United States House of Representatives
Committee on Financial Services

Testimony of Nell Minow
Editor, The Corporate Library
March 8, 2007

I am very grateful to the Committee for inviting me to participate in this hearing on a matter of vital importance to the credibility and sustainability of our capital markets.

Mr. Chairman and Members of the Committee, if our current system of executive compensation tied pay to performance, if it provided an effective incentive to create long-term shareholder value, if it met any possible market test, I would stand up and cheer. As I have said to this committee before, executive compensation must be looked at as any other asset allocation. And the return on investment for the expenditures on CEO pay is by any measure inadequate. We are not getting what we pay for.

That is because under our current system there is no consequence for excessive pay. The fundamental irony – and the fundamental hypocrisy -- is that the very same people who claim that the free market is the most efficient mechanism for assigning value are less enthusiastic when it comes to applying that test to their own pay packages.

The failure of 162-M shows how difficult it is for the federal government to address the issue of executive compensation. The result has been a sort of whack-a-mole game, as every time we slam down one abuse, others start popping up.

I do not think that the Senate Finance Committee's current proposal, again addressing the issue through the tax code, is the right solution. I am a strong supporter of the approach in Congressman Frank's bill, an advisory vote on executive compensation. This is a very modest step, but, as the experience in the UK shows, it is a significant one. Here is an excerpt from a report on the subject prepared by my company's top specialist on executive compensation, Paul Hodgson:

> [I]t was not until May 2003, after the remuneration report vote became mandatory, that a company felt the full force of shareholder disapproval. Pharmaceutical giant GlaxoSmithKline (GSK) suffered a defeat at its annual general meeting when shareholders voted against the remuneration report. The results indicated that 50.72 percent of votes were cast against.
>
> It is sometimes claimed that a vote against a remuneration report, or a CD&A, is a blunt instrument as it is not clear to what shareholders are objecting. However, in the GSK instance it was very clear what shareholders found objectionable. The item in questions was an employment agreement with its CEO Jean-Paul Garnier that would have been regarded as moderate in the US but which was considered excessive in the UK The company's response was to ask Deloitte & Touche, its compensation consultants, to conduct an independent review and report back for 2004.
>
> The proposed employment agreement contained provisions for salary and bonus continuation of two years, with all the normal US bells and whistles – outplacement counseling, excise tax reimbursement, immediate vesting of equity awards, etc., etc. By the time the agreement was signed in March 2004, this had been cut back to a plain one year's salary and bonus continuation with equity vesting governed by the respective incentive plans. The excise tax gross-up was maintained, but given that such severance is unlikely to trigger it, this was not much more than a sop.
>
> Much of this was disclosed in GSK's announcement of its annual meeting in 2004, when it described the prior year's fracas and its resolution thus:
> "The Remuneration Report, which is the subject of Resolution 2, embodies the results of the Board's thorough review of remuneration policy. The thrust of the revised policy is to reward performance and eliminate what might be deemed 'payment for failure'. This policy has resulted in significant voluntary changes to the contracts of the Executive Directors and the senior executive group; and I thank the executive, particularly Dr Garnier and John Coombe, for their help in

working with the Board's Non-Executive Directors to determine what was in the best interests of GSK, and acting accordingly.

"After the very full consultation with shareholders in June and July, the Board decided the changes in remuneration policy that would best bridge the gap between the views of shareholders and the competitive needs of the business. These were announced in December and are outlined in the Remuneration Report.

"Since then we have held further discussions with shareholders to ascertain if and where there still exist points of difference. We had always recognised that, due to GSK's transatlantic straddle, some would remain. However, the recent discussions have confirmed that we have moved substantially towards compliance with shareholders' guidelines. They have also, I hope, engendered trust that we will continue to listen to shareholders; and that we are committed to timely and appropriate consultation hereafter in order to avoid the differences of view which we have had to resolve in 2003."

This might have been the signal for a new contentious era in UK executive compensation but, while there have been a number of near misses and controversial rows – at telecommunications giant Cable & Wireless, major utility National Grid, and telecom company Vodafone for example – there have been no other majority votes against pay since the GSK meeting. The key to this outcome can actually be found in the extract from the GSK notice of meeting above: "further discussions with shareholders". In each of the cases where controversy has appeared to have been brewing, behind the scenes discussions with major institutional shareholders have averted protests.

Steve Tatton, editor of Executive Compensation Review, a UK journal specializing in the area, said that at the journal's recent conference on executive pay, a consistent story was told by senior human resource professionals who gave speeches. This was that companies now regularly work closely with shareholders to ensure that there is full agreement on pay issues prior to the annual meeting and that sometimes companies will have to incorporate changes in order to gain this support. Most of the issues have to do with equity incentive plans that create excessive dilution.

Perhaps because of the lack of continued controversy, the practice of submitting remuneration reports to shareholder vote has spread. A year after the UK made the practice mandatory, the Netherlands took it a step further by requiring companies to submit remuneration reports to a binding vote. And in 2005, Sweden and Australia both adopted requirements for non-binding share

Opponents of the practice claim that shareholders already vote on the largest parts of executive compensation – annual and long-term incentive plans. But recent announcements of outsized severance packages belie the assertion that incentives represent the largest element of compensation. Furthermore, a vote on a compensation plan is a vote on the theoretical application of a policy not on actual practice; it is a vote on inputs not outcomes. And the outcomes sometimes come as something of a surprise even to those shareholders who have approved them.

While some companies may be justified in fearing the implementation of such an advisory vote, there are surely many where the compensation paid is entirely reasonable and tied closely to performance. Such companies should welcome this vindication of the compensation committee's decision making.

As I have said above, I believe that requiring an advisory vote on pay strikes exactly the right balance in providing a mechanism that is meaningful but not disruptive. I ask the committee to consider three other points.

First, we want to make it clear that this new rule would not infringe on the current rights shareholders have to submit proposals related to specific elements of pay and other corporate governance matters permitted under 14(a)(8).

Second, while I do not believe that shareholders should have a binding vote on pay, I would like to see some consequences for companies that insist on imposing a pay plan that is objected to by a majority of shareholders. If the British example is any indicator, it would be extremely rare to have such a vote and almost unheard of to have a company proceed contrary to the expressed wishes of the shareholders. If such a case did occur, I would suggest that the board be required to replace a majority of the members of the compensation committee. If the committee then decided to go ahead with the compensation plan rejected by the shareholders, it would at least ensure an additional layer of review and it would at least encourage the new members of the committee to communicate with the shareholders more effectively.

Third, I ask this committee to consider asking the SEC and the Department of Labor to look into the conflicts of interest in proxy voting by mutual funds and pension funds. Last year, The Corporate Library and AFSCME issued a report on this subject. We found that with a few exceptions, the largest mutual fund families are complicit in runaway executive compensation because they have not used their voting power in ways that would constrain pay by tying it more closely to individual company performance. In the aggregate, the mutual funds voted to support management recommendations on compensation issues—both recommendations to vote in favor of management compensation proposals and recommendations to vote against shareholder proposals seeking executive pay reform—73.9 percent of the time and rejected the management position only 23.7 percent of the time.

Both mutual funds and pension funds are subject to legal standards requiring them to vote in the best interests of beneficial owners – investors and pension plan participants. But the agencies with oversight have failed to issue guidance or provide any enforcement when they cast proxy votes in favor of excessive pay and directors who approve it. It is just too easy to vote “yes” when there is no risk of enforcement and when that vote can enhance relationships with portfolio companies with whom they may have (or would like to have) other business relationships. It would be a shame to give investors this important opportunity to cast an advisory “no” vote without making sure that those votes are not compromised through negligence or conflicts of interest.

A couple of years ago, in a debate on CEO pay, my opponent said, “It’s not fair. You have all the good examples.” Mr. Chairman and members of the Committee, this is not a case of a couple of outrageous anecdotes. It is a systemic problem. And excessive CEO compensation is not just an immaterial aberration. It is the symptom of a fundamental disconnect and abuse that undermines the credibility of our capital markets and increases the cost of capital. We will lose critical investors to economies that tie pay to performance if we do not address this issue. I believe that Chairman Frank’s proposal is the best possible way to begin.

Thank you again and I would be happy to answer your questions.