment letter from Denise L. Nappier, Connecticut State Treasurer, to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, RE: Executive Compensation and Related Party Disclosure, File No. S7-03-06. 5 July 2006.

*amounts of services commissioned from the advisers and their firms by the client company's management.*⁶

The link between independence and committee members' fiduciary responsibility was made in a 2006 Conference Board study, "The Evolving Relationship between Compensation Committees and Consultants."⁷ The study concludes that compensation committees that utilize outside consultants could best meet their fiduciary duties if such consultants did no other work for management.

In its listing standards, the New York Stock Exchange (NYSE) underscores the importance of the compensation committee in deciding the terms of the compensation consultant engagement. In the listing standard dealing with the compensation committee, the NYSE suggests that a compensation committee charter should grant the committee "sole authority to retain and terminate the consulting firm, including sole authority to approve the firm's fees and other retention terms."⁸

Disclosure of compensation consultant independence was recently included among best practices in a RiskMetrics Group publication, which stated, "Companies should describe the role of any compensation consultants and specifically address their independence from management."⁹ The report also stated that companies should include such disclosure in the CD&A portion of the annual proxy statement.

The Investor Coalition and the Compensation Consultant Initiative

As mentioned above, Treasurer Nappier first engaged on the issue of compensation consultant independence in April 2006, with an open letter to chairs of compensation committees. The letter was published by the National Association of Corporate Directors. This letter questioned how well-prepared compensation committee chairs were for the increased scrutiny expected in the wake of the new SEC executive compensation disclosure requirements. The Treasurer also sent two letters to the SEC, urging it to require boards to disclose whether consultants were performing work for both the board and management.

⁶ Council of Institutional Investors Corporate Governance Policies, page 8. According to the Council's website, the Corporate Governance Policies, "set standards or recommend practices that Council members believe companies and boards of directors should adopt to promote accountability, independence, integrity, rigor and transparency." Available at <http://www.cii.org/policies/index.html>.

⁷ The Conference Board, "The Evolving Relationships between Compensation Committees and Consultants," January 2006.

⁸ Section 303A.05 of the NYSE Listed Company Manual, pertaining to the compensation committee, contains commentary on the importance of compensation committee oversight and hiring authority of compensation consultants who are hired to provide guidance on executive compensation matters. The full text of the relevant portion of the commentary is as follows:

[I]f a compensation consultant is to assist in the evaluation of director, CEO or executive officer compensation, the compensation committee charter should give that committee sole authority to retain and terminate the consulting firm, including sole authority to approve the firm's fees and other retention terms.

⁹ The report continues, "In particular, the CD&A should identify any potential conflicts of interest that might compromise their independence and explain how the consultant or the compensation committee resolves those potential conflicts." See RiskMetrics Group, "Proposed Best Practices in Executive Compensation Disclosure," October 2007, page 7.

In October 2006, Treasurer Nappier led a coalition of institutional investors¹⁰ representing \$849.5 billion in assets under management in calling on 25 of the nation's largest corporations¹¹ in the S&P 500 to exceed SEC compensation reporting requirements in the CD&A for the 2007 proxy season by disclosing the nature of compensation consultant engagements, including whether the consultant was independent. The coalition sent letters to the companies describing the coalition's concerns about conflicts of interest arising from dual compensation consultant engagements, and asking them (a) whether compensation consultants worked for both the company's board compensation committee and management; and (b) whether the board would adopt a formal policy on compensation consultant independence and disclose it in the new CD&A portion of the 2007 proxy. The letter also emphasized that the 25 companies were chosen because they had the clout to set a best practice in this area.

The engagement efforts drew parallels to past concerns regarding audit firms receiving compensation for providing consulting work for the same corporations for which they served as external auditor, a practice that came under scrutiny in 2002 and was later directly addressed as part of the corporate governance Sarbanes-Oxley reforms in the wake of Enron and other high-profile corporate scandals.

Initial Findings of the Project

In January of 2007, the coalition released the preliminary results of the first 18 responses and identified the top ten¹² companies whose practices and/or policies represented a best practice.

The 18 responses showed that the majority of the compensation committees supported the issue of independence of consultants and believed that it was not only achievable but also desirable. In February 2007, the coalition again wrote to the top 25 companies acknowledging responses to the October letter (or lack thereof) and included the top ten best practice examples, urging each board to examine its practices and consider adopting policies if none existed.

Key Findings of the Project

Based on the 2007 proxy filings, the majority of compensation committees (23 compensation committees of the top 25 companies) chose to address the issue of compensation consultant independence directly and therefore exceeded the SEC's requirements to disclose only the name of the consulting firm and the nature of the agreement with the compensation committee. Twelve of

¹⁰ Investor coalition members include: Connecticut State Treasurer's Office, North Carolina State Treasurer's Office, CalSTRS, New York State Common Retirement Fund, City of New York Comptroller's Office, AFL-CIO Reserve Fund, SEIU Pension Fund, State of Illinois Board of Investment, F&C Asset Management, Walden Asset Management, International Brotherhood of Teamsters, Universities Superannuation Scheme Ltd, Central Laborer's Pension Fund Co Petroleum.

¹¹ Exxon Mobil Corporation, Microsoft Corporation, Bank of America, Citigroup Inc., General Electric, Pfizer Inc., Johnson & Johnson, JP Morgan Chase, Cisco Systems Inc., Verizon Communications, Conoco, Phillips, Wal Mart Stores Inc., Wachovia, Morgan Stanley, Goldman Sachs Group Inc., Motorola Inc., Home Depot Inc., Procter and Gamble Co., Hewlett Packard Co., Texas Instruments Inc., Occidental Petroleum, Dow Chemical, Lockheed Martin Corporation, AT&T Inc., Merck & Co., Inc.

¹² Cisco Systems, Inc., Wachovia Corp., Conoco, Phillips, Pfizer Inc., ExxonMobil, Goldman Sachs & Co., Motorola Inc., Lockheed Martin Corp., Procter and Gamble Co., and the Home Depot.

the 25 compensation committee reports included formal policies on compensation consultant independence in addition to the actions taken by the committee to consider consultant independence. In addition, eleven of the 25 companies reported that an independent consultant did no work for management of the same company.

Seven of the 2007 proxies, exhibited dramatic changes from the 2006 proxy disclosure in the degree to which practices and policies related to the independence of the compensation consultant were discussed and described in detail. *Motorola* and *Lockheed Martin's* 2007 proxies showed the most dramatic changes from 2006. *Morgan Stanley* and *Verizon* reported the hiring of new compensation consultants in an effort to start anew with an independent consultant that performed no work for management.

The 2007 proxy filings and correspondence with the top 25 companies provided information as to the variety of approaches boards take to address compensation consultant independence. Five compensation committees have adopted innovative approaches to independence. For example, *Conoco* has a policy that the compensation consultant must be independent, rotate every five years and attest annually to independence in a written disclosure to the committee. *Goldman Sachs* uses a third consultant to weigh in on advice given by two other consultants. *Pfizer* has a unique approach in that the committee spells out as a policy fairly detailed selection criteria for a consultant that includes independence as a key element in the screen.

Several boards, including *Pfizer*, *Wachovia* and *Cisco* have had written policies that have been in place for several years. *Lockheed*, *Wachovia*, *Cisco*, *Procter and Gamble*, and *Verizon* have written policies prohibiting compensation consultants from doing any work for the management side of the company. Other boards have formulas for de minimus tests that allow some work to be performed for the management side, but such work must be pre-approved by the compensation committee. The formulas range from *Home Depot's* prohibition against work performed for management exceeding 2 percent of the consulting firm's revenues to *Morgan Stanley's* preapproval process of any fees greater than \$25,000 by the compensation committee.

Overall, the initiative raised several important concerns about the role of the compensation consultant and consultant practices, which are addressed below.

Business Relationships and Independence

When the Compensation Consultant Initiative first began, it was not atypical to find full service consulting firms (those that provide both consulting and a range of services including actuarial/accounting functions and Human Resources consulting services) providing consultant advice for both the committee and the management. Depending on the company, it was possible for two different individuals to provide the same services such as compensation advice, or a mix of services such as compensation advice to the committee and actuarial/accounting advice to management. The contact for hiring also varied with some compensation committees solely in charge of the hiring decision while other companies delegated that function to human resources or even the CEO.

As we learned more about the various business relationships that consultants could have with a company and its board, it became clear that conflicts of interest were driven not by whether the consultant did any work for management but how much that consultant or the consultant's company earned from both engagements. The question was whether work performed for management is monetarily significant enough to influence the behavior of the consultant's work for the board committee and therefore create a conflict of interest.

Discussions with corporate secretaries as well as consultants confirmed that traditionally, a full service firm earns significantly more working for management by providing actuarial or accounting services related to employee benefit matters than a firm could earn working solely for the compensation committee. Even non-full service consulting firms (referred to as "boutiques") may provide compensation consulting for both the compensation committee and management and may also be conflicted when more fees are generated by services provided to management.

While the analogy is not perfect, there are some parallels to past concerns regarding the audit firms that receive compensation for providing consulting work for the same corporation. As noted above, the CD&As of *Morgan Stanley* and *Verizon* note that the compensation committees hired entirely new compensation consultants so as not to even give the appearance of conflict.

Best Practices

The overarching objective of the Compensation Consultant Initiative was to urge the top 25 U.S. companies to exceed the SEC reporting requirements and directly address the issue of compensation consultant independence in the 2007 CD&A. The original October 2006 request by the investor coalition stated that compensation committees should consider prohibiting a consultant from simultaneously working for management. The letter also requested that the committees adopt a formal policy to institutionalize this practice.

The responses received by the Initiative as well as the reporting on consultants in the 2007 CD&A began to build the broader elements of a best practice. Such elements included a formal policy that vests the hiring and oversight of consultants and, a ban against any work for management of the same company. If extenuating circumstances exist to provide for dual engagements, such as the need for certain compensation survey data, the compensation committee should have the final say according to a predetermined de minimis standard. De minimis work is best defined through a percentage-based formula or monetary threshold. Some committees invoked innovative arrangements described above to achieve the goals of compensation consultant independence. Additionally, a description of how the policy was put into practice for that reporting year would be important information for investors. Specific information, including the name of the consultant and the fees earned, should also be included in disclosures on consultants.

SEC Current Disclosure Rules

The SEC's current reporting requirement on compensation consultants does not provide adequate information for investors to evaluate the independence of the consultant. Even the SEC's most recent effort to encourage better reporting through its targeted review stops short of requiring full disclosure of business relationships with the company.

In conclusion, we believe that in order to understand how excessive executive compensation is so prevalent, investors must begin by examining how the data used by compensation committees to support pay packages is constructed. This data is more often than not supplied by outside compensation consultants. Eliminating concerns about compensation consultant independence allows investors to tackle the more difficult issues of whether such data/advice justifies the pay and whether incentives are built in to ensure pay for performance and long-term shareholder value creation. The compensation consultant project showed that as reported in the 2007 proxy statements, practices and policies supporting compensation consultant independence were achievable and desirable in the majority of the compensation committees included in our query.

As the Treasurer requested in her June 5, 2006, letter to the SEC, the Commission should require that companies disclose whether a compensation consultant employed by the board's compensation committee is also performing other work for the same company, the nature of that work and the fee arrangement for the services. While it is clear that some of the largest companies are willing to exceed the SEC reporting requirements, it is unclear how smaller companies are reporting on this issue. Without specific information about all of the business relationships a consultant may have with a company, investors must rely on the judgment of the compensation committee to determine if potential or actual conflicts of interests exist. The SEC took a step in the right direction by requiring expanded disclosure in the form of the CD&A. The question of whether a consultant has conflicting monetary relationships is no less important than other required items. As with all regulations, uniformity levels the playing field.

On behalf of the Office of Connecticut State Treasurer Denise L. Nappier, thank you for this opportunity to share our views with the Committee on these important issues. If we may be of further assistance to the Committee, please do not hesitate to contact us.

Chairman WAXMAN. Mr. Shadab.

STATEMENT OF HOUMAN SHADAB

Mr. SHADAB. Mr. Chairman and distinguished members, thank you for the opportunity to appear here today and testify on executive pay and the role of compensation consultants. I am a senior research fellow at the Mercatus Center, a research, education and outreach organization affiliated with George Mason University. The Mercatus Center's mission is to bridge academics and policy. We conduct interdisciplinary research in the social sciences that integrates practice and theory. My own research focuses primarily on securities and financial markets regulation.

My remarks today will focus on, one, the academic law and economics literature regarding explanations for increased compensation of public company executives and, two, other empirical findings relevant to potential conflicts of interest among executive compensation consultants.

The ultimate goal of any system of corporate governance and the criterion by which to judge good from bad governance is promoting the wealth of shareholders. Today, a corporation is primarily governed by its board of directors which is typically responsible for setting executive compensation. The New York Stock Exchange and NASDAQ listing standards passed in the wake of the Sarbanes-Oxley Act of 2002 require a majority of the company's board to be independent, and the New York Stock Exchange in particular requires wholly dependent compensation committees.

Although setting excessive executive compensation may violate directors fiduciary duties to shareholders, compensation decisions are made in the ordinary course of business and therefore are afforded substantial judicial deference under a longstanding pillar of American corporate law known as the business judgment rule.

Currently, there is a dispute among academics as to the precise source of the increases in executive compensation that took place over the past decades and years. One influential line of thought argues that increased CEO compensation is the result of entrenched CEOs unduly influencing directors to grant themselves excessive pay to the detriment of shareholders. While certainly possible, the managerial entrenchment theory fails to explain why CEO compensation continued to increase even while boards of directors were becoming increasingly independent of management at least as far back from 1997 to the present.

Another problem with the entrenchment theory already referred in to this hearing was that to be able to capture a board a manager should most likely be employed by the corporation to establish the requisite close ties with directors to capture them. However, empirical evidence shows that CEOs promoted from within a company earn about 15 percent less than CEOs hired from the outside and that this premium for outside hires actually grew throughout the 1970's and through the 1990's.

Just because the managerial entrenchment theory does not explain all the data does not mean it is completely wrong. However, there are in fact other explanations for increases in absolute and relative executive compensation. Indeed, a substantial body of recent empirical corporate governance research finds that executive

compensation is primarily the result of increased value of corporate assets, increased competitive pressures faced by executives in corporations and increased liability and regulatory risk stemming from passage of the Sarbanes-Oxley Act.

As former Labor Secretary Robert Reich has noted, our CEO compensation does not reflect social or moral worth. Increased CEO pay is best explained not by the impingement theory but by boards of directors choosing their CEOs from a relatively small pool of executive talent and that today “under super-competitive capitalism, boards are willing to pay more for CEOs because their rivals are paying more and the cost of making a bad decision is so much greater than it was decades ago when competition for investors and customers was far less intense and shareholders were far more placid.”

Indeed, a recent study by the Federal Reserve on compensation from 1936 to 2005 concluded that compensation arrangements have served to tie the wealth of managers to firm performance and perhaps to align managerial incentives with shareholders’ interest for most of the 20th century.

Further, the rise in income inequality between top earners and average employees can perhaps be explained by technological progress raising the productivity of skilled workers more than it raises the productivity of less skilled workers. For instance, e-mail and videoconferencing have arguably helped executives add more value to their day-to-day activities than factory workers.

Taken as a whole, many studies deeply call into question the assumption that increased executive compensation eats into corporate profits and thereby hurts investors. Indeed, they suggest that current levels of executive pay largely reflect the benefits that good CEOs create for shareholders.

Regarding potential conflicts of interest or a lack of independence of compensation consultants who also provide noncompensation services, I simply want to draw the committee’s attention to the empirical record on the provision of nonaudit services that the wrong lesson is not learned. Although corporate governance reform such as the Sarbanes-Oxley Act prohibits auditors from providing nonaudit services to audit clients, empirical records strongly supports a view that audit independence is not jeopardized by providing nonaudit services.

In a 2005 review of the empirical literature regarding the provision of nonaudit services, Yale law professor Roberta Romano found that the overwhelming majority of the numerous studies on the issue found no relationship between audit quality and the provision of nonaudit services; and, in fact, three studies found that auditors providing nonaudit services actually improved audit quality. In addition, in 2006, yet another academic study found that the provision of nonaudit services improves audit quality.

A general reason why providing nonaudit services may improve audit quality is because auditors benefit in their auditing work from so-called knowledge spillovers. The knowledge auditors gain about the company from providing nonaudit services may enable them to conduct a more effective audit. The provision of noncompensation services may similarly have no or even a positive impact on compensation decisions.

I would like to again thank the committee for inviting me to share my views.

Chairman WAXMAN. Thank you very much.

[The prepared statement of Mr. Shadab follows:]

MERCATUS CENTER
GEORGE MASON UNIVERSITY

TESTIMONY

Houman B. Shadab
Senior Research Fellow, Regulatory Studies Program
Mercatus Center at George Mason University

Before the House Committee on Oversight and Government Reform

December 5, 2007

Executive Pay and the Role of Compensation Consultants

Mr. Chairman and Distinguished Members;

Thank you for the opportunity to appear here today and testify on “Executive Pay and the Role of Compensation Consultants.” I am a senior research fellow at the Mercatus Center, a research, education, and outreach organization affiliated with George Mason University and located on the Arlington, Virginia campus. The Mercatus Center’s mission is to bridge academics and policy: we conduct interdisciplinary research in the social sciences that integrates practice and theory. Toward that end, we have a variety of policy-relevant research programs and also operate the largest economics-based professional development program for congressional staff, called Capitol Hill Campus. My own research focuses primarily on securities and financial markets regulation.

My remarks today will focus on (1) the academic law and economics literature regarding explanations for increased compensation among public company executives; and (2) other empirical findings relevant to potential conflicts of interest among executive compensation consultants.

Corporate Governance Basics

Corporate governance consists of the rules, entities, and processes that govern how corporations use their assets to generate and distribute revenues among shareholders, employees, and other parties. The ultimate goal of any system of corporate governance, and the criterion by which to judge good from bad governance, is promoting the wealth of shareholders.¹ Today, a corporation is primarily governed by its board of directors, which delegates its own decision-making authority and control to top managers who, in turn, delegate their decision-making authority to subordinate managers and employees.²

Under U.S. law, both directors and executive officers of public companies owe shareholders a fiduciary duty of care and loyalty. Furthermore, directors are typically

responsible for setting executive compensation. The New York Stock Exchange (“NYSE”) and NASDAQ listing standards passed in the wake of the Sarbanes-Oxley Act of 2002 require a majority of a company’s board to be independent, and the NYSE in particular requires wholly independent compensation committees.³ Executive compensation decisions may implicate both fiduciary duties. Although executive compensation decisions can be a form of self-dealing or economically excessive in that it decreases the wealth of shareholders, compensation decisions are made in the ordinary course of business and therefore have a tradition of being afforded substantial judicial deference under a long-standing pillar of American corporate law known as the business judgment rule.⁴

Explaining Increased Executive Compensation

It is undisputable that the compensation earned by executives of public companies has risen in recent decades, in both absolute terms and relative to the compensation of others. What is disputed among academic researchers is the precise source of increased executive compensation and its impact on shareholder welfare.

One influential line of thought argues that increased CEO compensation is the result of entrenched CEOs unduly influencing directors to grant themselves excessive pay to the detriment of shareholders.⁵ While certainly possible, the managerial entrenchment theory fails to explain why CEO compensation continued to increase even while boards of directors became increasingly independent of management. That is, from 1997 to the present, a period during which executive compensation grew, the percentage of outside directors serving on boards was consistently increasing and the percentage of insider-dominated boards was decreasing.⁶ The entrenchment hypothesis thus leaves us with a puzzle: if CEO compensation has increased because management has “captured” boards, then why do more independent boards also increase pay?

There is a second problem with the managerial entrenchment explanation for increased executive pay. To be able to capture a board, a manager would have to actually be employed by the corporation to establish the requisite close ties with directors. However, CEOs promoted from within the company earn about 15% *less than* CEOs hired from the outside, and this premium for external hires actually grew throughout the 1970s, 1980s, and 1990s.⁷ If entrenched managers are unduly influencing compensation decisions of the board, then why do CEOs without the ability to capture directors earn more?

A related problem with the entrenchment thesis is that it does not explain the phenomenon of high compensation generally. There are other groups who earn incomes at least as high as public company executives and do not exploit unsophisticated parties such as retail shareholders. Despite their increased pay, top executives accounted for only 6.1% of the top 5% of income earners in 2004, a space also occupied by financial service professionals, corporate lawyers, and professional athletes.⁸ In short, some kind of entrenchment is not needed to obtain an executive-level income, so given the other weaknesses of the entrenchment theory, perhaps we should look elsewhere for an explanation of executive pay.

Now just because the managerial entrenchment theory does not explain all of the data does not mean it is completely wrong. In fact, there have undoubtedly been cases where executives negotiated compensation which benefited themselves at the expense of investors. However, as a law and economics scholar, I must look for theories of executive compensation that best explain what is generally true as a rule, not just stories that explain a few outlying cases. If a policy is based on anecdotes rather than a scientific understanding of what is generally true, then that policy does everyone—investors, employees, consumers, and executives—a disservice.

And there are in fact explanations other than managerial self-dealing for the increases in absolute and relative executive compensation. As former Labor Secretary Robert Reich noted, although CEO compensation does not reflect social or moral worth, increased in CEO pay is best explained by “boards of directors choos[ing] their CEOs from a relatively small pool of proven executive talent” and that today, “[u]nder super-competitive capitalism, boards are willing to pay more for CEOs because their rivals are paying more—and the cost of making a bad decision is so much greater than it was decades ago when competition for investors and customers was far less intense and shareholders were far more placid.”⁹

While no economic explanation is likely to perfectly explain all data and decisions regarding executive pay, a substantial body of recent empirical corporate governance research finds that executive compensation is primarily the result of the increased value of corporate assets and the increased competitive pressures faced by executives and corporations. Further, the rise in income inequality between top earners and average employees may be explained by technological progress raising the productivity and/or the prices of goods and services supplied by skilled workers relative to less skilled workers.¹⁰ For instance, advances in computing power likely added more value to the activities of executives than it has added value to the activities of manual workers. These results undermine the notion that executive pay hurts shareholders. To the contrary, they suggest that current levels of executive pay reflect the benefits that good CEOs create for shareholders.

The first explanation comes from a basic principle of economics, which states that compensation for any employee, including CEOs, will be proportional to the economic value the employee adds to the company. Accordingly, to the extent a CEO’s value to the company increases as the value of a company’s assets increase, then so should the compensation paid to CEOs. As researchers at MIT have found, CEO compensation rose in proportion to the increase in the market capitalization of the largest firms between 1980 and 2000.¹¹ During that time, while the average asset value of the 500 largest firms grew by 500% (or a factor of six), so did CEO pay rise by that amount.¹²

Consistent with the notion that adding value to a company will cause executive pay to increase is a University of Chicago and National Bureau of Economic Research Working Paper finding that top executives’ compensation is strongly related to the performance of a company’s stock in a sample of over 1700 hundred public companies in both 1994 and 2004.¹³ Perhaps even more significant, a long-term study of executive compensation from

1936 to 2005 by researchers at the Federal Reserve found a significant correlation between executive compensation and firm performance over the past 70 years, concluding that “compensation arrangements have served to tie the wealth of managers to firm performance—and perhaps to align managerial incentives with shareholders’ interests—for most of the twentieth century.”¹⁴

Another study, last updated in January of 2007 by researchers at the University of Texas, Washington University, and Indiana University, looked at the data on executives’ stock-based compensation and found it to be consistent with companies compensating CEOs for greater ability and effort.¹⁵ Indeed, they found the skewed distribution of CEO pay to be explainable by plausible assumptions about the relative talent of the CEO’s compared to that of other employees.¹⁶

Another explanation for the rise in CEO compensation comes from two observations. The first is that in the past three decades, CEO success has depended more upon possessing general managerial skills; that is, skills transferable across companies and industries, in contrast to skills valuable only to a single company. Second, thanks to advances in information technology, company-specific knowledge and data is now much more easily and quickly acquired thereby reducing the importance of possessing company-specific knowledge. As general managerial skill has increased relative to company specific skills, the market for CEOs has become more competitive, and along with that increased competition, the pay of the most talented managers has increased.¹⁷ The increased importance of general managerial skills also explains why, from 1970 to 2000, pay for externally hired CEOs is higher than for incumbents and also higher for CEOs in industries where hiring from the outside is common.¹⁸

Another study finds that the market for executive talent has also become more competitive due to globalization. In 2006, researchers from the Institute for the Study of Labor in Bonn, Germany found that “the increase in foreign competition resulting from reductions in trade barriers” was a major explanation for increased executive pay.¹⁹ According to these researchers, more competitive product markets have led to an increased use of incentive compensation among executives which has, in turn, led to higher compensation for the managers talented enough to compete on a global scale.²⁰

A final reason for increased executive pay in the last several years may be to compensate executives for increased liability and regulatory risk stemming from passage of the Sarbanes-Oxley Act (SOX) in 2002. The Act requires that the CEO and the chief financial officer (CFO) annually certify to the truth of the company’s financial and non-financial disclosures, affirm their responsibility for maintaining internal control, and publicly disclose any significant changes in internal controls. It also increased penalties for violations of its mandates, including increased criminal liability for false certifications and other types of fraud.

Several empirical findings support the notion that SOX increased liability to corporate executives. First, it seems that subsequent to SOX, U.S. public companies have undertaken fewer risky activities such as research and development (R&D). Researchers

found that after SOX the gap between the ratio of R&D spending to assets for U.S. and U.K. firms decreased; there was a statistically significant decrease in U.S. R&D spending relative to U.K. firms; and stock-based measures of U.S. firm risk decreased most noticeably among high R&D spenders.²¹ Another study found that post-SOX the managerial “hurdle rate” has increased.²² A hurdle rate is the minimum rate of return required to invest in a project, and an increase is consistent with the notion that managers have become more hesitant in their investment decisions. Second, since the passage of SOX, there has been a substantial increase in turnover among CEOs, CFOs, and directors (although turnover rates may be decreasing and not all increases are attributable to SOX).²³ Third, at least one survey has found that CFOs have shifted their attentions away from strategy and increased their focus on regulatory compliance and short-term risk-management.²⁴ Finally, post-SOX, director and officer insurance premiums have dramatically increased, with one study from researchers at the University of Georgia and Clemson finding that premiums have more than doubled.²⁵

Taken as a whole, these studies seem to paint a more accurate picture of the economics underlying executive pay than the entrenchment theory and, at the very least, deeply call into question the assumption that increased executive compensation is due to entrenchment and board capture, and therefore hurts investors.

Potential Conflicts of Interest Among Executive Compensation Consultants

As executive compensation has increased, so has the use of third-party compensation consultation services. Because compensation consultants also provide noncompensation services, a potential conflict may exist to the extent they have an incentive to advocate for excessive compensation in return for obtaining lucrative noncompensation consulting contracts.

Although a conflict may exist in the abstract, it would be unwise to limit or even prohibit the provision of noncompensation services by compensation consultants. Consider the example of outside auditors providing of nonaudit services. Although corporate governance reforms prohibit auditors from providing nonaudit services to audit clients, the empirical record strongly supports the view that auditor independence is *not* jeopardized by providing nonaudit services. In a 2005 review of the empirical literature regarding the provisions of nonaudit services, Yale Law professor Roberta Romano found that the overwhelming majority of the numerous studies on the issue found no relationship between audit quality and the provision of nonaudit services, and in fact three studies found that auditors providing nonaudit services actually improved audit quality.²⁶ In addition, in 2006 yet another academic study found that the provision of nonaudit services improves audit quality.²⁷ A general reason why providing nonaudit services may improve audit quality is because auditors benefit in their auditing work from so-called “knowledge spillovers.” The knowledge auditors gain about the company from nonaudit services may enable them to conduct a more effective audit.²⁸

Thus, if Congress is considering placing limitations upon the ability of compensation consultants to provide noncompensation services based upon an analogy to conflicts of

interest in the provision of nonaudit services, its analogy is faulty. The evidence from the auditing industry suggests that allowing compensation consultants to provide noncompensation services may in fact further shareholder interests. The knowledge spillovers from noncompensation consulting may increase the ability of compensation consultants to construct pay packages appropriately tailored to the unique circumstances of the company and the industry in which it operates.

In sum, lessons from the impact on shareholders by the provision of nonaudit services by auditors strongly cautions against legislative or regulatory action regarding the provision of noncompensation services by compensation consultants. Given the dearth of academic research on this particular issue, certainly all interested parties would benefit from more studies before any further action is taken.

I would like to end with a final caution about increased disclosure. Recently, the Securities and Exchange Commission passed a rule requiring public companies to disclose their use of executive compensation consultants. Some might argue that public companies should also disclose whether these same compensation consultants provide other services to the company. While transparency and disclosure are generally beneficial, shareholders are only better off when companies disclose material information, that is, information relevant to the value of the companies' securities. Since there is not adequate research showing that hiring compensation consultants for nonconsulting services affects shareholder value one way or the other, there is little justification at the moment for requiring companies to disclose such information.

¹ *Katz v. Oak Indus.*, 508 A.2d 873, 879 (Del. Ch. 1986) ("Its is the obligation for directors to attempt, within the law, to maximize the long-run interests of the corporation's stockholders."); Jean Tirole, *Corporate Governance*, 69 *ECONOMETRICA* 1, 1 (2001) ("The standard definition of corporate governance among economists and legal scholars refers to the defense of shareholders' interests."); Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 *GEO. L. J.* 439, 411 (2001) (noting the scholarly consensus that "the best means to this end (that is, the pursuit of aggregate social welfare) is to make corporate managers strongly accountable to shareholder interests, and, at least in direct terms, *only to those interests*") (emphasis added); Sanjai Bhagat & Roberta Romano, *Empirical Studies of Corporate Law*, Yale ICF Working Paper No. 05-16, 3 (2005) ("the benchmark for evaluating the benefit of corporate and securities laws is whether they improve investor welfare").

² Stephen M. Bainbridge, *Why A Board? Group Decisionmaking in Corporate Governance*, 55 *VAND. L. REV.* 1, 4-5 (2002).

³ NYSE Rules 303A(1)-A(2) (requiring majority board independence), 303A(4)-(6), A(7)(c) (requiring independent audit, nominating/corporate governance and compensation committees); NASDAQ Rule 4350(c).

⁴ ARTHUR R. PINTO & DOUGLAS M. BRANSON, *UNDERSTANDING CORPORATE LAW*, 211-13 (1999).

⁵ See, e.g., Lucian Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 *U. Chicago L. Rev.* 751 (2002)

- ⁶ Linck et al., *The Effects and Unintended Consequences of the Sarbanes-Oxley Act, and its Era, on the Supply and Demand for Directors* (University of Georgia Department of Banking and Finance and Clemson University Working Paper, Feb. 14, 2007)
- ⁷ Kevin J. Murphy & Jan Zabochnik, *Management Capital and the Market for CEOs*, Working Paper, University of Southern California, 2003.
- ⁸ Steven N. Kaplan & Jashua Rauh, *Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?*, University of Chicago Graduate School of Business and NBER Working Paper 37 (September 13, 2006).
- ⁹ Robert Reich, *Why CEO Pay Continues to Soar*, Robert Reich's Blog, November 11, 2007, <http://robertreich.blogspot.com/2007/11/why-ceo-pay-continues-to-soar.html>.
- ¹⁰ Steven N. Kaplan & Jashua Rauh, *Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?* University of Chicago Graduate School of Business and NBER Working Paper 38 (September 13, 2006).
- ¹¹ Xavier Gabaix & Augustin Landier, *Why Has CEO Pay Increased So Much?*, Massachusetts Institute of Technology Working Paper 06-13 (May 8, 2006).
- ¹² *Id.* at 12-13.
- ¹³ Steven N. Kaplan & Jashua Rauh, *Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?*, University of Chicago Graduate School of Business and NBER Working Paper 37 (September 13, 2006).
- ¹⁴ Carola Frydman & Raven E. Saks, *Executive Compensation: A New View from a Long-Term Perspective, 1936-2005* 33, Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs Federal Reserve Board, Washington, D.C. (July 6, 2007).
- ¹⁵ Nina Baranchuk, Glenn MacDonald & Jun Yang, *The Economics of Super Managers*, Working Paper (January 15, 2007).
- ¹⁶ *Id.* at 3, 21-25.
- ¹⁷ Kevin J. Murphy & Jan Zabochnik, *CEO Pay and Appointments: A Market-Based Explanation for Recent Trends*, 94 Am. Econ. Rev. 192 (2004).
- ¹⁸ Kevin J. Murphy & Jan Zabochnik, *Management Capital and the Market for CEOs*, Working Paper, University of Southern California, 2003.
- ¹⁹ Vincente Cufiñat & Maria Guadalupe, *Globalization and the Provision of Incentives Inside the Firm: The Effect of Foreign Market Competition*, Institute for the Study of Labor (October 2006).
- ²⁰ *Id.* at 16-21.
- ²¹ Leonce Barger, Kenneth Lehn & Chad Zutter, *Sarbanes-Oxley and Corporate Risk-Taking*, (American Enterprise Institute for Public Policy Research Working Paper, June 18, 2007); Daniel A. Cohen, Aiyasha Dey & Thomas Z. Lys, *The Sarbanes-Oxley Act of 2002: Implications for Compensation and Risk-Taking Incentives of CEOs* 19, 22 (New York University, University of Chicago and Northwestern University Working Paper 21, July 8, 2005).
- ²² Qiang Kang & Qiao Liu, *The Sarbanes-Oxley Act and Managerial Risk Taking: A Structural Assessment* 4 (University of Miami and University of Hong Kong Working Paper, March 1, 2007).
- ²³ See Dan R. Dalton & Catherine M. Dalton, *Sarbanes-Oxley and the Guidelines of the Listing Exchanges: What Have We Wrought?* 50 BUS. HORIZONS 93, 95-96 (2007); Telos Demos, *Doesn't Anyone Want to Be a CFO Anymore?*, CNNMoney.com (reporting that public "[c]ompanies with a market cap of at least \$1 billion changed CFOs three times more often in 2005 than in 2002" and that "among public companies of all sizes, CFO exits increased from 1,867 in 2005 to 2,302 in 2006."); FINANCIAL OFFICERS' TURNOVER, 2007 STUDY, RUSSELL REYNOLDS ASSOCIATES 1 (noting that after SOX CFO, controller and treasurer "turnover has increased dramatically"); Deloitte, *How CFOs Can Thrive Under Pressure* 1 Breathing Lessons, A Monthly E-newsletter for CFOs (September 2006); Linck et al., *The Effects and Unintended*

Consequences of the Sarbanes-Oxley Act, and its Era, on the Supply and Demand for Directors 36-37 (University of Georgia Department of Banking and Finance and Clemson University Working Paper, Feb. 14, 2007).

²⁴ FINANCIAL OFFICERS' TURNOVER, 2007 STUDY, RUSSELL REYNOLDS ASSOCIATES 1 (noting that "[s]ince the introduction of Sarbanes-Oxley . . . the role of the CFO has changed from a strategic role to one that carries much more risk and liability than in previous years. . . As the Sarbanes-Oxley dust is settling, a new breed of CFO is emerging: a *regulatory* expert, with the ability to extend knowledge into accounting, strategy and communications.") (emphasis added).

²⁵ Linck et al., *The Effects and Unintended Consequences of the Sarbanes-Oxley Act, and its Era, on the Supply and Demand for Directors* (University of Georgia Department of Banking and Finance and Clemson University Working Paper, Feb. 14, 2007); Jo Lynne Koehn & Stephen C. DeVecchio, *Revisiting the Ripple Effects of the Sarbanes-Oxley Act*, CPA J. ONLINE, May 2006.

²⁶ Roberta Romano, *Sarbanes-Oxley and the Making of Quack Corporate Governance*, 114 Yale L. J. 1521, 1535-36 (2005).

²⁷ Seong-Yeon Cho et al., *Do Nonaudit Services Enhance Value? Evidence from the Capital Markets*, Working Paper, August 2006.

²⁸ *Id.* at 3.

Chairman WAXMAN. Mr. Pedrotty.

STATEMENT OF DANIEL PEDROTTY

Mr. PEDROTTY. Good morning, Chairman Waxman and Ranking Member Davis and members of the committee. My name is Dan Pedrotty. I'm the director of the Office of Investment at the AFL-CIO representing more than 10 million members and their 55 national unions. We commend your leadership on this issue and inquiry into the provision of biased advice by compensation consultants.

Consultants and Boards of Directors remain unaccountable, while CEO pay continues reach dizzying heights. Last year, the average S&P 500 CEO received almost \$15 million in compensation, a 9½ percent hike from 2005. Directors overcharged with seeing and protecting investors and forcing and negotiating arms-length pay packages seem resigned to a pay-for-failure status quo. Two-thirds of directors believe "that their boards are having trouble controlling the size of CEO compensation."

Outsized pay packages for senior executives hurt shareholders, including pension plans investing the retirement savings of America's working families. Union members participate in benefit plans with over \$5 trillion in assets, and union-sponsored plans have assets of over \$350 billion. Outrageous pay packages are giveaways of our members' money.

One of the cruelest ironies of the current housing crisis is that while hundreds of thousands of Americans are losing their homes, CEOs of financial institutions that steered borrowers into risky loans or traded in sub-prime mortgages may walk away with hundreds of millions of dollars.

In October, 1 in every 555 households is facing foreclosure. Yet CEOs of the 16 largest financial services companies involved in the subprime crisis could collect more than \$1 billion in total compensation if they are forced from their job, according to the Corporate Library.

Already, former Merrill Lynch CEO Stan O'Neal has walked away with over \$161 million; Angelo Mozilo, the chief executive of Countrywide, stands to gain \$75 million if he is forced out; and Richard Fuld of Lehman could collect nearly \$300 million in severance as a result of his dismissal.

For each overpaid CEO who contributed to the subprime mortgage crisis, there is likely to be a conflicted comp consultant who designed the pay package. Consider Merrill Lynch, where the firm Towers Perrin has advised the board's compensation committee since 2003. According to the company's 2007 proxy, Towers Perrin also provides consulting services that are not related to executive compensation; and we believe this dual role endangers the impartiality of consultants.

A recent study confirms investors' worst suspicions. Companies that use comp consultants tend to pay their CEOs higher salaries without better performance. Companies that used 4 of the 10 largest firms—paid salaries 15 percent or higher than the average CEO pay.

Mr. Chairman, I believe the report that you put out this morning adds even more grist to the mill here. The problem is that there

are no safeguards in the system to assure independence. All too often, the firms hired to ensure that the executive pay is appropriate earn enormous fees for the consulting work that they are hired to do for the company.

Consider the role that Hewitt played at Verizon. As Verizon's comp consultant, CEO Ivan Seidenberg received over \$19 million in 2005, which was 48 percent higher than the prior year, while at the same time the company's stock fell 26 percent and earnings fell 5.5 percent. A New York Times article last year disclosed the fact that Hewitt from 1997 until the present time of 2005 provided consulting services worth over half a billion dollars in fees from employee benefits and HR services to the company. Not surprisingly, Verizon became the first public company where shareholders demanded a say on pay.

Now worker funds also with other governance initiatives at Verizon during this proxy season. The Communications Workers of America filed a compensation consultant proposal that insisted that the company disclose the relationship of the compensation consultant and their relative independence or lack thereof. The proposal received a strong vote. It got over 46 percent, and we're pleased that Verizon last month agreed to a policy that would ban the comp consultant from doing other work for the company.

While encouraged with the efforts of companies to voluntarily adopt policies of independence, more must be done. Consulting work should be limited to advising company boards so pay packages are geared to incentivize long-term-value creation. As a first step, the SEC should require companies to disclose the total dollar amount paid to consultants and the amount paid for advice provided to the board of directors.

The conflicts of interest that compromise an impartiality of comp consultants do parallel the auditor independence concerns that led to the passage of Sarbanes-Oxley. Like audit firms prior to SOx, comp consultants performed lucrative consulting work unrelated to the investor protection role they are supposed to play. Investors need new standards for comp consultant independence, just as Sarbanes-Oxley created for auditor independence.

In that context, while disclosure is an important first step, we as investors need the tools to hold consultants accountable. Our funds currently vote on auditors at annual meetings, and the movement behind the say on CEO pay at annual meetings is gaining momentum.

Given the scope of conflicts as detailed in this report this morning and the central role of consultants in pay for failure, we believe an up-or-down vote on the company's compensation consultant in any context where a conflict exists would be appropriate.

I again thank you, Mr. Chairman, and would be happy to answer any questions.

Chairman WAXMAN. Thank you very much, Mr. Pedrotty.

[The prepared statement of Mr. Pedrotty follows:]

TESTIMONY OF DANIEL PEDROTTY
DIRECTOR, OFFICE OF INVESTMENT
AMERICAN FEDERATION OF LABOR AND
CONGRESS OF INDUSTRIAL ORGANIZATIONS
Before the
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
UNITED STATES HOUSE OF REPRESENTATIVES
DECEMBER 5, 2007
on
“EXECUTIVE PAY: THE ROLE OF COMPENSATION CONSULTANTS”

Good morning, Chairman Waxman and Ranking Member Davis. My name is Dan Pedrotty, and I am the director of the Office of Investment for the American Federation of Labor and Congress of Industrial Organizations (“AFL-CIO”). I am honored to participate in today’s hearing on the role of consultants in CEO pay.

The AFL-CIO is the federation of America’s labor unions, representing 55 national and international unions and their membership of 10 million working men and women. The AFL-CIO commends your leadership on this issue, and your investigation into biased advice by compensation consultants that contributes to the ratcheting up of the pay of corporate chief executives, with little or no link to long-term performance.

CEO pay continues to reach dizzying heights, while both consultants and boards of directors remain unaccountable. Last year, the average CEO of an S&P 500 company got \$14.8 million in total compensation, a 9.4% hike from \$13.4 million in 2005, according to the Corporate Library. Directors charged with overseeing arms length pay packages seem resigned to a pay for failure status quo. Two-thirds of directors believe that U.S. corporate boards are “having trouble” controlling the size of CEO compensation, according to a new survey from PricewaterhouseCoopers.

Outsized compensation packages for senior executives hurt shareholders, including pension plans investing the retirement savings of America’s working families. Labor union members participate in pension plans with more than \$5 trillion in assets. Union-sponsored pension plans hold more than \$450 billion in assets. Outrageous pay packages are giveaways of our members’ money.

One of the biggest ironies of the current housing crisis is that while hundreds of thousands of Americans are losing their homes, the CEOs of financial institutions that steered borrowers into risky loans, or traded in the sub-prime mortgages, may walk away with hundreds of millions of dollars in compensation.

In October, one in every 555 households filed for a foreclosure. Yet, CEOs of the 16 largest financial service companies involved in the sub-prime mortgage crisis could collect more

than \$1 billion in total compensation if they were forced out of their jobs, according to a study by The Corporate Library.

Already, Merrill Lynch's former CEO Stan O'Neal walked away with a compensation package of \$161.5 million when he was forced to retire on Oct. 30, after the company reported a record \$8.4 billion write-down of sub-prime mortgages. Angelo Mozilo, chief executive of Countrywide, the nation's biggest mortgage lender, could collect more than \$75 million if he is asked to leave. And Richard Fuld, CEO of Lehman Brothers, could leave with nearly \$300 million in a severance package.

For each overpaid CEO who contributed to the sub-prime mortgage crisis, there is likely to be a conflicted compensation consultant who designed the pay package. Consider Merrill Lynch, where the executive compensation consultant firm Towers Perrin has advised the Board of Director's compensation committee since 2003. According to Merrill Lynch's 2007 proxy statement, Towers Perrin also provides consulting services to Merrill Lynch that are not related to executive compensation. This dual role endangers the impartiality of compensation consultants.

Charlie Munger, Warren Buffett's partner and vice chairman of Berkshire Hathaway Inc., places the blame for runaway CEO pay squarely on compensation consultants. "Some of the worst sinners are compensation consultants," Munger told the *Los Angeles Times* in a January 1 interview this year.

A recent study confirms investors' worst suspicions. Companies that use compensation consultants tend to pay their CEOs higher salaries without getting better performance. Companies that used four of the 10 largest compensation consulting firms—Pearl Meyer & Partners, Towers Perrin, Hewitt Associates and Mercer Human Resource Consulting—paid salaries 15 percent or higher than the average CEO pay.

The problem is that there are no safeguards in the system to ensure the independence of compensation consultants advising directors on CEO pay. All too often, the consulting firms hired to ensure that executive pay is appropriate and fair also earn generous fees for the consulting work they are hired to do for the company. The fee they are paid for setting and reviewing the pay of senior executives is merely the icing on the cake.

In a new book, *Corpocracy*, Robert Monks, a long-time shareholder activist, says "the system is flawed up to its ears, and the more so because it pretends so earnestly to accuracy."

The potential for conflicts of interest by compensation consultants is similar to that of auditing firms that performed lucrative consulting services for companies whose financial reports they were auditing. This practice ended when the Sarbanes-Oxley Act of 2002 set new standards for auditor independence and the Securities and Exchange Commission began requiring companies to disclose how much they were paying to their accounting firms in consulting and auditing fees.

Consider the role that Hewitt Associates played as the compensation consultant for Verizon Communications. CEO Ivan Seidenberg received \$19.4 million in salary, bonus, restricted stock and other compensation in 2005, 48% higher than what he earned the previous year, while its stock fell 26%, and earnings fell 5.5 %. An April 2006 *New York Times* article reported that Hewitt also received more than half a billion dollars in fees from Verizon and its predecessor company since 1997 for services to the company for its employee benefit plans and human resources management. Not surprisingly, Verizon is the first public company whose shareholders voted by a majority to demand their company adopt a shareholder say on the executive pay process.

Compensation consultants aren't alone in their culpability. The problem all too often is the lack of independence of directors on compensation committees who hire the compensation consultant in the first place. Once again, Verizon was the classic example. At the time, all of the directors on Verizon's compensation committee were chief executives or former chief executives of other companies. Three out of four of the directors on Verizon's compensation committee represented companies where Seidenberg sat on their boards. Among the members of Verizon's compensation committee was John Stafford, previously the chairman and chief executive of Wyeth. As a member of the compensation committee of Wyeth, Seidenberg helped set the pay for Stafford when he was its chief executive.

Perhaps it was no coincidence that the consultant advising Wyeth's compensation committee at the time was also Hewitt. In August 2006, Verizon's compensation committee hired Pearl Meyer to replace Hewitt as its compensation consultant. But Verizon continued to use Hewitt to provide employee benefits administration and actuarial services to the company. At Wyeth's 2007 annual shareholder meeting, CEO Robert Essner said that Wyeth had replaced Hewitt as the compensation consultant advising the board with Exequity, a consulting firm started last year by former Hewitt employees.

Warren Buffett bemoaned this lack of independent compensation committees in his 2006 annual report. "I have been the Typhoid Mary of compensation committees," he wrote. "It's likely that the reason I was rejected for service on so many comp committees was that I was regarded as *too* independent."

Weak boards, particularly around executive pay, are a key reason why shareholders are generally supportive of long-term investors having the right to have their board candidates be included in management's proxy materials. This is why there has been such an outcry over the decision by the SEC last week to take away shareholders' right under the federal securities laws to put the idea of proxy access up for a shareholder vote.

Concern over situations such as Verizon, as well as the scandal involving the manipulation of stock option grants at hundreds of companies, prompted the AFL-CIO and other large investors last year to focus on the independence of compensation consultants. We and other investors asked the SEC, which was drafting revisions to the rules on executive pay disclosure, to require companies to identify their compensation consultants and discuss the other services they performed for the company's management.

The request was not unusual. As early as 2003, a blue-ribbon panel of the National Association of Corporate Directors (the “NACD”) issued guidelines that called upon directors to “consider engaging an independent compensation consultant, who does no work for management, to assist the compensation committee.” These voluntary guidelines stated that:

The consultant should be hired by and report directly to the committee, and should not be retained by the company in any other capacity. To be effective, the consultant should be afforded full access to management, in-house counsel, the human resources staff, and any consultant hired by management. To avoid “dueling consultants,” any consultant hired by management should not be engaged in assignments involving CEO or senior executive pay.

The NACD report also recommended that if a compensation committee did not adopt this best practice and used the same compensation consultant as management, it should seek the approval of the full board for this arrangement and disclose it to shareholders. “This approval and disclosure should occur regardless of who hires the consultant,” the report noted. The NACD reasoned that:

[The] separation from management eliminates possible confusion about the consultant's role and responsibilities. A consultant hired by management might feel conflicted in making recommendations. A consultant engaged by the committee is much more likely to take an objective view that is consistent with the board's responsibilities to shareholders and other constituencies. This may result in a higher cost of board operations, but it can be an appropriate investment, considering the impact and magnitude of executive compensation.”

A report issued by The Conference Board in December 2005 also noted that in Delaware, where a majority of publicly traded companies are incorporated, state law imposes a fiduciary duty on directors to act in the best interests of shareholders and permits them to “rely in good faith on the advice of experts who are chosen with reasonable care.” To ensure objective advice from a compensation consultant, members of a compensation committee should select a consultant who has not historically done work for the company or its current management.

But the SEC’s revised executive pay disclosures that were issued in September 2006 did not fully heed our call for greater compensation consultant independence. While the new rules require better disclosure of the role played by compensation consultants in setting executive pay, the SEC did not require that companies adopt standards for compensation consultant independence.

Shortly after the rules were published, the AFL-CIO and a group of investors, led by Connecticut State Treasurer Denise L. Nappier, jointly sent a letter sent to the heads of

compensation committees of the 25 largest U.S. companies in the S&P 500 index asking for an end to the practice of board-hired compensation consultants also doing work for company management. In February 2007, the coalition sent a follow-up letter to the companies that did not respond to the initial letter, and included the best examples of how 10 different companies responded.

The best practices include those of the Proctor & Gamble Co., which reported that its agreement with the board compensation consultant specifies that it “will do no work for management and have no other connection to the company.”

The chair of Wachovia Corp.’s compensation committee also replied that the company had a policy of having a separate, independent compensation consultant reporting to the board compensation committee since 2004.

Morgan Stanley is among those companies that took a half step. It decided to replace Hewitt Associates with an independent consultant that does not currently do any compensation consulting work for the company. But it stopped short of imposing a complete ban on the independent consultant doing any work for the company. Instead, the company adopted a policy requiring the board compensation committee to approve the consultant doing work for the company of \$25,000 or more.

Verizon Communications was among the companies that did not reply to the coalition’s letter. In follow-up action, the Communications Workers of America, a union affiliated with the AFL-CIO, filed a shareholder proposal at Verizon’s 2007 annual meeting. The proposal asked that the company disclose any relationships that could compromise the compensation consultant’s independence. The proposal received over 46% of the votes cast by investors at the company’s May 5 annual meeting. We are pleased that at its November 1 board meeting Verizon agreed to adopt a policy that would ban the compensation consultant from doing any other work for the company.

The AFL-CIO has also had productive discussions with several other companies that led to their adopting policies on the independence of compensation consultants, including General Electric, Home Depot, and Sara Lee.

For the 2008 annual meeting season, the AFL-CIO has filed a shareholder proposal at MetLife asking it to disclose to shareholders the extent of the work the compensation consultant does for the company, and to disclose the fees paid to the consultant for the work done for the compensation committee. The AFL-CIO has also filed a shareholder proposal at Occidental Petroleum to ban the board’s compensation consultant from doing any other work for the company.

While we are pleased with our efforts so far in getting companies to voluntarily adopt a policy on the independence of compensation consultants, more must be done. The types of consulting work that compensation consultants perform should be limited to their role as advisors to the compensation committee. As a first step, the SEC should require that

companies disclose the total dollar amount paid to compensation consultants and the amount paid for executive compensation advice provided to the board of directors.

The conflicts of interest that compromise the impartiality of compensation consultants parallel the auditor independence concerns that led to the passage of the Sarbanes-Oxley Act. Like audit firms prior to Sarbanes-Oxley, today's compensation consultants perform lucrative consulting work unrelated to the investor protection role they are supposed to play. Investors need new standards for compensation consultant independence just as Sarbanes-Oxley created for auditor independence.

In that context, while disclosure is an important first step, investors ultimately need the tools to hold consultants accountable. Our funds are currently able to vote on auditors at company annual meetings, and the movement for a say on CEO pay is gaining increasing momentum. Given the scope of conflicts and the central role of consultants in "pay for failure," we also believe an up or down vote on the company's compensation consultant in any context where a conflict existed would be appropriate.

I will be happy to answer any questions you may have. Thank you.

Chairman WAXMAN. I want to start off the questions.

Many experts have suggested that compensation consultants have contributed to the traumatic rise of CEO pay over the last several years. They argue that compensation consultants as a whole are directly responsible for some of the most pernicious and costly developments in executive pay.

One well-respected investor, Warren Buffett, has stated, "Too often, executive compensation in the United States is ridiculously out of line with performance. That won't change moreover because the deck is stacked against investors when it comes to the CEO's pay. The upshot is that a mediocre or worse CEO, aided by his handpicked vice president of human relations and a consultant from the ever-accommodating firm of Ratchet, Ratchet & Bingo, all too often received gobs of money from an ill-designed compensation arrangement."

In the report that I released today, we surveyed the leading compensation consultants and found that over 100 of the largest companies in America have higher compensation consultants that have significant conflicts of interest. I want to ask whether you think these conflicts of interest are a serious problem.

Professor Elson, you've studied this issue as both a corporate director and professor. Are you concerned about these conflicts and how widespread they are and do you believe these conflicts are having an impact on the levels of CEO pay?

Mr. ELSON. Well, first of all, I am very concerned about the conflicts, I think in several regards.

No. 1, what the question is, do the conflicts in interest actually ration a pay? And I think that, frankly, given the subjective nature of the way pay is put together, there is no clear objective standards on pay. It is not a body of law that you apply. There is a lot of subjectivity to the process. And I think that, given that and given these other relationships, there is certainly the potential to be influenced by those other relationships in what you are recommending. And I think that is clear and there is no way around that.

The question is, I guess once you establish that, is where do you go from there with it? What in fact do you do about it? Does it in fact create higher pay?

Well, let's assume that—the worst possible case would be, obviously, someone who was directly compromised by the relationship and recommended a higher package based on those subjective factors. That's problem one.

Problem two is someone who, using those subjective factors, has been influenced by those relationships; and that to me is actually the real problem. It is much more subtle than a direct "I will give you other business if you recommend a higher package." It is much more subtle and again, because of the subjectivity involved, more subject to abuse.

The third reason is the optical reason to the investors, and this is where I am really concerned as well. Because to the investor the presence of the compromise consultant, the resulting pay will always be challenged and questioned. As a director, why would you want to put yourself in that position vis-a-vis your investors, saying to them, well, we used a compromised consultant or a consultant with other responsibilities, but it's OK, don't worry, trust us.

Chairman WAXMAN. Yes.

Mr. ELSON. I think the optics, frankly, aren't all that good; and that's why I think that separating the two out—consultancy from the actual pay advice—is warranted here.

Chairman WAXMAN. Let me ask some other questions of the panel.

Ms. Miller, you're responsible for managing Connecticut's pension fund, so you approached this as an investor. Are you concerned about these conflicts of interest? Do you believe they are affecting the levels of CEO pay and therefore we ought to be concerned about it?

Ms. MILLER. Yes, Mr. Chairman, we are very, very concerned. In fact, this is an issue the Treasurer has written to the SEC on, just this issue about asking for disclosure. That's how concerned we have been.

I think that we continue to see problems in rising executive compensation. There has been a blackout on information without knowing whether the consultants are conflicted in the SEC disclosure. It has been very difficult for investors to be able to even begin to figure out how much of the executive pay increases could be attributed to conflicted and compromised consultants.

Chairman WAXMAN. Well, for many people, investors and the public alike, they look at the pay for the executives and there seems to be a disconnect often between the pay and the performance of the CEOs. Do you think this is one of the reasons we have this disconnect?

Ms. MILLER. I think you're asking exactly the right question. When you sort of peel the onion and you look at the role the consultant plays, there are key elements of the executive compensation package, like the peer group that is chosen, the benchmarks that are used for performance. These are the elements within the compensation package that could contribute to ratcheting up of pay and how you set those performance goals amongst the peers that are chosen.

Oftentimes, compensation committees get both the data that supports the peer group and the data on other comparative measures from the consultant; and it is our concern that, when you sort of take a closer look, these pieces that contributed to the ratcheting up of pay are pieces that for us we would feel more comfortable and have a lot more investor confidence if they were associated with an independent consultant.

Chairman WAXMAN. Now, one of the findings of the committee in the report released today is that companies are failing to provide adequate disclosure of conflicts of interest to investors and the public. The committee identified 113 cases where compensation consultants used by Fortune 250 companies had conflicts of interest but the proxy reports filed by the companies only disclosed those conflicts for about 25 percent of the companies. So the vast majority of the Fortune 250 companies are not disclosing their use of pay advisors with conflicts.

Mr. Pedrotty, what's your reaction to this finding?

Mr. PEDROTTY. We think that's particularly troubling, Mr. Chairman, and another example of the how the Securities and Exchange Commission betrayed investors by not going far enough in their

disclosure rules. We think just by naming the consultant we are not getting enough transparency and disclosure and that when investors are evaluating pay packages they should have all the information.

So, again, the analogy that's used all the time by CEO pay apologists is this is much like movie stars or sports stars in terms of escalating pay, but it's fundamentally different in that this is not an arms-length negotiation. It is not arms-length in the people who are negotiating or the people who are advising the negotiators. That's why we have two-thirds of directors, our representatives, saying we ourselves can't get a handle on this problem.

Chairman WAXMAN. The lack of disclosure of this information is a problem, and we pointed that out and seemed to agree to that. In some cases, it seems like companies may be providing inaccurate information about their consultants. The committee report found that in 30 cases where Fortune 250 firms hired consultants with conflicts of interest, the firm described their consultants as "independent." If a Fortune 250 firm hires a consultant to provide executive compensation advice and company management also pays that consultant millions of dollars for other services, do you think it is misleading for the firm to describe their consultant as "independent?"

Mr. PEDROTTY. We think it is absolutely misleading, Mr. Chairman; and we think the core problem here is a consultant isn't going to want to alienate the person who is going to award them significant amounts of other business. I think, as your report shows out, that's a multiple of sometimes 40 to 50 times. And in some cases it is not only awarding them business with the company for actuarial services or HR consulting, it's also if the CEO is chairman of the board, the CEO himself is hiring the pay consultant who will decide his or her own pay. So we think that's a problem.

Transparency is the first step, but we ultimately think, much like the fight around equal access to the proxy, that investors need the tools to hold their representatives accountable.

Chairman WAXMAN. I know some people feel this problem should be left to the market, but if there is a problem with conflicts, companies will hear about it from investors and will take action to stop it. But markets can't function without good information. It is clear that companies are not providing necessary information about their compensation consultants' conflict of interest.

Ms. Miller, can you make well-informed decisions about companies when they fail to provide information about conflicts or, worse, when they provide information that appears to be misleading?

Ms. MILLER. Yes, I think that is—no, it is very difficult to make good, informed decisions about compensation and compensation consultants' advice when the information may be misleading.

I think the problem that we saw was that the definition of independence varied; and oftentimes the compensation committee would assert that it was, in their judgment, based upon their relationship and their past history with the consultant, that they believed that the consultant was independent. Without some kind of standardized definition and standardized reporting, it is very difficult for an investor to be able to determine exactly what that relationship is, what their definition of independence is.

Chairman WAXMAN. Thank you very much.

Mr. Davis.

Mr. DAVIS OF VIRGINIA. Thank you, Mr. Waxman.

Mr. Shadab, let me start with you. Are you aware that the consulting firms that only advise on executive compensation are generally associated with the corporations that had the highest levels of executive pay?

Mr. SHADAB. I was not aware of that fact, no.

Mr. DAVIS OF VIRGINIA. Well, that is a fact, which kind of negates the whole thesis of this today. It negates the thesis, which is the basis of the hearing.

Isn't it far more threatening financially for a firm that would advise only an executive compensation to lose a client than it was for a larger firm with multiple lines of consulting business?

Mr. SHADAB. Is possibly could be, yes.

Mr. DAVIS OF VIRGINIA. Mr. Elson, you serve as a board member on several public companies, is that correct? In this capacity, have you been involved in improving executive compensation packages?

Mr. ELSON. Yes, sir.

Mr. DAVIS OF VIRGINIA. Now are you testifying today that your board members are unable to request or do you request from your management information relating to the other business relationships that a third-party consulting firm has with your companies when they are advising you on questions of executive compensation?

Mr. ELSON. Well, on the compensation committee that I chaired, we in fact brought in an independent consultant. Because I believed, as chair of the committee, that the other consultant, because they were doing—it came to our attention that they were doing other work for the company, it was appropriate that we bring in an independent advisor to create a better process.

Mr. DAVIS OF VIRGINIA. But even if you didn't bring in—say you weren't chairman of the committee, as a board member you're free to ask that information, request that information. In fact, it would be appropriate to do so, wouldn't it?

Mr. ELSON. Yes, I do, but I don't think a lot of directors ask that question. I would ask that question because it is an area as an academic I find interesting, but I don't think most do, no, sir.

Mr. DAVIS OF VIRGINIA. And once you have access to that information then you can make a judgment whether it is appropriate or inappropriate, right?

Basically, what we're talking about here is saying directors aren't doing their jobs, and so we are scapegoating it and putting it out on these independent consultants. But any wide-awake director ought to be looking at and asking these kind of questions, and you really want to limit their ability to get the best advice just because they may have another line of business with the corporation.

Now I think one of the difficulties is we're restricting how corporations can get information and who they can get it from. Whereas a wide-awake director ought to be asking—I think it is certainly entirely appropriate to ask, do you have other businesses relations with the firm as part of the decisionmaking process. But to restrict it seems to me you are hamstringing corporations' ability to get information, and I'm not sure that's our job.

Mr. ELSON. I'm not really sure you're restricting it. You are simply disclosing it.

Obviously, the director is free to use a conflicted director or not—conflicted consultant or not. I think the key is a wise director, in my view, in this day and age, given investor pressure and certainly given what we are seeing coming out of the legal system, would be well advised to seek out independent advice or uncompromised or unconflicted advice. Clearly, as director, you can weigh conflicted advice one way or another, but to do your job effectively for the investor I think you'd want the best possible advice, which in my view is nonconflicted.

Mr. DAVIS OF VIRGINIA. Do you really think the reason corporate salaries are so high is because of these compensation consultants or do you think there are a lot of other factors?

Mr. ELSON. Oh, I do think there are a lot of other factors, but I do think they are a factor. Clearly, a compensation consultant misused by a passive, management-dominated board will create—and combined with overreaching executives will create pay unrelated to performance.

It is all part of the picture. You have to solve all the elements. One is, management will always have an incentive to ask for more, but certainly a board, if it is independent of management and owns stock in the company, advised by a nonconflicted advisor is going to do a better job in my opinion than a board of directors—let's say a director who was appointed by management, has no independence and has no stake in the company.

Mr. DAVIS OF VIRGINIA. Let me just tell you, the way the laws work now, it is hard to get good corporate directors because of the liabilities involved. The fiduciary duties of corporate directors at this point—I talk to people in the private sector. There's a huge reluctance on the part of a lot of talented people to go on and make cases because of the opportunity of being sued. So you're going to be asking these things, it seems to me, if you are any kind of wide-awake director. Do you not think that culture is changing—or not?

Mr. ELSON. Well, I chair nominating governance committees of two publicly traded companies, and so I'm on the search for directors all the time. And I don't think that there is a shortage in supply of directors because of the concerns about compensation, a compensation issue or whatnot.

I think the job of the director has become much more complex today because, obviously, in the old days you were simply an advisor of management, and today you are expected to be a monitor for the shareholders, and there is more required, more time involved, and certainly the potential of liability is greater the more you do.

I don't think there is a shortage of people who are willing to go on board, and I certainly wouldn't believe that changing disclosure compensation consultant conflicts would have anything to do with the ability to recruit effective directors. Frankly, as a director, I would want to be on a board where you have as clean a governance package as possible, because that makes it much less likely that I will be successfully sued.

Mr. DAVIS OF VIRGINIA. I don't know that I disagree with that. The question is, should Washington mandate it or should the corporate boards have the ability to mandate it? And my experience

has been you are better off probably not mandating it. There are a lot of unintended consequences.

Let me move ahead with it. A full-services consulting firm that provides nonexecutive consulting services for a client company is going to be I think by definition more familiar with the operations of that company than a smaller single-purpose boutique firm that specializes just in executive compensation. If you would limit executive compensation consulting work to such boutique firms you would be depriving compensation committees of advice that reflects a more complete understanding of respective companies. Now your argument is you don't believe that they should be restrictive, you just think it should be disclosed, is that fair?

Mr. ELSON. I'm a believer in the market, and I think the market itself is pushing us toward using the boutiques, but I wouldn't have a government regulation that said you couldn't use a full service firm. No, I believe the solution is disclosure.

Mr. DAVIS OF VIRGINIA. Ms. Miller, do you think the solution is disclosure or should there be a ban?

Ms. MILLER. I think that, as the first step, we should start with disclosure, but in the event that investors continue to have concern about escalating executive comp or the quality of the disclosure, I think we ought to seriously consider a ban.

I'm reminded of concerns we had about the auditor issue back in 2000, prior to Enron, when the SEC promulgated the first wave of rules and they were weak. And then we had a number of scandals and then they had to issue new rules.

So I think that this issue is an iterative process, and I think it is going to take some time to work through it, but I would say that in the very first instance we need the SEC to revisit this and require disclosure.

Mr. DAVIS OF VIRGINIA. Thank you.

Mr. SHADAB, do you think that the analogy between compensation consultants and accounting firms is an accurate one?

Mr. SHADAB. I think to some extent it is accurate, but it is accurate in a way that—you have a third party coming in and providing services to management, that could have a potential conflict of interest. But I don't think it is accurate in the way perhaps some advocates have disclosure or prohibitions on not providing the core services that the company provides, whether it be auditing or compensation services.

It is an accurate analogy for the reasons I stated in my oral testimony, namely that there is no good evidence, in fact, better evidence in the opposite direction showing that potentially conflicted auditors reduce audit quality where in fact the empirical studies show that to whatever extent there is an actual impact from allegedly or potentially conflicted auditors there wasn't improvement in audit quality.

Now, that analogy I think, to the extent it carries over to consultation consultants, could also be the case that a compensation consultant providing noncompensation services also has, as you are referring to, more knowledge about the company and therefore can make more accurate compensation packages for executives that do serve the interest of shareholders.

Now, taking a step back, I think it is important for all of our concerns to be driven by empirical data and so, first of all, concerns about what services should be prohibited and what types of services that company—

Mr. DAVIS OF VIRGINIA. Let me ask you this. An audit report out there, shareholders are going to rely on an audit report, not just directors, right?

Mr. SHADAB. Correct.

Mr. DAVIS OF VIRGINIA. Put an audit report out. Shareholders don't rely on that. The directors rely on that in setting compensation and use that as one of several factors, including the marketplace, to determine bringing someone in. Maybe you want a CEO in. Whatever the compensation, if you want the right guy, he can negotiate his own price notwithstanding—

Mr. SHADAB. Correct. So there is a disanalogy between audit services and compensation services, and the primary consumer of financial statements are investors, where the primary consumer of compensation advice is the board.

Mr. DAVIS OF VIRGINIA. So the question for us from the policy perspective is, are we here to protect the board or are we here to protect investors? And it seems to me that we have a duty to protect investors out in the marketplace, but I'm not sure we have a duty to protect board members.

Mr. SHADAB. Surely you don't, correct.

Mr. DAVIS OF VIRGINIA. Mr. Pedrotty, let me ask you, do you favor disclosure or would you like to have a ban on these kind of conflicts?

Mr. PEDROTTY. Congressman Davis, we think disclosure is a good start. Clearly, from the report this morning, disclosure is a long way from being adequate for investors. We think that separating the role of consultant advising the board and advising the company is the best practice already. We have already found companies like Proctor & Gamble, Wachovia and Verizon taking that lead. So we think that if that's the best practice and you have other institutions like the National Association of Corporate Directors and the conference board leading in a similar direction, we think others should follow.

Finally, Congressman Davis, we think that a vote is appropriate here.

To go back to your earlier question about the auditor issue, for our markets to be at their competitive best, information is key. We don't have information and, much like the auditor, shareholder confidence in pay and pay for performance is eroding. So I think from an investor protection standpoint we have a long way to go. Disclosure is the first step, but there are other steps.

Mr. DAVIS OF VIRGINIA. But the compensations are disclosed, aren't they?

Mr. PEDROTTY. The compensations are disclosed, but we still—on comp consultant independence and conflicts, we still have a way to go.

Chairman WAXMAN. Thank you, Mr. Davis.

I want to now recognize Mr. Danny Davis.

Mr. DAVIS OF ILLINOIS. Thank you, Mr. Chairman.

Many Americans have no idea what a compensation consultant does and what kind of impact they have on the explosion in CEO pay. Some may understand that if you need a consultant to determine your pay that you're doing pretty good. But few people outside of the investment world really understand what they do.

Experts on corporate governance are different. They understand who these consultants are and what role they play. And there is a consensus among these experts that conflicts of interest are a serious issue. The Conference Board, the National Association of Corporate Directors, the Business Roundtable and the New York Stock Exchange have all expressed concerns. Yet they all express the view that corporate boards should strive to avoid hiring consultants who have been awarded lucrative contracts by CEOs they are supposed to be evaluating. Despite the recommendations of these experts, the report released today found that over 100 of the Fortune 250 companies are using consultants with conflicts of interest.

Professor Elson, you are active on corporate boards. Have corporate boards been too slow to respond to this red flag? And if so, why do you think so?

Mr. ELSON. I think for a long time people really didn't think about it. I think several factors were at play.

No. 1, a lot of boards were dominated by management. And, frankly, the compensation consultant legally was a great thing to have for a director, because it protected you legally. The problem with the use of compensation consultants really comes from sort of a legal view that the use of the consultant protects the director from a State law challenge against the director's actions. The fact that you had a third-party advisor was considered helpful to you legally. And that explained the proliferation.

And I think that initially a lot of directors, obviously dominated by management, were happy to have that protection and, frankly, didn't question it. And I think what's happened now, as we began to think about it and look at compensation under the microscope and following the scandals of the last couple of years, realize that we really do have a problem vis-a-vis managerial—I've got to say in many companies, some companies—managerial integrity. There's a real concern. And based on that concern, there's a real re-examination of all processes that boards go through, including compensation. And obviously, given investor concern, there's a heightened interest in it. And I think that's why it explains the shift.

I think also, legally, the courts of Delaware, for instance, are beginning to shift in their definition of independence and the use of independent advisors. That's why I included in my testimony the comments of the chief justice of Delaware on the necessity of an independent advisor to the comp committee.

And as a director, having an independent advisor I think is not only smart from an investor's standpoint, it's smart from a legal standpoint. And I've got to tell you, as a director, to knowingly, intentionally keep on a conflicted comp consultant in the presence of investor pressure would be almost moronic. There's absolutely no reason to do it. And I think, at that point, we've begun to see a shift in practice, and I think it's a valued shift. But I think, for a long time, people didn't think about it.

Mr. DAVIS OF ILLINOIS. Thank you very much.

Mr. Pedrotty and Ms. Miller, what are your views? And are corporate boards acting responsibly when they hire compensation consultants, knowing that there are conflicts of interest?

Mr. PEDROTTY. Go ahead.

Ms. MILLER. Thank you, Dan.

I do believe that corporate boards are not acting responsibly when they're hiring compensation consultants when they know that there's a disproportionate monetary tie to the management side and that they're supposed to be consulting to the committees in the best interest of both the company but also of shareholders. And the board members are supposed to represent shareholders' interests. And so, that conflict can't work well for our interests, the investors to be represented.

I think that, in our study, when we approached the 25 top companies, we engaged the compensation committee chairs. And when we brought to their attention this issue and the concern about the conflict of interest that investors had, they were willing to positively address the issue of independence. I think that it is surprising there has been a lag within compensation committee chairs of corporate America.

But I do believe that brought to their attention, through a required disclosure, we can really get away from really hoping that the market will take care of this and hoping that this will just be a best practice. I don't think we, as investors, can tolerate this issue to just continue to be a best practice. I think that we cannot tolerate conflicts of interest and definitely need a disclosure standard.

Mr. PEDROTTY. Just to followup, Congressman Davis, I think the situation is getting better. I mentioned some companies that were engaging in best practices. But we still have a long way to go.

And something that was pretty representative for us is we joined with the investor coalition led by Connecticut and sent letters to directors, asking for more disclosure. A number of companies in the S&P top 25 didn't even respond to the letter. So I think we've got a challenge in making directors more aware that this is part of their fiduciary duty and educating companies.

And we're interacting with companies almost on a one-on-one basis by filing shareholder proposals, but we continue to see glaring and egregious examples. One was last year at Wal-Mart, which, from our standpoint, is a pay-for-failure company, a pay-for-pulse company. The company was surprised at our outrage at the fact that their management hired the comp consultant and not the board. They didn't understand why we would be concerned about that as a potential conflict.

So there are leaders, but we still have a long way to go, just getting that information and then having the standard brought up through the SEC.

Mr. DAVIS OF ILLINOIS. Thank you very much.

Thank you, Mr. Chairman.

Chairman WAXMAN. Thank you, Mr. Davis.

Mr. Westmoreland.

Mr. WESTMORELAND. Thank you, Mr. Chairman.

And, Mr. Pedrotty, you made a comment a while ago about the executive pay, the majority staff report, the executive pay. That was embargoed until 10 a.m., and you were sitting there at 10 a.m. How did you get a copy of that?

Mr. PEDROTTY. Mr. Westmoreland, I was reacting to the comments of the chairman on the information within the majority staff report.

Mr. WESTMORELAND. OK. So I guess it wasn't embargoed to the public? Or did he just want to give it to the witnesses to—would that bias your statement in any way, that you got a copy?

Mr. PEDROTTY. No. The statement I brought—

Mr. WESTMORELAND. It wouldn't? Even though you commented on it and quoted from it?

Mr. PEDROTTY. I think that adds further concern on the part of investors. And there was a Corporate Library study that looked at comp consultants and companies and found that companies that retained these consultants paid higher than the median without better performance. I think this is a different cut on that, so I was accentuating information I already had in my statement.

Mr. WESTMORELAND. I'm wondering, Mr. Chairman, whether we could get a copy of who all got advanced copies of the report.

The other thing: Mr. Pedrotty, you are the director of the investment office for the AFL-CIO. Is that correct?

Mr. PEDROTTY. That's right.

Mr. WESTMORELAND. It says here that the union-sponsored pension plans holds more than \$450 billion in assets.

Mr. PEDROTTY. That's right.

Mr. WESTMORELAND. Do you have a compensation plan? Or could I ask how much you make?

Mr. PEDROTTY. How much do I make? Actually, Mr. Westmoreland, I think we practice what I preach, in that what I make is not just publicly available—it's a little bit over \$110,000—but every single employee in every single labor union has disclosed what their salary is to the Department of Labor. So if we had commensurate disclosure at companies, it would be, you know, quite an improvement.

Mr. WESTMORELAND. Is that based on performance of what these assets do?

Mr. PEDROTTY. It's based on advising our pension plans around best practices in corporate governance. And we feel like we've got a long way to go. We've been successful at some companies like Pfizer and Home Depot and Verizon, so I think we feel good about our success, but there's lots more challenges and initiatives that we need to take up.

Mr. WESTMORELAND. OK. But, I mean, are you going to get any type of bonuses for doing better? Or if you don't do well, are they going to take any money away from you? I mean, is this just a package that you agreed with—

Mr. PEDROTTY. And just to clear up on any confusion on your part, I don't actually manage money on behalf of the union.

Mr. WESTMORELAND. Oh, OK.

Mr. PEDROTTY. I'm, as my role here today, in more of a policy role and advising trustees who do manage our members' money.

Mr. WESTMORELAND. OK. Do they get compensated?

Mr. PEDROTTY. Does who get compensated?

Mr. WESTMORELAND. The trustees.

Mr. PEDROTTY. The trustees are not paid. I think their expenses are picked up, but they're not paid themselves for managing funds.

Mr. WESTMORELAND. But the AFL-CIO, from reading your testimony, has had some success with Verizon. I think you made the point that they went to a stockholders meeting with Verizon, put together these votes and actually got Verizon to change their policy about the compensation. Is that not true?

Mr. PEDROTTY. That's right, both on the say on pay and compensation.

Mr. WESTMORELAND. It says you also had success with General Electric, Home Depot and Sara Lee.

Mr. PEDROTTY. That's right.

Mr. WESTMORELAND. So do you think the free market system works?

Mr. PEDROTTY. In relation to disclosure?

Mr. WESTMORELAND. Yeah.

Mr. PEDROTTY. No, I don't think it works. I think a certain few companies are responding—

Mr. WESTMORELAND. You all had some success with it, didn't you?

Mr. PEDROTTY. We had success. But, Mr. Westmoreland, a handful of companies doing right by their investors doesn't mean the free market's working.

Mr. WESTMORELAND. But other investors in these companies could do the same thing and have the same success that you've had, right?

Mr. PEDROTTY. And they increasingly are. But they can't be able to vote in an informed fashion on CEO pay or know about the conflicts that exist if the information isn't there. A basic premise that I operate under is markets operate well under good information. We don't have good information, let alone the tools to hold people who act on that information accountable.

Mr. WESTMORELAND. OK. Well, you know, we, on our march to socialism, you know, we just tend to interfere in business. You know, we started out at the bottom and working our way up with minimum wage, and now we're starting at the top, working our way down. It's going to be interesting what happens when we get to middle management and supervisors.

But, you know, talking about pay for performance, I think if you looked at the 110th Congress, if we got paid for our performance, we'd be making about \$1.98. So let's just thank God that we haven't gotten to—

Mr. PEDROTTY. What about the prior Congresses?

Mr. WESTMORELAND [continuing]. Where we make sure everybody's getting paid for performance.

But I yield back the balance of my time.

Chairman WAXMAN. Do you yield back the balance of your time or the balance of your salary?

Mr. WESTMORELAND. Well, either one is fine.

Chairman WAXMAN. Mr. Murphy.

Mr. MURPHY. Thank you very much, Mr. Chairman.

I want to welcome Ms. Miller here today. The Office of the Treasurer in the State of Connecticut has been for a very long time an outspoken advocate for the investor community in general and, as you can see by Ms. Miller's testimony here today, a leader in this Nation in looking out for investors' rights.

And I wanted to just talk specifically about the issue of the SEC actions that took place about a year ago in terms of the new regulations and rules that were promulgated and how far we still have to go. We've talked a little bit about it here today, but obviously we've at least uncovered the fact that the SEC can do more, at the very least to require disclosure about what kind of other work these consultants are doing.

I wanted to just to give you, Ms. Miller, the opportunity to talk a little bit more about the adequacy of the SEC regulations in the first year of promulgation and whether there are other avenues in addition to trying to look at what other work these consultants are doing for the company that we should be advocating for as we ask the SEC to pursue this issue further.

Ms. MILLER. Thank you very much for that question.

As many of the people in this room know, this is the first year that the SEC had new disclosure rules, and they inserted a new portion called the Compensation Disclosure and Analysis [CD&A]. And both the public's analysis, investor analysis, consultants' analysis, and even the SEC's analysis of the performance of the reporting by companies in that first year determined that it was woefully inadequate. And so, the problems were that a lot of the compensation committees did not provide clear information.

And so the SEC actually tried to deal with this issue by doing a targeted review, where it sent out over 300 letters to companies saying, "You need to do better reporting on a number of issues." What was noticeably lacking in the staff's questioning of the companies was, again, this issue of disclosing whether compensation consultants were independent. And then even furthermore, once the staff sort of went through the first few hundred of the letters, they recently issued a document that's on the SEC Web site called "Staff Observations on the Compensation Disclosure and Analysis." And, again, in there, on their observations, they do not guide companies to better disclose on the compensation consultant conflict.

And so, there are so many opportunities here that we've had with the SEC to pay attention to this issue. They've ignored investor comments on this. The treasurer wrote a letter generally about it when they first proposed rules. She wrote another letter just focusing on the compensation consultant conflict. The Council of Institutional Investors and many more organizations commented from the investor point of view about the importance of this issue. And the SEC has continued to ignore it and decide that it's in the best interest for us that the compensation committees make a determination about what is independence.

And I think when we just see this recent action by the SEC, I think it shows that there is tremendous need to bring to their attention the investor community's concerns and now the empirical data from the chairman's report.

Mr. MURPHY. Thank you.

And just one other question to the whole panel. Other than potentially being a step toward our unending march toward socialism, would increased disclosure from the SEC on these particular points—do you see any downside? We've talked a lot about the upsides, but do you see any downside to asking the SEC to pursue disclosure at an increased level going forward?

And I will just ask for everybody to comment very briefly on that.

Mr. ELSON. I can't imagine there would be a downside. You're not talking about, you know, vital corporate secrets that if you disclose will destroy the corporation. I think it's effective. Look, we disclose the auditors' conflicted transactions, and there's no damage done. I can't imagine any damage by disclosing the other forms of services that are offered. There are routine personnel issues that I don't think go to the heart of the strategy of the business, in my view.

Ms. MILLER. I don't think there's any downsides from the investor point of view. I do understand the impact that it may have on the industry, on the consulting industry, which they may view as a downside because of the organizational change. But I think that in the long run, in the long-term interest, this would be a good move for all parties interested.

Mr. SHADAB. I think a potential short-term downside is having companies disclose information which may not be material to the choice of whether or not to purchase or sell securities or to the value of securities. That's the short-term potential downside. And because investors only want information that is actually material to the price of the securities. Other information that's not relevant would just be confusing and flood the marketplace with information that's irrelevant.

A second, more long-term potential downside is setting the precedent for further mandatory disclosures on the Federal level of information which is also not relevant to the choice to invest or not.

Mr. PEDROTTY. I think more information and better disclosure on conflicts is necessary and important, and I don't see any downside.

What we are sensitive to is ensuring that companies, when they disclose their benchmarks and how they're paying and who they're comparing to, that not put competitive information out in the market. So we think retroactive disclosure in some cases, in terms of their peer group, is important.

In terms of the march to socialism, I should just comment that I think we're to the right of some of our Republican friends, in that there's an interesting contrast: When it's the taxpayers money, there's outrage over how it's spent, but when it's the shareholders' money being given to an undeserving CEO, somehow that seems OK.

So thank you, Congressman Murphy.

Chairman WAXMAN. Thank you, Mr. Murphy.

Ms. Foxx.

Ms. FOXX. Thank you, Mr. Chairman.

I really wonder why we are here today. There is a tremendous amount of work to be done in this Congress, which we are not doing. And to me, this has to be the most far afield hearing that I have seen since I have been in the Congress in the last 3 years.

I spoke to the chairman recently and said, you know, I really got on this committee because I wanted to do something about the way the Federal Government operates. I want it to be more consumer-friendly. And I really want us to do our job. The title of this committee is Government Oversight and Reform. And here we are meddling in the private sector in a place we have absolutely no place being. This is not our responsibility.

I think that it's an indication of how detached from the real world some of our friends are. They've been in Washington way too long. They have no idea how the private sector works. And I think it's really a sham. And I'm sorry that we are even doing this and wasting the time of these people and our time on it. I just find it unbelievable.

But I want to point some things out. I think that if shareholders were upset about this issue, they'd be coming to us. I, frankly, have not gotten a single letter from any shareholder saying, "This system isn't working. Why don't you fix this system?"

And I find it very difficult to believe, Mr. Elson, that you say you believe in the market. Well, if you believe in the marketplace, then you wouldn't be trying to destroy business and industry in this country, as you are.

We have more and more firms moving offshore in large part because of Sarbanes-Oxley and the rules that have been put in place. And we're going to see more of that. The more you try to restrict the marketplace, the more you try to make this a socialistic country, the more businesses are going to move. And I'm terribly distressed by this. We are the most successful country in the world, and it is in large part because of our capitalistic system.

I want to ask Mr. Pedrotty—Pedrotty?

Mr. PEDROTTY. Pedrotty. You got it.

Ms. FOXX. Thank you, Mr. Pedrotty. I want to ask you a couple of questions.

The first one is, did you say, did I hear you say Wal-Mart is a pay-for-failure company?

Mr. PEDROTTY. That's right. Or pay-for-pulse, depending on your preference.

Ms. FOXX. Or pay-for-what?

Mr. PEDROTTY. Or pay-for-pulse. Pulse.

Ms. FOXX. OK. Undeniably one of the most successful companies this country's ever seen, you say it's pay-for-failure.

Mr. PEDROTTY. And that's not us speaking, Congressman Foxx. That's an institution like the Corporate Library that puts out a pay-for-failure report that looks at the total shareholder return, the value delivered to institutional investors, including our funds. And they've characterized Wal-Mart as such.

Ms. FOXX. OK. Well, let me ask you this. In your description of your job, it sounded like you do several different things, right? You said you advise the trustees. Could you name, like, the three or four major aspects of your position?

Mr. PEDROTTY. Sure. It's primarily advising our union pension funds and affiliates on corporate governance initiatives and strategies. Also doing a significant amount of work in front of the Securities and Exchange Commission on regulatory issues, everything

from private equity to equal access to the proxy to CEO pay. So it's a fairly diverse policy platform.

Ms. FOXX. Well, why shouldn't we demand, then, that the AFL-CIO restrict you to one aspect of your work? I mean, why should you be allowed to be working sort of two or three sides of an issue? I mean, if you want to stop the private industry from doing that, why shouldn't you be stopped from doing that?

Mr. PEDROTTY. I don't think we want to stop private industry from doing that. I think we want the advice they provide to our representatives of the board to be free from conflict. If there's some suggestion that, you know, I'm conflicted in any way, I would be interested in hearing that. But I think that's the basis on which our recommendation emerges.

And, Congresswoman, it's also the basis for why companies themselves are following this system. If this was so egregious and burdensome, why are right-wing outfits like the Business Roundtable and the National Association of Corporate Directors making these recommendations?

Ms. FOXX. OK. Another question is, don't you see a conflict of interest in your role in negotiating labor contracts with companies and also investing in those companies? Isn't that a conflict of interest and much worse than what you are describing for these consulting companies?

Mr. PEDROTTY. Congresswoman, we don't see any conflict at all. In fact, our goal is the same. Our goal is to both own and negotiate with companies that are creating long-term value, that can both provide substantial returns to our pension funds and employ our members. So those goals are the same.

Chairman WAXMAN. Thank you, Ms. Foxx.

Mr. Welch.

Mr. WELCH. Thank you, Mr. Chairman.

As I understand it, the reason for our hearing is to see whether there are some policies that could wisely be promoted in order to protect shareholders and preserve corporate accountability. And we obviously have a debate about whether that's a valid purpose, but my view is that it is.

Mr. Elson, one of the questions I have, the point's been made about the importance of having independence in compensation consultants. In materials we've seen, oftentimes the consultants get \$1 in payment for compensation advice and they have \$11 in services for other contracts, and they're being hired for those other contracts by the executives whose pay for performance they're reviewing.

Is it your view that for many of these firms that do multiple services, that executive compensation is, in effect, a loss leader?

Mr. ELSON. Yes, I believe so. Executive comp is, frankly, a way into the executive suite, if you will, to access, you know, high-level folks at the company. So that as the other work would come in, I would assume—I mean, not having been a comp consultant, I would assume that the large amount of money that they make is not related to compensation consultants but the other services that they're in. And compensation, particularly when go in at the CEO level, puts you in a place, a very high point of visibility, a high point of contact within the organization that enables you to make

those contacts to make the other businesses happy. I wouldn't suppose real money has been made. It's probably not on consulting but certainly on the other services. In fact, if you look at the income of these companies, the bulk of their revenue is coming from the other part.

Look, I'm not attacking comp consultants. I think they provide a very valuable function to the comp community. I think they're actually quite helpful, in many circumstances. I think you just have to tweak a little bit how their advice is being given or the parameters under which their advice has been given to a committee.

Mr. WELCH. The loss is generally, whether it's Wal-Mart or executive compensation firms, that you offer a good price for providing other services. And my understanding, if I'm listening to your testimony correctly, is that for some of these firms, the opportunity to provide the compensation service gives them access to the management people who then make the hiring decisions on the other \$11.

Mr. ELSON. Well, that explains why a lot of consultants—the trend has now been to using independent consultants—have peeled off of the large firms and went and set up their own boutiques. The nice thing about getting a boutique player today is that most of them are graduates of these large firms. And the firms themselves chose to keep the other work.

Mr. WELCH. Thank you.

Ms. Miller, I want to ask you a question. There's been some back and forth here about whether the labor organization has some agenda that interferes with capital.

Your responsibility is to the pension holders, which are workers and others in the State of Connecticut. Correct?

Ms. MILLER. Yes.

Mr. WELCH. So your bottom line is to have the maximum return to your pension holders and the minimum cost to your taxpayers. Is that correct?

Ms. MILLER. Yes.

Mr. WELCH. So do you have any—just explain to me briefly what the policy basis is for your view about executive compensation needing some rules or regulations that will protect the interest of the people that you represent as the deputy treasurer.

Ms. MILLER. Sure. Thank you.

My testimony includes some empirical data from the Corporate Library that Dan also referred to that shows the losses that shareholders incur when executives are paid excessively while at the same time companies are performing poorly. And the losses over time accumulate to be significant amounts, which obviously impact a pension fund such as the State of Connecticut's.

Even more recently, we saw the losses due to the subprime mortgage problem that many companies have incurred while their exiting CEOs were paid handsomely and, in some cases, you know, total packages that were astounding.

So I think that our goal—the treasurer is the sole fiduciary, principal fiduciary of the Connecticut \$26 billion pension fund. And in that regard, she moves on these issues, which is really your question, because she has a fiduciary responsibility not only to vote her proxies and to monitor them but to engage in corporate governance

activities, whether it be directly with companies or on a policy level that can enhance the value of our investments.

Mr. WELCH. Thank you.

You know, my friend Congresswoman Foxx said that she hasn't heard much from shareholders, and I have to say I haven't heard from shareholders either. Yet you've indicated that on behalf of your pension holders, you have been an advocate for some reform.

What impediments have you run into when you've made efforts to try to get greater oversight and independence on this executive compensation?

Ms. MILLER. Well, the SEC has totally ignored investor comments. There's a public record of comments submitted when the SEC proposed rules, where investor coalitions, the Council of Institutional Investors, which is the largest consortium of public funds and private funds, weighed in on this issue as well. And so the impediment is that we cannot seem to get the attention of the SEC throughout any of its work in this area or any of its oversight on the quality of the reporting of companies on compensation.

Chairman WAXMAN. Thank you, Mr. Welch.

Mr. WELCH. Thank you, Mr. Chairman.

Chairman WAXMAN. Mr. Souder.

Mr. SOUDER. Thank you, Mr. Chairman.

I was watching earlier in my office because we can have wall-to-wall committees on in our committee C-SPANS.

Mr. ELSON, I thought I heard you say you serve on several boards?

Mr. ELSON. Yes, sir.

Mr. SOUDER. Could you name them?

Mr. ELSON. Currently on the board of HealthSouth Corp. and AutoZone Corp.

Mr. SOUDER. How much do you get compensated on those boards?

Mr. ELSON. I think the AutoZone, I think it's \$3,000 stock options a year and I think \$40,000-some in cash that can be taken in company stock.

Mr. SOUDER. Have you exercised any of those stock options?

Mr. ELSON. No, sir.

Mr. SOUDER. On the HealthSouth, what did you say your—

Mr. ELSON. I think it's about—we have a half-stock, half-cash retainer system—about, oh, \$100,000 in cash which may be converted to company stock and then another, oh, I'd say about \$80,000, \$90,000 in restricted stock.

Mr. SOUDER. Did I understand you to say that you felt board members were idiots?

Mr. ELSON. No, sir. I think a board member who would ignore the demand of a shareholder or shareholders and knowingly willfully hire a conflicted consultant in the face of a serious investor opposition and with the changed legal environment, it would be acting problematically for them, from their own standpoint.

Mr. SOUDER. So you think that any company such as Verizon, until they got under—that the reason companies are switching is because they're being smeared. It isn't because of a stockholder opposition. It's because you and others are smearing them in the general public, and it becomes difficult.

Now, the question is, you in effect just said that every board in the country that hires one of these consultants aren't acting in the interest of their shareholders, that they're more or less idiots, and smeared them, when you yourself sit on different boards, earn an incredible amount of money, have potentially multiple different conflicts in what you are saying here and how what you say here influences. The answer of the representative from the AFL-CIO was laughable.

You do have a conflict of interest. That's what businesses deal with on a daily basis. When I went to undergrad and grad school and went through case work, trust departments and banks have inherent conflicts of interest because people who are on their boards sit on companies that the presidents of the banks and the vice presidents sit on companies, then they make investment decisions. Every day they have to decide which stock do they dump first based on information, who do they know. You have conflicts of interests in country clubs. You have conflicts of interest in how you do cost accounting.

Government can't fix every ethical lapse. We try to have clarity. These things try to get supported. But you have come here today and smeared multiple companies.

And, Mr. Chairman, in your opening statement I heard you say that you didn't have any evidence that—what you said was, you said what we have in front of us is compensation going up and executive consultants being involved in this process who, in your opinion, have conflicts of interest, not understanding apparently divisions in companies and rules that exist in the division of companies. And though you didn't have any evidence, you said the evidence was compensation is going up and consultants exist. That's not evidence. That's what you said in your opening statement. That's what this so-called Democratic report states.

There's no facts. We've had one person here talk about economics today and three witnesses talk about politics. And you can go back to George Mason and talk to other economic people and capitalists, and this is why they mock Congress. We have a hearing that's supposed to be about economics. And instead it of economics, you are the only one who talked about how the markets actually work. Everything else has been political today, about opinions.

Do you think the AFL-CIO has a conflict up here today talking about Wal-Mart when you picket them all over the country, when you attack them? Look, companies can or can't unionize. But you have a conflict of interest in smearing Wal-Mart. You quoted some organization that I don't know, may have reflected one annual survey where they did, you know—and then put your editorial comment, implying that organization said that Wal-Mart has either basically dead people or reward false, you know, reverse compensation. Now, nobody in this country believes that Wal-Mart would be the best—the fastest-growing company in the United States or in the world if, in fact, their management was, as you stated, quoting your interpretation of 1 year's probable report of a company we don't know about that claims that they reward deadweight. If they rewarded deadweight, Wal-Mart would disappear. There is a market that's holding Wal-Mart accountable, not you.

And I find, quite frankly, this hearing one of the most appalling, embarrassing hearings I've ever had—that we've had in this committee. Instead of oversight like we did under the past, Mr. Chairman, we are having repeated hearings where we release some dramatic statement, then no facts come at the hearing. The committee is embarrassed. Anybody who watches the details of the hearing—the hearings themselves don't match the allegations. And it's been an embarrassing process. As a senior Member of this House who has been through under four or five chairmen, this is just embarrassing. I'm just sorry.

Chairman WAXMAN. The gentleman's time has expired, but Mr. Elson ought to have an opportunity, I think, to respond to the statements made.

Mr. DAVIS OF VIRGINIA. Mr. Chairman, can I just make one comment on George Mason University? Not only is it economics, but we've produced two Nobel Prize winners out of our Economics Department at George Mason University.

Chairman WAXMAN. Mr. Elson, do you want to respond to the personal attacks on you?

The attacks on me I'll just ignore.

Mr. ELSON. Well, I think that, first of all, those companies that made the changes, I think they did it because it was the right thing to do. And I think they recognized that if you don't protect the investors, then the capital that is fundamental to our free market system disappears. If you don't respect the—

Mr. SOUDER. Mr. Chairman, he is not defending my attack on him. He is continuing to talk like he's been talking—

Chairman WAXMAN. Mr. Souder, you can't evidently accept the fact that anybody disagrees with you. You made a statement about him, and do you think he should not have a chance to respond?

Mr. SOUDER. He is not responding about himself. He's just giving—

Chairman WAXMAN. You don't like his response, but do you think he ought to have a chance to respond?

Mr. SOUDER. No, I didn't attack him personally any more than he attacked all the other people.

Chairman WAXMAN. You attacked him as saying he's smearing capitalism, he should go back to his university and whatever else you had to say.

Do you feel you have anything else to say, Mr. Elson, because we do have to—

Mr. ELSON. I am a free-market capitalist and happy to be so.

Chairman WAXMAN. You are. Thank you.

We'll now turn to Mr. Cummings.

Mr. CUMMINGS. Thank you very much, Mr. Chairman.

In light of what Mr. Souder just said, I want to remind all of us that it was the Conference Board, the National Association of Corporate Directors, the Business Roundtable and the New York Stock Exchange that expressed concerns about conflicts and wanting those conflicts to be revealed. And I don't know that those are but so much political folk, I don't know, but the fact is that they are reputable and they expressed concerns.

Experts and some of our panelists today note that the consultant conflict we are discussing is analogous to the conflict faced by audit

firms prior to passage of the Sarbanes-Oxley reforms. One of the lessons of Enron was that when auditors have multiple business relationships with a company, their independence is questionable. Arthur Andersen, which was one of the most distinguished audit firms in the Nation, signed off on Enron's books. An independent auditor should not have done this. But in Arthur Andersen's case, it was being richly paid by Enron to provide a range of consulting services.

To prevent these kinds of abuses, the Sarbanes-Oxley law said that auditors have to be independent. Compensation consultants appear to have similar conflicts. Like auditors that were motivated to cross-sell more lucrative nonaudit services, compensation consultants are selling more lucrative services beyond executive compensation, and this is where the real money is. As the committee report shows, the fees for these other services far exceed those earned for pay advice.

Professor Elson, is the conflict that we see with compensation consultants similar to the auditor conflicts that were pervasive before Sarbanes-Oxley?

Mr. ELSON. It is extremely similar. And that's why I think Congress's response on the auditor conflicts on Sarbanes-Oxley makes perfect sense on disclosure of the conflicts that we have in this situation. It's almost identical.

Mr. CUMMINGS. Mr. Pedrotty and Ms. Miller, what is your view on this? And have regulators and investors been able to resolve similar situations involving conflicts in the past?

Mr. PEDROTTY. Congressman, we have. And that's why we think Verizon's a good example. Verizon responded not to a smear campaign but to the vote of a majority of investors, including large mutual funds and recommendations like you cited—NACD, NYSE and Business Roundtable—and agreed to ban work for both advising the committee and also advising the company.

But that's why we got here, Congressman. The consultant at Verizon had done a half-a-billion dollars' worth of business for the company at the same time they were advising the board. That's why we think, despite the performance suffering, the CEO's pay went up.

So we think it's sort of a good-news/bad-news tale, that companies are responding now, they're following best practices, but we have much farther to go. And that includes going beyond just naming the consultant, as required by the SEC right now. We need, A, better disclosure so we can take these conflicts into account, but, B, we should have the tools to hold them accountable, just like we can vote increasingly on the CEO's pay and just like we can vote on the auditor. So that's why that analogy is pertinent.

Mr. CUMMINGS. Ms. Miller.

Ms. MILLER. Yes, thank you, Congressman.

The study that Treasurer Nappier led, where we approached the 25 top U.S. companies, resulted in showing that 12 of those compensation committees did pass formal policies in the recent disclosure addressing the issue of compensation consultant independence. This confirms and underscores Dan's remarks that a lot of the companies, when brought to their attention, are willing. And the letters that they wrote back to the treasurer affirmed that they

are in agreement with us, these compensation committees, that indeed there is a potential conflict of interest, whether it be actual or just perceived, that it's important that they address it. And we are very much aligned in that. Eleven of the 25 companies have an outright ban on the use of compensation consultants who work for management of the same company.

I just wanted to address your point about the auditor and whether this hearkened back—

Mr. CUMMINGS. And while you are answering that, would you let me know whether you think that Congress should be considering legislation to eliminate this conflict, like we did with Sarbanes-Oxley?

Ms. MILLER. Thank you.

I think that we should first take the step to urge the SEC to revisit this issue and to require disclosure by the compensation committees about the potential conflicts. And then we should take a hard look at that, and if the best practice hasn't spread rapidly throughout corporate America, we should seriously consider legislation that would prohibit the use of conflicted consultants.

I just wanted to mention that, prior to the passage of Sarbanes-Oxley, the SEC ignored investor comments to have a strong ban against auditor consulting work. They passed a rule. And after that rule was when Enron and the other companies' corporate scandals occurred. And that is what caused the passage of—in part, the passage of Sarbanes-Oxley.

We're exactly on the same path here with the SEC, where they are ignoring investor comments and concerns about this issue. And should they pass something, we would hope that it would be strong enough not to have to lead to legislation, like we ended up with Sarbanes-Oxley.

Chairman WAXMAN. Thank you, Mr. Cummings.

To conclude the questioning of this panel, I wanted to recognize Mr. McHenry.

Mr. MCHENRY. I thank the chairman.

Mr. Shadab, this is directed to you. I'm on the Financial Services Committee. We've had a lot of discussion about the cost of Sarbanes-Oxley, the raw cost. And that is directly passed on to the investors, and the cost of separating consultants and auditing and everything else.

Now, it seems to me that others on this panel from the majority's witnesses contend that this is, you know, very good; we should sort of expand Sarbanes-Oxley to consultants of all sorts; that you only can consult on one issue area and that's it.

So can you talk about—let's talk about the cost to this. Because we've done a number of hearings on the Financial Services Committee and on this committee in the last Congress on the cost of Sarbanes-Oxley. So if you could touch on that.

Mr. SHADAB. Sure. Several studies have shown very high compliance costs with Sarbanes-Oxley. And those are pretty well-known. There are other studies and there are some conflicting reports out there about the cost to American competitiveness or the capital markets, the extent to which companies are either going private, staying private or going public elsewhere in response to not only just Sarbanes-Oxley but other regulatory issues that are unique to

the American legal structure, such as plaintiff lawsuits and other forms of regulatory burdens unique to American companies.

In addition, several studies, such as one of my own, has shown that Sarbanes-Oxley seems to have reduced the risk-taking activity by public companies and reduced their incentives and ability to undergo innovation activities and create more new products and services for consumers than they otherwise would have.

So those are some of the costs of Sarbanes-Oxley.

Now, specifically with respect to the issue of nonaudit services and auditors, Sarbanes-Oxley is a really poor example of legislation that was based upon actual—the benefiting the investors based upon economic evidence with respect to whether or not there is an actual conflict of interest when auditors provide nonaudit services. In fact, that aspect of Sarbanes-Oxley and many others were really rushed through Congress not based on empirical evidence but, actually, to the contrary, most of the empirical data that shows any impact on investors when auditors provide nonaudit services, consulting services for example, shows that it actually improves audit quality.

So we shouldn't sit here and I urge the committee not to draw the wrong lesson from Sarbanes-Oxley, especially with respect to the issue of auditors and conflicts of interest and try to analogize to compensation consultants on their potential conflicts of interest. Certainly, there are potential conflicts of interest throughout the business community, but potential conflicts of interest are not actual conflicts of interest. And we shouldn't assume them to be so, especially when we at least perceive to be tradeoffs and benefits from providing noncompensation consulting services.

Thank you.

Mr. MCHENRY. Thank you. I appreciate you touching on that.

Now, Mr. Pedrotty from the AFL-CIO, now, looking at your testimony, it says, "Today's compensation consultants perform lucrative consulting work unrelated to the investor protection role they're supposed to play." Now, so, with that, the consultant has a fiduciary responsibility to the investor; is that your contention?

Mr. PEDROTTY. We think that when a consultant is at the same time advising the board on how to strike the best arm's length deal but also doing a significant amount of business for the company itself, in some cases hired by the person whose pay they're weighing in on, that presents a concern for us. And at the very least, we need better information. It's much like—

Mr. MCHENRY. All right. But let me ask this. Does a consultant have a fiduciary responsibility to the investor?

Mr. PEDROTTY. No, but they should.

Mr. MCHENRY. OK. No, but they should. Under your testimony, you said "unrelated to the investor protection role they are supposed to play." It's the board that has the fiduciary responsibility.

Mr. PEDROTTY. Fiduciary. Right.

Mr. MCHENRY. Thank you for correcting me. I've got a cold, so I'm having a hard time getting words out.

Not the consultants. It is the board that makes the decision. Is that correct?

Mr. PEDROTTY. It is. But we see—

Mr. MCHENRY. The condition is that everyone who does any consulting work for any company has to have fiduciary responsibility?

Mr. PEDROTTY. No. I think the problem at the very beginning, though, is the board is relying on advice that may be conflicted. Investors should know about that conflict, and they don't. And we even have boards making almost an admission of failure. Two-thirds of boards are saying that, you know, CEO pay is out of control; they're having trouble controlling it.

Mr. MCHENRY. That's a different issue. What you are trying to do is actually take consultants who provide market information—which is what the AFL-CIO does to a good extent, as well. You provide market information on pay and you want to raise people's pay, but you actually want to lower executives' pay, which is an interesting conflict.

Mr. PEDROTTY. That's not what we're saying. We're not saying that—

Mr. MCHENRY. Let me finish here, sir.

Chairman WAXMAN. Well, the gentleman's time has expired.

Mr. MCHENRY. If I may finish this thought, Mr. Chairman.

Chairman WAXMAN. OK.

Mr. MCHENRY. You know, the interesting thing here is your contention is, if you are a consultant advising the board, yet your contention is they may have a conflict of interest because they have another part of their business that does work for the company. So your contention is that maybe they're charging a much higher rate than they should, thereby deriving—that's what a conflict is really about. So if they have another line of business that is charging this company extra money, thereby pocketing money for the consultants, that the board's too dumb to actually realize it.

And that's something that I just think is flat wrong. It's a failure to understand the fiduciary responsibility of the board and let them make the best judgment call, not have Congress dictate to them what they shall and shall not do.

Mr. PEDROTTY. We want consultants to drive the best bargain we can in negotiating with CEOs. The board drives that bargain. They rely on advice from consultants.

If the consultant knows that enormous amount of business, a multiple of what they're earning for advising the board is with the company itself, if the consultant knows that the CEO has hired them, are they want to alienate that person and not be in a position to be hired—

Chairman WAXMAN. The gentleman's time—

Mr. MCHENRY. Mr. Chairman, this is really about executive compensation and not about consultants. So I think it's a valid hearing to have about executive compensation. But the consultants are simply providing information. It's the boards that are really making the decisions.

So with that, I will be happy to yield back.

Chairman WAXMAN. You have no time to yield back. But the gentleman's time has expired. I want to thank you for your comments.

I want to thank this panel for your presentation and answering the questions of the Members.

We are going to have to recess to respond to votes on the House floor. So we will return and start with the next panel at 12:20. Thank you very much.

[Recess.]

Chairman WAXMAN. I would like to reconvene the hearing.

For our second panel I would like to welcome Donald Lowman, the managing director of Towers Perrin Executive Compensation and People Advisory consulting services; Charlie Scott, president of Mercer's human capital consulting business, which handles executive compensation matters for the company. Michael Powers is the global practice leader for executive compensation and corporate governance for Hewitt Associates. George Paulin is the chairman and chief executive officer of Frederick W. Cook & Co. James Reda is the managing director and founder of the James F. Reda & Associates, an executive compensation consulting firm.

We're pleased to have you with us today. Your prepared statements will be in the record in their entirety.

Before I ask you to make an oral presentation, it is the practice of this committee that all witnesses that testify before us do so under oath. So I would like to ask you if you would stand and raise your right hands.

[Witnesses sworn.]

Chairman WAXMAN. The record will indicate that all of the witnesses answered in the affirmative.

I mentioned all your prepared statements will be in the record in full. We'd like to ask, if you would, to try to limit the presentation to around 5 minutes. We'll have the clock there. It will be green, and then it will turn yellow, indicating 1 minute left, and then red, indicating the 5 minutes have expired.

Mr. Lowman, why don't we start with you? There's a button on the base of the mic. Be sure to press it.

STATEMENTS OF DONALD LOWMAN, MANAGING DIRECTOR, TOWERS PERRIN; CHARLIE SCOTT, PRESIDENT OF HUMAN CAPITAL CONSULTING, MERCER; MICHAEL POWERS, GLOBAL PRACTICE LEADER FOR EXECUTIVE COMPENSATION AND CORPORATE GOVERNANCE, HEWITT ASSOCIATES; GEORGE PAULIN, CHAIRMAN AND CEO, FREDERICK W. COOK & CO.; AND JAMES REDA, MANAGING DIRECTOR, JAMES F. REDA & ASSOCIATES

STATEMENT OF DONALD LOWMAN

Mr. LOWMAN. Thank you, Chairman Waxman. Good afternoon to all the committee members, and thank you for inviting Towers Perrin to participate today in this discussion.

My name is Don Lowman. I am managing director of Towers Perrin and also a member of our board of directors. I've been with the firm 25 years, have held various leadership positions in addition to my consulting experience. And I hope my comments today will address many of the issues that are of greatest importance to the committee.

First, a few words about Towers Perrin's executive compensation consulting practice. We certainly recognize, as many others have commented, that there's a perception of and also the potential for

conflict of interest in compensation consulting, indeed in all consulting. Our executive compensation practice, which is delivered by a separately identified line of business, is built around strong and effective processes and protocols which preclude conflict issues and which allow us to achieve our goal of providing input, sound and objective advice to our clients.

And among these protocols are the following. First, we perceive that our client is always the company. We are not agents for the CEO. We don't consult to, nor advocate for, any individuals. And, indeed, we're not paid by the CEO. Second, our fees are unrelated to any level of executive pay. Our fees are not a function of the size of any given executive's compensation package. Third, our consultants receive no direct reward for promoting or selling other services provided by our firm. Fourth, our code of business conduct, which has been in place for nearly 15 years, clearly articulates the firm's commitment to providing clients with services that are impartial and objective. Last, we have operating procedures, such as independent peer review. We wall off individuals who serve as board-appointed consultants from other client-related work.

This committee has expressed a concern about a firm providing both executive compensation consulting services and other consulting services to the same company. We don't believe a firm's ability to deliver sound, objective and conflict-free advice is compromised simply because other people in the same firm may also provide other consulting services to the client. Precluding executive pay consultants from other company engagements will not resolve what I believe this committee's fundamental concern with CEO pay is and the so-called wage gap. In fact, there's evidence that where executive pay consultants do no other work for a company, the result has often been the highest levels of executive pay. I will refer to the Corporate Library report later on during the question period.

I would like to talk a little bit about what we see as some of the possibilities for improving the processes around setting executive compensation. As the committee considers this issue, it's important to keep in mind that a company's compensation committee and board are vested with responsibility for pay decisions. There are, indeed, egregious examples in the areas of corporate governance and executive pay that don't represent the overwhelming majority of companies and boards nor the professionals who advise them.

Moreover, we have seen significant changes and reforms which have been implemented to enhance transparency, strengthen corporate boards and increase shareholder rights, among them improvements in governance resulting from Sarbanes-Oxley; shareholder activism coupled with new proxy disclosure requirements; stock option expensing requirements; directors who have become smarter, more committed, better prepared and, for the most part, unafraid to ask tough questions; compensation committees that focus on what's right for their company today; and the challenging of outmoded elements of historical conventional wisdom.

All of what I just talked about is good, and it should be given a chance to work. Corporate America has never been more conscious of executive pay and the implications for not getting it right. Indeed, I would just submit to this committee that the fact that you've asked for this information, that it's been provided to you,

has actually raised the awareness of this issue in corporate board rooms and compensation committees around the country. We've been asked to testify to and reaffirm our independence, and we've done that in all cases. And in a majority of cases, there has been no change.

While no ready-made formula exists to satisfy all interested parties, certain enduring principles are receiving increased emphasis in board rooms across the country. These include good governance. It all starts with good governance. In today's environment, duty of loyalty and duty of care define the commitment and responsibility the board members have to the shareholders they serve.

More committed and courageous board members make a difference. These days, compensation committees are taking an increasingly active role. Polite and predictable give-and-take has given way to far more searching analysis and negotiation. Testing scenarios help ensure sound design. The relatively recent use of what we call tally sheets helps ensure that virtually all scenarios are explicitly contemplated by the compensation committee. We believe that survey data should be used judiciously with a host of other information to inform, but not determine, how much a particular executive should be paid.

Talent management and succession planning make for more affordable pay. Increased emphasis on thoughtful talent management and succession planning can reduce the need to buy expensive outside talent.

Towers Perrin clearly recognizes the critical importance of the role we play in ensuring good corporate governance. We take this role very seriously. And, again, I want to thank you, Mr. Chairman, for inviting us to be with your panel today.

[The prepared statement of Mr. Lohman follows:]

UNITED STATES HOUSE OF REPRESENTATIVES

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

HEARING

**“EXECUTIVE PAY: THE ROLE OF COMPENSATION
CONSULTANTS”**

TESTIMONY OF

DONALD L. LOWMAN

**MANAGING DIRECTOR
TOWERS, PERRIN, FORSTER & CROSBY, INC.**

Washington, DC

December 5, 2007

**TESTIMONY OF DONALD L. LOWMAN
MANAGING DIRECTOR
TOWERS, PERRIN, FORSTER & CROSBY, INC.
December 5, 2007**

Good morning Chairman Waxman, Ranking Minority Member Davis, and Members of the Committee. Thank you for the opportunity to express our views today on executive compensation consulting services, the role of compensation consultants in the determination of the compensation of senior corporate executives, and the question whether potential conflicts of interest might arise when a consulting firm simultaneously provides compensation consulting and other services to a single client.

These are all subjects of great interest to Towers Perrin and our clients. It is our long held belief that executive compensation is a critically important component of good corporate governance.

Today I'd like to provide you with some background about Towers Perrin and describe the nature of our executive compensation consulting practice, including the various forms that executive compensation engagements may take. I also would like to outline for you steps we take to help ensure that our consulting work is not affected by other relationships our firm may have with a given company. Finally, I will address some issues that have been raised regarding the role of executive pay advisors, and will discuss some positive steps that we believe can improve the executive compensation process in various respects.

About Towers Perrin

Towers Perrin is a global consulting firm that was founded in 1934 and has been privately owned by full-time employees since its inception. With our global workforce of approximately 6,000 employees we deliver consulting services in a broad range of disciplines including human resource strategy, design, and management; actuarial and risk management services in the insurance and financial services industries; and reinsurance intermediary services. Our mission is to help improve our clients' business performance through our unique combination of talent, expertise, and commitment, thereby creating value for our stakeholders. In all of the work we do, we adhere to our stated values of integrity, respect, and professionalism.

I am a Managing Director of Towers Perrin's Human Capital Group and a member of our Executive Council and our Board of Directors. Our eight-person Executive Council has overall responsibility for setting Towers Perrin's strategic direction and overseeing the management of the firm's operations. In my 25 years with Towers Perrin, I have had a variety of leadership roles and have managed different parts of our global geographic operations and a number of our lines of business. I remain an active consultant today, and was honored as one of the top 25 consultants in the world by Consulting Magazine in 2003.

Towers Perrin's Executive Compensation Consulting Practice

Towers Perrin began offering compensation consulting services to its clients in 1962. Our firm's compensation consulting services are delivered by a separately identified line of business with its own leadership structure. The services this line of business offers include both executive compensation consulting and consulting relating to rewards for broad-based employee groups. We have provided executive compensation consulting services to

thousands of clients worldwide and have been ranked first in U.S. market share by various analyses of 2007 proxy disclosures.

Towers Perrin's executive compensation practice has specific and clearly articulated policies and procedures that we use to govern the delivery of our services to our executive compensation consulting clients. These policies and procedures build on long-standing policies that govern all of Towers Perrin's consulting work.

It is important to understand how the executive compensation process works in most companies. Generally, executive compensation consultants provide advice and support to a company's board of directors (or one or more of its committees), which ultimately makes the decisions about executive pay for the company. Sometimes, however, the executive compensation consultant is not asked to offer advice at all, but rather is assigned to provide and analyze data. In any event, the key point is that consultants neither displace nor provide a substitute for sound corporate governance and the proper exercise of authority by the company's board of directors and compensation committee. Sound governance, including a compensation committee that exercises its authority with courage, conviction, integrity, and discipline – and with the best interests of shareholders top of mind - is the cornerstone of sound executive compensation decisions.

Towers Perrin fully supports the proposition that shareholders, boards of directors, compensation committees, and company management should receive the information they need to carry out their respective roles in an environment characterized by transparency and objectivity. Executive compensation consultants help to provide that information, but they do not create or control the market for executive talent, nor do they make the ultimate executive compensation decisions.

In contrast to outside auditors, the services of which publicly traded companies are required to retain, no compensation consultant need be hired at all by a corporation or its

compensation committee. In light of the optional nature of company board decisions to secure outside executive compensation advice, such engagements, for Towers Perrin, vary considerably from client to client, in both nature and scope. In some cases – for example, where our consultants are asked simply to supply data about competitive practices or calculate the value or cost of a particular award – we have minimal interaction with the compensation committee. At the other extreme, our consultants may attend compensation committee meetings, develop materials for the committee’s review, serve as a sounding board, technical expert and/or advisor to the committee, and provide other input to the committee’s decision-making process. Thus, our compensation consulting engagements can range from only a few hours per year to hundreds of hours per year.

Companies may engage more than one executive compensation advisor for different reasons – *e.g.*, for multiple sources of data, specialized expertise, compliance with applicable laws and regulations, additional perspectives, or second opinions. In addition to consultants, companies frequently turn to lawyers for compensation advice or help in crafting public disclosures about particular programs or individual remuneration arrangements.

As a general matter, Towers Perrin’s executive compensation consulting engagements reflect a variety of structures, depending upon four main variables: first, the number of consulting firms employed by the client; second, whether the board compensation committee or management retains the consulting firm; third, the specific terms of the engagement, *i.e.*, whether or not the firm is permitted to provide other services and, if so, any approvals or restrictions that might apply to such other services; and fourth, the nature of the particular assignment that the client expects the consulting firm to execute. While the foregoing four variables could yield any number of possible models, in practice we

find that the following three approaches have proved most prevalent in the executive compensation consulting industry:

1. The compensation committee hires one consulting firm, which works for both the committee and management, at the direction of the committee. In this compensation model, there normally are no restrictions on other work provided by the consulting firm to management, so long as the committee is kept informed of such other work and has an opportunity to disapprove it.
2. Two consulting firms are hired: one by management to do the work involved in designing a particular compensation package, and a second by the compensation committee to review and audit work done by management and management's compensation consulting firm. Under this model, the committee's consulting firm normally performs no other work for the company but management's consulting firm is allowed to do such other work. Usually, the committee employs a firm that specializes exclusively in executive compensation work, while management's consulting firm is a full-service human resources firm.
3. A single consulting firm, hired by the committee, which usually (but not always) is allowed to interact with management on executive compensation matters, at the direction of the committee, but is barred from performing any other (*i.e.*, non-executive compensation) work for the company.

Whatever the nature and scope of Towers Perrin's executive compensation consulting engagement or the roster of professionals advising a particular client, our firm is committed to delivering sound, expert advice, consistent with our high standards of quality work and objectivity, in an environment that is free from conflicts of interest. In our view, this objective can be achieved through hiring talented consultants, training them fully, and operating in a culture of integrity, reinforced and monitored by properly designed policies and procedures, such as those described in detail below, provided those policies and procedures are implemented effectively and applied consistently.

We do not believe that the delivery of sound, objective, and conflict-free advice on executive compensation requires a particular corporate structure or a regulatory limitation on the types of engagement a consulting firm may pursue. Nor do we believe a firm's ability to deliver sound, objective, and conflict-free advice is automatically or necessarily

compromised simply because the same firm also may provide other consulting services to a client.

Indeed, to this point, recent published reports – such as the one released less than two months ago by the Corporate Library – indicate that consulting firms that offer only executive compensation consulting advice and whose revenues derive exclusively from that one line of business are associated with the very highest levels of executive pay. These reports also suggest that such specialized firms may well not be as objective as firms whose revenue sources are more numerous and diverse. For Towers Perrin, the complete loss of a relationship with any single client, while obviously regrettable, typically would have a far less significant impact than such an event would have for a specialized firm with far fewer clients and a far greater percentage share of revenues associated with any particular client relationship. Accordingly, far from presenting an obvious or attractive solution to the perceived problem of conflict of interest in the delivery of executive compensation consulting services, a rule barring firms from accepting both executive compensation and other types of consulting engagements from the same company actually could exacerbate the risk that a company could receive conflict-compromised advice.

All of Towers Perrin's executive compensation consulting engagements share certain features that, we submit, enable us to achieve our goal of providing sound and objective advice to our clients. First, regardless of whether we have been retained by the compensation committee or by management, we invariably consider our client to be the enterprise itself, not a particular individual. Indeed, we do not accept engagements from individual executives to further their personal interests (even where the company would be paying our fee) and we have declined to pursue potentially lucrative business offerings to provide executive search, coaching and outplacement services that might engender a risk of our becoming too closely aligned with individual executives' financial interests.

Second, the fees for Towers Perrin's executive compensation consulting services are calculated by hourly rate or based on a fixed, pre-established amount unrelated to any level of executive pay. Thus, contrary to what some believe, the size of our fee is not a function of the size of any given executive's compensation package.

Third, Towers Perrin's executive compensation consultants receive no direct reward for promoting or selling other services provided by our firm. We do not pay sales commissions, nor do we provide specific financial incentives for our executive compensation consultants to help sell other work to clients for whom we already provide executive compensation services. In fact, as noted below, Towers Perrin executive compensation consultants who serve as advisors to compensation committees are precluded from participating in any significant way in account planning for clients to whom we provide significant other consulting services beyond executive compensation. By the same token, Towers Perrin consultants in other lines of business do not review executive compensation consulting reports and have no input into the content of such reports or the direction of any recommendations they may contain.

Towers Perrin's Protocols for Ensuring Professionalism, Independence and Objectivity

Many Towers Perrin clients want to be able to take advantage of the breadth of services and global expertise our firm offers. Mindful of the potential for conflicts of interest, we long ago established formal policies and procedures to help ensure the soundness and objectivity of our consulting advice.

Among the policies and procedures that allow us to deliver such advice are the following:

- Towers Perrin's Code of Business Conduct, which governs the work of every employee of our firm, clearly articulates the firm's commitment to providing clients with services that are impartial and objective.
- Towers Perrin designates senior leaders in each of our consulting practices to serve as Professional Standards Officers ("PSOs"). PSOs have been responsible for many years for ensuring that professional standards are adhered to and that all potential conflicts of interest are considered and resolved before an engagement proceeds.
- In any case where an executive compensation PSO determines that other consulting work is resulting (or potentially could result) in undue influence on the objectivity or independence of our executive compensation advice, the PSO can take steps to impose structural changes to the relationship, including mandating Towers Perrin's withdrawal from the executive compensation or other consulting relationship if he or she makes a judgment that objectivity cannot be preserved.
- Towers Perrin's formalized executive compensation quality assurance protocols mandate that all significant executive compensation recommendations be reviewed by at least one senior practitioner in addition to the consulting team performing the work.
- Towers Perrin's policy is to preclude an individual who serves as a board-appointed executive compensation consultant from also serving as the firm's client relationship manager in any instance where we deliver both executive compensation and other consulting services to the client.
- Towers Perrin's policy is to cooperate with reasonable client requests to implement any other steps that may be designed to address any perceived conflict of interest and to preserve the objectivity and independence of our consulting advice. Several examples of such additional steps have been reported in the press.

We believe that close adherence to these policies and procedures – which apply equally regardless of whether Towers Perrin is the lone consulting firm in a particular engagement or is teamed with another firm – has enabled Towers Perrin to ensure the objectivity and independence of our executive compensation consulting advice over many years. Indeed, we believe that the objectivity and integrity that are the hallmarks of our work are in large measure responsible for the success we have enjoyed.

In sum, we firmly believe that, handled responsibly and professionally, executive compensation consulting engagements will provide clients with the information they need to design and/or modify or approve sound and defensible pay packages. It is neither wise nor appropriate to impose on companies a particular model that would limit their flexibility to adopt the system for setting compensation that best meets their own needs.

Towards an Improved Process for Setting Executive Compensation

As noted earlier, responsibility for executive compensation decisions resides ultimately with each company's compensation committee and board. The quality of such decisions is a function of the collective knowledge and experience of the members of those bodies, the due diligence they follow in reaching decisions, their objectivity, and their individual integrity. They decide whether or not to engage outside advisors to assist them and whether or not to follow any advice they receive. The quality of consulting advice is a function of consulting firm resource depth and individual consultant experience.

The debate around executive compensation – already heated – plainly has intensified, prompted not only by the new SEC disclosure requirements, but also by other emerging developments such as Congressman Barney Frank's "say on pay" bill. And, to be sure, there have been cases of abusive compensation packages that have rightfully raised eyebrows not only in Congress, but in boardrooms and living rooms across the country.

The issues that typically make front page business news and appropriately attract the attention of this Committee include the worst things that have happened in the areas of corporate governance and executive pay. They are not flattering portraits, to be sure, but neither do they represent the overwhelming majority of companies and boards, nor the

professionals who advise them. Moreover, we have also seen significant changes for the better; specifically:

- Improvements in governance resulting from Sarbanes-Oxley (2002) and new stock exchange corporate governance requirements (2003) have improved the way that compensation committees operate.
- Threats of lawsuits and criminal prosecution against directors have provided wake-up calls for any board members in need of one. Directors who participated in or witnessed stock option backdating investigations or observed derivative suits now have a renewed appreciation for the breadth of their fiduciary responsibilities and for the scrutiny accorded senior executive compensation by regulators, shareholders and the general public.
- Shareholder activism, coupled with new proxy disclosure requirements, has caused certain questionable past practices to fall out of favor or nearly vanish (e.g., executive loans, stock option repricing, reload stock options, director retirement plans).
- Stock option expensing requirements put the brakes on the wasteful use of equity compensation. Most investors now believe dilution is at or near acceptable levels.
- Directors have become smarter, more committed, better prepared, and for the most part, unafraid to ask tough questions. Polite and perfunctory "give and take" at compensation committee meetings has been replaced by rigorous discourse and debate.
- Increased use of lead directors or independent board chairs and greater use of executive sessions (without management present) at compensation committees have established a more equal balance of power between management and the independent board members (who comprise compensation committees).
- Statements like "because we've always done it that way" are no longer defensible, and "everyone else does it this way" is increasingly being challenged. Committees focus on what's right for their company today. This is starting to have effects on lower severance multiples, tax gross-ups and so forth.

For some companies, these changes represent only minor modifications of past practices, while for others, they have caused a complete overhaul of the past. We have seen more changes in executive compensation program design in the last five years than in the previous 25. Over the last few years, many companies have re-thought, re-mixed and re-designed their executive pay programs. They are getting far better at pay design. They

are using sophisticated tools and approaches to create incentives that contemplate a broad range of business and performance outcomes, from success to failure to change-in-control. Corporate America has never been more conscious of executive pay and the implications for not getting it right.

Still, no ready-made formula exists to satisfy all interested parties. After all, it is difficult, if not impossible, to reconcile the core belief of some that “the company that pays least pays best” with the equally fundamental principle that the market for executive talent should be permitted to function with a minimum of interference. Nevertheless, certain basic, undeniable precepts endure. Long followed by many companies, these principles are receiving increased emphasis in boardrooms across the country:

- **It all starts with good governance.** In today’s environment, the words “duty of loyalty” and “duty of care” are serious and substantial – defining the commitment and responsibility that board members have to the shareholders they serve. The chain of governance is only as strong as its weakest link. Increasingly, companies are taking measures to ensure that each link *is* strong. Good governance is foundational and necessary for sound pay decisions. But governance itself does not guarantee good decisions.
- **More committed and courageous board members make a difference.** These days, compensation committees are taking an increasingly active role. The best directors are better prepared (thanks, in part to their increased reliance on executive compensation consultants) and unafraid to ask the tough questions. Polite and predictable “give and take” has given way to far more searching analysis and negotiation.
- **Testing scenarios helps ensure sound design.** Few would argue that, in the past, a number of U.S. companies have underestimated or not even known the “upside potential” of numerous pay plans. The relatively recent increased use of “tally sheets,” however, helps ensure that virtually all realistic scenarios, from change-in-control to voluntary termination, are explicitly contemplated by the compensation committee. Both upside and downside outcomes need to be balanced. By minimizing the potential for surprises after the fact, committees are reaching decisions less susceptible to the second-guessing of Monday morning quarterbacks.
- **Survey data should inform, but not determine, pay levels.** No doubt, slavish reliance on competitive survey data can cause the “Lake Wobegon” effect that critics rightly condemn as generating widespread, if not universal, “above

average” levels of compensation. But this does not mean we should ignore the wealth of information that describes pay practices and reports pay levels within various sectors of the economy. Rather, pay data should be used judiciously, in conjunction with a host of other factors, in reaching the ultimate determination of how much a particular executive should be paid.

- **Talent management and succession planning make for affordable pay.** Increasingly in the business world, the “whatever it takes” mentality to hire top executives is giving way to thoughtful succession plans and careful talent management. Without a solid succession plan in place, many companies can end up over-paying an under-performing executive for protracted periods. Building a strong internal talent pool can also reduce the need to buy expensive outside talent and eliminate the costs and risks of bringing that talent up to speed.
- **Use of long-term performance plans improves the “pay-for-performance” linkage.** Many companies now realize that cash and stock-based performance plans can provide executives with tangible rewards directly aligned with the overall objective of shareholder value creation. Such plans, of course, require companies to answer three important questions: What’s the measure? What’s the target? And what’s the range of performance around which we will pay? Unlike stock options, which allow companies essentially to outsource performance management to the vagaries of the stock market, performance plans require goal-setting and negotiation.

Rather than resign themselves to an unending stream of criticism about executive pay, companies increasingly are recognizing the value of taking proactive steps, along the lines outlined above, to present their shareholders with sound, well thought out performance-based programs. We respectfully submit that – with the aid of outside professionals demonstrably committed to rendering objective advice – corporate America is fully capable of improving the credibility of the executive compensation process.

Full service executive compensation consulting firms like Towers Perrin clearly have a role to play in helping companies meet this challenge. Indeed, given the increased attention being directed to senior executive pay packages, companies need to have access to our technical expertise and sophisticated analytical skills now more than ever.

As I hope we have succeeded in demonstrating, companies use numerous and different models for engaging consultants, and many variables factor into sound executive

compensation decisions. These many moving parts, combined with the complex policy and business considerations raised by the debate surrounding executive pay, highlight the risk of adopting a solution that, while perhaps simple on its surface, actually may do more harm than good.

Again, thank you for this opportunity to share our views and suggestions. We will continue to follow the Committee's work in this area with great interest and are confident that it will give careful consideration to these important and complex issues.

Chairman WAXMAN. Thank you very much, Mr. Lowman.
Mr. Scott.

STATEMENT OF CHARLIE SCOTT

Mr. SCOTT. Mr. Chairman, Ranking Member Davis and members of the committee, my name is Charlie Scott, and I am president of Mercer's Human Capital Consulting business.

We welcome this opportunity to describe for you the nature of our working relationship with executive compensation clients, our consulting framework for promoting responsible executive pay, and the steps we take to give our clients objective, unbiased advice and help them discharge their responsibilities.

Mercer's executive compensation consultants help compensation committees in two primary ways. First, our consultants help the committee establish a philosophy regarding executive pay that provides the backdrop for specific programs. Second, they provide a context of objective and expert analyses, advice and information to assist the committee in its decisionmaking role.

Mercer and its affiliates also provide a wide variety of products and services in the consulting, outsourcing and investments arenas to clients, their benefit plans and to employees.

Mercer's aware that some have raised concerns that providing executive compensation services as part of a diversified business model could present a potential conflict of interest. The critical issue, which your committee has identified, is whether potential conflicts of interest are prudently and effectively managed and disclosed. Mercer has recognized this and other potential stresses on executive compensation decisionmaking and elected to take market-leading position on the need for a more reasonable approach to the process.

In 2005 Mercer developed and implemented our Global Business Standards. These standards are the central governing document for our executive compensation consulting business. These standards are provided to all of our clients. They enhance transparency, establish a framework for the effective management of these issues, and allow Mercer consultants to provide high-quality, unbiased advice.

Mercer's Global Business Standards address three areas: first, managing the consulting relationship; second, ensuring the quality of consulting services; and third, structuring our business to manage potential conflicts of interest.

Let me first discuss how we manage the consulting relationship. A clearly defined client relationship provides the foundation for ensuring the objectivity and integrity of our advice. This begins with an engagement letter that documents the key elements of the assignment and relationship. It sets forth responsibilities, scope of services, fees, timeframe and client reporting relationships, including how and to whom information and recommendations are communicated. Engagement letters with a compensation committee include disclosure of any other financial relationships Mercer has with a company.

Now let me talk about the second element of our Global Business Standards, which is ensuring the quality of our advice. Executive compensation consulting services are performed only under the di-

rection of a human capital business principal. These individuals are Mercer's most senior consultants. Mercer's professional standards require that all consulting advice be peer-reviewed before it is rendered.

Mercer has also developed a framework for working with clients in four critical areas: remuneration, performance, regulations and governance. This framework helps clients avoid focusing on pay competitiveness at the expense of performance against peers and prudent governance of the programs.

Let me turn to the final element of our Global Business Standards, how we structure our business. Our executive compensation consultants are not paid based upon client revenue from other Mercer lines of business. Furthermore, our client relationship managers and other sales-focused employees do not evaluate performance or determine compensation for executive compensation consultants. This is done only through our human capital leaders.

Our Global Business Standards also require our consultants to seek advice from the human capital business leadership if there's ever any question that our objectivity or integrity is at risk of being comprised.

Consultants have the authority to discontinue relationships in cases where potential conflicts cannot be resolved.

Finally, Mr. Chairman, for clients that need the depth and breadth of resources that Mercer can provide but also want an additional review, we suggest an independent oversight model. Under that model, clients retain a separate outside advisor to provide oversight and review of our recommendations. This advisor would have no other relationship with the company. We believe that these elements provide a best-practices approach to our work.

Thank you.

[The prepared statement of Mr. Scott follows:]

**STATEMENT OF CHARLIE SCOTT, PRESIDENT OF MERCER'S HUMAN
CAPITAL CONSULTING BUSINESS**

**BEFORE THE
UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM**

DECEMBER 5, 2007

Mr. Chairman, Ranking Member Davis and Members of the Committee. My name is Charlie Scott and I am President of Mercer's human capital consulting business. I appreciate the opportunity to appear before the Committee today to discuss the executive compensation services Mercer (US) Inc. ("Mercer"), through its human capital line of business, provides to many of America's leading companies. We welcome this opportunity to describe for you:

- The nature of our working relationship with executive compensation clients;
- How our consulting framework promotes consideration of responsible executive pay;
and
- The steps we take to give our clients objective, unbiased advice and help them discharge their responsibilities.

The Compensation Committee of a company's board of directors has the responsibility to determine the appropriate level and types of compensation for the company's senior executives. Mercer executive compensation consultants provide advice on the design and implementation of executive compensation programs in support of aligning executive performance with shareholder interests and the company's business strategy. Depending upon the company's need, the consultant may provide these services to a company's management or to a company's Compensation Committee. The primary roles of a compensation consultant to a Compensation

Committee are (i) to help the Committee establish a philosophy regarding executive pay that provides the backdrop for specific program design, and (ii) to provide a context of objective and expert analysis, advice, and information to assist the Compensation Committee in its decision-making role. Generally, the consultant is responsible for providing the Compensation Committee with the information it requests for use in its decision-making process. Inherent in that responsibility is working with the Compensation Committee to help it understand the choices available to it as well as the tax, accounting, disclosure, regulatory, and human resource implications of those choices.

In addition to providing executive compensation consulting services like those described above, Mercer and its affiliates provide a wide variety of products and services in the consulting, outsourcing and investments arenas to companies, their benefit plans, and employees. For example, among other things, Mercer provides (i) plan design, actuarial valuation, investment consulting, investment management and administration services to defined benefit pension plans; (ii) consulting, insurance brokerage and administration for health and welfare plans; and (iii) human resource consulting to HR departments and senior management.

Mercer is aware that some have raised concerns that providing executive compensation services as part of a diversified business model could present a potential conflict of interest. The critical issue, which the Committee has identified, is whether potential conflicts of interest are prudently and effectively managed and disclosed. Mercer has recognized this and other potential stresses on executive compensation decision making, and elected to take a market leading position on the need for a more responsible approach to the process.

Mercer's Global Business Standards

In 2005, Mercer developed and implemented Global Business Standards for managing our business and the potential conflicts of interest that may be present in advising boards of directors on executive compensation issues. These Global Business Standards – which are revised periodically – are the central governing document for our executive compensation consulting business. We believe that these standards -- which are provided to all of our clients -- enhance transparency and establish a framework for the effective management of these issues by Mercer and our clients and allow Mercer executive compensation consultants to provide high-quality, unbiased advice to a Compensation Committee.

Mercer's Global Business Standards address how we (i) manage the executive compensation consulting relationship, (ii) ensure the quality of executive compensation consulting services, and (iii) structure our business to manage potential conflicts of interest.

Clear and Transparent Relationship with Clients

A clearly defined client relationship provides the foundation for ensuring the objectivity and integrity of our advice. At the beginning of each engagement, our consultants establish with clients a clear mutual understanding of our role and client reporting relationship, premised on our commitment to providing objective advice.

An Engagement Letter documents the key elements of the assignment and relationship: roles, responsibilities, scope of services, fees, timeframe and client reporting relationships, including how and to whom information and recommendations are communicated. For example, Engagement Letters with a Compensation Committee include disclosure of Mercer's other

financial relationships with the company, if any. In addition, where we work with management to develop a compensation proposal, our Engagement Letter also specifies that management cannot attribute findings or recommendations to Mercer in meetings with the Compensation Committee unless Mercer is present in those meetings.

Ensuring the Quality of our Advice

Mercer is committed to providing advice that is both objective and of the highest quality. To carry out our professional standards, executive compensation consulting services are performed only under the direction of a human capital business principal. These individuals comprise our most senior consultants and each possesses extensive experience in the executive compensation field. Mercer's professional standards require that all consulting advice be peer reviewed before it is rendered. Mercer has also developed a framework for working with clients in the four critical areas of executive compensation (remuneration, performance, regulations, and governance) to help clients avoid focusing too much on pay competitiveness at the expense of performance against peers and prudent governance of the programs.

Structuring our Business

The structure of our business not only facilitates the exchange of our best thinking, but also demonstrates to employees and clients the integrity of our advice. Our human capital business leaders -- not client relationship managers or other sales-focused employees -- evaluate performance and determine compensation for all executive compensation consultants. Our executive compensation consultants report through the human capital line of business and are ultimately accountable to me, as the business president, for their performance. Executive

compensation consultants are not compensated based upon client revenue from other Mercer lines of business.

Our Global Business Standards require our consultants to seek guidance from the human capital business leadership whenever there is any question that our objectivity or integrity is at risk of being compromised. Consultants may discontinue executive compensation consulting relationships where apparent or actual conflicts that would impact the quality or objectivity of our advice cannot be resolved to both our clients' and our satisfaction.

A Solution for Independence – Independent Oversight Model

Some Compensation Committees need the breadth and depth of resources that Mercer can provide, but desire to take additional steps to demonstrate the independence of the executive compensation advice that they receive. To address this issue, we are recommending to these clients that their Compensation Committees retain a separate “independent advisor” who can consult with the Compensation Committee on matters of compensation policy, review compensation plan proposals, and support the Compensation Committee as it discharges its review and approval responsibilities. The independent advisor performs no other work for the company, including no design or implementation work pertaining to the compensation programs it is reviewing and on which it is advising the committee. Management or the Compensation Committee retains whatever additional resources they need, including a company such as Mercer, to design and implement the company's compensation programs. We believe this Independent Oversight Model gives the Compensation Committee the freedom and flexibility to engage other advisors to perform other aspects of executive compensation work and still fulfill any need that they be able to demonstrate the “independence” of advice received.

Conclusion

Mercer is committed to providing objective and unbiased executive compensation advice to our corporate clients. Accordingly, we have taken proactive steps to build industry standards through our Global Business Standards, and through our Independent Oversight Model. We have also taken prudent and appropriate steps to protect the integrity of our advice and recommendations. We also will continue to review our Global Business Standards to meet the challenges of an ever-changing marketplace for our services. The obligation to provide uncompromised advice in this area so that corporate boards may make executive compensation decisions that are consistent with their fiduciary duties to shareholders is one that all executive compensation firms should share. Thank you for inviting us to participate in today's hearing. I look forward to answering any questions the Committee has in pursuit of this important goal.

Chairman WAXMAN. Thank you very much, Mr. Scott.
Mr. Powers.

STATEMENT OF MICHAEL POWERS

Mr. POWERS. Good afternoon, Chairman Waxman and members of the committee. I'm Michael Powers. I am our global practice leader at Hewitt for executive compensation and corporate governance consulting. Thank you for the opportunity to appear before you today.

I will be discussing our role in the executive compensation decisionmaking process, as well as the policies and safeguards we follow to ensure that we provide objective and unbiased counsel.

Hewitt takes very seriously its obligation to provide sound, informed, independent advice. Companies and boards of directors engage our services because of our strong and longstanding reputation for both quality and objectivity.

It is important to note that our role in determining executive compensation is strictly as an advisor. It is up to each company's compensation committee, as part of their fiduciary responsibility to shareholders, to decide on the process it will follow, the input it will consider and, ultimately, the final design and amount of executive compensation arrangements.

Compensation committees have a complex task in managing executive pay decisions. They often review a wide variety of information. This might include data on both what and how other peer organizations pay, the company's recent or long-term financial performance, the returns generated for shareholders, the company's prospective leadership needs and the demand for talent in that industry. They may also rely on input from senior management, legal counsel, executive recruiters or other consultants.

By working with a multi-service consulting firm, Hewitt's comp committee clients have access to perhaps the broadest array of global resources, comprehensive market data, and design and technical experts. The information and advice Hewitt provides are just one of many sources that a board's comp committee may draw on to meet its fiduciary obligation to make appropriate pay decisions.

Hewitt employs a number of practices and procedures to ensure the independence of our executive compensation services. These safeguards have evolved over time, and we certainly adopt new ones in an ongoing process of establishing and improving best practices.

Hewitt's executive compensation consulting services are a separate business unit. As part of that structure, our executive pay consultants are paid solely based on the results of that unit and their own individual performance.

Our additional safeguards are also recognized as best practices. These would include establishing distinct engagement agreements directly with our comp committee clients that detail our role and responsibilities as the committee advisor; proactively providing summary disclosures to our comp committee clients detailing all Hewitt services provided to the company; adhering strictly to internal and external confidentiality requirements regarding all client information; strictly following Hewitt's code of conduct and professional standards prohibiting public disclosure and discussion of cli-

ent-specific information; enforcing a policy prohibiting a Hewitt employee from directly investing in the client organizations they serve; and establishing separate overall account management by professionals who are not involved in executive compensation consulting.

In our experience, most compensation committees have both thoroughly and regularly reviewed perceived and potential conflicts-of-interest issues and have arrived at informed conclusions tailored to their unique situations. In some cases, boards have chosen to require exclusive relationships with their executive compensation consultants. Other boards have taken different approaches to ensure they are receiving high-quality, independent advice, including evaluating the advice given, monitoring fees paid, restricting the provision of additional services, and the use of the two-consultant model.

To conclude, we provide information and perspectives to help our clients design effective executive pay programs. Our approach enables our clients to make decisions based on the best available data and advice.

But at the end of the day, we believe executive pay levels are driven primarily by global market forces. The competition for the talent pool of qualified men and women who are capable of effectively leading and managing complex organizations has intensified. Increasingly, companies are bidding for the services of this same cadre of talented executives, a trend which is expected to continue.

Our role as compensation consultants is to help our clients attract, retain and motivate the leaders they need to run successful global companies and to advise compensation committees on best practices.

Thank you for this opportunity to discuss Hewitt's executive compensation practices and safeguards. And we're happy to take questions from committee members.

[The prepared statement of Mr. Powers follows:]

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Testimony

of

Michael J. Powers

Hewitt Associates LLC

before

House Committee on Oversight and Government Reform

on

**“Executive Pay and the Role of the Compensation
Consultant”**

December 5, 2007

Introduction

Chairman Waxman, Ranking Member Davis, and Members of the Committee, my name is Michael J. Powers. I am the Hewitt Associates Global Practice Leader for Executive Compensation and Corporate Governance Consulting. Thank you for the opportunity to appear before the Committee today on this important subject. In accordance with the Committee's request, today I will discuss Hewitt's role as an executive compensation consultant and describe the policies we follow to provide advice on executive compensation to our clients.

We respect the Committee's concern in addressing perceived and potential conflicts of interest that may arise from the engagement of an executive compensation consultant. In recent years, corporate scandals and volatile company performance have generated shareholder dissatisfaction with the current pay practices of some public companies, intensifying the spotlight on senior executives, their compensation packages and those who are involved in determining those packages. These circumstances and the resulting media attention and regulatory scrutiny have contributed to the ongoing evolution in corporate governance, and in how consultancy services are provided to management, Compensation Committees, and Boards of Directors.

Hewitt Associates has more than a 65-year tradition of providing innovative, value-driven solutions to help our clients around the world address their complex human capital challenges. Hewitt's executive compensation consulting services play an important role in our portfolio of Human Resources disciplines. Today, we have approximately 23,000 employees in 33 countries who deliver Human Resources solutions and services that help our clients reach their business objectives. Our leadership, reputation, capabilities and relationships set the benchmark in our industry.

Hewitt has provided executive compensation consulting services to a wide range of companies – large and small, public and private – for nearly thirty years. Hundreds of companies and their boards choose to work with us because of our integrity, experience, professionalism, objectivity and access to a global array of market data and specialist resources.

The Compensation Process

Today's successful companies need talented, effective and motivated leaders. Among the most important and complex responsibilities of a company's Board of Directors is the approval of executive pay programs that both attract and retain strong leaders.

In most public companies, a Board's Compensation Committee establishes compensation philosophies specific to their organization. In our experience, sound compensation philosophies align executive pay with shareholder interests, reward the achievement of financial or strategic results, meet certain competitive standards within the company's specific labor market, and attract and retain the talent needed to lead the company. These philosophies and the resulting programs that support them are unique to the business strategies of each organization.

Determining executive pay is a complex undertaking whereby Compensation Committees often review a variety of information and seek perspectives from a variety of disciplines when applying that philosophy to make sound executive pay decisions. This might include data on what and how other peer organizations pay, the company's recent or long-term financial performance, the returns generated for shareholders, the company's prospective leadership needs, and the demand for talent in their industry. In reaching conclusions, effective Compensation Committees exercise business judgment based on the information they review, the

perspectives provided by management or third parties, and the individual perspectives of each Committee member.

Hewitt's Executive Compensation Services

Hewitt delivers a broad array of services in the area of benefits and compensation for senior executives.

As an executive compensation consultant, Hewitt provides competitive market data and perspectives that help companies and their governing bodies make informed business judgments around executive pay. Companies or their Compensation Committees may engage us to help in a variety of ways, including:

- Development and articulation of compensation philosophies and strategies.
- Design of compensation programs aligned with the company's business strategy, especially short- and long-term incentive plans.
- Evaluation of compensation components or the total compensation provided by similarly situated peer companies, for senior executive positions. In fact, providing high-quality, global competitive market data on executive compensation is a significant part of our business.
- Assessments of absolute and relative company performance against company goals, competitive industry norms, and shareholder expectations.
- Review of technical issues associated with executive compensation programs, including new or pending regulations, tax and accounting treatment, and SEC disclosure requirements.
- Suggestions on process and protocol to enhance Committee governance and oversight.

- Participation in Compensation Committee meetings where decisions on executive pay are made, including executive sessions where management is not present.

Providing this range of services requires experience and expertise in many related disciplines. Our Compensation Committee clients oversee the development, assessment, reward and succession of key leadership positions. The compensation programs they manage cover multiple components, such as base salary, annual incentives, long-term incentives, and retirement and financial security programs. By working with a multi-service consulting firm, Hewitt's Compensation Committee clients have access to perhaps the broadest array of global resources, comprehensive market data, and design and technical experts available across these diverse and complex fields.

However, our information and perspectives are but one of many sources that a board's Compensation Committee may draw from to meet their fiduciary obligation to make appropriate pay decisions. Committees may periodically seek input from senior management, inside counsel, outside counsel, executive recruiters, or other management consultants as part of this process. It is important to note that companies and their boards do not always ask for our counsel and they are not required to follow our suggestions or recommendations, or those of other advisors.

In our experience Compensation Committees understand the importance of their oversight responsibility on executive pay. Today they are more focused than ever on due diligence, the duties of care and good faith to the organization and its core stakeholders, and on meeting the myriad requirements of the SEC, stock exchanges, and other federal and state laws.

Independent and Objective Advice

Hewitt takes very seriously its obligation to provide sound, objective, and informed advice to our clients. Companies and Boards of Directors engage our services because of our strong and longstanding reputation for quality and objectivity. Compromising independence in any of our consulting services would both contradict our values and jeopardize our reputation.

While we recognize that the potential for conflicts of interest can be found in any professional services firm, Hewitt employs a number of practices and procedures to ensure independence in our executive compensation services. These safeguards have evolved over time, and we regularly adopt new ones as corporate governance and regulatory standards continue to change in an ongoing process of establishing and improving best practices.

We segregate Hewitt services associated with executive compensation consulting into a single, separate business unit within Hewitt. As part of that structure, our executive compensation consultants are paid solely based on the results of the executive compensation business unit, and not based on the performance of any other business unit or any other aspect of Hewitt's performance. Executive compensation consultants are not eligible for Hewitt equity awards. We also proactively provide summary disclosures to Compensation Committee clients of all of Hewitt's services to the company.

These additional safeguards supplement our long-standing and recognized Best Practices which include:

- Establishing engagement agreements directly with our Compensation Committee clients that specify our role and responsibilities as Committee advisor and that are distinct from agreements for our other services.

- Adhering to strict internal and external confidentiality requirements regarding client information and Hewitt's strong code of conduct, including public disclosure and discussion of client-specific information.
- Enforcing a strict policy against a Hewitt employee's direct investment in the client organizations they serve.
- Maintaining separate account management. Our large multi-service clients are managed by professional account executives who are not involved in the provision of consulting services to the client's Board of Directors.
- Following additional safeguards and policies as appropriate to satisfy individual client requests or needs and governance practices.

In our experience, most Compensation Committees have both thoroughly and regularly reviewed perceived and potential conflicts of interest issues and have arrived at informed conclusions tailored to their unique situations. We respect that some boards have chosen to require exclusive relationships with their executive compensation consultants. Other boards have taken different approaches to ensure they are receiving high-quality independent advice – including evaluating the advice given, monitoring fees paid, restricting the provision of broader services, use of a “two-consultant” model, or employing other oversight procedures. We have proactively discussed these approaches with clients and will continue to help them evaluate the best course of action based on their unique circumstances.

Our Active Role in Governance

We have both supported and contributed to the goals of the SEC's new executive compensation disclosure requirements to better inform shareholders about the scope of executive

pay packages. Public companies must now identify their compensation advisor, who engaged the consultant, the nature and scope of the assignment, and the direction given to the consultant. In fact, the SEC referenced numerous Hewitt contributions to the new disclosure requirements in its release of the final rules. We believe these new rules are having a significant positive effect and we are providing additional input to both the SEC and our clients.

We also regularly provide input to large institutional investors and their advisors to help them understand the compensation process and develop effective means to evaluate complex executive compensation issues.

Our consultants also write frequently and serve as speakers to industry groups on suggested Compensation Committee best practices for exercising sound governance and compensation program oversight.

Important Differences from Independent Audit Services

Recent corporate governance initiatives have resulted in the limitation of additional services that independent auditors of public companies can provide to audit clients, due to perceived conflicts of interest. While some may draw parallels between the roles of independent auditors and compensation consultants; in our view, there are important differences in the services we provide as compensation consultants.

- Auditors certify that financial disclosures are complete and accurate, and meet specific standards set forth by the Financial Accounting Standards Board (FASB) and other standard-setting bodies. Investors and lenders rely on this information in making investment and capital allocation decisions. In contrast, there is no corollary for executive

compensation consultants. Compensation consultants do not make public certifications about executive pay that are relied upon by investors, lenders or other third-parties.

- Prior to the required filing of its financial statements with the SEC, a public company must obtain certification from its independent auditor that the financial statements have been prepared in accordance with applicable accounting and auditing standards. Any material disagreement between a company and its auditor may result in the issuance of an adverse opinion by the auditor or, if necessary, the auditor's resignation and the public disclosure of the points of disagreement. Conversely, Compensation Committees are not obligated to agree with our analyses, adopt our recommendations or follow our advice. The Compensation Committee exercises its own independent judgment, and sometimes uses more than one compensation consulting firm. Compensation consultants like Hewitt represent an outside perspective with no vote or veto power on the ultimate actions taken.

While we view the legal and functional roles of auditors and compensation consultants to be very different we have embraced several of the safeguards employed in that context. These include reporting directly to the Compensation Committee; eliminating incentives to cross-sell services; disclosing to the Compensation Committee other services provided to the company; and pre-approval of future services, if required by the Compensation Committee. We believe these steps to be an appropriate response to help Compensation Committees to evaluate any perceived conflict.

The Foundation to Exercise Independence

In our experience, the large majority of Compensation Committees for public companies manage sound and transparent executive compensation programs. We believe the services Hewitt provides help these companies meet their high standards of governance and oversight.

We believe executive pay levels are driven primarily by global market forces. A relatively small talent pool exists of the men and women who are capable of effectively leading and managing complex global organizations. Companies worldwide are bidding for the services of this cadre of talented executives and the “war for talent” is only expected to intensify in the coming years.

We do not believe, and have seen no empirical data supporting the notion that the executives at companies where Compensation Committees have engaged multi-service firms such as Hewitt are paid consistently more or less than executives at companies where Compensation Committees have engaged single-service firms.

As a company with more than 3,000 active client relationships for a broad range of Human Resources consulting and administrative services and \$3 billion in revenue, our consultants have the freedom to provide completely independent advice without any concern for the viability of our business. We alert our clients that we fully expect that they may not always agree with our opinions or perspective, and we believe our Compensation Committee clients both expect and respect that position.

We are committed to our clients and believe we have earned our leadership position as a human resources services firm, and in the executive compensation business because of the quality of our work and the objectivity of our counsel. Having a strong executive compensation consulting practice is an important component of Hewitt’s total Human Resources solutions

strategy. We receive positive feedback regarding the quality of our work and the objectivity of our advice from both our Compensation Committee clients and our management clients. We employ appropriate safeguards to ensure the quality and independence of our advice, and our consulting professionals carry out their responsibilities with the highest level of commitment and integrity.

We are proud of our role in promoting strong corporate governance practices and helping our clients effectively manage their pay programs.

Thank you again for the opportunity to present our views today on these important issues.

Chairman WAXMAN. Thank you very much, Mr. Powers.
Mr. Paulin.

STATEMENT OF GEORGE PAULIN

Mr. PAULIN. Thank you, Mr. Chairman, members of the committee. My name is George Paulin. I'm the chairman and CEO of Frederick W. Cook & Co. Our firm has about 60 employees.

Currently, we are independent advisors on executive compensation to the board compensation committees at 27 of the Fortune 100 companies. We've got a number of other clients with which we work directly with board compensation committees or, in fewer cases, separately with management. Our services include analyzing and recommending compensation levels and compensation program design. We advise on how much to pay and how to pay—the whole gamut of executive compensation.

We provide no other services except executive compensation consulting. We are 100 percent owned by our senior consultants. We have no outside equity or reciprocal financial relationships. We don't sell any services or products other than executive compensation consulting.

And this has been the model of our firm by design since it was founded in 1973, 35 years ago. And I have been with the firm 26 of those 35 years. We designed it this way with the specific purpose of avoiding business conflicts that would potentially compromise our objectivity in advising on sensitive executive compensation matters.

There are two overriding reasons, in my mind, why board compensation committees need their own source of independent expert counsel on executive compensation. The first is a legal reason. I'm not a lawyer, but my understanding of Delaware law is that outside directors are bound by a duty of care. The duty of care includes the exercise of due diligence, where the use of expert advisors has been encouraged, as recently demonstrated by the decision in the Disney case. If those advisors aren't independent or are deemed to have a conflicting interest, then the directors could be at risk for not fulfilling their responsibility to the shareholders in terms of the duty of care.

The other reason is a practical one. It's the need to balance resources available to and beholden to management, which are not only vast but inherently less than objective. Compensation committees don't have any staffs. They meet three or four times a year to make complex and often contentious decisions. As a matter of routine, they should have credible, unbiased, professional support that they can trust, in the same way that audit committees rely on outside accountants.

Basic economics inevitably creates business conflict with regard to advising compensation committees and providing other services to the same corporations, especially when these other services are financially more lucrative. And any of my colleagues here will agree that revenues from actuarial consulting, insurance commissions, human resources, outsourcing services, pay-survey data bases can be tens of times executive compensation consulting revenues.

To avoid such conflict, we believe that consultants chosen to be the independent advisors to board compensation committees should, in fact, be independent from management. They shouldn't be allowed to conduct other business with or provide other services to those same organizations.

A simple solution can be taken right from the New York Stock Exchange rules, which would be to apply the same definition of independence to the compensation consultants in their firms that already apply to the directors who serve on the compensation committees.

Assuming a definition of independence for compensation committee advisors similar to the one for directors in the New York Stock Exchange rules were adopted, then there'd be a question of what's the appropriate relationship between the independent consultant and management. Should the independent consultant merely serve in an audit capacity, reviewing analyses and recommendations prepared by management and its advisors, or should it work cooperatively with management in developing the analyses and recommendations?

Based on many years of experience, we believe that the latter approach provides a better-informed and more effective governance process. There is conflict, maybe, but any potential we feel can be controlled here by simply having a sensible process where the compensation committees would hire and fire the independent consultant; make clear that the consultant's sole responsibility is to the committee and that any interaction with management is on behalf of the committee and as the committee's agent; approve the scope of the consultant's involvement that doesn't go beyond direct support for the committee; act directly with the consultant in identifying peer companies for competitive benchmarking to finding the pay philosophy and setting CEO pay; meet regularly with the consultant in executive session without management; and fully disclose the relationship and the fees to shareholders in the proxy statement.

Thank you for the opportunity to make these comments and for the committee's concern with improving the fairness and effectiveness of executive compensation practices, which are an important element of the American economy.

[The prepared statement of Mr. Paulin follows:]

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**Congress of the United States
House of Representatives
Committee on Oversight and Government Reform
Hearing on Executive Compensation Consultants' Independence**

**Testimony of George B. Paulin
Chairman & CEO
Frederic W. Cook & Co., Inc.
December 5, 2007**

Background of Our Firm

Currently, we are independent advisors on executive compensation to the board compensation committees at 27 of the *Fortune* 100 companies. We also have many other clients with which we work either directly for their compensation committees or, separately, for management. Our services include analyzing and recommending compensation levels and compensation program design, i.e., how much to pay and how to pay.

We provide no services except executive compensation consulting. We are owned 100% by our senior consultants and have no outside equity or reciprocal financial relationships. Furthermore, we do not sell or represent any products. This has been our model since we were founded in 1973, with the specific purpose of avoiding business conflicts that could potentially compromise our objectivity in advising on sensitive executive compensation matters.

Why Independence Is Important

There are two overriding reasons why board compensation committees need their own source of independent expert counsel on executive compensation.

The first is a legal reason. I am not a lawyer, but my understanding of Delaware law is that outside directors are bound by a "duty of care." The duty of care includes the exercise of due diligence where the use of expert advisors is encouraged, as recently demonstrated by the decision in the Disney case. If the advisors are not independent or are deemed to have a conflicting interest, then directors could be at risk for not fulfilling their responsibility to shareholders.

The second is a practical reason. It is the need to balance resources available to and beholden to management, which are not only vast but inherently less than objective. Compensation committees have no staffs. They meet three-or-four times a year to make complex and often contentious decisions. As a matter of routine, they should have credible unbiased professional support that they can trust in the same way that audit committees rely on outside accountants.

Future Safeguards

Basic economics inevitably creates business conflict with regard to advising compensation committees and providing other services to the same corporations, especially when the other services are financially more lucrative. (Revenues from actuarial consulting, insurance commissions, human resources outsourcing, and pay survey databases can be tens of times executive compensation consulting revenues.) To avoid such conflict, we believe that consultants chosen to be "independent" advisors to board compensation committees should be, in fact, independent from management. They should not be allowed to conduct other business with or provide other services to those corporations. A simple solution taken right from the New York Stock Exchange rules (NYSE Rule 303A.02 Independence Tests) is to apply the same **definition** of independence to the compensation consulting firms that is already applied to directors who serve on the compensation committees.

Assuming a definition of independence for compensation committee advisors similar to the one for directors in the NYSE rules were adopted, then what is the appropriate relationship between the independent consultant and management? Should the independent consultant merely serve in an audit capacity reviewing analyses and recommendations prepared by management (and its advisors), or work cooperatively with management in developing these analyses and recommendations? Based on experience, we believe the latter approach provides a better-informed and more-effective process. Any potential conflict can be controlled by simply having the compensation committee: (1) hire and fire the independent consultant; (2) make clear that the consultant's sole responsibility is to the committee, and that any interaction with management is on behalf of the committee and as its agent; (3) approve the scope of the consultant's involvement that does not go beyond direct support for the committee; (4) act directly with the consultant in identifying peer companies for competitive benchmarking, defining the pay philosophy, and setting CEO pay; (5) meet regularly with the consultant in executive session without management; and (6) fully disclose the relationship and fees to shareholders in the proxy statement.

Thank you for the opportunity to make these comments and for your concern with improving the fairness and effectiveness of executive compensation practices, which are an important element of the overall American economy.

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Chairman WAXMAN. Thank you very much, Mr. Paulin.
Mr. Reda.

STATEMENT OF JAMES REDA

Mr. REDA. Good afternoon, Mr. Chairman, Ranking Minority Member Tom Davis and other members of the committee. My name is James Reda, and I'm founder and managing director of James F. Reda & Associates, based in New York City.

I'm an independent compensation advisor to numerous publicly traded corporations, with over 20 years of executive compensation consulting experience. I'm the author of over 20 articles and two books. My most recent book, entitled, "The Compensation Committee Handbook," is now in its third edition. In addition, I was a member of the National Association of Corporate Directors' Blue Ribbon Commission entitled, "Executive Compensation and the Role of the Compensation Committee."

I am in favor of providing corporate board members with a higher standard of disclosure to verify the independence of compensation advice they receive from consulting firms. This recommended disclosure would be similar to that found in the audit committee report so crucial in making the audit process independent of senior management. Such an added disclosure could help remedy the negative perception executive compensation holds with shareholder groups, the public and the media.

Like the audit firms before Sarbanes-Oxley, providers of compensation advice, which I will refer to as diversified human resources consulting firms, have significant economic incentives to provide additional services which are oftentimes more lucrative and beyond executive compensation. These other services include human resources consulting, business process outsourcing, information technology consulting, risk and insurance underwriting, and actuarial consulting.

We estimate that compensation consulting services represent 0.5 percent to 2 percent of the diversified HR consulting firm revenues. A large part of the other 98 percent to 99.5 percent of revenues comes from the same companies who also use compensation consulting services. When you combine the access and impact that executive compensation consultants have on a client with the need to sell other services, you have a prescription for heavy cross-selling activities where executive compensation consultants lead the charge and as a result are conflicted.

Consider for a moment: If the firm providing advice to the board of directors on CEO and VP of HR pay is also providing other service to the CEO and VP of HR, how can the board ensure the consulting firm's recommendations are independent and objective? Even if the compensation consultant is not providing other services to management but has the potential to provide such services, the public may perceive a direct conflict of interest and lack of independence.

While some diversified HR consulting firms may also use a Chinese wall or a firewall to separate their compensation advice from other consulting services, there remains the perception that a conflict of interest exists. A Chinese wall or firewall simply does not

work, as shown in other areas such as accounting and investment banking.

There are a growing number of independent firms like my firm made up of experts that formerly worked at large, diversified HR consulting firms. These independent experts continue to offer compensation advice but without any potential or perception of conflict of interest. The use of independent consulting services can only help quiet the critics of executive compensation, provide additional transparency to shareholders, and benefit American business.

In my letter to the SEC of April 2006, I recommended that the Commission take action to shed light on this issue and improve the independence of competition committee operations by requiring further disclosure on compensation consultant independence. The recommended disclosures include, among other items, a table presenting fees paid to compensation consultants for executive compensation consulting services and all other fees paid to the consultant's firm or affiliated firms for other services. But as it stands today, the SEC disclosure rules stop short of requiring a detailed list of duties and fees. This reinforces the public perception that the compensation consulting profession is not helping and perhaps even exacerbating problems with executive pay.

We seek to change this. My independent advisor colleagues and I offer no additional unrelated services to management. We view the compensation decisionmaking process as crucial and in the best interest of shareholders and American business. In this way, U.S. Corporations can implement executive compensation programs that truly pay for performance and will help improve our companies' credibility at home and abroad.

Thank you for the opportunity to testify on this important issue.
[The prepared statement of Mr. Reda follows:]

**United States House of Representatives
Committee on Oversight and Government Reform
Room 2154, Rayburn House Office Building
Testimony for the December 5, 2007 Hearing on:**

**Executive Pay: The Role of Compensation Consultants
By James F. Reda**

Founder and Managing Director
James F. Reda & Associates, LLC
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Good morning Mr. Chairman, Ranking Minority Member Tom Davis, and other members of the Committee, I thank you for this opportunity to speak to you on the role compensation consultants play in determining the pay for senior corporate executives, and the importance of independent compensation advice. My name is James Reda, and I'm the Founder and Managing Director of James F. Reda & Associates, based in New York City. I am an independent compensation advisor to numerous publicly-traded and privately held corporations, with over 20 years of executive compensation consulting experience. I am the author of over twenty articles and 2 books, one of which is in its third edition, entitled *The Compensation Committee Handbook*, co-authored with my colleagues Stewart Reifler and Laura Thatcher. In addition, I was a member of the National Association of Corporate Directors' Blue Ribbon Commission entitled "Executive Compensation and the Role of the Compensation Committee," which was initially published in 2003.

My comments today are adapted from a letter, which I sent on behalf of my firm, to the Securities and Exchange Commission as they renewed their Proposed Rules on Executive Compensation and Disclosure. The purpose of this letter to the SEC, and my testimony today, is to focus more attention on an independent decision-making process for corporate Boards of Directors in setting senior executive pay, particularly in relation to outside compensation advisors.

I am in favor of providing corporate board members with a higher standard of disclosure to verify the independence of the compensation advice they receive from consulting firms. This

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December 5, 2007
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recommended disclosure would be similar to that found in the Audit Committee Report, so crucial in making the audit process independent of senior management. Such an added disclosure could help remedy the negative perception executive compensation holds with shareholder groups, the public and the media.

Compensation Committees, those members of a corporate Board responsible for setting senior executive pay, always need to take a hard look at compensation levels and continually reassess their operations from start to finish. Though there is an evolving set of best practices, including pay-for-performance, the difficulty of board members' work is that there is not one "right" compensation level or philosophy that works for all companies at all times. Therefore, board members seek outside expertise from advisors to provide them with a view of competitive market levels of executive pay, and to review all aspects of executive compensation, including base salaries, annual cash incentives or bonuses, long-term incentives, and stock awards.

Like the audit firms before Sarbanes-Oxley, traditional providers of compensation advice, which I will refer to as diversified Human Resources Consulting firms, have significant economic incentives to provide additional services, which are oftentimes more lucrative, beyond executive compensation, include business process outsourcing, information technology consulting, risk and insurance underwriting and actuarial consulting. Consider for a moment: if the firm providing advice to the board of directors on CEO and HR Director pay is also providing other services to the CEO and HR Director, how can the board ensure the firm's recommendations are independent and objective? Even if the compensation consultant is not providing other services to management but has the potential to do so, the public still *perceives* a direct conflict-of-interest and lack of independence. While diversified HR firms may also use a "firewall" to separate their compensation advice from the other consulting services, there remains the perception that a conflict-of-interest exists.

JAMES F. REDA
& ASSOCIATES, LLC

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In a 2006 report, the Conference Board Global Corporate Governance Research Center, a not for profit research organization focusing on corporate governance best practices, likened this situation to that between audit committees and outside auditors prior to the Sarbanes-Oxley Act. To quote briefly from that report:

The [Sarbanes-Oxley] Act, as implemented, mandates that independent audit committees control this relationship by making them solely responsible for the hiring, firing, compensation, and monitoring the independence and performance of the outside auditors... These limitations have strengthened the integrity of the outside audit by effectively eliminating economic incentives for the auditors to curry favor with management to preserve and expand lucrative non-audit consulting contracts, rather than focusing all efforts on the independent audit and audit-related services. Compensation committees can find themselves in an analogous position if their consultants stand to profit more from the work performed for management, rather than services provided to the [Compensation] committee. (Page 15)

Having identified this potential for a conflict-of-interest and the demand for objective, independent compensation advice, there are a growing number of independent firms, like my firm, made-up of experts that formerly worked at large diversified HR firms. These independent experts continue to offer compensation advice but *without any potential or perception* for conflict-of-interest. This can only help quiet the critics of executive compensation, provide additional transparency to shareholders and benefit American business.

In my letter to the SEC, I recommended that the Commission take action to shed light on this issue and improve the independence of Compensation Committee operations by requiring

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further disclosure which pertains to compensation consultant independence. The recommended disclosures include:

1. The procedure the Compensation Committee follows in choosing a compensation consultant and a declaration by the Compensation Committee identifying its position on the degree of independence of its executive compensation consultant,
2. A table presenting fees paid to compensation consultants for executive compensation consulting services and all other fees paid to the consultants' firm or affiliated firms for other services,
3. The type of work performed by the compensation consultant, and finally
4. The relative fee structure for work performed for the Compensation Committee and for management, if applicable.

Additionally, we recommend that the Compensation Committee provide a description of the type of work performed when the compensation consultant works with management.

But as it stands today, the SEC's disclosure rules stop short of requiring a detailed list of duties and fees. This reinforces the public perception that the compensation consulting profession is not helping and perhaps even exacerbating problems with executive pay.

We seek to remedy this. My independent advisor colleagues and I offer no additional unrelated services to management. We view the compensation decision making process as crucial and in the best interest of shareholders and American business to remain truly independent of any and all other consulting. This way, publicly-traded US corporations can implement executive compensation programs that truly pay-for-performance and will help improve our companies' credibility at home and abroad.

Thank you for the opportunity to testify on this important issue.

JAMES F. REDA
& ASSOCIATES, LLC

Supplemental Materials and References for Testimony of December 5, 2007

Submitted by James F. Reda

- 1. House Rule XI clause 2(g)(4) Disclosure**
- 2. James F. Reda & Associates, LLC Firm Description**
- 3. Biography and Curriculum Vitae of James F. Reda**
- 4. James F. Reda & Associates, LLC Comment Letter Re: File No. S7-03-06; Proposed Rules on Executive Compensation and Related Party Disclosure, Items 402 (b) and 407 (e) of Regulation S-K submitted to the U.S. Securities and Exchange Commission on April 6, 2006**

List of Additional References

"Executive Compensation: If There's a Problem, What's the Remedy? The Case for Compensation Discussion and Analysis," by Jeffrey N. Gordon of Columbia Law School, The Center for Law and Economic Studies Working Paper No. 273/2006 forthcoming, Journal of Corporation Law (Summer 2006), available at <http://ssrn.com/abstract=686464>.

"The Evolving Relationship Between Compensation Committees and Consultants," by Carolyn Kay Brancato and Alan A. Rudnick, The Conference Board Global Corporate Governance Research Center, January 2006, available at www.conference-board.org

"Executive Compensation Consulting, A Research Working Group Report on Best Practices," by Charles Peck and Jude Rich for The Conference Board, September 2005, available at www.conference-board.org.

The Conference Board Commission on Public Trust and Private Enterprise, January 2003, available at www.conference-board.org.

House Rule XI clause 2(g)(4) Disclosure

House Rule XI clause 2(g)(4) requires that witnesses appearing in a nongovernmental capacity submit to the Committee in advance of the hearing "a curriculum vitae and a disclosure of the amount and source (by agency and program) of each Federal grant (or subgrant thereof) received during the current fiscal year or either of the two previous fiscal years by the witness or by an entity represented by the witness."

See Supplemental Materials Section 3 for James F. Reda' curriculum vitae

No member of James F. Reda & Associates, LLC has received any Federal grant in the last two previous fiscal years



About James F. Reda & Associates, LLC
www.ifreda.com

James F. Reda & Associates is an independent compensation and corporate governance consulting firm that works with clients to develop pay structures, manage their talent, and improve their economic performance. Headquartered in New York City, JFR's principal consultants have over 75 years of combined experience with compensation consulting, designing, implementing and communicating performance-oriented compensation programs.

We believe in exceeding our client's expectations.

At James F. Reda & Associates, our clients trust us to provide independent expert compensation advice, whether to the board of directors, compensation committee or executive team. In light of today's environment of public scrutiny around compensation, we are able to maintain an objective focus for our clients by providing them solely with compensation and governance services. Our independent focus translates to more personal contact and a quicker response time from our team, without the pressure to sell additional services. We exceed expectations by providing compensation and governance plans that stand up under scrutiny and deliver true pay-for-performance.

We provide total compensation consulting services for executives, employees and outside directors, and engage in three broad practice areas:

- Total Compensation Services
- Corporate Governance Advisory Services
- Special Situation Services

Strategies Aligned with Business Goals

Our compensation strategies are anchored in what drives your business.

At James F. Reda & Associates, we align the interests of our client's management team with its most critical stakeholders by designing, implementing, and communicating performance-oriented compensation programs that improve the bottom-line.

Our experienced practitioners take pride in our objectivity and singular focus on executive compensation and governance consulting, and place compensation in a broader context that includes recruitment, retention, and performance management.

Discover how our independent, seasoned professionals can provide perspective on your compensation and governance issues. Contact us at (646) 367-4460. For additional articles and information on compensation, visit us online at www.ifreda.com.

Our Consulting Services

We consult with clients across a broad range of industries, for both public and private organizations. Our services include:

- Total Compensation Services
 - Total Rewards Strategy
 - Strategic Incentive Plan Design (both executive and employee)
 - Performance Measurement and Goal Analysis
 - Executive Benefits and Perquisites
 - Executive Compensation Benchmarking
 - Employment Contracts
 - Change-in-Control and Severance Analysis
 - Employee Pay Benchmarking
- **Corporate Governance Services**
 - Compensation Committee Advisory
 - Board Evaluation Services
 - CEO Performance Evaluation
 - Board Cash Compensation
 - Board Equity Compensation
 - Special Committee Compensation
 - Lead Director/Non-Executive Chair Compensation
 - **Special Situation Services**
 - Transaction Incentives Including Asset Sales
 - IPOs, Mergers, Spin-Offs
 - Technical Guidance (FAS 123R, SEC, and Tax)
 - Expert Witness Testimony

James F. Reda's Biography and Curriculum Vitae

James F. Reda
Founder and Managing Director
James F. Reda & Associates, LLC

James F. Reda is Founder and Managing Director of James F. Reda & Associates, LLC, a firm specializing in executive compensation based in New York City. Mr. Reda's areas of expertise include senior executive employment arrangements, change-in-control metrics, business combinations, and long-term and short-term incentive arrangements, for both public and private companies.

Experience

James F. Reda, Managing Director of James F. Reda & Associates, LLC, has served for more than 20 years as advisor to the top management and boards of major corporations here and abroad in matters of executive compensation, performance, organization and corporate governance.

Mr. Reda has played an integral role in the field of executive compensation and the definition of the role of the compensation committee. As a recognized authority on corporate governance, he also is typically retained by compensation committees as an outside independent advisor on matters of executive compensation, particularly that of the Chief Executive Officer.

Prior to forming his own firm, Jim worked at three major executive compensation consulting firms. He began his executive compensation consulting career in 1987 for a boutique compensation consulting firm where he worked nine years. He has worked with three large, world-wide benefits consulting firms in the area of executive compensation.

Education

Jim has a B.S., Industrial Engineering, Columbia University, and a S.M., Management, Massachusetts Institute of Technology, Sloan School of Management.

Professional Activities

Jim is a member of the Society of Corporate Governance Professionals, WorldatWork, The National Association of Stock Plan Professionals (NASPP), National Association of Corporate Directors, and the New York Society of Security Analysts for which he serves on the Corporate Governance and Shareholders Rights Committee. Previously, he served as Chair of the Atlanta Chapter of NACD. He is a commissioner member of the December 2003 Blue Ribbon Commission report entitled "Executive Compensation and the Role of the Compensation Committee" and is a member of the Executive Compensation Task Force created by the NASPP.

Mr. Reda has written numerous articles on executive compensation, stock award programs, new economy compensation, merger & acquisition issues, and compensation

JAMES F. REDA
— & ASSOCIATES, LLC

committees in publications such as The Corporate Board, Directorship, Directors & Boards, Journal of Deferred Compensation, ACA Journal, Director's Monthly, Journal of Taxation of Employee Benefits, and Journal of Compensation & Benefits. He has published two books on executive compensation entitled, Pay to Win: How America's Successful Companies Pay Their Executives (Harcourt 2000), and The Compensation Committee Handbook (John Wiley, 2001 and 2004), the Third Edition of which will be released in December of 2007.

Organization of CV

Mr. Reda's CV is divided into two main areas:

Section I. Society and Association Membership

Section II. List of Conference Presentations and Recent Publications

Section I. Society and Association Membership

A. Professional Affiliations and Distinctions

- Included in Who's Who in America (55th edition) and Who's Who in Finance and Industry (2004 edition).

Memberships:

- Society of Corporate Governance Professionals.
- CFA Institute.
- National Association of Stock Plan Professionals.
- National Association of Corporate Directors.
- National Center for Employee Ownership.
- New York Society of Security Analysts.
- World at Work.

B. Distinctions as Represented by Leadership Roles

- Member of NYSSA Committees on Corporate Governance and Shareholder Rights, and Improved Corporate Reporting.
- Past President and Chair, Atlanta Chapter of the National Association of Corporate Directors.
- Commission Member, NACD Blue Ribbon Commission of "Executive Compensation and the Role of the Compensation Committee" (December 2003).
- Formerly on Board of Advisors, The Journal of Taxation of Employee Benefits.
- Formerly on Board of Advisors, Executive Compensation Advisory Service Newsletter.
- Completed Chartered Financial Analyst Exam, Level II, and Level III.
- Guest professor and lecturer at Penn State University Graduate School of Business (September 1999); University of Georgia Terry School of Business (July 1999); Northwestern University Kellogg School of Management (February 2000); and Yale School of Organization and Management (December 2001 and February 2004).
- Faculty member of National Association of Corporate Directors/Terry College of Business Directors' College (2001, 2002, 2003 and 2004).

Section II. List of Conference Presentations and Recent Publications

A. Conference Presentations (in chronological order)

"Growing Trend: Huge Payoffs for Executives Who Fail Big." Atlanta Area Compensation Association, Atlanta, Georgia, 7 October 1997.

"Stock Plan Issues Related to Privately Held Entities." National Association of Stock Plan Professionals Annual Conference, Las Vegas, Nevada, 21 October 1998 (with Stewart Reifler, and Robbi Fox).

"New Accounting Rules." New York Society of Security Analysts New York, New York, 23 April 1999 (with Fred Cook, and Alan Nadel).

"Executive Stock Ownership Guidelines: How Far Should We Go?" American Compensation Association (changed name to WorldatWork) National Conference, Boston, Mass., May 1999 (with Jane Romweber, and Pam Kimmet).

"Creating an Ownership Culture: How Far Should We Go?" National Association of Stock Plan Professionals Annual Conference, Washington, D.C., 1 November 1999 (with Stewart Reifler, Laura Thatcher, and Steven Layne).

"New Developments in Equity-Related Shareholder Proposals" National Association of Stock Plan Professionals Annual Conference, Washington, D.C., 2 November 1999 (with Patrick McGurn, Beth Young, John Olson, George Paulin, and Ann Yerger).

"Web Co., Inc.'s Governance Infrastructure: Should Dot.com Governance Practices be Different." <http://www.governance2000.com>, New York, New York, 20 January 2000 (with Stuart Burch, and Bernie Strom).

"Pre-IPO Strategies" <http://www.governance2000.com>, New York, New York, 21 January 2000.

"Deferral Compensation Strategies: Including Tax Effective Funding Strategies" Atlanta Tax Forum, Atlanta, Georgia, 21 February 2000 (with John Lagana).

"Board of Director Compensation: A Challenge for All Companies." American Society of Corporate Secretaries Regional Conference, Ft. Lauderdale, Florida, 23 March 2000 (with Robert Reed, and Katherine Combs).

"Challenges Facing Compensation Committees." American Compensation Association National Conference, Seattle, Washington, 24 May 2000 (with Patrick McGurn, Kenneth Bertsch, and Samuel Brown).

"Board of Director Compensation: How to Attract and Retain the Best." Presentation before National Association of Corporate Directors, Atlanta, Georgia, 13 September 2000 (with Laura Thatcher).

"Challenges Facing Compensation Committees." National Association of Stock Plan Professionals Annual Conference, San Francisco, Calif., 25 September 2000 (with Patrick McGurn, Dolph Bridgewater, and Stewart Reifler).

"A "Brick and Mortar" Guide to the New Economy: Innovative Ways to Attract and Retain an Internet Workforce." San Francisco, California, 27 September 2000 (with Laura Thatcher, Carol Bowie and Angela Macroupolis).

"Challenges Facing Compensation Committees." American Society of Corporate Secretaries Regional Conference, Asheville, North Carolina, 6 October 2000 (with Patrick McGurn).

"Policy, Practices, Abuses, and Best Practices in CEO Compensation." National Association of Corporate Directors National Conference, Washington, D.C., 16 October 2000 (with Pearl Meyer, Gary Strauss and Nina Dixon).

"Good Governance in Private Companies." American Society of Corporate Secretaries Essentials Course, Orlando, Florida, 25 January 2001 (with David Smith).

"Best Practices in Executive Compensation." Executive Benefits Peer Group Forum, Turnberry Isle, Florida, 9 February 2001.

"Potpourri of Executive Compensation and Benefits." Enrolled Actuary Annual National Conference, Washington, D.C., 20 March 2001 (with Max Schwartz and Michael Rosenbaum).

"Stock Option Exercise Strategies." American Institute of Certified Public Accountants National Conference on Executive Compensation, San Diego, California, 14 June 2001.

"Strategies for Improving Corporate Performance." Terry College of Business and National Association of Corporate Directors Directors' College, Atlanta, Georgia, 21 September 2001 (with Veronica Biggins and Mary Madden).

"Compensation Practices of Top-Performing Companies (Best Practices)." Benefits Management Forum & Expo, Atlanta, Georgia, 9 October 2001 (with Richard Johnson, William Mays, and Laura Thatcher).

"Compensation Committee Challenges: Seeking Solutions that Pay Off." Benefits Management Forum & Expo, Atlanta, Georgia, 10 October 2001 (with William Vesely and Steven Nord).

"The Compensation Committee." Terry College of Business and National Association of Corporate Directors Directors' College, Atlanta, Georgia, 3 May 2002 (with Charles Elson).

"Ways to Improve Corporate Performance through More Effective Compensation Programs." World at Work National Conference, Orlando, Florida, 15 May 2002 (with

Steven Nord).

"Equity Compensation in a New Environment: New design practices in light of market changes and regulatory environment." NASPP Carolinas Regional Conference, Winston-Salem, North Carolina, 21 May 2002.

"Stock Option Exercise Strategies." American Institute of Certified Public Accountants National Conference on Executive Compensation, Chicago, Illinois, 14 June 2002.

"Executive Compensation". The Conference Board Conference on Corporate Governance, New York, New York, June 2003 (with Alan Rudnick, Jerry Dempsey and Steve Nord).

"Director Compensation." NASPP Chicago Regional Conference, Chicago, Illinois, September 2003 (with Scott Witz).

"The Compensation Committee." Terry College of Business and National Association of Corporate Directors Directors' College, Atlanta, Georgia, June 2003 (with Earnie Deavenport).

"Executive Compensation." The Conference Board Conference on Corporate Governance, New York, New York, February 2004 (with Alan Rudnick and Dan Ryterband).

"The Compensation Committee." Terry College of Business and National Association of Corporate Directors Directors' College, Atlanta, Georgia, June 2004 (with Bob Womack).

"Structuring Incentive Plans." American Institute of Certified Public Accountants National Conference on Executive Compensation, Orlando, Florida, 10 June 2005.

"Critical Issues Facing Compensation Committees." The Conference Board Conference on Executive Compensation, New York, New York, 21 June 2005 (with Jerry Carter, Barbara Diamond, Bob Lamm and Steve Nord).

"Taking Stock: Equity and Other Long-Term Incentives." The Conference Board Conference on Executive Compensation, New York, New York, 4 April 2006 (with Chet Kuchinad and Steve Nord).

"Taking Stock: Equity and Other Long-Term Incentives." The Conference Board Conference on Executive Compensation, Chicago, New York, 2 May 2006 (with Allison McBride and Steve Nord).

"Compensation Committee Workshop." World at Work National Conference, Anaheim, California, 9 May 2006 (with Stewart Reifler).

"Equity Compensation: How New FAS123R will Radically Impact Stock-Based Compensation Plans" American Institute of Certified Public Accountants National Conference on Executive Compensation, New York, New York, 5-6 June 2006 (with

Andrew Gibson, Stephan Tackney and Jaleigh White).

"Executive Compensation: What Have the New Rules Wrought?" American Bar Association (ABA) Section of Business Law, Spring Meeting 2007, Washington, D.C., 17 March 2007 (with Charles Elson, John Gates, Claire Keyles, Ron Mueller, and Martha Steinman).

"Taking Stock: Equity and Other Long-Term Incentives." The Conference Board Conference on Executive Compensation, San Francisco, Chicago, New York, 25 April 2007, 8 May 2007, 6 June 2007 (with Allison McBride, Nancy Mesereau, Steve Nord, John Gates, Jerry Carter, and Earnest Deavenport).

B. Publications (in reverse chronological order)

The Compensation Committee Handbook, 3rd Edition. forthcoming December 2007. New York: John Wiley & Sons (with Stewart Reifler and Laura Thatcher).

"Executive Compensation: How much is enough?" *FinancierWorldwide*, May 2006.

"Importance of a Compensation Philosophy." *Directors & Boards Boardroom Briefing*, (Winter 2005): 30-31.

The Compensation Committee Handbook, 2nd Edition. 2004. New York: John Wiley & Sons (with Stewart Reifler and Laura Thatcher).

"Till Wealth Do Us Part: The Truth Behind Executive Employment Arrangements." *World at Work Journal*, 11, 2 (Second Quarter 2002): 34-43.

"Committees: A Glimpse at the Future Boardroom." *Corporate Board*, 23, 133 (March/April 2002): 21-25.

The Compensation Committee Handbook. 2001. New York: John Wiley & Sons.

"Compensation Committee Structure: Blueprint for Success." *National Association of Corporate Directors' Director's Monthly*, 25, 10 (October 2001): 6-10.

"Executive Pay Today and Tomorrow." *Corporate Board*, 22, 126 (January/February 2001): 18-21.

"Option Plans for Tax Exempt Employers." *Journal of Deferred Compensation*, 5, 2 (Winter 2000): 1-17 (with Laura Thatcher and Daniel Kennedy).

"CEO Stock Ownership Guidelines." *Directors & Boards*, 25, 1 (Fall 2000): 46-47.

2000 Pay to Win: How America's Most Successful Companies Pay Their Executives. 2000. San Diego: Harcourt (with James McMahon and Eric Lane).

"Executive Compensation in the New Economy." *Compensation and Benefits Solutions*, April 2000, 48-50 (with Kent Graham).

"The Compensation Committee: A Potential Strategic Asset." *ACA Journal* 9, 1 (First Quarter 2000): 39-46.

"The Six Habits of a Highly Effective Compensation Committee." *Directorship* 26, 1 (January 2000): 6-9, 12-13, 16.

"The New World of the Compensation Committee." *Corporate Board*, 20, 119 (November/December 1999): 18-21.

"Imperatives for Compensation Committees." *National Association of Corporate Directors' Director's Monthly*, 23, 10 (October 1999): 1-5 (with John Chandler).

"Change-in-Control Severance Arrangements: Practical Considerations." *Journal of Compensation and Benefits*, 15, 2 (September/October 1999): 21-26.

"Reload Stock Options: Facts and Fictions." *Journal of Compensation and Benefits*, 14, 6 (May/June 1999): 38-43 (with Thomas Hemmer)

"Repricing Stock Options: How to Win a Loser's Game." *Journal of Taxation of Employee Benefits*, 7, 1 (May/June 1999): 45-48.

"What You Need to Know about Pooling of Interests Accounting." *Journal of Compensation and Benefits* 14, 5 (March/April 1999): 33-39.

"What's New in Accounting for Executive Stock Awards." *Journal of Taxation of Employee Benefits*, 6, 5 (January/February 1999): 214-220.

"Repricing Stock Options: Surviving the Great American Blowout," *NACD Director's Monthly Newsletter*, 22, 12 (December 1998): 7-10 (with Stewart Reifler).

"Repricing Stock Options: Current Trends and Dangers." *Journal of Compensation and Benefits*, 14, 3 (November/December 1998): 5-10 (with Stewart Reifler).

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April 6, 2006

Ms. Nancy Morris
Secretary
Securities and Exchange Commission
100 F Street NE
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**Re: File No. S7-03-06; Proposed Rules on Executive Compensation and Related
Party Disclosure, Items 402 (b) and 407 (e) of Regulation S-K**

Dear Ms. Morris,

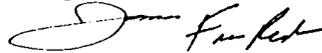
This letter is a comment on the Securities and Exchange Commission's ("SEC" or "Commission") proposed rules on executive compensation and related party disclosure, Item 402 (b) and Item 407 (e) of Regulation S-K ("Proposed Regulations") and represents the views of James F. Reda & Associates, LLC, advisors to Compensation Committees ("Committee") on matters of executive and board pay. We serve in the role of outside advisor to the Committees of Fortune-100 companies. The purpose of this letter is to focus more attention on an independent decision making process for Committees, particularly in relation to outside compensation advisors.

The traditional providers of compensation advice have significant economic incentives to provide other unrelated HR services in addition to compensation advice. This causes a direct conflict of interest and gives at least the appearance of lack of independence with regard to their advice.

In the following pages, we outline specific suggestions for addressing the issue of independent Committee operations, and cite supporting arguments made by Professor Jeffrey Gordon of Columbia Law School, The Conference Board, the National Association of Corporate Directors ("NACD"), and other leading corporate governance experts.

I applaud the efforts of the Commission in preparing the proposed rules and welcome the chance to address questions or requests for further information.

Best regards,



James F. Reda
Managing Director

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Our Comments on File No. S7-03-06; Proposed Rules on Executive Compensation and Related Party Disclosure, Item 402 (b) and 407 (e) of Regulation S-K

Introduction

My name is James Francis Reda, Managing Director of James F. Reda & Associates, LLC based in New York City. I am an independent compensation advisor to numerous publicly traded companies. I have about 18 years of executive compensation consulting experience and have authored two books and co-authored another as well as over twenty articles in the area of executive compensation.

Numerous comment letters have and will be submitted to the SEC that address technical matters relating to the completeness and accuracy in disclosing executive compensation programs and associated dollar amounts. These discussions are crucial, but we will not address them here.

Our primary issue is, from a shareholder's point of view, "Are executive compensation decisions being made within a truly independent process?"

Business as usual cannot continue in the world of executive compensation. Lucian Bebchuk and Yaniv Grinstein have shown that the ratio of aggregate pay for top-five executives to aggregate earnings has increased from 5% in the period 1993-95 to 10% in 2001-03.¹ Compensation Committees need to take a hard look at these numbers and reassess their operations from stem to stern. The SEC can help Committees by providing them with a higher standard of disclosure to verify the independence of compensation advice.

We view the decision making process as crucial and in the best interest of shareholders that it be truly independent. This is the only way that publicly traded corporations can achieve a fair and equitable executive compensation program that pays for performance.

¹ BEBCHUK and GRINSTEIN supra note 7, at 1.

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Summary of Recommended Changes to Proposed Regulations

Overall, we recommend the SEC consider changes to the Proposed Regulations, which are as follows:

- (1) Require that the members of the Committee sign the Compensation Discussion & Analysis ("CD&A") report as proposed by Professor Jeffrey Gordon in his forthcoming article for the Journal of Corporation Law, *Executive Compensation: If there's a Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis"*.²
- (2) Where the Proposed Regulations refer to compensation consultants, change "consultants" to "advisors," to include other outside advisors, such as legal advisors, that may be retained to advise the Committee ("Compensation Advisors").
- (3) Require further disclosure pertaining to Compensation Advisor independence, such as the procedure the Committee followed in choosing a Compensation Advisor, a table presenting fees paid to Compensation Advisors, the type of work performed by the Compensation Advisor, and the relative fee structure for work performed for the Committee and for management, if applicable. The Committee should provide a description of the work performed when the Compensation Advisor worked with management. This disclosure is similar to that found in the Audit Committee Report and has been crucial in making the audit process independent of management.

1. Approval of CD&A by Committee

The CD&A was proposed to give shareholders additional information about the basis for the executive compensation decision making process and to provide more specific justification of the structure and amounts paid to senior executives. The current executive compensation disclosure rules include a "Compensation Committee Report" that requires that the Committee describe the compensation paid to all Named Executive Officers, with an additional discussion of CEO pay. This requirement has been in place since 1993 (the last time the Commission changed the disclosure rules) and has given the Committee an opportunity to discuss their decisions and decision making process. But, overall, the effect of this reporting requirement has been minimal.

We view the CD&A as a step in the right direction for shareholders. We also endorse the thinking behind requiring filing vs. a disclosure in that a filing carries additional liability. However, the SEC must further stress that the CD&A is the responsibility of the Committee. It is surprising that the Proposed Regulations cite Professor Gordon's article as the basis for suggesting the CD&A, but they do not require approval of the CD&A by the Committee³.

² Jeffrey N. Gordon, *Executive Compensation: If There's a Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis,"* Columbia Law School, The Center for Law and Economic Studies Working Paper No. 273/2006 forthcoming, *Journal of Corporation Law* (Summer 2006), available at <http://ssrn.com/abstract=686464>.

³ See Proposed Item 402 (b). See GORDON *supra* note 1, at 116.

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As part of board ownership for compensation decisions, the members of the Committee should be required to sign their names to the end of the CD&A report, completely attesting to their pay decisions as business judgments and staking their reputations on the dotted line. The CEO and CFO can attest to the accuracy of the compensation data, particularly the change-in-control severance amounts, but the Committee should have final approval authority over the CD&A. With Committee member signatures, the CD&A will strengthen the basic premise that the Committee is accountable for pay decisions and, in particular, the decision making process

2. Broaden Meaning of Compensation Consultants to Compensation Advisors

Committees are seeking guidance from an increasing number of advisors, not all of which focus exclusively on providing independent advice to Committees.

Law firms, actuarial firms, and other business advisors are being consulted by directors when determining executive pay. Lawyers are bound by ethical standards and a duty to serve clients. They can be subject to censure. On the other hand, consultants do not even have minimum qualification standards. Lawyers are advocates for their clients. If they are hired by the committee they must go through conflict checks and get releases from conflicted parties.

Therefore, we advocate that the terminology be broadened from "compensation consultants" to "compensation advisors." A description of the advisor's business should be included in the CD&A report. In the next section, we review additional items which should be disclosed in order to determine the independence of the compensation advisor.

With regard to law firms, we would suggest that the law firm be named, but that the suggested fee disclosure (see our next recommendation) apply to those firms whose advice pertained to setting pay and pay techniques, which are typically limited to executive compensation consultants.

3. Further Disclosure on Compensation Advisor Independence

A key ingredient for an independent decision making process is a truly independent compensation advisor. In a recent report, the Conference Board Global Corporate Governance Research Center recommended that Committees consider independence from management as "the crucial question in selecting and using compensation consultants."⁴ For many firms, executive compensation consulting is only one of an array of products and services which it provides to the corporation. If an executive compensation consulting firm is part of such an organization, disclosure of any affiliates that also provide services to the company is necessary.

Currently, major compensation consulting firms can easily have conflicts, thus impairing the independence of their compensation advice, for reasons as follows:

⁴ Carolyn Kay Brancato and Alan A. Rudnick, *The Evolving Relationship Between Compensation Committees and Consultants*, The Conference Board Global Corporate Governance Research Center, January 2006, available at www.conference-board.org

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(i) Of the largest consulting firms in the U.S., only one provides only compensation consulting services. All others provide a multitude of HR-related consulting services and some also provide insurance brokerage services or IT outsourcing services either directly or through affiliates (collectively referred to as "Diversified Consulting Firms").

(ii) Compensation consulting makes up a very small percentage of revenue for most Diversified Consulting Firms providing compensation consulting services.

(iii) It is general knowledge in these Diversified Consulting Firms that they want to sell other services in addition to compensation consulting. This approach involves "cross-selling" and many points of contact within an organization (almost all with management).

The combination of these factors leads to a situation where the compensation consultant is obviously beholden to management and is subject to various types of pressure to satisfy management. The authors of the Conference Board report liken this to the situation between audit committees and outside auditors prior to the Sarbanes-Oxley Act:

The Act, as implemented, mandates that independent audit committees control this relationship by making them solely responsible for the hiring, firing, compensation, and monitoring the independence and performance of the outside auditors... These limitations have strengthened the integrity of the outside audit by effectively eliminating economic incentives for the auditors to curry favor with management to preserve and expand lucrative non-audit consulting contracts, rather than focusing all efforts on the independent audit and audit-related services. Compensation committees can find themselves in an analogous position if their consultants stand to profit more from the work performed for management, rather than services provided to the committee. (Page 15)⁵

Another analogy can be seen in the case of investment banks providing investment research advice. In both cases, there was supposedly a "Chinese Wall" of well intentioned professionals who were looking out for the interests of all concerned to prevent conflicts of interest. We all know how that turned out. Scandals and poor judgment wreaked havoc on the accounting profession as well as the investment banking profession⁶. A similar set of circumstances surrounds the compensation consulting profession today. In our view, the SEC must take action to shed light on this issue and improve the independence of Committee operations.

⁵ Id page 15.

⁶ John Goff, *Wall? What Chinese Wall?*, Apr 22, 2002, CFO.com. See also Ariel Markelevich, Charles A. Barragato, and Rani Hoitash, *The Nature and Disclosure of Fees Paid to Auditors: An Analysis Before and After the Sarbanes-Oxley Act*. The CPA Journal Special Edition November 2005, available at http://www.nysscpa.org/cpajournal/2005/1105/special_issue/essentials/p6.htm

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Diversified Consulting Firms admit that "cross-selling" is an objective between HR consulting and other parts of the firm.⁷ This is especially prevalent when selling services to Fortune-100 firms, as shown by Affiliated Computer Services in their earnings discussion after acquiring Buck Consultants.⁸

To highlight the point of the diversification of firms that provide compensation consulting, additional HR services and other types of services, we have constructed a chart that is a companion to Chart 1 at end of this letter.

<i>Firm</i>	<i>Services Provided Other Than Compensation Consulting</i>	<i>% of Overall Revenues Made up by HR Consulting</i>
Affiliated Computer Services, Inc. (Buck Consultants, Inc.)	Business Process Outsourcing HR Consulting* IT Consulting Systems Integration	13%
Aon Corporation	HR Consulting* Risk and Insurance Insurance Underwriting	12%
Clark, Inc.	HR Consulting* Banking Executive Benefits Healthcare Federal Policy	12%
Hewitt Associates, Inc.	HR Consulting* Outsourcing	28%
Mercer, Inc.	HR Consulting* Retirement Management and Organizational Change Healthcare/Group Benefits Economic	14%
Watson Wyatt Worldwide, Inc.	HR Consulting* Benefits Technology Solutions	8%

Source: Hoovers.com

* Includes other than compensation consulting services, such as pension, health & welfare, communications, etc.

⁷ ACS Q1FY06 Earnings Release Slides dated October 20, 2005, which can be located at http://www.acs-inc.com/invest/q1fy06_earningslides.pdf

⁸ Id. Slide #10

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It is clear that HR consulting is not the primary source of revenue at these companies. More importantly, the revenue derived from compensation consulting is a fraction of total HR consulting revenue. For example, for a typical HR consulting firm, compensation consulting revenue will be about 3% to 10% of total HR consulting revenue. Using this estimate, we estimate compensation consulting revenue to be between .5% and 2% of total firm revenue. In other words, all other revenue completely overwhelms the compensation consulting revenue and calls into question the independence of their compensation-related advice.

Since compensation consultants or any HR-related consultant are not bound by a credible code of ethics that will affect their ability to practice, there is no real impediment for a compensation consultant to bend towards management. In fact, there are many cases where a compensation consultant was fired, demoted or re-assigned when they did not go along with management or at least did not enthusiastically support management's demands. Thus, the situation provides extreme economic pressure to bend to management without a corresponding code of ethics or something else to resist this pressure.

To ensure that disclosures are complete and provide shareholders with all relevant information as to advisor independence, we advocate that the CD&A should include a table showing the fees paid to the advisor and its affiliates. This approach would be analogous to and consistent with disclosure requirements for a corporation's independent auditors.

An example of what this table might look like is shown below. The table should show (i) the fees paid for Compensation Committee consulting services and (ii) aggregate fees paid by the Company for all services performed by all entities in the company of which the consulting unit is a part. Along with attesting to the accuracy of their pay decisions, Committee members, by signing the CD&A with a table of outside advisor fees, will attest to the independence of the process in determining compensation programs and amounts.

The following table would help to clarify the independence of Committee advice:

Compensation Advisor Fees	\$	XX,XXX
All other fees paid to Compensation Advisor and Affiliated Companies	<u>\$</u>	<u>XXX,XXX,XXX</u>
Total		\$XXX,XXX,XXX

The term "Compensation Advisor" refers to the firm providing compensation consulting services and all other affiliated companies. The shareholders may be shocked by the amounts some companies are (a) paying their Compensation Advisor (may be in millions of dollars) and (b) total fees for all services (may be close to \$100 Million in certain cases where all HR services are being provided to large, global companies). The amount paid would also give an indication to the amount of work that went into the review of the executive compensation program.

This chart is similar to that included in the Audit Committee Report. This would provide a snapshot of the independence of compensation consulting advice. This small change would

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compel Committees to review their Compensation Advisor and their independence (or alignment with management).

As stated above, we would suggest that the law firm be named in the CD&A (or other advisors used by the Committee), but that the suggested fee disclosure apply to those firms whose advice pertained to setting pay and pay techniques, which are typically limited to executive compensation consultants.

Affordability of Compensation Advisors

Some have said that two consultants or advisors (or in some cases three if the Committee engages legal counsel) will be costly. At the same time, it is clear that a large part of shareholder value is being paid to management and employees in general in compensation and benefits. While the Committee does oversee many aspects of the compensation and benefits, it really gets very involved in the design and payout from the Company's incentive plans. Moreover, executive pay amounts to executive officers have increased by 9.4% each year over the past ten years.⁹

In a typical Fortune 100 company, approximately 1% to 1-1/2% of market capitalization is paid out in short- and long-term incentives with a substantial portion paid to its executive officers. Using an average market capitalization of \$25 billion as an example, the annual incentive pool (annual bonus plus long-term incentive awards) could be in the range of \$250 million to \$375 million. The Committee and other directors have an obligation to shareholders to make sure that this pool is created (e.g., incentive plan design), paid out in a proper manner and that the payouts are tied to corporate performance in a meaningful way. With such large amounts at stake, it seems foolish not to require that the Committee hire its own advisors, after a rigorous assessment of their independence from management.

In our view, it is extremely important that (a) the Compensation Advisor provide no other work to the company unless it is closely related to their advice and no other firm can accomplish the task in a reasonable time and cost and (b) the Committee keep a short leash on the Compensation Advisor by requiring a detailed engagement letter be entered into and close scrutiny of interaction with management be maintained.

⁹ Lucian Bebchuk and Yaniv Grinstein, "The Growth of Executive Pay," Harvard Olin Center, Working Paper No. 510/2005 as revised for publication in 21 Oxford Review of Economic Policy 283-303 (2005), available at <http://ssrn.com/abstract=648682>, 3.

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Review of Commentary on Independence of Compensation Consulting Advice

In the past three years, there has been a substantial amount of commentary attesting to the importance of independent compensation consulting advice to aligning executive pay with corporate performance. We summarize these documents below, from A to F, beginning with the groundbreaking "Restoring the Public Trust" in January 2003 and ending with a March 2006 article in the New York Times questioning the independence of compensation consulting advice.

A point to note is that the Conference Board may have reversed its position on the issue of independent compensation consulting advice. In September 2005, a Conference Board report by a working group composed of human resource executives and compensation consultants (and one corporate governance expert who dissented from the working group's report) suggested that a single consultant could avoid "non-constructive behavior" by using the firm's Diversified Consulting Firm as their compensation consultant so as to not "deprive the Company of the firm's talents."¹⁰

In January 2006, in a subsequent report focusing on compensation committees' processes to ensure independence and objectivity of outside advice, the Conference Board report states "When the committee hires a consultant only for itself, and the consultant has not historically done work for the company or its current management, the committee can easily assure itself about independence."¹¹

In his aforementioned working paper, Professor Jeffrey Gordon describes the "faulty governance story" that authors Lucian Bebchuk and Jesse Fried outline in their thought-provoking book, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*. Clearly it can be seen that the "use of compensation consultants with disabling conflicts of interest, in particular, provision to the firm of a wide range of compensation consulting services" is a main factor in the "faulty governance story."¹²

Finally, there are connections between lack of independence and unusual pay arrangements as reported by the New York Times with regard to Northfork's very unusual pay programs.¹³

¹⁰ Charles Peck and Jude Rich for The Conference Board, *Executive Compensation Consulting, A Research Working Group Report on Best Practices*, September 2005, available at www.conference-board.org. 8.

¹¹ KAY BRANCATO and RUDNICK supra note 3, at 15.

¹² GORDON supra note 1, at 103.

¹³ See Gretchen Morgenson's *Bank Deal's Payout Plan Questioned*, New York Times, March 15, 2006, Section C, Page 1, Column 6, electronic copy available at www.nytimes.com.

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A. Commission on Public Trust and Private Enterprise. (Conference Board: January 2003)

In the *Commission on Public Trust and Private Enterprise* (sometimes referred to as “Restoring the Public Trust Report”), the Conference Board considers it highly advisable for Compensation Committees to hire independent compensation consultants to ensure the objectivity of their executive pay recommendations. The report states “The committee needs to act independently of management, hire its own consultants, and avoid benchmarking that keeps continually raising the compensation levels of executives.”¹⁴

B. Executive Compensation and the Role of the Compensation Committee. (National Association of Corporate Directors: December 2003)

The National Association of Corporate Directors (“NACD”) set up a Blue Ribbon Commission (“BRC”) to examine issues related to executive compensation and oversight of the executive compensation decision making process. The commission was made up thirty four people, four of which were compensation consultants. (I was on this panel.)

The BRC reported that Committees can work more effectively with the help of qualified professionals who are independent of management. For that reason, the BRC recommended that Compensation Committees consider engaging an independent compensation consultant, who does no work for management, to assist the Committee. The report suggested appointing an independent compensation consultant to assist in the development of a compensation philosophy and executive pay packages. It goes on to state “any consultant hired by management should not be engaged in assignments involving CEO or senior executive pay.”¹⁵

The NACD believes that by separating the consultant’s role from management, it eliminates possible confusion. They contend that if a consultant is hired by management, he or she might feel conflicted when making recommendations: “A consultant engaged by the committee is much more likely to take an objective view that is consistent with the board’s responsibility to shareholders and other constituencies. This may result in a higher cost of board operations, but it can be an appropriate investment, considering the impact and magnitude of executive compensation.”¹⁶

C. Executive Compensation Consulting: A Research Working Group Report on Best Practices (Conference Board: September 2005)

The Conference Board’s “Executive Compensation Consulting: A Research Working Group Report on Best Practices,” focused on guidelines for committees, HR managers and advisors. It is important to note that the majority of those who compiled this report were representatives

¹⁴ The Conference Board Commission on Public Trust and Private Enterprise, January 2003, page 6. available at www.conference-board.org.

¹⁵ National Association of Corporate Directors Blue Ribbon Commission, *Executive Compensation and the Role of the Compensation Committee*, 2003, 18.

¹⁶ *Id.* 19.

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from large Diversified Consulting Firms. One of their main arguments was: "The consultant (the individual and the firm) should be allowed to do other work for the company. Since many consulting firms provide services other than executive compensation, the company would be deprived of the talents of these firms."¹⁷ Judging from their claims, it is evident that their primary focus is not on independent decision making process for Committees and promoting maximization of shareholder value.

At the end of the working group report (Appendix C), Professor Charles Elson and Mr. Dan Lynch provide a dissenting view, arguing that this would impair the independence of committees. "First, I believe that the compensation committee, in most circumstances, should engage its own executive compensation consultant separate and apart from any such consultant working for management, given the current legal and regulatory environment in addition to public sentiment. Second, any such consultant engaged by the committee must agree to do no other work for the company other than the committee's work so as to preserve the consultant's actual and perceived independence from company management. These two points, I believe, are critical to enhancing the integrity and effectiveness of the executive compensation process in both fact and shareholder perception."¹⁸

It is this view that prevailed as the Conference Board introduced another report just four months later in response to this dissension (see below).

D. Executive Compensation: If There's a Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis," Professor Jeffrey N. Gordon, Columbia Law School, The Center for Law and Economic Studies Working Paper No. 273/2006 forthcoming, Journal of Corporation Law (Created in September 2005, to be published in Summer 2006)

Jeffrey N. Gordon, professor at Columbia University Law School, provides the seminal argument for the CD&A, and also provides another necessary part to the process of setting executive pay, which is an independent Compensation Advisor.

Professor Gordon suggests that the Committee sign the CD&A report and advocates independence in the process of determining executive pay. Below are a select number of excerpts from Professor Gordon's paper:

"Various governance arrangements make it unlikely that the board will act as a good faith bargaining agent for the shareholders in an arm's-length process." (Page 103)¹⁹

[One of the salient elements in the faulty governance story is the] "use of compensation consultants with disabling conflicts of interest, in particular, provision to the firm of a wide range of compensation consulting services." (Page 103)²⁰

¹⁷ PECK and RICH supra note 8, at 8.

¹⁸ Id at 3.

¹⁹ GORDON supra note 1 at 103

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“Drawing from new practices of audit committees influenced by Sarbanes-Oxley...compensation committees may well insist on independent compensation consultants and perhaps independent counsel...board process is likely to improve considerably...these process improvements could make a significant difference in compensation policies.” (Page 120)²¹

**E. “The Evolving Relationship Between Compensation Committees and Consultants”
 (Carolyn Kay Brancato and Alan A. Rudnick for the Conference Board: January 2006)**

This Conference Board report resulted from an array of dissenting views on guidelines and arguments made in the Working Group report mentioned previously. Importantly, it addressed the questions raised about compensation consultants who provide other services directly to management and also discussed the advantages to hiring independent advisors.

This report concluded that “when the compensation committee uses information and services from outside consultants, it must ensure that consultants are independent of management and provide objective, neutral advice to the committee. At a minimum, the committee must control all aspects of the committee-consultant relationship, including consultant retention, the scope of work, oversight and monitoring of work, and if necessary, dismissal of the consultant.”²²

The report emphasizes that compensation committees must assure themselves of consultants’ independence from management.

“Directors must be able, in good faith, to conclude that advice they receive from consultants is unvarnished and responsive to the issues before the committee. Unless directors are satisfied that the consultants are independent and provide objective advice, directors risk impairing their own independence and thus violating their fiduciary duties.” (Page 15)²³

Another main finding in the recent Conference Board report, is that a good way to determine the independence of the consultants is by scrutinizing how much they are being paid for compensation and other services that they provide.

“Any imbalance in fees generated by management versus fees generated on behalf of the committee should receive intense scrutiny.” (Page 15)²⁴

In remarking on the role of professional advisors in the pre-Sarbanes-Oxley era, of companies, this Conference Board report found as follows:

²⁰ Id at 103.

²¹ Id at 120.

²² KAY BRANCATO and RUDNICK supra note 3, at 6.

²³ Id at 15.

²⁴ Id at 15.

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“various professional advisors of companies, such as public auditors, compensation consultants, and, in some cases, law firms, failed to provide truly independent advice and professional judgment as they came to view management as the ‘client’ instead of the corporation.” (Page 21)²⁵

F. “Bank Deal’s Payout Plan Questioned” (New York Times; March 15, 2006)

Pulitzer-Prize winning journalist, Gretchen Morgenson, wrote an article in the NY Times on March 15, 2006, addressing escalating concerns about the executive pay recommendations made by Mercer HR Consulting to North Fork. The thrust of her argument was as follows: “When the same consulting firm that advises a board on pay practices generates revenue by providing other services to the company, questions can arise about which master the consultant is serving.”²⁶

In addition to advising on pay matters, many large compensation consulting firms, including Mercer, Hewitt, and Watson Wyatt, also provide other services to companies, like actuarial and outsourcing services and pension plan administration. “Mercer earned a total of almost \$1 million in 2002 and 2003 for its services as actuary to North Fork’s cash-balance retirement plan.”²⁷

Paul Hodgson, a senior research associate at the Corporate Library, contends, “We like clear lines of distinction in corporate governance because you avoid the possibilities of anyone raising a red flag saying, wouldn’t the consultant be worried about losing their contract with the HR department if they came to the compensation committee and said we find the CEO is overpaid?”²⁸

Accordingly, Committee advisors should have the ability to exercise independent judgment free from any relationship or influence that could appear to compromise their ability to approach compensation issues decisively and independently.

²⁵ *Id.* at 21.

²⁶ MORGENSON *supra* note 11.

²⁷ *Id.*

²⁸ *Id.*

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Chart 1. Partial List of Diversified Consulting Firms²⁹

Consulting Firm	Professional Services	% of Total Revenue	Total Revenue (\$ mil.)
<i>Aon Corporation</i>	Risk and Insurance	56%	\$5,696.3
	Insurance Underwriting	31%	\$3,153.3
	Consulting (HR & Other)	12%	\$1,220.6
	Other	1%	\$101.7
			\$10,172.0
<i>Clark, Inc.</i> <i>(Pearl Meyer)</i>	Banking	45%	\$123.2
	Executive Benefits	22%	\$60.2
	Healthcare	14%	\$38.3
	Pearl Meyer (compensation only)	12%	\$32.9
	Federal Policy	4%	\$11.0
	Other	3%	\$8.2
			\$273.8
<i>Hewitt Associates, Inc.</i>	Outsourcing	70%	\$2,022.7
	Consulting (HR)	28%	\$817.6
	Adjustments	2%	\$58.2
			\$2,898.5
<i>Mercer, Inc.</i>	Retirement	44%	\$1,350.8
	Management and Org. Change	19%	\$583.3
	Human Capital (HR)	14%	\$429.8
	Healthcare and Group Benefits	13%	\$399.1
	Economic	5%	\$153.5
	Other	5%	\$153.5
			\$3,070.0
<i>Watson Wyatt Worldwide, Inc.</i>	Benefits	63%	\$464.6
	International	13%	\$95.9
	Technology Solutions	10%	\$73.7
	Human Capital (HR)	8%	\$59.0
	Other	6%	\$44.2
			\$737.4
<i>Towers Perrin</i>	Human Consulting Services (HR)		N/A
	Reinsurance		N/A
	Tillinghast		N/A
			\$1,620.0
<i>Affiliated Computer Services, Inc.</i> <i>(Buck Consultants, Inc.)</i>	Business Process Outsourcing	75%	\$3,238
	Buck Consultants, Inc (HR).³⁰	13%	\$640
	IT Consulting	17%	\$859
	Systems Integration	5%	\$254
			\$4,991

²⁹ Source: Hoovers.com. Segment that provides compensation consulting services is show in bold italics.

³⁰ Revenue listed for Buck Consultants is based on ACS Q1FY06 Earnings Release Slides dated October 20, 2005, which can be located at http://www.acs-inc.com/invest/q1fy06_earningslides.pdf.

Chairman WAXMAN. Thank you very much, Mr. Reda. I appreciate your testimony.

I'm going to start off the questioning.

Mr. Scott, as I understand your testimony, you're the head of executive compensation at Mercer Consultants, one of the largest executive compensation firms. And your view is you defend current practices and have said that firms like yours can provide both executive compensation advice and other services to a company without a conflict of interest.

But my understanding is that your own company takes a very different approach to executive compensation. I would like to ask you about this apparent double standard.

My understanding is that Mercer Consultants is a subsidiary of a larger publicly traded firm, Marsh & McLennan. Is that right?

Mr. SCOTT. Marsh & McLennan, yes.

Chairman WAXMAN. I's like to read for you—I have a copy of their annual meeting and proxy statement for 2007, and here's what it says in the report: "the committee has engaged an independent compensation consultant, Towers Perrin. The independent compensation consultant reports directly to the committee and does not do any work for management."

In other words, your own company insists on hiring executive compensation consultants without conflicts of interest. Why does your parent company have this policy in place?

Mr. SCOTT. Our parent company has that policy in place so that they, like many other firms who are concerned that their shareholders be confident that they are getting an outside review of the pay practices they intend to follow for their executives has been given.

Chairman WAXMAN. Well, doesn't this say that your company's board understands the problems that can occur with the use of a consultant with a conflict of interest, and they want to assure that there is not going to be a conflict of interest?

Mr. SCOTT. I can't interpret the statement that way. I can interpret it as them wanting to assure shareholders that an independent review by someone who does no other work with the company is in the best interest of shareholders.

Chairman WAXMAN. Do you advise your clients that this approach, hiring an independent compensation consultant, is the best approach to executive compensation decisionmaking?

Mr. SCOTT. When we're working with clients and it's clear to them that they do have a worry about that, that's something that concerns them, that they want to be able to demonstrate to shareholders that independent review does occur, we do. And we do, as a matter of policy, recommend to them, as in our statement, an independent oversight model where there is someone who is not Mercer, who does no other work with the company, work with them.

Chairman WAXMAN. So you have clients that utilize your company's executive compensation services and they also hire Mercer to do other work for management, but before they do that, you inform them that you're doing both tasks. So, therefore, they're deciding whether they want a separate, independent consultant only on compensation.

Mr. SCOTT. Yes, Mr. Chairman. In 2005, well before a lot of the discussion and requirement, we instituted with all of our executive compensation relationships the requirement that, whether they liked it or not, we were going to tell them how much money we received over the last 3 years for executive compensation advice and how much money we received over the last 3 years for work we had done for management.

Chairman WAXMAN. And if they want an independent consultant, you would refer them elsewhere? Is that how you handle it?

Mr. SCOTT. No, we don't refer them, but we certainly suggest that they consider that option. And we are happy to bow aside or to work with that other consultant, but not as the independent overseer, which is a role we won't take for a company.

Chairman WAXMAN. And, Mr. Reda, you operate an independent firm. What are your views on this subject? Do you think problems can arise when a consulting firm is cross-selling other services to a client?

Mr. REDA. It's been my experience that it can arise, yes.

Chairman WAXMAN. And how about you, Mr. Paulin? What do you think about it?

Mr. PAULIN. They can. They don't always, but it's certainly there, potential conflict.

Chairman WAXMAN. Well, it's difficult for me to understand how a company like Mercer can claim that compensation consultant independence is not important. Its own board of directors obviously believes it is. There's an old adage, you can learn more by watching what someone does than you can by listening to what someone says.

How do you respond to that, Mr. Scott? Doesn't it sound like your company is telling that they care about having independent consulting and that you, on the other hand, are not following that practice?

Mr. SCOTT. Mr. Chairman, I would respectfully disagree. I think, in fact, what Marsh & McLennan Companies does is an exact demonstration of the way that we do work with clients, which is we allow them to decide how and if they want to use us and in what way. And if, in this particular case, Marsh & McLennan felt in order to assure its shareholders that it's receiving independent review that it retained Towers Perrin, who has no other relationship with Marsh & McLennan—and we have other clients that would similarly make those kinds of decisions.

On the other hand, if they don't have a shareholder concern and they feel that using Mercer is the best option for them for whatever reason, then we'll work with them in that fashion. Again, going back to our global standards in which we'll work with them, but only on the basis they understand that there is going to be complete transparency in the relationship—

Chairman WAXMAN. Pursuant to transparency, do you think the shareholders know that there is this potential conflict situation and they're agreeing to it?

Mr. SCOTT. In the cases of—

Chairman WAXMAN. Of the shareholders.

Mr. SCOTT. At Marsh & McLennan?

Chairman WAXMAN. No, the shareholders for the company where you're doing the consulting work, do they know that you're doing both the compensation part of the effort as well as other activities for that company?

Mr. SCOTT. Sure. What we can do for that process is we can make sure that the compensation committee has that information, which we insist they do.

Chairman WAXMAN. The compensation committee at the corporation?

Mr. SCOTT. That's correct.

Chairman WAXMAN. But not the investors.

Mr. SCOTT. In some cases, we have clients who are going above and beyond the SEC requirements and they are sharing that with investors, and in other cases they're not.

Chairman WAXMAN. So, in other cases, they're not.

Mr. SCOTT. Right.

Chairman WAXMAN. OK. So we don't know—it's hard to say that all of them know.

Mr. Lowman, in your written statement you say that your executive pay consultants do not receive any compensation for selling other work to their corporate clients. This is one of the ways in which you attempt to manage the conflict of interest, by trying to make sure your pay consultants aren't cross-selling other services and, thus, dependent on the executives whose pay they provide advice on.

But job postings from your company seem to contradict your position. They show that you do place a premium on cross-selling. I believe we can display an exhibit, and we'll ask our staff to hand it to you.

Mr. LOWMAN. Thank you.

Chairman WAXMAN. This is a recent Towers Perrin job notice for an executive compensation consultant, and it lists the job responsibilities. It says, "The applicant will be cross-selling consulting and other Towers Perrin services to existing and new clients." It also says, "Minimum revenue generation from all sources, i.e., not just executive compensation services, goal of \$750,000 in the first 12 months would be expected."

So that's confusing to me. You've told the committee you don't encourage cross-selling other services to management because this could impede your independence, yet this job notice indicates that cross-selling is a critical part of the job of compensation consultant. How do you explain this conflict?

Mr. LOWMAN. The job posting—the \$750,000 is an important number because that indicates that it's a fairly junior position in Towers Perrin. Typically, someone that's consulting to a board, someone that's consulting to senior management would be responsible for many more millions of dollars in services. This is a junior-level position that would not be advising on senior—

Chairman WAXMAN. But it does say you expect them to cross-sell—

Mr. LOWMAN. Yes, let me explain.

Chairman WAXMAN [continuing]. As part of their responsibilities.

Mr. LOWMAN. I'll continue my answer, Mr. Chairman. This is a junior-level position. They would be responsible for working inside

an organization in support of whatever kinds of incentive design might be done for middle management, perhaps for sales, compensation and so forth. It is not for a position that would be advising the CEO or advising the chairman of the compensation committee.

Actually, I want to reaffirm what I said in the written testimony, which is that our board-appointed compensation consultants do not get involved in cross-selling services for any other part of Towers Perrin.

Chairman WAXMAN. They don't.

Mr. LOWMAN. They don't.

Chairman WAXMAN. But the company does.

Mr. LOWMAN. I'm sorry?

Chairman WAXMAN. Those consultants don't, but the company does.

Mr. LOWMAN. We have a broad-based consultancy, and we work in a number of different areas. Other people within our organization will have responsibility for selling services to various clients, whether they're executive compensation clients or not.

Chairman WAXMAN. Mr. Paulin and Mr. Reda, do you have any comments on this? You've had long experience in the field. Do you think cross-selling occurs at firms like Towers Perrin and other multi-service consultants, even though they have different people doing different jobs, or is there still the same problem?

Mr. PAULIN. My sense of the work that's done by executive compensation consultants, those people who are very senior and who are advising boards of large companies, is that they are not paid directly to cross-sell to those companies, as a policy. I believe that to be true.

I also believe that there are corporate rewards. So Mr. Scott probably receives stock options in the stock of Marsh & McLennan that reflects the overall economics of the organization. And I think those are part of the overall compensation program for the senior people.

Chairman WAXMAN. Mr. Reda, do you have any comment?

Mr. REDA. Well, it's been my experience that, say, maybe 3 years ago, maybe 4 years ago, it was a free-for-all, that you did see cross-selling from the compensation consultant that was advising the board, and it was pretty blatant. That now, for these firms here, has been restricted to some degree.

But do you have to see that these consultants are part of a bigger organization. They hold stock in the actual organization that they're a member of. So, depending on how well they do selling—and you heard that there's goals for people to sell and to do and so forth—it's all economic, that the more they sell, the more they earn their retirement and increase their wealth.

So my feeling is that these Chinese walls and firewalls do not work because of the economic interest of the people who work for the firm, they are essentially tied at the hip economically, and it's impossible to break that tie.

Chairman WAXMAN. Thank you very much.

Mr. Davis.

Mr. DAVIS OF ILLINOIS. I'll pass to Ms. Foxx.

Chairman WAXMAN. Oh, OK.

Ms. FOXX.

Ms. FOXX. Thank you, Mr. Chairman.

I'm going to ask one question of each of you.

And, Mr. Reda, if you would start, and then just go down the line. This just requires a yes or no answer.

Do you believe that your firm has adequate safeguards to address Chairman Waxman's concerns?

Mr. REDA. Yes.

Mr. PAULIN. Yes.

Mr. POWERS. Yes.

Mr. SCOTT. Yes.

Mr. LOWMAN. Yes.

Ms. FOXX. OK. Thank you.

I have another question then. Mr. Lowman, this one's for you. In Daniel Pedrotty's testimony, he said your organization advised Merrill Lynch board of directors compensation committee, has advised them since 2003, but that you also provide other consulting services to Merrill Lynch that are not related to executive compensation.

Do you believe this dual role endangered the impartiality of your compensation consultants? And explain. If you say yes, then explain why. If you say no, you can explain why not.

Mr. LOWMAN. I suspect you're not going to be surprised to hear me say no, I don't believe it endangered our objectivity. What I'd like to do is just expand on that a bit, if I may.

I think there is an underlining assumption, make assertion, that somehow having a so-called independent advisor—and I say so-called because I believe that all of us can operate and do operate independently—but to have a so-called independent advisor who does no other work elsewhere in the organization will either result in better pay, lower pay. Maybe there's an assumption that he who pays least pays best.

But, indeed, going back to Mr. Pedrotty's repeated references to the Corporate Library report, I thought it was interesting that he did something that we advise our consultants never to do, if you're going to be objective and if you're going to be responsible, and that's to cherry-pick data. Mr. Pedrotty cherry-picked probably the least important piece of data in that report, which was base salaries. As anyone on this panel will tell you, if a CEO is making \$15 million, probably half or more of that is in stock options or in stock compensation. And referring to that very report which Mr. Pedrotty cherry-picked from, on page 7 of that report it talks about the biggest piece of compensation, which is the stock piece, and the top four firms there that are the greatest percent above median stock option value are Radford, Frederick W. Cook, Pearl Meyer and Compensia.

So if the assertion is that what you refer to as an independent advisor who does no other work of any sort is going to result in lower pay or somehow better pay, this report that's continually referenced by Mr. Pedrotty would suggest that's patently untrue.

Ms. FOXX. And a followup, if I might, to that. I believe you said in your prepared testimony that the report from Corporate Library shows, indeed, that independent compensations determined by, again, those so-called independent consultants are higher than

those that are recommended or set by what I would call comprehensive firms or firms that do multiple tasks.

Mr. LOWMAN. Yes, ma'am. If I may, I don't want to give too much credence to this report, because, again, I would defer to my colleagues on this panel. I can't testify to the credibility and validity of this report. But if we're going to reference it, then we should reference what's in it fully and not cherry-pick the information.

I think that it's a very important point that not one of us on this panel has their integrity for sale. The reputations of our company are not for sale. We operate with integrity. We consult to compensation committees of the board. Occasionally we consult to management. The compensation committees need to make the decisions—indeed, do make the decisions—about executive pay. We provide advice. They may choose to accept it; they may choose not to. And at times I don't know why they don't accept some of the advice I give them because I think it's a lot better than what they adopt, but they do what they do.

Ms. FOXX. Thank you, Mr. Lowman. I appreciate your pointing out again in an indirect way that the decisions these corporations are making are made freely. Stockholders buy stock freely. Boards make their decisions. As you say, you may give them advice, but nobody is holding a gun to their head to make them do this.

Mr. POWERS, I'd like to ask you one additional question. There has been an analogy made between compensation consultants and accounting firms. Do you think that's an accurate analogy? And, again, whatever way you answer, please explain a little bit why you feel that way.

Mr. POWERS. Congresswoman Foxx, we do not agree that it's a completely analogous situation to the audit role. We think there are several significant differences between the role we provide as compensation consultants and the role that outside auditors provide to public companies. Some of those would include that public companies are required to have an outside auditor. It is also required that they report directly to the audit committee. They are approved by shareholders, and their primary function is to certify as to the veracity of the financial statements. Those financial statements are relied upon by third parties like investors and lenders.

On our side of the shop, there really aren't any specific GAAP-like standards for us to follow. And there is no report that we publish that investors or other third parties rely on.

Chairman WAXMAN. Thank you for your questions.

Mr. Davis.

Mr. DAVIS OF VIRGINIA. Thank you, Mr. Waxman.

On panel one, Professor Elson testified that most board members don't inquire about potential conflicts of interest among compensation consultants. Let me just ask each of you, do you agree with Professor Elson, based on your firm's interaction with board members?

Mr. Lowman.

Mr. LOWMAN. Compensation committees are very concerned about conflicts of interest of all types, not just whether or not you're doing work elsewhere in the organization. Yes, they are concerned, and they do inquire about it.

Mr. DAVIS OF VIRGINIA. Mr. Scott.

Mr. SCOTT. I would echo that, as well, and, in addition, point out that, even were they not to ask, through our global standards we require that they have that information.

Mr. DAVIS OF VIRGINIA. OK. Thank you.

Mr. POWERS. I would agree with that as well, Congressman Davis. We regularly advise our clients to have that conversation. They are the ones who are both making pay decisions and also assessing whether the advice they're getting is objective or not. And they are certainly not required to have an advisor in this capacity. And I think if they weren't serious about finding out if we had conflicts that they were uncomfortable with, they would not be turning to us for this kind of advice.

Mr. DAVIS OF VIRGINIA. Mr. Paulin.

Mr. PAULIN. I think most large companies and their boards both recognize and accept that best practice is to have an independent consultant. And they would, in that definition, view potential business conflict as a concern.

When you get down into smaller companies—and I'm still talking about public companies, but middle-market, small-cap companies—the sophistication and resources sort of falls off. So I'm not sure I would make the statement as generally down there as I would for the S&P 500.

Mr. DAVIS OF VIRGINIA. And the compensation is not as large for the smaller companies.

Mr. PAULIN. I'm sorry?

Mr. DAVIS OF VIRGINIA. The compensation is not as great, either, for the small companies.

Mr. PAULIN. Yes, that's correct.

Mr. DAVIS OF VIRGINIA. OK.

Mr. Reda.

Mr. REDA. It's been my experience that it's about 50/50. Half do; half don't. And I'm surprised to learn that there is a full disclosure at the time that the engagement is entered into. A lot of the board members I deal with haven't really had that full disclosure, to the best of my knowledge, in actual dollars, who was paid what, when and for what services. So, again, my experience is about half do and half don't.

Mr. DAVIS OF VIRGINIA. Let me ask this. You make recommendations on ranges, I gather, of what salaries and the package ought to be. How often do they take your suggestions verbatim, and how often do they make significant changes from that?

Mr. LOWMAN. That's hard to quantify, to be honest with you. I'm going to guess, I'd say more often than not they'll take our recommendations—not verbatim. You know, typically there's discussion. And I think—

Mr. DAVIS OF VIRGINIA. Ballpark basically. Is that—

Mr. LOWMAN. Yeah, I think it is really important to understand a couple of things here. I mean, I don't know how many—

Mr. DAVIS OF VIRGINIA. At these levels, it's basically negotiated at the end, isn't it? Don't usually they have the—

Mr. LOWMAN. This is what I want to get to.

Mr. DAVIS OF VIRGINIA. Yeah.

Mr. LOWMAN. You know, all of us have the experience of working with a lot of companies over many years and seeing how this works.

Mr. DAVIS OF VIRGINIA. I was general counsel to a public company before I came here.

Mr. LOWMAN. So you know a lot about it.

Mr. DAVIS OF VIRGINIA. I have any own reference point, but that's one company. I want to hear yours.

Mr. LOWMAN. So my experience is that we'll come in giving observations about competitive practice. We'll put that competitive practice in context, usually in the context of performance, corporate performance. And then there is a lot of discussion that the compensation committee members enter into, with respect to how did the CEO, him or herself, actually perform the job, how did the corporation do, how did they follow through on various initiatives.

And so we can provide ranges of what we think some sort of reasonable practice might be, but the compensation committee will triangulate on a number. Typically it's not formula-driven. Typically there's a lot of reference to performance.

Mr. DAVIS OF VIRGINIA. Your recommendation is just one of a number of factors in the final product.

Mr. LOWMAN. Absolutely.

Mr. DAVIS OF VIRGINIA. Mr. Scott, is that your observation, as well?

Mr. SCOTT. That would be our observation, as well, that the process in fact is one where we're working together to find the right solution. And because part of what we're doing is hopefully asking the right questions about what industries they need to compete in and how competitive they need to be and whether they want to structure the package more to reinforce short-term or long-term performance, that through that question process we're going to eventually get down to a prescription, that then our job is to help—

Mr. DAVIS OF VIRGINIA. Well, let me ask this. Generally, at the level you're talking about, you're not talking about bringing somebody from unemployment that you're offering them a job. You're sometimes wooing them from other attractive jobs. Is that right? So it's very market-based.

Mr. SCOTT. Well, that is correct. Usually in those cases where you are heading outside to find a candidate, they are very comfortably paid and protected where they are.

Mr. DAVIS OF VIRGINIA. Mr. Powers, what's your observation? Similar?

Mr. POWERS. To your original question, Congressman, you had asked how often do our compensation committee clients take our advice, and I'd say they certainly use our advice, trust our advice as one of the important factors in determining executive pay. However, they really have their own process. We've seen a much better, I would say, corporate governance process over the last couple of years in particular, where we are seeing more robust debates about executive pay. The committee members are more informed about executive pay. They are asking us to provide more information as backdrop to their decision. But ultimately it is their decision on both how much and what form of pay.

Mr. DAVIS OF VIRGINIA. Let's ask the two—

Mr. PAULIN. It's pretty common for compensation committees not to act directly upon what I recommend. It's much less common for them to act on something that I seriously object to.

Mr. REDA. It's been my experience that what we provide to compensation committees and boards is very complex; it's a lot of numbers, statistics. And depending on how the information is prepared, you can point the committee in one direction or another. That was my first point.

And my second point, they typically use what we give to them as a guideline. And about three-quarters of it is approved, ultimately, in the form that we present it, at least in my experience.

Mr. DAVIS OF VIRGINIA. Thank you.

Chairman WAXMAN. Thank you, Mr. Davis.

Mr. Danny Davis.

Mr. DAVIS OF ILLINOIS. Thank you very much, Mr. Chairman.

Our first panel of experts today gave us one prescription for solving the problem of conflicts of interest among executive pay advisors, and that was disclosure for them. At the very least, investors and the public should know if a compensation consultant has a conflict of interest.

Mr. Scott, your testimony highlights the need for your company to have, "a clear and transparent relationship with clients." Do you believe that your clients, the Fortune 250 companies, should have the same relationship with their investors?

Mr. SCOTT. Congressman Davis, thank you.

We do provide that transparency to every single relationship, and I think they value that. And it helps them manage the potential conflict that they deal with—one of many potential conflicts they deal with all the time.

It's really not my position or Mercer's position to say whether their investors should have that same sort of transparency. I will tell you that several clients have voluntarily made the decision to do that.

Mr. DAVIS OF ILLINOIS. Well, by this standard, then, do you think that companies should be disclosing if their compensation consultant has a conflict of interest?

Mr. SCOTT. Congressman Davis, I would only disagree with what you were saying, because I make a distinction between a potential for conflict of interest and a conflict of interest. There are many potential forms of conflict. One certainly comes about when you have a relationship with a compensation committee and another part of your firm has a relationship with management. But there are other forms of potential conflict, as well, even if you only have a relationship with a compensation committee.

And I would say, in all of those cases, the transparency of the relationship is the thing that those in the decisionmaking role need in order to perform their role, which is to manage the potential for conflict.

Mr. DAVIS OF ILLINOIS. Thank you.

We heard from institutional investors earlier this morning that they actually want this information. We also saw that a wide range of experts on corporate governance say that this independence is critical.

If you would and if you could, I would like to ask if each one of you would answer these two questions for me with a yes or no, perhaps just beginning with you, Mr. Lowman.

If investors considered it important, shouldn't they have the right to know if a pay advisor is being paid for other work by management?

Mr. LOWMAN. I think if an investor wants to have that information, the investor should be provided the information.

I do want to—may I just add one clarifying remark to that? I think that, to Mr. Scott's point, there may be an apparent conflict but not necessarily a real one. And the other point I'd like to make is that simply providing a number does not necessarily provide insight into the nature of the relationship.

Mr. DAVIS OF ILLINOIS. Mr. Scott.

Mr. SCOTT. Congressman Davis, I'd like to answer—you mentioned two questions, though. I have the one about whether investors should receive that information about the fees. Was there a second?

Mr. DAVIS OF ILLINOIS. Well, I didn't mention the second one yet, but whether or not companies should be required to disclose when their consultant has a conflict of interest.

Mr. SCOTT. OK. I can't answer those yes/no. I'll go ahead and answer them if you'd like me to, but they don't lend themselves to a yes/no answer.

Mr. DAVIS OF ILLINOIS. All right.

Mr. SCOTT. Would you like me to answer?

Mr. DAVIS OF ILLINOIS. Yes, go right ahead.

Mr. SCOTT. To your first question, again, I would say that it's not Mercer's and it's not a compensation consultant's role to make policy in investor relations with companies. And so, our answer there—that would be our answer there.

With regard to your second point about whether companies should disclose whether the consultants they use have conflicts, again, I cannot agree with the underlying question, because I don't think that the potential for conflict means there is a conflict.

Mr. DAVIS OF ILLINOIS. All right.

Mr. Powers.

Mr. POWERS. To your first question, Congressman, our position is really the SEC has evaluated that issue fairly carefully and has made a decision. Up until recently, there was no disclosure of the compensation consultant. With the new disclosure rules, for consultants who are involved in either determining or recommending executive pay, the company has an obligation to identify both the consultant, who engaged the consultant and some specifics about the roles and responsibilities.

We believe the SEC thought that was a reasonable balance between investors' needs in that context. But I think from a policy standpoint we believe, again, that the compensation committee is the body that really has to make a determination on whether they're getting credible, objective advice or not. And, again, our policy is to provide them with all the information they need to make that assessment, and then it's up to them to decide.

Mr. DAVIS OF ILLINOIS. Mr. Paulin.

Mr. PAULIN. Congressman Davis, I think it would be simple enough to give investors the confidence without any real regulatory baggage that compensation consultants are independent, the same way that members of compensation committees are independent, which is why I suggested in my testimony that the New York Stock Exchange independence test be used.

Now, I can say I'm independent because I don't provide any other services. But what if I'm advising General Electric and my brother-in-law is the CEO of General Electric or I'm a former employee who's getting a pension from them or who has stock options, that type of thing? All of this is covered by a simple rule, and it goes beyond just cross-selling services. And I think something like that could be very easily used to address this problem.

Mr. DAVIS OF ILLINOIS. Mr. Reda.

Mr. REDA. Well, as a starting point, I would say, yes, the fees for executive compensation consulting services should be disclosed, as well as all other services, including affiliated companies.

The second question is, yes, if there's any conflicts, including potential conflicts, which is the fee disclosure aspect to the answer to the question, yes, I think that should be disclosed. I don't think that the outside consultant should be called independent if they are providing substantial other services to the company.

Mr. DAVIS OF ILLINOIS. Thank you very much, Mr. Chairman.

Chairman WAXMAN. Thank you.

Mr. Tom Davis.

Mr. DAVIS OF VIRGINIA. Yes, I just have one question. And, Mr. Reda, I'll address it to you, and Mr. Paulin.

Large corporations, certainly like any company in the Fortune 250, are likely to have a host of subsidiaries, subdivisions, many of which are far removed, operationally speaking, from either the parent entity or each other.

In such large corporations, don't you think it's far less likely that a consulting firm that is providing non-compensation consulting services to a particular corporate subdivision would face any kind of conflict when it comes to also providing pay advice to the parent company's compensation committee and board?

Mr. REDA. I'll answer first.

Yes, I think if there was other compensation consulting services to a subsidiary in another country totally unrelated to compensation, I could see that's not as conflicting. But it should be disclosed.

Mr. DAVIS OF VIRGINIA. Mr. Paulin, do you agree with that?

Mr. PAULIN. Yes. I mean, I think that there should be full disclosure of potential conflicts.

Mr. DAVIS OF VIRGINIA. But neither one of you would favor an absolute bar. If it's disclosed, that would be it, and then the board would be forewarned, and then they could appropriately make a decision?

Mr. PAULIN. Generally, to me, more important than disclosure would be some rule or definition for independence that could be applied. And if that were applied, then I don't know why additional disclosure would be necessary. If people knew that if I were the independent consultant I met certain independence tests, then maybe we wouldn't need disclosure.

Mr. DAVIS OF VIRGINIA. I mean, I'll just tell you, if I sat on a corporate board and I overcompensated somebody based on—I mean, I would be scared to death. We make it sound like being on a board is such a great thing, but with the lawsuits out there today, not everybody wants to serve on a board and subject themselves to that kind of potential liability. You put everything at risk. And I'm sure these questions are asked on a pretty consistent basis by wide-awake board members.

But I appreciate everybody's input into this thing. I think it's been illuminating to us. I don't see any reason for governmental intervention at this point. I think it's always important for the industry to come up with its own standards, and corporations, as they move ahead. But thank you very much.

Chairman WAXMAN. Thank you, Mr. Davis.

I want to thank the panel for your testimony.

I just want to conclude by saying there are millions of Americans, when they look at the soaring amounts that CEOs are getting paid in this country, they think the system's rigged. And I can't see what objection there would be that this potential conflict or apparent conflicts of interest at least be disclosed. As long as major companies hire consultants where there is no information to everyone involved, including the investors, that there's a potential or apparent conflict of interest, I think that cynicism of the American people will continue.

All right. Thank you all very much. We, I think, gave an airing to this issue, and your testimony was very helpful.

That concludes our hearing today, and we stand adjourned.

[Whereupon, at 1:32 p.m., the committee was adjourned.]

[The prepared statement of Hon. Bill Sali follows:]

Statement of U.S. Rep. Bill Sali (R-ID)
Given to the House Committee on Oversight and Government Reform
Hearing on Executive Compensation Consultants
December 5, 2007

Mr. Chairman and ranking Member Davis,

Today this Committee convenes to, and I quote, “examine the role played by compensation consultants in the determination and setting of executive compensation.”

In the words of Claude Rains in *Casablanca*, I am sure we will all be “shocked – shocked!” to learn that top executives make a bundle of money, and that compensation committees periodically get outside advice on how much CEOs, COOs and others who lead major corporations get paid.

The SEC has already addressed this issue, and done so in a thorough, dispassionate way. Yet playing on the frustrations of those with modest incomes is a great way to get headlines and encourage dissatisfaction. So here we are.

It is, in my view, rather cheap to go endlessly after the men and women who head up America’s biggest firms. I do not justify exorbitant salaries or any unethical practices which enable them. However, I do question, most seriously, the wisdom of Congress relentlessly sticking its finger in the eyes of those who keep our private and free enterprise system productive and, without exaggeration, the envy of and model for the rest of the world.

It also strikes me that this Committee’s focus is curiously limited. If we were truly interested in what some of our colleagues call “fairness,” why not ask about the compensation that many leading entertainment and sports figures obtain?

Surely we must be concerned with those brutal denizens of grinding greed, America’s top entertainers. In 2006, Tom Cruise earned a total of \$67 million over the course of the year. Denzel Washington, in that same year, earned \$38 million. Jodie Foster was a piker by comparison, pulling in a mere \$27 million in 2006.

Steven Spielberg trumped them all, garnering \$332 million in 2006. Oprah Winfrey pulled down a cool \$225 million.

And what of those great exploiters of the working class, America’s sports heroes? The latest data I’ve found is for 2004, during which Tiger Woods earned \$80 million. Peyton Manning received more than \$40 million and Shaq earned around \$30 million.

Mr. Chairman, I wonder if we will ever have a hearing where these paragons of injustice are hauled before this Committee and taken to task for their heartless capitalism.

In all seriousness, I hope we don’t. And I hope my sarcasm is taken for what it is.

The reality is that the men and women I've mentioned are earning high incomes because in the open market, the American people have chosen to reward them for their achievements. In the same way, leaders of business and industry are rewarded for their performance by their peers, colleagues and associates for their stewardship of the firms and organizations entrusted to their leadership.

Where there is legal malfeasance or ethical impropriety, let's go after it. But let's not use this dais as a means of mere finger-pointing for political advantage. Sadly, that's my sense of what we're doing today.

The late Milton Friedman, with his unique blend of understatement and insight, commented, and I quote, "History suggests that capitalism is a necessary condition for political freedom."

We in Congress endanger the very foundation of our nation's prosperity, the capitalist system, when we relentlessly probe it for every possible deficiency. In the strongest terms, I urge caution here, Mr. Chairman. We are on dangerous ground.

Thank you, Mr. Chairman, and I yield back.

