Testimony of

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Before the
Committee on Financial Services
U.S. House of Representatives

On

H.R. 1257
The Shareholder Vote on Executive Compensation Act

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Good morning, Chairman Frank and members of the Committee on Financial Services. My name is Richard Ferlauto. I am the Director of Pension and Benefit Policy at the American Federation of State, County and Municipal Employees. AFSCME is the largest union in the AFL-CIO with 1.4 million members who work in the public service. Our members have their retirement assets invested through public retirement systems with more than one trillion dollars in assets. They depend on the earnings of these systems to support their benefits in retirement. Large public pension system investments in the public markets are diversified, largely owning the market, and heavily indexed, which operate with time horizons of 20 years or more to match the benefit obligations they have to their plan participants. Indeed, public pension systems are the foundation of patient capital investment in this economy, which seeks long-term shareholder value creation.

AFSCME places strong emphasis on improving corporate governance through direct company engagement, regulation and legislation as a way to achieve long-term shareholder value. As an active shareowner, we have been a leading advocate for a shareholder advisory vote on CEO compensation and shareholder proxy access to nominate directors on company proxy materials. We believe that both are required to align the compensation of the most highly paid executive officers with the long-term performance objectives of public fund shareholders.

Executive compensation that is not aligned with long-term value creation has been a problem for shareholders for years. Inappropriate compensation arrangements can distort the incentive structure for implementing strategic planning and can waste corporate assets that could be distributed to shareholders or reinvested in the company and its employees, making companies less competitive. And, when so much money is at stake, inappropriately structured compensation can generate the motivations to manage earnings, obfuscate financial statements or simply cook the books. The latest versions of this phenomenon are the “options back dating” and “spring loading” scandals that, according to statistical models, ultimately may implicate thousands of publicly listed companies.

In addition to the important issue that this is for corporate shareowners, there are compelling public policy reasons why concerns about spiraling and out of control CEO pay needs to be addressed through legislation. Social equity concerns should be heeded when internal corporate governance failures lead to the creation of a super-rich class, whose rise is not based on merit, but rather on ineffective corporate boards, crony relationships and financial manipulation. When failed CEOs walk away with hundreds of millions of dollars or when golden handshakes are given to the newest "rock star" executive with contract guarantees or when books are manipulated to meet payout thresholds, then the American ideal of working hard to get ahead rings hollow. This type of inequity may eventually tear at the fabric of our society.

The numbers tell the story. The average S&P 500 CEO took home $13.51 million in 2005, up by more than 16 percent over the year before.[i] The average pay for all CEOs comes to $7.09 million in 2005.[ii] Yet these numbers do not include the to-date "hidden" pensions, tax gross-ups, country club memberships, personal jet use and myriads of other CEO perquisites.

Looked at another way, the average CEO in the United States earned 262 times the pay of the average worker in 2005. In 2005 a CEO earned more in one workday than an average worker[iii] earned in 52 weeks.[iv] Put executive pay up against a minimum wage worker, and the CEO was paid 821 times as much as a minimum wage worker in 2005.[v]

A 2006 poll found that 80 percent of Americans thought executives were overpaid.[vi] It is not just the public that is outraged over soaring pay for executives. Ninety percent of institutional investors think the current executive compensation system has dramatically overpaid executives.[vii] Even a majority of directors realize there is a problem. Sixty-one percent of corporate directors think the current executive compensation system has overpaid executives.[viii]

A study by Towers Perrin of top executive pay in 26 major countries found that American executives make an average of twice as much as their French, German and British counterparts and four times as much as the Japanese and Koreans.[ix]

The argument that CEOs are paid handsomely because they are great generators of wealth for the US economy is not sustained by the facts. Much of the time CEO compensation has little relationship to performance. For example, the 60 companies at the performance bottom of the Russell 3000 index lost $769 billion in market value and destroyed $475 billion in economic value over the five years ending in 2004, while the top five executives at the companies were paid more than $12 billion dollars according to the consulting firm MVC Associates International.[x]

Out of control compensation many times is an indicator of other problems that are linked to failures of the board of directors. Too often, CEO pay is driven by outside consultant surveys and the fact that boards believe their CEO has to be in the top half, if not the top quartile of their peer group, regardless of performance. When pay is not performance-based or is an outlier to its peer group, it often indicates that appropriate CEO succession planning with the strategic objectives of the company in mind has not taken place. Rather than nurturing internal talent, boards which go outside the company need to make whole the current "hot" executive at an auction price. Boards have little discipline when shopping for executives and often get stuck with a non-performing CEO who then needs to be paid off to leave. Witness Carly Fiorina's $21.1 golden parachute at Hewlett Packard; the re-pricing of 1,100,000 stock options for Paul Pressler, the recently departed CEO at the Gap; and, Bob Nardelli's $257 million exit package at HomeDepot, just to highlight a few instances of board failure.

The root cause of these board failures is that directors are not accountable to shareowners. In fact, the American way of corporate governance is fundamentally flawed because the lack of ownership rights creates the classic problem of agency. American investors and companies deserve something better if we are to most efficiently create wealth as well as remain competitive with the global markets where director accountability and shareholder influence on pay is more advanced.

AFSCME supports H.R 1257, "The Shareholder Vote on Executive Compensation Act," because those who have been in a position to link pay to performance and give shareholders an increased voice in the pay review process have not lived up to that responsibility. It would have been our preference that corporate boards, the Self Regulatory Organizations (SROs) or the SEC give increased power to shareholders to effect better pay models. However, they have had their chance to act in the shareholder's interest and failed to do so for years. Under the circumstances that exist today, where only one U.S. company has come forward and said it would voluntarily provide a shareholder advisory vote, we see no other alternative but to support congressional action and continued congressional oversight.

We remain hopeful that the SEC's new disclosure rules on executive pay will create substantially more transparency about general compensation, retirement benefits and perquisites for top executives. In establishing those rules, however, the SEC has given shareholders only half of what is needed. Better disclosure is necessary but not a sufficient tool to rein in compensation unaligned with value creation. The SEC-required disclosures give us more information, but not the ability to act on that information, although many institutional investors asked for such rights in the rulemaking comment period. In fact, it is not at all clear that market forces given this new information will not act to drive up pay levels even further as CEOs observe and demand the richer pay packages of their peers.

Similarly, U.S. stock exchange listing standards require shareholder approval of equity-based compensation plans. Those plans, however, only set general parameters and accord the compensation committee substantial discretion in making awards and establishing performance thresholds for a particular year. The SROs certainly have the ability to require advisory votes on pay as a requirement of their listing standards, but given the internally conflicted nature of regulatory control contained within the current for-profit SRO structure, we see little hope for action from these bodies. Even the investor outrage over Dick Grasso's $187 million pay package from the New York Stock Exchange has not resulted in listing standards that empower shareholders with the right to object to company pay packages.

Finally, we believe that shareholders do not have any mechanism for providing ongoing feedback on the application of those general listing standard requirements to individual pay packages. Withholding votes from compensation committee members who are standing for reelection is a blunt and insufficient instrument for registering dissatisfaction with the way in which the committee has administered compensation plans and policies in the previous year.

Most company director elections continue to be governed by plurality voting, so a vote withheld from directors is meaningless. Plurality voting ensures that a director will be elected even if the holders of a majority of shares voting decide to withhold support from a director. Ironically, with the increase in the number of companies moving to majority election standards-- as they should, shareholders' ability to send messages to compensation committees may actually be reduced. Today, "no votes", which withhold support for directors, are used as part of the dance of shareholder messaging to directors. As votes become more meaningful, proxy voters and advisors may be less willing to send these messages on specific issues like pay, if the board is otherwise well-functioning or if corporate performance is high.

In contrast to U.S. practices, in the United Kingdom public companies are required to give shareholders an advisory vote on the "directors' remuneration report," which discloses executive compensation. Such a vote is not binding, but gives shareholders a clear voice that can help shape senior executive compensation. In the U.K. and other markets we can observe the history and effectiveness of a shareholder advisory vote on pay.

Advisory shareholder votes are established in the U.K. by law in the Director's Remuneration Report regulations, which require a detailed annual remuneration report that is put to a shareholder vote at every annual general meeting of quoted companies with financial years ending on or after December 31, 2002. The purpose of the legislation as stated by the United Kingdom's Department of Trade and Industry (DTI) was to: 1) enhance transparency in setting director's pay; 2) improve accountability to shareholders and; 3) provide for a more effective performance linkage.[xi] The first required votes of the remuneration reports took place at annual general meetings between March 2003 and March 2004. In addition to these newly legislated reporting and voting requirements the Association of British Insurers and the National Association of Pension Funds issued voluntary guidelines for shareholders engaging with companies over compensation issues.

The impact of the new advisory vote requirement was felt beginning in May 2003 at GlaxoSmithKline, the global pharmaceutical company, when shareholders rejected the remuneration report with 50.72 percent of votes cast against the report. The protest vote proved to be humiliating for the GSK board - the historic vote, although only advisory, made Glaxo the first, and to date, only British company to have its pay scheme rejected by shareholders. Shareholders were particularly angry about the "golden parachute" payment chief executive Jean-Pierre Garnier would have received if he lost his job.

When GlaxoSmithKline lost its vote, a sea change occurred with an almost immediate realization among boards that they now had to talk to their shareholders about pay packages. And not just talk *at* them, they actually had to explain the numbers, to justify the incentives, and to persuade their shareholders to accept them.

Paul Munn of Hermes describes the benefits of the vote in the U.K, "We see it as a useful means of engaging with companies on the issue of executive pay. Having an advisory vote sets up the basis for having a dialogue, and that is what is useful."[xii]

With greater shareholder consultation on executive compensation packages in the United Kingdom last year, the growth of executive salaries is declining.[xiii] A study of Britain's 100 largest companies by New Bridge Street Consulting found that the rate of increase in executive salaries in 2006 was five to six percent, down from roughly 14 percent five years earlier.[xiv]

The DTI engaged the consulting firm Deloitte to issue the November 2004 <u>Report on the impact of the Directors' Remuneration Report Regulations</u>.[xv] Among its most important findings, more than 70 percent of shareholders believed that the advisory vote on the remuneration report had significant impact on the "board attitudes and behaviours."

In 2004, the Netherlands took it a step further by requiring companies to submit remuneration reports to a binding vote. In 2005, both Sweden and Australia adopted requirements for non-binding shareholder votes on remuneration reports. An Australian survey in 2006 found that 40 percent of corporate officers believed that directors should take notice of shareholder concerns if a pay report receives a ten percent negative vote, while another 48 percent stated there should be a response if a pay report received a 20 percent negative vote.[xvi]

From discussions and consultations with the largest global institutional investors experienced with the advisory vote, AFSCME has drawn the following lessons about the use of advisory votes on executive compensation:

- Communication and consultation between shareholders and compensation committees would increase, become more substantative and take place earlier in the pay setting process.

- These communications would better align compensation packages with pay for performance practices that reflect shareholder interest in long-term value and wealth creation.

- With pay for performance in place, the pay practices better reflect individual company situations and better align CEOs with long-term strategic objectives because appropriate incentive structures are put in place.

- The vote is an effective antidote to the tendency of executive compensation to spiral up with enhanced disclosure requirements.

Based on this history and outcomes, in 2006 the AFSCME Employees Pension Plan imported the U.K. advisory vote model by filing “say on pay” shareholder proposals at seven companies, seeking to test the concept with institutional investors and the reaction of board compensation committees. The proposals averaged more than 41 percent support from shareholders, which according to Institutional Shareholder Services is the strongest showing ever for any first year shareholder proposal.

So far in 2007, more than 60 “say on pay” advisory vote proposals have been filed by a broad network of institutional investors, including public pension systems such as CalPERS, the New York City Employees' Retirement System, and Connecticut Retirement Plans and Trust Funds; international funds such as Hermes Investment Management Limited; and the mutual funds Walden Asset Management, Boston Common Asset Management, Calvert Group, and Trillium Asset Management. Labor funds in addition to the AFSCME Employees filing these proposals include the IBEW, SEIU Master Trust and the AFL-CIO Pension Fund Reserve.

The 2007 formulation of the proposals urges the adoption of a policy that company shareholders be given the opportunity at each annual general meeting to vote on an advisory resolution, to be proposed by company's management, to ratify the compensation of the named executive officers as set forth in the proxy statement's Summary Compensation Table and the accompanying narrative disclosure of material factors table. The management would make clear that the vote is non-binding and would not affect any compensation paid or awarded to any named officer.

Just two weeks ago in reaction to one of these shareholder proposals, Aflac became an early adopter of the process, perhaps opening the door for others to follow. Aflac CEO Dan Amos says a vote would make a difference even if it is non-binding. "We would go back to our big shareholders and ask: 'Why did you vote against? What was it you didn't like?' From there, we'd make adjustments."[xvii]

The shareholder proposals also have resulted in the formation of a working group composed of top U.S. corporations and major institutional investors. The working group is examining how the shareholder advisory might be adapted from the U.K. to the U.S. market. Company participants in the group believe that the concept has considerable merit, but have raised questions about differences between U.K. and U.S. governance systems that need to be explored. It is my hope that the output from this working group will lead to general principles and best practices about how to structure compensation committee/shareholder consultation and produce additional voluntary adopters of the advisory votes. I believe that this effort will bring about a trend of voluntary adoption by leading-edge corporate governance companies. What will not occur with this voluntary approach, however, is broad use of the advisory vote in the immediate future nor its acceptance by entrenched boards with the worst compensation practices.

We want to emphasize that the shareholder vote on pay should be structured only as an advisory vote and not a mandatory vote, which directly rejects or sets compensation levels. It is the responsibility of the compensation committee and the board to establish pay schemes and they are the ones who must ultimately be held accountable for the pay schemes they establish. An advisory vote would provide directors with additional information about shareowners' views on pay and generate the benefits I describe earlier in this testimony. Furthermore, to the extent that the SEC disclosure requirements in the Compensation, Disclosure and Analysis (CD&A) look back on compensation already awarded, and are not prospective, mandatory compensation votes on the CD&A would have large implications for how the terms of compensation agreements are negotiated.

Most importantly, in order for the shareholder advisory vote on compensation to be effective it must be paired with a shareholder proxy access right to nominate directors. Proxy access is the accountability tool that will drive a robust consultation process and focus directors on long-term value issues. Shareowners today have no meaningful way to hold accountable dysfunctional and entrenched boards that are unresponsive to votes on pay reform or other issues. Proxy access is a cost-effective and efficient safety valve for good corporate governance, director accountability and long-term value creation.

The advisory vote and proxy access are necessary complements in the modernization of shareholder rights in the United States. Shareowners will be allowed to evaluate whether or not the compensation committee has produced an appropriate compensation package. If an advisory vote fails to produce reform, then shareholders could withhold votes or replace members of compensation committees that overpay or do not properly link CEO pay to performance.

The experience in the United Kingdom offers instructive guidance for the situation we have today. In the U.K., which has both rights, these shareholder powers are viewed much like soccer's yellow and red card warning system. The advisory vote is the yellow card. A large shareholder vote against a pay report is the yellow card warning to the company board. If this warning is not heeded and pay practices are not reformed and better aligned with performance, then shareholders have the opportunity to use the red card by replacing failed directors.

Finally, I would urge one important clarifying amendment to the legislation, which is required to guarantee the ability of shareholders to continue to submit proposals on the specific elements of senior executive pay. We suggest that language be added to the effect that no requirement imposed by this Act on companies shall be construed to permit a registrant to exclude shareholder proposals on specific elements of executive compensation. The current form of the legislation could be interpreted by companies as permitting them to omit specific pay-related proposals on the basis of SEC 14a-8(i)(9) and (i)(10) issues, which allow exclusion of proposals that directly conflict with one of the company's own proposals to be submitted to shareholders at the same meeting or proposals that have already been substantially implemented by the company, respectively.

Thank you Mr. Chairman for allowing me to share the views of AFSCME, and many institutional investors on H.R. 1275, and more generally on how enhancing shareholder rights through an advisory vote on pay and proxy access will lead to long-term shareholder value and create a more competitive capital market in the United States. I would be pleased to answer any questions from the Committee.

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[i] "2006 CEO Pay Survey," The Corporate Library, September 29, 2006, p. 8
[ii] Ibid, p. 7.
[iii] Calculated average worker pay is $41,861. Worker pay is the hourly wage of production and nonsupervisory workers, assuming the economy-wide ratio of compensation to wages and a full-time, year-round job.
[iv] Mishel, Lawrence, "CEO to Worker Imbalance Grows," Economic Policy Institute, 6/21/06.
[v] Mishel, Lawrence, "CEO Pay-to-Minimum Wage Ratio Soars," Economic Policy Institute, 6/27/06.
[vi] "In the Money," The Economist, 1/18/07.
[vii] "Institutional Investors Dissatisfied with U.S. Executive Pay System, Watson Wyatt Study Finds," Watson Wyatt, 12/13/05. 55 institutions managing $800 billion in assets were surveyed.
[viii] "Corporate Directors Give Executive Pay Model Mixed Reviews, Watson Wyatt Survey Finds," Watson Wyatt, 6/20/06. 50 directors who serve on corporate boards were surveyed.
[ix] Hunt, Albert, "Capitalistic Democracy: Let Shareholders Vote on CEO Pay," St. Paul Pioneer Press, 2/20/07.
[x] MVC Associates International, wwwmvcinternational.com.
[xi] In the U.K. the term director translates to executive in the U.S.
[xii] Morgenson, Gretchen, "A Sneak Peak Preview of Proxy Battles," The New York Times, 12/17/06.
[xiii] Kopinski, Thaddeus, "Executive Pay Raises Slow in the U.K." ISS Friday Report, 3/3/2006.
[xiv] Nash, Jeff, "Say on Pay? Some Say Duck and Cover," Financial Week, 2/19/07.
[xv] Report on the impact of the Directors' Remuneration Report Regulations, Deloitte, November 2004.
[xvi] Yates, Robert, "Focus on Pay Marks Australian Proxy Season," ISS Governance Weekly, 2/10/06.
[xvii] Jones, Del, "Aflac Will Let Shareholders Vote on Pay for Top Executives," USA Today, 2/14/07.