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Madame Chairman and members of the committee, thank you very much for the opportunity to appear today. I am very pleased that this committee is looking into this vital area of concern.

I am a passionate capitalist. If our current system of executive compensation tied pay to performance, if it provided an effective incentive to create long-term shareholder value, if it met any possible market test, I would stand up and cheer. If I thought, as some have argued, that the amounts at issue are so small in proportion to the assets being managed that they do not have any material impact, I would not be here. On the contrary, the CEO compensation in America's public companies is a perversion of the market that imposes enormous and growing costs on America's working families – as shareholders, customers, employees, and members of the community. Executive compensation must be looked at as any other asset allocation. And the return on investment for the expenditures on CEO pay is by any measure inadequate. We are not getting what we pay for. These outrageous pay packages juxtaposed with losses in share value and jobs diminishes our credibility and increases our cost of capital. In today's global economy this is an expense we clearly can no longer afford.

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

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

My firm, The Corporate Library, maintains an extensive database on corporate governance in public companies, and that includes a great deal of information and analysis of executive compensation. The data show that the disparity between pay and performance is enormous and growing. We have done a series of studies showing that the largest percentage increases in total compensation for CEOs had very little connection to long-term value creation.

It's a very small group in the stratosphere of pay: rock stars, movie stars, athletes, investment bankers, and CEOs. Of that group, the first four are in the ultimate pay-for-performance category, with a tiny percentage at the very top

making millions of dollars, and with deals that evaporate quickly if a movie, a CD, or a corporate acquisition tanks. Their pay is set through tough arms-length negotiations.

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

In the 1990s, the cult of the CEO was based on the idea that vision and the ability to inspire were what made the CEOs worth the hundreds of millions of dollars they were paid. But a book by Harvard Business School professor Rakesh Khurana, *Searching for a Corporate Savior: The Irrational Quest for Charismatic CEOs*, makes a compelling case that corporate boards err seriously when they pick chief executives based on "leadership" and "vision" or when they pay huge premium pay that is not sensitive to performance to attract a "superstar." Bringing in a CEO with a great record at another company may give the stock price a short-term boost. But high-profile transplants such as Al Dunlap at Sunbeam (which went into bankruptcy) and Gary Wendt at Conseco (which went into bankruptcy), CEOs should have to make the same disclaimers that money managers do: "Past performance is no guarantee of future performance."

Some have argued that CEO pay is set by the market. But it is not, as a return on investment assessment shows. And the consequence can be disastrous.

For example: the very first report we ever issued at The Corporate Library, in January of 2000, we said that we thought there was a problem at what was then the fastest-rising stock in the history of the New York Stock Exchange. We said that the CEO's insistence on receiving 2 million stock options at $10 a share *below* the stock's trading price indicated that he expected the stock to decrease in value and did not want to pay the price for that decline that the shareholders did. It also indicated that the board of directors had no ability to provide any independent oversight and no ability to say "no."

That was Global Crossing which a year later became the fourth biggest bankruptcy in U.S. history.

At one financial services company there was a pay plan that had nine different measures of performance. But the plan gave the board discretion to award all of the bonuses for meeting any or all of those goals. They decided for fiscal 2006 to base the formula on the single metric of return on equity. The company was Bear Stearns. Another harbinger of and contributor to disaster. We also noted problems at a bank where the CEO's pay was as large as CEO salaries at firms exponentially larger and included $260,000 one-time initiation fee to a country club; reimbursement for payment of taxes ($12,650), financial planning ($15,000) and other perks. Is there any reason that the shareholders should be paying a CEO's taxes or financial planning? That bank is IndyMac, now the second-largest bank failure in history.

The subprime crisis was in part caused by pay plans that were based on volume of loans rather than quality of loans. That was a guarantee of disaster. Here are some of the mind-boggling numbers:

For 2006, Angelo Mozilo's total actual compensation was valued at over $102 million. His annual bonus for that year was based on a performance target of diluted earnings per share, or "EPS." For Fiscal 2006, Countrywide Financial's reported EPS was $4.30, which was an increase of 4.62% over Fiscal 2005 EPS of $4.11, resulting in a cash incentive award of $20.5 million to Mr. Mozilo. These inflated earnings forced the company's stock up by 26%.

But by the end of 2007, when Countrywide finally revealed the losses it had previously obscured, shareholders lost more than 78% of their investment value. Meanwhile, in early 2007 Mr. Mozilo sold over $127 million in exercised stock options before July 24, 2007, when he announced a $388 million write-down on profits. On August 16, Countrywide narrowly avoided bankruptcy by taking out an emergency loan of $11 billion from a group of banks. Mr. Mozilo continued to sell off shares, and by the end of 2007 he had sold an additional $30 million in exercised stock options. Mr. Mozilo received more than $102 million in compensation and $157 million in exercised stock options, while total shareholder return was negative 78% over the same period. He was entitled to receive another $58 million in non-qualified deferred compensation and supplemental pension benefits when he retires in connection with the Bank of America merger in 2008.

At Citigroup, Charles Prince received total compensation valued at over $25.9 million in 2006. His incentive awards for that year totaled more than $23 million and were based on multiple performance measurements. Specifically, the company stated that "revenues grew 7%, almost all of which was organic," "net income from continuing operations grew at about the same rate as total revenues (about 7% in each case)," "the 2006 return on equity was 18.8%," and "total return to stockholders was 19.6%." Then in 2007, the company announced its $24.1 billion write-down in connection with sub-prime lending. Soon after, Charles Prince announced his resignation and left the company with $40 million

in severance. Shareholders lost 45% of their investment value by the end of the year.

At Merrill Lynch, former-CEO Stanley O'Neal received total compensation of more than $91 million for 2006. His incentive compensation was also based on multiple performance measurements. The company stated the following about the Mr. O'Neal's performance against objectives:

The Committee considered performance against the CEO objectives determined at the beginning of the year and noted that all financial targets were met or exceeded and all strategic and leadership objectives were met with distinction. This review included consideration of numerous objectives.

On October 24, 2007, Merrill Lynch reported an $8.4 billion subprime mortgage-related write-down. Just days later, Stanley O'Neal announced his retirement. He received more than $160 million in stock and retirement benefits in connection with his departure, while shareholder lost more than 41% of their investment value over the year. On January 17, 2008, Merrill Lynch took an additional $14.1 billion write-down, bringing its subprime mortgage-related losses to nearly $23 billion.

During 2006, management at New Century Financial Corp issued false and misleading statements about the company's financials to boost earnings, which allowed New Century stock traded at artificially inflated prices. On March 2, 2007, the company announced that it was the subject of federal criminal probes related to securities trades and accounting fraud. On April 2, 2007, the company filed for Chapter 11 bankruptcy. Over the three year period prior to filing for bankruptcy, Robert K. Cole, Chairman and CEO of New Century Financial Corp, received over $22 million in total compensation, most of which he received from exercised stock options that he sold at artificially inflated stock prices.

In 2006, management at Novastar Financial Inc. reported a rise in earnings after the company originated a record $2.8 billion in loans, boosting the company's stock price to inflated levels. Then in February 2007, the Novastar's stock fell by 42% after announcing fourth quarter and year-end 2006 results, and warned that NovaStar was expecting to earn little or no taxable income in the next five years. In November 2007, Novastar stock plunged after the subprime mortgage lender posted a $598 million third-quarter loss and said that bankruptcy was possible. Over the three-year period leading to the enormous losses, Scott F. Hartman, Chairman and CEO of Novastar, received more than $13.6 million in total compensation.

In January 2007, American Home Mortgage earnings soared 288% after the sub-prime lender originated a record $15.5 billion in loans during the fourth quarter of 2006. Just eight months later, on August 6, 2007, American Home Mortgage Corp filed for bankruptcy. The stock was at 44 cents a share, down from an

annual high of $36.40. Total compensation awarded to Michael Strauss, Chairman and CEO of American Home Mortgage, over the three-year period prior to the bankruptcy was over $8 million, largely based on bonuses tied to inflated earnings targets.

On June 15, 2008, American International Group (AIG) announced its plans to replace Chief Executive Officer Martin Sullivan with a director of the company who has been chairman since 2006, Robert Willumstad after the company posted losses for two consecutive quarters totaling $13 billion. Mr. Sullivan's contract entitled him to approximately $68 million.

There is an obvious disconnect between the performance of these CEOs and the compensation they received. They led the companies in a risky strategic direction that resulted in significant losses for investors across nations. Incentive compensation based on earnings and revenue increases is problematic in a situation like that of sub-prime mortgages. Principal officers, for themselves and in particular for those down the line who are similarly incentivized, can push "sales" without adequate concern for quality. There is a disconnect in that bonuses are "earned" as business is booked; only when it is clear that the business is defective – and that such defect should have been apparent at the outset – is the hit to earnings recognized. By that time, the CEO has been paid based on the inflated numbers. Fewer than 13 percent of public companies have clawback policies requiring executives to return bonuses based on inflated numbers. So why should they worry about manipulating the figures to get the money upfront?

There is no way to justify any of these pay plans by saying they meet a market test. Marie Antoinette would be ashamed to get paid like this while shareholders are losing money and employees are losing jobs. The last time Congress tried to fix this problem it made it worse by adopting the notorious 162m of the tax code. It poured gasoline on the fire by encouraging the award of stock options. Just thirty years ago, a CEO might get 30,000 options. Now million-option grants are not unusual and even stock option grants have only a tangential relationship to the creation of long-term, sustainable value. As long as CEOs pick the people who serve on their boards and shareholders have no ability to remove them, this will continue. In the 2006 proxy season, 25 director candidates failed to get the support of a majority of the shareholders. Yet 24 of them continue to serve on those boards. If shareholders cannot get rid of directors who agree to pay completely disconnected from performance, it will only get worse.

The pay-performance disparity is so outrageous, so atrocious that it undermines the credibility our system of capitalism. In a global environment, information and the ability to trade in any market at any time will provide our system with the toughest market test in the history of our country. As we compete for capital, we must be able to show those inside and outside our country that we deserve their

trust and will provide them with a competitive return instead of shoveling more money into the pockets of the top executives.

I would like to acknowledge the assistance of Paul Hodgson, Alex Higgins, Marjorie Schwietering, Lauren Warmington, and other staff members at The Corporate Library in preparing this testimony. Many thanks to the committee and its staff for the opportunity to appear, and I will be glad to answer any questions.