Written Testimony
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Chairman Oxley, Congressman Frank, and members of the Committee, I am pleased to provide the perspective of an institutional investor on the issue of executive compensation and its related legislation.

I am Christianna Wood, Senior Investment Officer for Global Equity, with the California Public Employees' Retirement System (CalPERS). CalPERS is the nation's largest public pension system with more than $200 billion in assets. We have long been a leading voice in Corporate Governance, and an advocate for better alignment of interests between shareowners and management.

Compensation programs are one of the most powerful tools available to companies to attract, retain and motivate key employees, as well as align their interests with those of shareowners. Poorly designed compensation packages may have disastrous impacts on a company and its shareowners by nurturing short-term, self-interested behavior. Conversely, well-designed compensation packages may help align management with owners and drive long-term superior performance.

Since equity owners have a strong interest in long-term performance and are the party whose interests are diluted by equity compensation plans, CalPERS believes shareowners should seek stronger oversight of executive compensation programs.

If I had to identify one issue that is at the heart of the problem with compensation in the United States, I would point to accountability. More appropriately perhaps to a lack of accountability. This is an area where we can make reform with the support of the Congress.

Therefore, we support legislation that would help investors and shareowners identify how their capital is being used. We want disclosure and communication about executive pay packages in simple English. We want pay clearly tied to performance, demonstrated in simple math with clearly defined measures of success and failure. Too often, we are paying not for performance, but for failure.

Executive Compensation Abuses

Something has gone wrong with executive compensation in the United States. It is disturbing to see example after example of top executives insulating themselves from any risk in their own compensation. They are ensuring their own financial security while shareowners are losing value.

There are countless examples of questionable executive compensation practices. Let me cite a few of them here.

Just this month, CalPERS asked other Home Depot shareowners to join us in supporting a resolution that would require the company to seek a non-binding investor vote on its executive pay plan. In part, this was in response to reports that Home Depot awarded its chief executive substantial pay raises in recent years despite a decline in the company's stock. Home Depot awarded Robert Nardelli more than $190 million over the past five years, while over the same period, the company's total stock return declined by 12 percent.[1] By comparison, the total stock return for Lowe's, Home Depot's chief rival, increased by 140 percent, and the industry as a whole experienced a 2 percent gain over the same five years.

Secondly, in March, large shareowners sued Hewlett-Packard to contest a $21.4 million severance package for former chief executive Carleton Fiorina, who was replaced last year after lagging company performance. The lawsuit said her severance package of $21.4 million was 3.75 times her salary and bonus of $5.6 million, and that it could be worth up to $42 million after factoring in the potential value of her stock and options.[2]

Third, Boeing's former chief executive received almost $11.5 million in salary and stock awards after working less than three months for the company before he was ousted. In three months, he couldn't have made much of a difference in the company's performance.[3]

These examples reflect an unfortunate national disconnect between pay and performance. They are just a few of the examples that reflect on how poorly designed compensation policies and packages can have negative impacts on a company and its owners – shareowners.

Nationwide, the median salary and bonus for chief executives in 2005 increased 7.1 percent to $2.4 million, according to a survey by Mercer Human Resource Consulting for the Wall Street Journal. That increase in cash compensation came after a record compensation increase of 14.5 percent the previous year.[4] Yet, it is not the absolute increase that is most troubling. It is the lack of clarity on how increased executive compensation is aligned with increased shareowner value creation.

Let me be very clear: CalPERS does not believe that it is appropriate for shareowners to approve individual contracts at the company specific level. However, CalPERS does believe that companies should formulate executive compensation policies that tie executive compensation to company performance and then seek shareowner approval for those policies on a periodic basis.

Executive compensation programs should be designed and implemented to ensure alignment of interest with the long-term interests of shareowners. Without the appropriate controls being in place, such as improved transparency, compensation schemes may give executives an incentive to avoid their duty to shareowners. For example, because senior executives often receive additional compensation when they acquire a new company or sell their current one, there is a conflict of interest between the executives' interest and the company's interest.

Defenders of soaring executive compensation attribute the trend to marketplace dynamics. They say it is in the interest of investors to award such compensation in a market where executive pay only matches the soaring value of top companies.

Yet that parallel fails to account for the widening pay gap between executives and ordinary employees and egregious compensation for executives whose companies lost money. Moreover, if executive pay were truly driven by productivity, there would be no need for the shell games that companies play to hide compensation.

While the absolute levels of pay are a concern, perhaps the most troubling element of executive compensation is the "Heads I win, tails you lose" attitude of corporate executives. CalPERS is concerned over what appears to be an attitude of entitlement in the executive suite of corporate America, regardless of the success – or lack thereof – of the corporation. This attitude manifests itself in many forms.

Perhaps some of the more offensive entitlements are the so called forms of "stealth compensation": severance packages complete with perks for life, guaranteed pension benefits far outstripping the value of benefits provided to employees, enormous loans to executives that are eventually forgiven, and provisions providing that the company shall pay all the taxes due (including gross-up provisions) should the executive incur a tax liability all send a clear message to shareowners.

The message is: "We do not respect you as owners. We do not feel accountable to you as owners."

As public markets investors, we rely upon boards of directors to represent us. In the case of compensation, a company's Compensation Committee is charged with representing shareowners. A major contributing factor to the problem with executive compensation is that Compensation Committees are not accountable to shareowners. They obviously do not feel that approving abusive compensation packages will cost them their job. Rather, it appears that not approving what the CEO wants is what they feel will cost them their job. This represents the central conflict of interest inherent in the problem of executive compensation today. Until this fundamental issue is solved, we will continue to have widespread abuse in compensation practices.

The Legislation

We believe that Congressman Frank's legislation addresses this fundamental problem. We are not asking the government to set artificial limits on executive compensation, and this bill would not set such limits. Instead, we are asking for more information about management pay packages and the ability to restrain management abuse. This bill would do that.

The legislation would provide full disclosure of the compensation of top executives, including pensions, golden parachute agreements, the use of private jets and company apartments, and other compensation now hidden. It would require disclosure of short- and long-term performance targets used to determine a top executive's compensation, and whether such measures were met in the preceding year.

It would require companies to have a "clawback" policy for recapturing any form of incentive compensation that is unjustified, based on subsequent findings that the numbers used to calculate the awards were inaccurate, requiring restatement.

The bill also would require separate shareowner approval of golden parachute packages and the posting of clear and simple disclosures of compensation on the company's Web site.

Legislation Fits Investors' Corporate Governance Goals

These provisions of "The Protection Against Executive Compensation Abuse Act" are well-aligned with CalPERS corporate governance principles.

CalPERS amended its U.S. Corporate Governance Core Principles and Guidelines recently to call on companies to formulate executive compensation policies and seek shareowner approval for those policies. Currently, Compensation Committees issue a statement in the proxy to briefly describe the company's compensation philosophy. Shareowners' role in this process presently is relegated to a distant back seat.

In discussions with companies about this issue, they often state emphatically that only the board has the right and the expertise to manage the affairs of the company and particularly the issue of compensation. Companies say the Compensation Committee must have the flexibility to attract and retain executives and that shareowners should essentially trust them to do the right thing. Yet the behavior of corporate America in regards to executive compensation indicates otherwise.

We believe it is a completely appropriate right of corporate owners to approve broad policies related to executive compensation. Perhaps most importantly, the exercise of that right would force Compensation Committees to face shareowners with a plan on how they will use compensation of all forms in optimizing managing of the corporation. This will help to shift the accountability back to where it belongs, to the owners.

Under current exchange rules, companies are not required in certain circumstances to obtain shareowner approval to adopt equity-based compensation plans. In other words, companies are allowed to unilaterally dilute the equity of owners of the corporation. It is ridiculous to think that an owner should not have the right to decide if he or she is willing to dilute their equity, no matter what the purpose. It is even more ironic when you consider the fact that boards and management have a significant self interest in adopting equity based compensation plans.

We believe executive compensation programs should be designed and implemented to ensure alignment of management's interest with the long-term interests of shareowners. Such programs should be comprised of a combination of cash and equity based compensation, and direct equity ownership should be encouraged.

We believe executive compensation policies should be transparent to shareowners. The policies should contain, at a minimum, compensation philosophy, the targeted mix of base compensation and "at risk" compensation, key methodologies for alignment of interest, and parameters for guidance of employment contract provisions, including severance packages.

Finally, companies should submit executive compensation polices to shareowners for approval, and executive contracts should be fully disclosed with adequate information to judge the "drivers" of incentive components of compensation packages.

Excessive CEO pay takes money out of the pocketbooks of shareowners, including the retirement savings of America's working families. Moreover, a poorly designed executive compensation package can reward decisions that are not in the long-term interests of a company, its shareowners and employees.

Pay decisions are one of the most direct ways for shareowners to assess the performance of the board.

To properly perform this assessment, shareowners must have comprehensive, accurate and clear information detailing long- and short-term compensation to executives. The Protection Against Executive Compensation Abuse Act would provide for full disclosure of information about all compensation paid to executives and the performance measures tied to compensation.

If enacted, the law would improve corporate governance in America which, as the research indicates, leads to better corporate performance. In a perfect world, we wouldn't need this law. The financial world isn't perfect, as our newspapers attest. We need the rule of law to help keep corporate America on course.

Thank you. I would be glad to answer any questions that you may have.

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[1] "Revolt Looms at Home Depot Over Executive Pay," Financial Times, May 18, 2006.
[2] "Pay Deal at Hewlett is Contested," New York Times, March 8, 2006.
[3] "Boeing's Ousted Chief Gets $11.5 Million in '05," Los Angeles Times, March 8, 2006.
[4] CEO Compensation Survey," Wall Street Journal, April 10, 2006.