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Hearing of the Committee on Financial Services

Protecting Investors and Fostering Efficient Markets: A Review of the S.E.C. Agenda

May 25, 2006

Chairman Oxley, Ranking Member Frank and members of the Committee, my name is Ann Yerger, and I am the Executive Director of the Council of Institutional Investors, an organization of more than 300 investment professionals, including more than 130 public, corporate and union employee benefit plans with more than \$3 trillion in investments. The Council, a leading advocate for improving corporate governance standards for U.S. companies and strengthening investor rights, appreciates the opportunity to discuss the agenda of the Securities and Exchange Commission, particularly the Commission's efforts regarding executive compensation issues.

Headlines in recent years have highlighted a host of executive compensation abuses at U.S. companies. Examples have included: lavish pay packages despite poor corporate performance or even, in some cases, corporate bankruptcies; outsized equity awards resulting in pay disproportionate to company performance; and poorly structured incentive programs creating pay-for-performance disconnects. Most recently articles have identified how executives at a growing list of U.S. companies have benefited by backdating stock option grants to take advantage of stock price lows.

These headlines highlight the reasons why executive compensation has long topped the list of corporate governance issues of concern to the Council and its members. Our concerns have centered not simply on the amount paid to CEOs and other top executives, but also the board processes for setting pay, the disclosure of pay, the structure of pay and the pay-for-performance metrics.

As long-term investors with a significant stake in the U.S. capital markets, Council members have a vested interest in ensuring that U.S. companies attract, retain and motivate the highest-performing employees and executives. They are supportive of paying top executives well for superior performance.

However, Council members and other investors are harmed when poorly structured executive pay packages waste shareowners' money, excessively dilute their ownership in portfolio companies and create inappropriate incentives that may reward poor performance or even damage a company's long-term performance. Inappropriate pay packages may also suggest a failure in the boardroom, since it is the job of the board of directors and the compensation committee to ensure that executive compensation programs are effective, reasonable and rational with respect to critical factors such as company performance and industry considerations.

The Council believes executive compensation issues are best addressed by requiring companies to provide full, plain English disclosure of key quantitative and qualitative elements of executive pay, by ensuring that corporate boards are held accountable for their executive pay decisions, by

giving shareowners meaningful oversight of executive pay and by requiring disgorgement of ill-gotten gains pocketed by executives. In general, the Council believes the regulatory bodies—the SEC and the stock exchanges—are best positioned to address shortfalls or problems with these checks and balances. The Council is very hopeful that the SEC’s current initiatives will address the important issues raised by Ranking Member Frank in H.R. 4291 “Protection Against Executive Compensation Abuse Act” and thus eliminate the need for legislation.

Disclosure

Of primary concern to the Council is full and clear disclosure of executive pay. As U.S. Supreme Court Justice Louis Brandeis noted, “sunlight is the best disinfectant.” Transparency of executive pay enables shareowners to evaluate the performance of the compensation committee and board in setting executive pay, to assess pay-for-performance links and to optimize their role of overseeing executive compensation through such means as proxy voting.

Current rules addressing the disclosure of executive pay are out of date and in need of significant improvement. The Council is very pleased the SEC recently proposed expansive updates to the current executive compensation disclosures and commends the Commission and its staff for preparing these rules, which we believe address a significant number of the most critical issues to investors.

The Council supports the SEC’s proposal. We believe the following disclosure elements are of critical importance:

Disclosure of all components of executive pay

The SEC proposal would require companies to provide complete disclosure of all elements of executive compensation. Such an approach is consistent with Council policy, which calls for clear, comprehensive and prompt disclosure, in plain English, of all aspects of executive pay, whether or not such disclosure is required by current rules and regulations.

Current disclosure rules are lacking. Because companies do not have to value or disclose key information regarding certain elements of compensation, shareowners have not had access to complete information about executive pay programs. As a result, shareowners and market forces have been unable to play an effective role in setting compensation parameters.

The Council realizes that disclosure of some components of executive pay—including a total compensation figure, the value of options and retirement benefits, and the potential value of severance agreements—necessarily involves estimates based on assumptions and valuation models. Some oppose these disclosures, arguing that valuation complexities make it impossible to fairly value these components and investors might not understand the disclosures. The Council disagrees. First, such calculations are necessary for compensation committees to fully understand major portions of compensation programs and the full value of executive pay packages. Second, such disclosure enables shareowners to analyze the compensation committee's decisions and to fully understand the compensation paid to top executives.

The Council notes that the SEC's proposal to require complete disclosure of any type of compensation paid, or to be paid, to an executive, including estimates of the value of pensions and contractual arrangements, is consistent with the disclosure provisions contained in H.R. 4291. The Council encourages the Committee on Financial Services and the SEC to work together to ensure the final disclosure rules provide full and complete disclosure of all forms of compensation.

Disclosure of performance-based pay

The Council believes executives should be rewarded for sustainable, superior long-term performance that is based predominantly on total stock returns and key operational measures. Council policies do not advocate arbitrary restrictions or caps on compensation. Rather, they emphasize the concept of pay-for-performance, including the full disclosure of qualitative and quantitative performance measures and benchmarks used to determine performance-based pay.

Many companies describe their compensation plans as "performance-based" and state they are designed to align the interests of management with those of the shareowners. However, some programs have not been adequately performance-based, resulting in excessive and abusive executive pay packages.

The Council is strongly supportive of enhanced qualitative disclosure of how plans are designed to be performance-based. We believe this is an area where current disclosures are lacking. One of the most critical elements of the SEC's proposal is how it addresses performance issues. The

proposed rules appropriately address some qualitative aspects of disclosure of links to performance. For example, the SEC proposes that a new Compensation Discussion and Analysis (CDA) section of the proxy statement would detail “what the program is designed to reward and not reward.” The CDA would also disclose how specific elements of compensation are structured to reflect items of the company’s performance and the executive’s individual performance.

However, another important element of performance-based disclosures is the quantitative measures used to determine incentive pay. Under current disclosure rules, companies are not required to disclose these performance hurdles or thresholds. This lack of disclosure is a major impediment to the market’s ability to analyze and understand executive compensation programs and to appropriately respond. Unfortunately, the SEC’s proposal would allow companies to exclude key information regarding performance targets and thresholds if the disclosure might be competitively harmful. The Council believes this approach provides too large an exemption for companies, ultimately leading to omission of valuable information.

The Council recommends an alternative under which companies would disclose actual performance targets either: (1) at the time they are established; or (2) at a future date—such as when the performance related to the award is measured—in cases when companies believe this information is competitively sensitive. If disclosure is postponed to a future date, the Council recommends that a company be required to explain that it is taking advantage of this exemption and the basis for taking this action.

The Council notes that provisions of H.R. 4291 that would require disclosure of short- and long-term performance measures used by companies to determine the compensation of executive officers are consistent with Council policy. The Council encourages the Committee on Financial Services and the SEC to work together to ensure shareowners are provided full disclosure of all performance criteria, including quantitative metrics and thresholds required to achieve payment.

Director Accountability

The board of directors, which is “elected” by shareowners to represent them and to oversee corporate strategy, monitor management performance and set executive compensation—is the cornerstone of the U.S. model of corporate governance. However, as compensation practices and other governance failures have repeatedly demonstrated, there are weaknesses in this model. We believe increasing the level of accountability of directors, including compensation committee members, to owners would strengthen the U.S. corporate governance model and would help rein in excessive or poorly structured executive pay packages.

The Council believes the accountability of directors at most U.S. companies is weakened by the fact that today shareowners do not have a meaningful vote in director elections. Under most state laws directors are elected by a plurality voting standard, which means that a director is elected in an uncontested situation even if a majority of the shares are withheld from the nominee. The Council considers plurality voting a fundamental flaw in the U.S. corporate governance system. This weakness has a direct impact on the issue of executive compensation by insulating directors from meaningful shareowner oversight. We believe moving to a majority

vote standard in the U.S. would have a demonstrable positive impact on the dynamics of compensation practices and director accountability for executive compensation decisions.

The Council recommends the Committee on Financial Services consider this important issue.

Shareowner oversight

A key responsibility of the compensation committee is to provide in the annual proxy statement clear disclosure of the company's compensation philosophy. The Council believes best practices also include shareowner approval of fully articulated, non-boilerplate compensation philosophies. Benefits to shareowners and companies of such approval would include:

- Enhancing the accountability of directors to shareowners, thereby increasing the sensitivity of boards to long-term shareowner interests;
- Providing owners with an appropriate role in approving broad policy parameters by which companies would implement and operate executive compensation programs;
- Providing a baseline for evaluating the effectiveness of executive compensation programs over time;
- Reinforcing a comprehensive and long-term view of the executive compensation program and improving communication between boards and shareowners; and,
- Reducing the instances in which the company and its shareowners are surprised by outcomes related to the compensation program, thereby reducing the negative reaction in the marketplace to specific events.

Because such an approval requirement would improve communication between compensation committees and shareowners and heighten director sensitivities to the interests of shareowners, the Council believes these items would rarely receive a majority “no” vote. The experience in the United Kingdom, where shareowners have an advisory vote on the annual remuneration report, supports the Council’s contentions. This advisory vote also ensures that a negative vote does not impede a company’s ability to compete for executive talent and compensate executives.

Since the Council is currently studying this issue to determine whether and how to best require such an approach in the U.S., the Council has no current position on the provision in H.R. 4291 to require shareowner approval of overall executive compensation plans. The Council does consider this approach a best practice.

Disgorgement

A Council policy calls for executives to be required to repay incentive compensation to the company in the event of malfeasance involving the executive, or fraudulent or misleading accounting that results in substantial harm to the corporation. This Council policy is strengthened by Section 304 of the Sarbanes-Oxley Act, which gave additional authority to the SEC to recoup bonuses or other incentive-based compensation in certain circumstances.

The Council notes that H.R. 4291 would require companies to adopt and disclose policies regarding disgorgement. Such an approach would supplement the Council’s policy and Section

304 of the Act and give companies the flexibility to establish and disclose whether disgorgement should address a broader set of executive officers. H.R. 4291 would also cover cases where performance-based compensation may be “unearned” in retrospect but not meet the high standard of “resulting from misconduct” required by Section 304.

The Council encourages the Committee on Financial Services and the SEC to work together to ensure that the final SEC rules require disclosure of disgorgement policies.

Conclusion

The Council is strongly supportive of the SEC’s proposed executive compensation disclosure rules, and we believe the Committee on Financial Services and the SEC should work together to ensure that final revisions to the executive pay disclosure rules address the issues raised in H.R. 4291.