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CONGRESS OF INDUSTRIAL ORGANIZATIONS
Before the
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
UNITED STATES HOUSE OF REPRESENTATIVES
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on
"EXECUTIVE PAY: THE ROLE OF COMPENSATION CONSULTANTS"

Good morning, Chairman Waxman and Ranking Member Davis. My name is Dan Pedrotty, and I am the director of the Office of Investment for the American Federation of Labor and Congress of Industrial Organizations ("AFL-CIO"). I am honored to participate in today's hearing on the role of consultants in CEO pay.

The AFL-CIO is the federation of America's labor unions, representing 55 national and international unions and their membership of 10 million working men and women. The AFL-CIO commends your leadership on this issue, and your investigation into biased advice by compensation consultants that contributes to the ratcheting up of the pay of corporate chief executives, with little or no link to long-term performance.

CEO pay continues to reach dizzying heights, while both consultants and boards of directors remain unaccountable. Last year, the average CEO of an S&P 500 company got $14.8 million in total compensation, a 9.4% hike from $13.4 million in 2005, according to the Corporate Library. Directors charged with overseeing arms length pay packages seem resigned to a pay for failure status quo. Two-thirds of directors believe that U.S. corporate boards are "having trouble" controlling the size of CEO compensation, according to a new survey from PricewatershouseCoopers.

Outsized compensation packages for senior executives hurt shareholders, including pension plans investing the retirement savings of America's working families. Labor union members participate in pension plans with more than $5 trillion in assets. Union-sponsored pension plans hold more than $450 billion in assets. Outrageous pay packages are giveaways of our members' money.

One of the biggest ironies of the current housing crisis is that while hundreds of thousands of Americans are losing their homes, the CEOs of financial institutions that steered borrowers into risky loans, or traded in the sub-prime mortgages, may walk away with hundreds of millions of dollars in compensation.

In October, one in every 555 households filed for a foreclosure. Yet, CEOs of the 16 largest financial service companies involved in the sub-prime mortgage crisis could collect more than $1 billion in total compensation if they were forced out of their jobs, according to a study by The Corporate Library.

Already, Merrill Lynch's former CEO Stan O'Neal walked away with a compensation package of $161.5 million when he was forced to retire on Oct. 30, after the company reported a record $8.4 billion write-down of sub-prime mortgages. Angelo Mozilo, chief executive of Countrywide, the nation's biggest mortgage lender, could collect more than $75 million if he is asked to leave. And Richard Fuld, CEO of Lehman Brothers, could leave with nearly $300 million in a severance package.

For each overpaid CEO who contributed to the sub-prime mortgage crisis, there is likely to be a conflicted compensation consultant who designed the pay package. Consider Merrill Lynch, where the executive compensation consultant firm Towers Perrin has advised the Board of Director's compensation committee since 2003. According to Merrill Lynch's 2007 proxy statement, Towers Perrin also provides consulting services to Merrill Lynch that are not related to executive compensation. This dual role endangers the impartiality of compensation consultants.

Charlie Munger, Warren Buffett's partner and vice chairman of Berkshire Hathaway Inc., places the blame for runaway CEO pay squarely on compensation consultants. "Some of the worst sinners are compensation consultants," Munger told the *Los Angeles Times* in a January 1 interview this year.

A recent study confirms investors' worst suspicions. Companies that use compensation consultants tend to pay their CEOs higher salaries without getting better performance. Companies that used four of the 10 largest compensation consulting firms—Pearl Meyer & Partners, Towers Perrin, Hewitt Associates and Mercer Human Resource Consulting—paid salaries 15 percent or higher than the average CEO pay.

The problem is that there are no safeguards in the system to ensure the independence of compensation consultants advising directors on CEO pay. All too often, the consulting firms hired to ensure that executive pay is appropriate and fair also earn generous fees for the consulting work they are hired to do for the company. The fee they are paid for setting and reviewing the pay of senior executives is merely the icing on the cake.

In a new book, Corpocracy, Robert Monks, a long-time shareholder activist, says "the system is flawed up to its ears, and the more so because it pretends so earnestly to accuracy."

The potential for conflicts of interest by compensation consultants is similar to that of auditing firms that performed lucrative consulting services for companies whose financial reports they were auditing. This practice ended when the Sarbanes-Oxley Act of 2002 set new standards for auditor independence and the Securities and Exchange Commission began requiring companies to disclose how much they were paying to their accounting firms in consulting and auditing fees.

Consider the role that Hewitt Associates played as the compensation consultant for Verizon Communications. CEO Ivan Seidenberg received $19.4 million in salary, bonus, restricted stock and other compensation in 2005, 48% higher than what he earned the previous year,

while its stock fell 26%, and earnings fell 5.5 %. An April 2006 *New York Times* article reported that Hewitt also received more than half a billion dollars in fees from Verizon and its predecessor company since 1997 for services to the company for its employee benefit plans and human resources management. Not surprisingly, Verizon is the first public company whose shareholders voted by a majority to demand their company adopt a shareholder say on the executive pay process.

Compensation consultants aren't alone in their culpability. The problem all too often is the lack of independence of directors on compensation committees who hire the compensation consultant in the first place. Once again, Verizon was the classic example. At the time, all of the directors on Verizon's compensation committee were chief executives or former chief executives of other companies. Three out of four of the directors on Verizon's compensation committee represented companies where Seidenberg sat on their boards. Among the members of Verizon's compensation committee was John Stafford, previously the chairman and chief executive of Wyeth. As a member of the compensation committee of Wyeth, Seidenberg helped set the pay for Stafford when he was its chief executive.

Perhaps it was no coincidence that the consultant advising Wyeth's compensation committee at the time was also Hewitt. In August 2006, Verizon's compensation committee hired Pearl Meyer to replace Hewitt as its compensation consultant. But Verizon continued to use Hewitt to provide employee benefits administration and actuarial services to the company. At Wyeth's 2007 annual shareholder meeting, CEO Robert Essner said that Wyeth had replaced Hewitt as the compensation consultant advising the board with Exequity, a consulting firm started last year by former Hewitt employees.

Warren Buffett bemoaned this lack of independent compensation committees in his 2006 annual report. "I have been the Typhoid Mary of compensation committees," he wrote. "It's likely that the reason I was rejected for service on so many comp committees was that I was regarded as *too* independent."

Weak boards, particularly around executive pay, are a key reason why shareholders are generally supportive of long-term investors having the right to have their board candidates be included in management's proxy materials. This is why there has been such an outcry over the decision by the SEC last week to take away shareholders' right under the federal securities laws to put the idea of proxy access up for a shareholder vote.

Concern over situations such as Verizon, as well as the scandal involving the manipulation of stock option grants at hundreds of companies, prompted the AFL-CIO and other large investors last year to focus on the independence of compensation consultants. We and other investors asked the SEC, which was drafting revisions to the rules on executive pay disclosure, to require companies to identify their compensation consultants and discuss the other services they performed for the company's management.

The request was not unusual. As early as 2003, a blue-ribbon panel of the National Association of Corporate Directors (the "NACD") issued guidelines that called upon directors to "consider engaging an independent compensation consultant, who does no

work for management, to assist the compensation committee." These voluntary guidelines stated that:

> *The consultant should be hired by and report directly to the committee, and should not be retained by the company in any other capacity. To be effective, the consultant should be afforded full access to management, in-house counsel, the human resources staff, and any consultant hired by management. To avoid "dueling consultants," any consultant hired by management should not be engaged in assignments involving CEO or senior executive pay.*

The NACD report also recommended that if a compensation committee did not adopt this best practice and used the same compensation consultant as management, it should seek the approval of the full board for this arrangement and disclose it to shareholders. "This approval and disclosure should occur regardless of who hires the consultant," the report noted. The NACD reasoned that:

> *[The] separation from management eliminates possible confusion about the consultant's role and responsibilities. A consultant hired by management might feel conflicted in making recommendations. A consultant engaged by the committee is much more likely to take an objective view that is consistent with the board's responsibilities to shareholders and other constituencies. This may result in a higher cost of board operations, but it can be an appropriate investment, considering the impact and magnitude of executive compensation."*

A report issued by The Conference Board in December 2005 also noted that in Delaware, where a majority of publicly traded companies are incorporated, state law imposes a fiduciary duty on directors to act in the best interests of shareholders and permits them to "rely in good faith on the advice of experts who are chosen with reasonable care." To ensure objective advice from a compensation consultant, members of a compensation committee should select a consultant who has not historically done work for the company or its current management.

But the SEC's revised executive pay disclosures that were issued in September 2006 did not fully heed our call for greater compensation consultant independence. While the new rules require better disclosure of the role played by compensation consultants in setting executive pay, the SEC did not require that companies adopt standards for compensation consultant independence.

Shortly after the rules were published, the AFL-CIO and a group of investors, led by Connecticut State Treasurer Denise L. Nappier, jointly sent a letter sent to the heads of compensation committees of the 25 largest U.S. companies in the S&P 500 index asking for an end to the practice of board-hired compensation consultants also doing work for company management. In February 2007, the coalition sent a follow-up letter to the companies that

did not respond to the initial letter, and included the best examples of how 10 different companies responded.

The best practices include those of the Proctor & Gamble Co., which reported that its agreement with the board compensation consultant specifies that it "will do no work for management and have no other connection to the company."

The chair of Wachovia Corp.'s compensation committee also replied that the company had a policy of having a separate, independent compensation consultant reporting to the board compensation committee since 2004.

Morgan Stanley is among those companies that took a half step. It decided to replace Hewitt Associates with an independent consultant that does not currently do any compensation consulting work for the company. But it stopped short of imposing a complete ban on the independent consultant doing any work for the company. Instead, the company adopted a policy requiring the board compensation committee to approve the consultant doing work for the company of $25,000 or more.

Verizon Communications was among the companies that did not reply to the coalition's letter. In follow-up action, the Communications Workers of America, a union affiliated with the AFL-CIO, filed a shareholder proposal at Verizon's 2007 annual meeting. The proposal asked that the company disclose any relationships that could compromise the compensation consultant's independence. The proposal received over 46% of the votes cast by investors at the company's May 5 annual meeting. We are pleased that at its November 1 board meeting Verizon agreed to adopt a policy that would ban the compensation consultant from doing any other work for the company.

The AFL-CIO has also had productive discussions with several other companies that led to their adopting policies on the independence of compensation consultants, including General Electric, Home Depot, and Sara Lee.

For the 2008 annual meeting season, the AFL-CIO has filed a shareholder proposal at MetLife asking it to disclose to shareholders the extent of the work the compensation consultant does for the company, and to disclose the fees paid to the consultant for the work done for the compensation committee. The AFL-CIO has also filed a shareholder proposal at Occidental Petroleum to ban the board's compensation consultant from doing any other work for the company.

While we are pleased with our efforts so far in getting companies to voluntarily adopt a policy on the independence of compensation consultants, more must be done. The types of consulting work that compensation consultants perform should be limited to their role as advisors to the compensation committee. As a first step, the SEC should require that companies disclose the total dollar amount paid to compensation consultants and the amount paid for executive compensation advice provided to the board of directors.

The conflicts of interest that compromise the impartiality of compensation consultants parallel the auditor independence concerns that led to the passage of the Sarbanes-Oxley Act. Like audit firms prior to Sarbanes-Oxley, today's compensation consultants perform lucrative consulting work unrelated to the investor protection role they are supposed to play. Investors need new standards for compensation consultant independence just as Sarbanes-Oxley created for auditor independence.

In that context, while disclosure is an important first step, investors ultimately need the tools to hold consultants accountable. Our funds are currently able to vote on auditors at company annual meetings, and the movement for a say on CEO pay is gaining increasing momentum. Given the scope of conflicts and the central role of consultants in "pay for failure," we also believe an up or down vote on the company's compensation consultant in any context where a conflict existed would be appropriate.

I will be happy to answer any questions you may have. Thank you.