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EXECUTIVE PAY: THE ROLE OF

COMPENSATION CONSULTANTS

Wednesday, December 5, 2007

House of Representatives,

Committee on Oversight and

Government Reform,

Washington, D.C.

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Committee Hearings

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The committee met, pursuant to call, at 10:00 a.m., in Room 2154, Rayburn House Office Building, Hon. Henry A. Waxman [chairman of the committee] presiding.

Present: Representatives Waxman, Cummings, Kucinich, Davis of Illinois, Higgins, Yarmuth, Murphy, Welch, Davis of Virginia, Souder, Platts, Duncan, Westmoreland, McHenry, Foxx, Sali and Jordan.

Staff Present: Phil Schiliro, Chief of Staff; Phil Barnett, Staff Director and Chief Counsel; Karen Lightfoot, Communications Director and Senior Policy Advisor; Roger Sherman, Deputy Chief Counsel; John Williams, Deputy Chief

Investigative Counsel; Brian Cohen, Senior Investigator and Policy Advisor; Michael Gordon, Senior Investigative Counsel; Earley Green, Chief Clerk; Teresa Coufal, Deputy Clerk; Caren Auchman, Press Assistant, Ella Hoffman, Press Assistant; Leneal Scott, Information Systems Manager; Kerry Gutknecht, Staff Assistant; William Ragland, Staff Assistant; Miriam Edelman, Staff Assistant; David Marin, Minority Staff Director; Jennifer Safavian, Minority Chief Counsel for Oversight and Investigations; Keith Ausbrook, Minority General Counsel; Ed Puccerella, Minority Professional Staff Member; Kristina Husar, Minority Counsel; Larry Brady, Minority Senior Investigator and Policy Advisor; Patrick Lyden, Minority Parliamentarian and Member Services Coordinator; Brian McNicoll, Minority Communications Director; Benjamin Chance, Minority Clerk; and Ali Ahmad, Minority Deputy Press Secretary.

Chairman WAXMAN. Meeting of the committee will please come to order.

Today the committee will be considering the issue of executive compensation. Reports of astronomical payouts to corporate CEOs have lead many to question the fairness and effectiveness of the system for setting executive pay. We will be exploring these questions today.

In the 1980s, the CEOs of the Nation's largest companies were paid 40 times more than the average employee. Now they make over 600 times more. At a typical company, 10 percent of corporate profits--a staggering sum--goes into the pockets of the top executives. These huge pay packages raise a basic question: Are corporate CEOs working for the company who hire them or are the companies working for the CEOs?

Many academic experts, financial analysts and investors believe that soaring CEO paychecks are a symptom of a corporate governance system that is not working. As noted investor Warren Buffett has commented: In judging whether corporate America is serious about reforming itself, CEO pay remains the acid test.

Today's hearing examines a practice that may be fueling this dysfunctional pay system: the use of executive compensation consultants with conflicts of interest.

Executive compensation has become incredibly complex, CEOs don't just get salaries anymore. They get stock options, restricted stock units, deferred compensation, executive pension plans, lucrative severance packages and a vast array of perks from corporate jets to tax and financial planning services and country club memberships. These compensation packages can be worth hundreds of millions of dollars.

Many companies now rely on the services of professional executive compensation consultants to evaluate these complex pay arrangements. Last year, in fact, over three quarters of the Fortune 250 retained outside compensation consultants.

Most Americans have never heard of Towers Perrin, Mercer and the other influential compensation consultants, but these pay advisors can have an enormous impact on executive pay. When they do their job right, they can align the interest of the CEO with the interest of the shareholder. But when they do their job wrong, the result can be vast wealth for the CEO and a plundered company for the shareholders and the employees.

That's why it is so important that these pay consultants be independent and free of conflicts of interest. Consultants who are paid millions of dollars by a corporate CEO won't provide objective advice to the board. They know what the CEO wants to hear, and they know what will happen to their lucrative contracts if they don't say it.

For the last 7 months, the committee has been investigating conflicts of interest among compensation consultants; and today I'm releasing a report that summarizes what the majority staff has found. And, without objection, this report will be made part of the hearing record.

[The information follows:]

******** INSERT 1-1 ********

Mr. DAVIS OF VIRGINIA. Mr. Chairman, I would also ask that the minority staff response be included in the record as well.

Chairman WAXMAN. Without objection, both requests will be granted.

[The information follows:]

******** COMMITTEE INSERT ********

Chairman WAXMAN. The results of our investigation should concern everyone who cares about corporate governance. Over 100 of the biggest companies in America are using compensation consultants with significant conflicts of interest to set CEO pay.

Last year, 113 Fortune 250 companies retained conflicted consultants. These consultants typically received $200,000 to advise the company about executive pay and over $2 million to provide other services, like benefit administration, to the company.

In fact, the consultants are being asked to evaluate the worth of the executives who hire them and pay them millions of dollars. Like the auditors who signed off on Enron's books, they have an inherent conflict of interest. For every dollar the consultants are paid to advise on CEO pay, they are being paid $11 by the CEO to perform other services to the company.

What's more, few of these conflicts are being disclosed to shareholders. We found that some companies call the consultants "independent" in their proxy statements when in fact the consultants were being paid millions of dollars to provide other services. And when we looked closely at the conflicts, we found that the Fortune 250 companies that use consultants with the most extreme conflicts of interest paid their CEOs more and raised their pay faster than other companies.

Today's hearing will give us additional insights on this issue. Our first panel includes corporate governance experts and institutional investors that have experience identifying, assessing and addressing potential conflicts of interest; and I thank them for being here today.

Our second panel consists of the consultants themselves. We will hear their side of the story: how they handle conflicts of interest and what they do to mitigate their impact. I appreciate their cooperation in the committee's inquiry and their willingness to appear before the committee today.

I am disappointed, however, that two leading compensation consultants, Watson Wyatt Worldwide and Pearl Meyer & Partners, declined our invitation to testify today.

At bottom, the issue we are examining goes to the heart of the executive compensation process. Are soaring CEO pay packages earned or are they the result of a rigged process? Today's hearing will give us a new perspective on this important question.

[Prepared statement of Chairman Waxman follows:]

******** INSERT 1-2 ********

Chairman WAXMAN. I would like to now recognize the ranking member of this committee, Mr. Davis.

Mr. DAVIS OF VIRGINIA. Well, thank you, Mr. Chairman.

The Enron fiasco reminded us all that corporate responsibility and transparency are critical components of a healthy capitalist system. Shareholders should have confidence in the soundness and independence of key decisions by company directors, including decisions on executive salaries, bonuses, stock options and benefits. But even after a majority staff report issued today I am just not ready to join them in the logical leap that presumes a causal connection between the services of compensation consultants and any kind of corporate malfeasance. It seems we were called here to discuss a problem that may not exist and one this committee can't solve, in any event.

The theory goes something like this: Pliant and corrupt consultants working both sides of the fiduciary street take huge fees for management and recommend unreasonably high compensation for those same managers. Company directors, unaware of the consultant's conflict of loyalties, blindly take the advice; and that's why executive pay has risen so high even while company's performance and stock prices fall.

It is an interesting theory, one steeped in anti-corporate populism, but there is little proof that it is true. Instead, in a dizzying whirl of fallacious reasoning, the majority first presumes an incurable conflict of interest whenever a compensation consultant provides advisory services to both the directors and the management of the same company. Having thus conjured this conflict into existence, it is easy to jump to the conclusion that any decision based on such tainted advice lacks the requisite independence and fiduciary care.

It is true the undue influence of compensation consultants, like the self-serving opinions rendered by some accounting firms, posed a threat to corporate integrity in the past. But post-Enron reforms like the Sarbanes-Oxley law put in place substantial new safeguards and stiff penalties to induce greater transparency and accountability in publicly traded companies. Those additional protections and liabilities short-circuit the majority's theory that consultants cause corporate misbehavior and that only additional regulation can fix the problem.

If there is a problem with the amounts or methodologies of executive pay, it is the legal and fiduciary duty of corporate directors to solve it. No amount of additional disclosure by compensation consultants would alter or abrogate the fundamental responsibility of corporate directors to make timely and informed decisions in the best interest of shareholders.

As Mr. Shadab in his testimony today from George Mason University in my district notes, that to be able to capture a board, a manager would have actually be employed by the corporation to establish the close ties, but CEOs promoted from within the company earn about 15 percent less than CEOs hired from the outside and that this premium for external hires actually grew throughout the '70s, '80s and '90s. But if entrenched managers are unduly influencing compensation decisions of the board, then why do CEOs without the ability to capture directors earn more? Good question.

If there is a problem with the amounts of methodologies, it is the legal and fiduciary duty of the corporate boards of directors to solve it, as we noted before.

Last year, the Securities and Exchange Commission considered and rejected the compensation consultants' disclosures abrogated here today by the majority and some of our witnesses. Why did they do this? Because the Commission found the attempt to regulate consultants like accountants inept and unworkable. The SEC concluded the proposed disclosure could do more harm than good if the information betrayed corporate strategy or otherwise caused competitive harm in the public realm.

Ironically, the Commission's concerns about irresponsible disclosures were borne out this morning. Sensitive, company-specific information provided this committee by compensation consultants is included in the majority staff report. Shareholders in those companies have cause to be concerned about the gratuitous, potentially damaging revelation of corporate policy in regulatory compliance practices.

Demonizing executive pay won't cure corporate ills or strengthen the performance of company stocks held by pension funds covering millions of Americans. Nor should envy or false egalitarianism be allowed to repeal the laws of supply and demand.

Recent evidence suggests corporate executive compensation levels reflect market forces and correlate with company growth and increase stock volume. High turnover in America's top executive suites also seems to prove that those who abuse the system or fail to perform are replaced with or without a consultant's help.

Mr. Chairman, I agreed when you said management of Federal Government funds and programs demanded our full attention, so while I appreciate the information our witnesses will provide today, I hope we can take the lessons that the private sector has to teach and refocus our oversight on that important work.

Thank you.

Chairman WAXMAN. Thank you, very much, Mr. Davis.

I do want to call on other colleagues that are here today. Ordinarily, just the two of us make opening statements, but if either of the other members that are here wish to make opening statements I will recognize them.

Mr. DAVIS OF ILLINOIS. I have no statement.

Chairman WAXMAN. I want to introduce our first panel:

Charles Elson, Edgar S. Woolard, Jr., Chair in Corporate Governance and Director of the John L. Weinberg Center For Corporate Governance at the University of Delaware's Lerner College of Business and Economics. Meredith Miller is the Assistant Treasurer for Policy for the State of Connecticut Treasurer's Office. Daniel F. Pedrotty is the Director of the AFL-CIO Office of Investment. Houman Shadab is a Senior Research Fellow in the Mercatus Center's Regulatory Studies Program.

We are pleased to have each of you here today, and I thank you for being here.

It is the practice of this committee that all witnesses testify under oath, so I would like to ask if you would stand and please raise your right-hand.

[witnesses sworn.]

Chairman WAXMAN. Thank you.

The record will indicate that each of the witnesses answered in the affirmative.

And what we'd like to now do is hear from you. Your written statements will be made part of the record in full.

We'd like to ask each of you to try to limit the oral presentation to 5 minutes. We will have a clock, and it will be green, and the last minute it will be yellow and then red when the 5 minutes is up. When you see red, I hope you will conclude.

STATEMENTS OF CHARLES ELSON, JOHN L. WEINBERG CENTER FOR CORPORATE GOVERNANCE, UNIVERSITY OF DELAWARE; MEREDITH MILLER, ASSISTANT TREASURER FOR POLICY, CONNECTICUT STATE TREASURER'S OFFICE; DANIEL PEDROTTY, DIRECTOR, OFFICE OF INVESTMENT, AFO-CIO; AND HOUMAN SHADAB, SENIOR RESEARCH FELLOW, MERCATUS CENTER, GEORGE MASON UNIVERSITY

Chairman WAXMAN. Mr. Elson, why don't we start with you. There is a button at the base of the mike. Be sure to press it in so we can hear.

STATEMENT OF CHARLES ELSON

Mr. ELSON. Thank you.

The problem with executive overcompensation is quite simple in its origins and solution. You see, high compensation leaves me totally voiceless.

Pay unrelated to performance is the result of the failure of effective bargaining between the corporate board and management. The elements leading to this failure are, first of all, overreaching management and, secondly, passive, management-dominated directors often advised by sometimes compromised compensation consultants.

The key to the solution is to stimulate better bargaining between the board and management. I think this can be accomplished by insisting that the board, and particularly the members of the board's compensation committee, negotiate with executive on pay, be comprised of individuals who are completely independent of management and hold personally meaningful equity stakes in the business itself. This will ensure that they have the objectivity and incentive to effectively negotiate pay.

Additionally important to the solution and I think the subject of the hearing today are reforms in the ways in which compensation consultants aid in the pay compensation process.

Traditionally, the consultant was hired by management to aid in the design and review of the executive pay package. Often, the consultant's firm was also engaged to do a significant amount of other work for the company. Additionally, it was believed that the presence of the consultant provided some legal protection to the board who ultimately approved the compensation package.

As a third-party, non-company employee, the consultant was supposed to add some objectivity to the process that could be effectively relied upon by the board in the review of the compensation package. However, because the consultants were hired by management and often did other highly compensated work for the company, their objectivity as to their review for the board of the comp agreement was either factually or certainly optically compromised. That's why corporate governance advocates have long suggested that the best practice in this case would be that the consultant who advises the compensation committee be hired exclusively by the committee and perform no other tasks for the company or its management. The idea was that directors who negotiate pay must receive completely unfettered and objective advice from outsiders solely responsible to the committee and full board, uncompromised by managerial relationships.

This advice presented to independent and motivated directors I think would ultimately result in effective incentive pay for the company's executives. At minimum, certainly the optics of such a process would be much more appealing to the shareholders, aiding in the restoration of pubic confidence in the integrity of our business institutions.

Now this approach, similar to that taken with regard to outside company auditors under Sarbanes-Oxley, has been endorsed by numerous business and investor organizations, including the National Association of Corporate Directors, and is supported by many in the financial community. In fact, Chief Justice Veasey of the Delaware Supreme Court, the Nation's leading appellate business court, in widely quoted remarks made at the University of Delaware a couple of years ago stated, that compensation committees should have their own advisers and lawyers. Directors who are supposed to be independent should have the guts to be a pain in the neck and act independently--suggesting judicial support for this theory.

Now, the trend today, given the obvious logical appeal of this approach and widespread shareholder support, the trend of which I have been familiar as a director and academic specializing in the area, has clearly been for board comp committees to engage their own compensation consultants who provide no other work for the enterprise. From a Federal regulatory standpoint, I think to further board adherence to this best practice, better disclosure on compensation consultant conflicts of interest needs to be provided to the investors.

While at present the Securities and Exchange Commission mandates disclosure to investors of the identity of a company's comp consultant and certain other retention details, there must also be disclosure of any other services the consultant provides to the organization, as well as the amount of fees paid to that consultant, similar to the required disclosure regarding the company's outside auditors. This disclosure, I think combined with public pressure and the resulting trend towards the use of non-conflicted consultants, I believe will lead to improved pay practices and a greater confidence by the investing public in the integrity of our public corporations.

Chairman WAXMAN. Thank you very much, Mr. Elson.

[Prepared statement of Mr. Elson follows:]

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Chairman WAXMAN. Ms. Miller?

STATEMENT OF MEREDITH MILLER

Ms. MILLER. Good morning, Chairman Waxman, Ranking Member Davis and committee members. Thank you, Mr. Chairman, and your staff for your leadership on this important issue.

My remarks this morning cover the findings of an investor initiative led by Treasurer Denise Nappier on compensation consultant independence. This initiative was launched in response to the SEC's failure to require in its new disclosure rules that companies disclose whether a compensation consultant worked for both the board and the management of the same company. The results of the investor initiative showed that compensation committees were willing to exceed SEC's reporting requirements and address the issue of independence of consultants in the proxy statements, with many adopting formal policies.

With these findings, we urged the SEC to revisit this issue and to take steps that a best practice cannot do, that is, issue new rules that require companies to disclose all compensation consultant business relationships and the fees paid by the company for these engagements.

The independence of compensation consultants is important to investors because of the influential role consultants play in advising boards on executive compensation. And, in turn, executive compensation is important to investors because of the ability to serve as a window into board accountability. It can show the quality of the decisions and the dynamics of the board, and it can show whether those decisions align the company interests with shareholders to create long-term, sustainable value.

Unfortunately, we continue to see executive levels of pay rising and rewards for poor company performance. Investors have responded with various strategies, including 60 shareholders proposals filed last year calling for an investor advisory vote on pay packages known as "say on pay". The House responded as well by passing legislation this year that would give investors this right.

With these trends and events, it follows that, whether it be perception or real, investors are concerned that consultants who earn more from providing services to management while at the same time providing services to the board's compensation committee may be biased in decisions related to executive pay in order not to lose the lucrative engagements.

We can agree that management would have a conflict of interest if it decided its own compensation. That's why shareholders seek to meet with the compensation committee members and not management of the company.

Executive compensation is one issue that comes before a board where such a conflict needs to be avoided, and the same principle applies if you can consider consultants paid by management as an agent of management. In 2006, when the SEC announced its intentions to propose new rules for executive compensation disclosure, Treasurer Nappier immediately issued an open letter to compensation committee members cautioning them about the need to be prepared for the increased scrutiny such disclosure would bring. The Treasurer highlighted the need for this disclosure, harkening back to the auditor consulting controversy pre-Enron.

When the SEC issued its final rules, it acknowledged comments from investors urging this disclosure, but ultimately it deferred to the consulting community that investors should rely on the business judgment of the competition committees and that that would suffice.

The Treasurer then embarked on the compensation consultant initiative in October of 2006. Along with a coalition of investors representing $850 billion, the Treasurer wrote to the top 25 companies in the S&P to ask whether compensation consultants did work for both the board and the company and to ask if the company would consider adopting a formal policy on compensation and consultant independence that prohibited work for management in the 2007

CDNA.

In response to the October letter, we received 18 replies and identified the top 10 best practices and sent those practices back to the companies so that the compensation committees could learn from each other and set a best practice for 2007 CDNA. When we examined the 2007 CDNAs of the top 25, we found that the vast majority, 23 out of 25, addressed the issue of independence, thereby exceeding the SEC's requirement. Out of the 25, 12 implemented formal policies that promoted the fundamental principles of independence, and 11 did no work for management. And we learned of several innovative approaches to this issue.

Elements of a best practice included a formal policy adopted by the compensation committee which ideally would bar work from management, but if management needed survey work data on compensation a de minimus test existed. This initiative showed that companies were willing and able to exceed the SEC reporting standards, but that without clear and uniform rules the definitions of independence varied, who made the determination varied, and even the decision to disclose on the issue varied.

We urged the SEC to recognize what investors, consultants and compensation committees recognize, that investors have a right to know if the advice their company receives on executive compensation could potentially be compromised by monetary ties to the management of that same company.

Thank you.

Chairman WAXMAN. Thank you very much, Ms. Miller.

[Prepared statement of Ms. Miller follows:]

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Chairman WAXMAN. Mr. Shadab.

STATEMENT OF HOUMAN SHADAB

Mr. SHADAB. Mr. Chairman and distinguished members, thank you for the opportunity to appear here today and testify on executive pay and the role of compensation consultants. I am a senior research fellow at the Mercatus Center, a research, education and outreach organization affiliated with George Mason University. The Mercatus Center's mission is to bridge academics and policy. We conduct interdisciplinary research in the social sciences that integrates practice and theory. My own research focuses primarily on securities and financial markets regulation.

My remarks today will focus on, one, the academic law and economics literature regarding explanations for increased compensation of public company executives and, two, other empirical findings relevant to potential conflicts of interest among executive compensation consultants.

The ultimate goal of any system of corporate governance and the criterion by which to judge good from bad governance is promoting the wealth of shareholders. Today, a corporation is primarily governed by its board of directors which is typically responsible for setting executive compensation. The New York Stock Exchange and NASDAQ listing standards passed in the wake of the Sarbanes-Oxley Act of 2002 require a majority of the company's board to be independent, and the New York Stock Exchange in particular requires wholly dependent compensation committees.

Although setting excessive executive compensation may violate directors fiduciary duties to shareholders, compensation decisions are made in the ordinary course of business and therefore are afforded substantial judicial deference under a long-standing pillar of American corporate law known as the business judgment rule.

Currently, there is a dispute among academics as to the precise source of the increases in executive compensation that took place over the past decades and years. One influential line of thought argues that increased CEO compensation is the result of entrenched CEOs unduly influencing directors to grant themselves excessive pay to the detriment of shareholders. While certainly possible, the managerial entrenchment theory fails to explain why CEO compensation continued to increase even while boards of directors were becoming increasingly independent of management at least as far back from 1997 to the present.

Another problem with the entrenchment theory already referred in to this hearing was that to be able to capture a board a manager should most likely be employed by the corporation to establish the requisite close ties with directors to capture them. However, empirical evidence shows that CEOs promoted from within a company earn about 15 percent less than CEOs hired from the outside and that this premium for outside hires actually grew throughout the '70s and through the '90s.

Just because the managerial entrenchment theory does not explain all the data does not mean it is completely wrong. However, there are in fact other explanations for increases in absolute and relative executive compensation. Indeed, a substantial body of recent empirical corporate governance research finds that executive compensation is primarily the result of increased value of corporate assets, increased competitive pressures faced by executives in corporations and increased liability and regulatory risk stemming from passage of the Sarbanes-Oxley Act.

As former Labor Secretary Robert Reich has noted, our CEO compensation does not reflect social or moral worth. Increased CEO pay is best explained not by the impingement theory but by boards of directors choosing their CEOs from a relatively small pool of executive talent and that today "under super-competitive capitalism, boards are willing to pay more for CEOs because their rivals are paying more and the cost of making a bad decision is so much greater than it was decades ago when competition for investors and customers was far less intense and shareholders were far more placid."

Indeed, a recent study by the Federal Reserve on compensation from 1936 to 2005 concluded that compensation arrangements have served to tie the wealth of managers to firm performance and perhaps to align managerial incentives with shareholders' interest for most of the 20th century.

Further, the rise in income inequality between top earners and average employees can perhaps be explained by technological progress raising the productivity of skilled workers more than it raises the productivity of less skilled workers. For instance, e-mail and videoconferencing have arguably helped executives add more value to their day-to-day activities than factory workers.

Taken as a whole, many studies deeply call into question the assumption that increased executive compensation eats into corporate profits and thereby hurts investors. Indeed, they suggest that current levels of executive pay largely reflect the benefits that good CEOs create for shareholders.

Regarding potential conflicts of interest or a lack of independence of compensation consultants who also provide noncompensation services, I simply want to draw the committee's attention to the empirical record on the provision of nonaudit services that the wrong lesson is not learned. Although corporate governance reform such as the

Sarbanes-Oxley Act prohibits auditors from providing nonaudit services to audit clients, empirical records strongly supports a view that audit independence is not jeopardized by providing nonaudit services.

In a 2005 review of the empirical literature regarding the provision of nonaudit services, Yale law professor Roberta Romano found that the overwhelming majority of the numerous studies on the issue found no relationship between audit quality and the provision of nonaudit services; and, in fact, three studies found that auditors providing nonaudit services actually improved audit quality. In addition, in 2006, yet another academic study found that the provision of nonaudit services improves audit quality.

A general reason why providing nonaudit services may improve audit quality is because auditors benefit in their auditing work from so-called knowledge spillovers. The knowledge auditors gain about the company from providing nonaudit services may enable them to conduct a more effective audit. The provision of noncompensation services may similarly have no or even a positive impact on compensation decisions.

I would like to again thank the committee for inviting me to share my views.

Chairman WAXMAN. Thank you very much.

[Prepared statement of Mr. Shadab follows:]

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Chairman WAXMAN. Mr. Pedrotty.

STATEMENT OF DANIEL PEDROTTY

Mr. PEDROTTY. Good morning, Chairman Waxman and Ranking Member Davis and members of the committee. My name is Dan Pedrotty. I'm the Director of the Office of Investment at the AFL-CIO representing more than 10 million members and their 55 national unions. We commend your leadership on this issue and inquiry into the provision of biased advice by compensation consultants.

Consultants and Boards of Directors remain unaccountable, while CEO pay continues reach dizzying heights. Last year, the average S&P 500 CEO received almost $15 million in compensation, a 9 and a half percent hike from 2005. Directors overcharged with seeing and protecting investors and forcing and negotiating arms-length pay packages seem resigned to a pay-for-failure status quo. Two-thirds of directors believe "that their boards are having trouble controlling the size of CEO compensation."

Outsized pay packages for senior executives hurt shareholders, including pension plans investing the retirement savings of America's working families. Union members participate in benefit plans with over $5 trillion in assets, and union-sponsored plans have assets of over $350 billion. Outrageous pay packages are giveaways of our members' money.

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

In October, one in every 555 households is facing foreclosure. Yet CEOs of the 16 largest financial services companies involved in the subprime crisis could collect more than $1 billion in total compensation if they are forced from their job, according to The Corporate Library.

Already, former Merrill Lynch CEO Stan O'Neal has walked away with over $161 million; Angelo Mozilo, the chief executive of Countrywide, stands to gain $75 million if he is forced out; and Richard Fuld of Lehman could collect nearly $300 million in severance as a result of his dismissal.

For each overpaid CEO who contributed to the subprime mortgage crisis, there is likely to be a conflicted comp consultant who designed the pay package. Consider Merrill Lynch, where the firm Towers Perrin has advised the board's compensation committee since 2003. According to the company's 2007 proxy, Towers Perrin also provides consulting services that are not related to executive compensation; and we believe this dual role endangers the impartiality of consultants.

A recent study confirms investors' worst suspicions. Companies that use comp consultants tend to pay their CEOs higher salaries without better performance. Companies that used 4 of the 10 larges firms biggest firms--Pearl Meyer, Towers Perrin, Hewitt and Mercer--paid salaries 15 percent or higher than the average CEO pay.

Mr. Chairman, I believe the report that you put out this morning adds even more grist to the mill here. The problem is that there are no safeguards in the system to assure independence. All too often, the firms hired to ensure that the executive pay is appropriate earn enormous fees for the consulting work that they are hired to do for the company.

Consider the role that Hewitt played at Verizon. As Verizon's comp consultant, CEO Ivan Seidenberg received over $19 million in 2005, which was 48 percent higher than the prior year, while at the same time the company's stock fell 26 percent and earnings fell 5.5 percent. A New York Times article last year disclosed the fact that Hewitt from 1997 until the present time of 2005 provided consulting services worth over half a billion dollars in fees from employee benefits and HR services to the company. Not surprisingly, Verizon became the first public company where shareholders demanded a say on pay.

Now worker funds also with other governance initiatives at Verizon during this proxy season. The Communications Workers of America filed a compensation consultant proposal that insisted that the company disclose the relationship of the compensation consultant and their relative independence or lack thereof. The proposal received a strong vote. It got over 46 percent, and we're pleased that Verizon last month agreed to a policy that would ban the comp consultant from doing other work for the company.

While encouraged with the efforts of companies to voluntarily adopt policies of independence, more must be done. Consulting work should be limited to advising company boards so pay packages are geared to incentivize long-term-value creation. As a first step, the SEC should require companies to disclose the total dollar amount paid to consultants and the amount paid for advice provided to the board of directors.

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

In that context, while disclosure is an important first step, we as investors need the tools to hold consultants accountable. Our funds currently vote on auditors at annual meetings, and the movement behind the say on CEO pay at annual meetings is gaining momentum.

Given the scope of conflicts as detailed in this report this morning and the central role of consultants in pay for failure, we believe an up-or-down vote on the company's compensation consultant in any context where a conflict exists would be appropriate.

I again thank you, Mr. Chairman, and would be happy to answer any questions.

Chairman WAXMAN. Thank you very much, Mr. Pedrotty.

[Prepared statement of Mr. Pedrotty follows:]

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Chairman WAXMAN. I want to start off the questions.

Many experts have suggested that compensation consultants have contributed to the traumatic rise of CEO pay over the last several years. They argue that compensation consultants as a whole are directly responsible for some of the most pernicious and costly developments in executive pay.

One well-respected investor, Warren Buffett, has stated--and I want to quote him--"Too often, executive compensation in the U.S. Is ridiculously out of line with performance. That won't change moreover because the deck is stacked against investors when it comes to the CEO's pay. The upshot is that a mediocre or worse CEO, aided by his handpicked vice president of human relations and a consultant from the ever-accommodating firm of Ratchet, Ratchet & Bingo, all too often received gobs of money from an ill-designed compensation arrangement."

In the report that I released today, we surveyed the leading compensation consultants and found that over 100 of the largest companies in America have higher compensation consultants that have significant conflicts of interest. I want to ask whether you think these conflicts of interest are a serious problem.

Professor Elson, you've studied this issue as both a corporate director and professor. Are you concerned about these conflicts and how widespread they are and do you believe these conflicts are having an impact on the levels of CEO pay?

Mr. ELSON. Well, first of all, I am very concerned about the conflicts, I think in several regards.

Number one, what the question is, do the conflicts in interest actually ration a pay? And I think that, frankly, given the subjective nature of the way pay is put together, there is no clear objective standards on pay. It is not a body of law that you apply. There is a lot of subjectivity to the process. And I think that, given that and given these other relationships, there is certainly the potential to be influenced by those other relationships in what you are recommending. And I think that that is clear and there is no way around that.

The question is, I guess once you establish that, is where do you go from there with it? What in fact do you do about it? Does it in fact create higher pay?

Well, let's assume that--the worst possible case would be, obviously, someone who was directly compromised by the relationship and recommended a higher package based on those subjective factors. That's problem one.

Problem two is someone who, using those subjective factors, has been influenced by those relationships; and that to me is actually the real problem. It is much more subtle than a direct "I will give you other business if you recommend a higher package." It is much more subtle and again, because of the subjectivity involved, more subject to abuse.

The third reason is the optical reason to the investors, and this is where I am really concerned as well. Because to the investor the presence of the compromise consultant, the resulting pay will always be challenged and questioned. As a director, why would you want to put yourself in that position vis-a-vis your investors, saying to them, well, we used a compromised consultant or a consultant with other responsibilities, but it's okay, don't worry, trust us.

Chairman WAXMAN. Yes.

Mr. ELSON. I think the optics, frankly, aren't all that good; and that's why I think that separating the two out--consultancy from the actual pay advice--is warranted here.

Chairman WAXMAN. Let me ask some other questions of the panel.

Ms. Miller, you're responsible for managing Connecticut's pension fund, so you approached this as an investor. Are you concerned about these conflicts of interest? Do you believe they are affecting the levels of CEO pay and therefore we ought to be concerned about it?

Ms. MILLER. Yes, Mr. Chairman, we are very, very concerned. In fact, this is an issue the Treasurer has written to the SEC on, just this issue about asking for disclosure. That's how concerned we have been.

I think that we continue to see problems in rising executive compensation. There has been a blackout on information without knowing whether the consultants are conflicted in the SEC disclosure. It has been very difficult for investors to be able to even begin to figure out how much of the executive pay increases could be attributed to conflicted and compromised consultants.

Chairman WAXMAN. Well, for many people, investors and the public alike, they look at the pay for the executives and there seems to be a disconnect often between the pay and the performance of the CEOs. Do you think this is one of the reasons we have this disconnect?

Ms. MILLER. I think you're asking exactly the right question. When you sort of peel the onion and you look at the role the consultant plays, there are key elements of the executive compensation package, like the peer group that is chosen, the benchmarks that are used for performance. These are the elements within the compensation package that could contribute to ratcheting up of pay and how you set those performance goals amongst the peers that are chosen.

Oftentimes, compensation committees get both the data that supports the peer group and the data on other comparative measures from the consultant; and it is our concern that, when you sort of take a closer look, these pieces that contributed to the ratcheting up of pay are pieces that for us we would feel more comfortable and have a lot more investor confidence if they were associated with an independent consultant.

Chairman WAXMAN. Now, one of the findings of the committee in the report released today is that companies are failing to provide adequate disclosure of conflicts of interest to investors and the public. The committee identified 113 cases where compensation consultants used by Fortune 250 companies had conflicts of interest but the proxy reports filed by the companies only disclosed those conflicts for about 25 percent of the companies. So the vast majority of the Fortune 250 companies are not disclosing their use of pay advisors with conflicts.

Mr. Pedrotty, what's your reaction to this finding?

Mr. PEDROTTY. We think that's particularly troubling, Mr. Chairman, and another example of the how the Securities and Exchange Commission betrayed investors by not going far enough in their disclosure rules. We think just by naming the consultant we are not getting enough transparency and disclosure and that when investors are evaluating pay packages they should have all the information.

So, again, the analogy that's used all the time by CEO pay apologists is this is much like movie stars or sports stars in terms of escalating pay, but it's fundamentally different in that this is not an arms-length negotiation. It is not arms-length in the people who are negotiating or the people who are advising the negotiators. That's why we have two-thirds of directors, our representatives, saying we ourselves can't get a handle on this problem.

Chairman WAXMAN. The lack of disclosure of this information is a problem, and we pointed that out and seemed to agree to that. In some cases, it seems like companies may be providing inaccurate information about their consultants. The committee report found that in 30 cases where Fortune 250 firms hired consultants with conflicts of interest, the firm described their consultants as "independent." If a Fortune 250 firm hires a consultant to provide executive compensation advice and company management also pays that consultant millions of dollars for other services, do you think it is misleading for the firm to describe their consultant as "independent"?

Mr. PEDROTTY. We think it is absolutely misleading, Mr. Chairman; and we think the core problem here is a consultant isn't going to want to alienate the person who is going to award them significant amounts of other business. I think, as your report shows out, that's a multiple of sometimes 40 to 50 times. And in some cases it is not only awarding them business with the company for actuarial services or HR consulting, it's also if the CEO is chairman of the board, the CEO himself is hiring the pay consultant who will decide his or her own pay. So we think that's a problem.

Transparency is the first step, but we ultimately think, much like the fight around equal access to the proxy, that investors need the tools to hold their representatives accountable.

Chairman WAXMAN. I know some people feel this problem should be left to the market, but if there is a problem with conflicts, companies will hear about it from investors and will take action to stop it. But markets can't function without good information. It is clear that companies are not providing necessary information about their compensation consultants' conflict of interest.

Ms. Miller, can you make well-informed decisions about companies when they fail to provide information about conflicts or, worse, when they provide information that appears to be misleading?

Ms. MILLER. Yes, I think that that is--no, it is very difficult to make good, informed decisions about compensation and compensation consultants' advice when the information may be misleading.

I think the problem that we saw was that the definition of independence varied; and oftentimes the compensation committee would assert that it was, in their judgment, based upon their relationship and their past history with the consultant, that they believed that the consultant was independent. Without some kind of standardized definition and standardized reporting, it is very difficult for an investor to be able to determine exactly what that relationship is, what their definition of independence is.

Chairman WAXMAN. Thank you very much.

Mr. Davis.

Mr. DAVIS OF VIRGINIA. Thank you, Mr. Waxman.

Mr. Shadab, let me start with you. Are you aware that the consulting firms that only advise on executive compensation are generally associated with the corporations that had the highest levels of executive pay?

Mr. SHADAB. I was not aware of that fact, no.

Mr. DAVIS OF VIRGINIA. Well, that is a fact, which kind of negates the whole thesis of this today. It negates the thesis, which is the basis of the hearing.

Isn't it far more threatening financially for a firm that would advise only an executive compensation to lose a client than it was for a larger firm with multiple lines of consulting business?

Mr. SHADAB. Is possibly could be, yes.

Mr. DAVIS OF VIRGINIA. Mr. Elson, you serve as a board member on several public companies, is that correct? In this capacity, have you been involved in improving executive compensation packages?

Mr. ELSON. Yes, sir.

Mr. DAVIS OF VIRGINIA. Now are you testifying today that your board members are unable to request or do you request from your management information relating to the other business relationships that a third-party consulting firm has with your companies when they are advising you on questions of executive compensation?

Mr. ELSON. Well, on the compensation committee that I chaired, we in fact brought in an independent consultant. Because I believed, as chair of the committee, that the other consultant, because they were doing--it came to our attention that they were doing other work for the company, it was appropriate that we bring in an independent advisor to create a better process.

Mr. DAVIS OF VIRGINIA. But even if you didn't bring in--say you weren't chairman of the committee, as a board member you're free to ask that information, request that information. In fact, it would be appropriate to do so, wouldn't it?

Mr. ELSON. Yes, I do, but I don't think a lot of directors ask that question. I would ask that question because it is an area as an academic I find interesting, but I don't think most do, no, sir.

Mr. DAVIS OF VIRGINIA. And once you have access to that information then you can make a judgment whether it is appropriate or inappropriate, right?

Basically, what we're talking about here is saying directors aren't doing their jobs, and so we are scapegoating it and putting it out on these independent consultants. But any wide-awake director ought to be looking at and asking these kind of questions, and you really want to limit their ability to get the best advice just because they may have another line of business with the corporation.

Now I think one of the difficulties is we're restricting how corporations can get information and who they can get it from. Whereas a wide-awake director ought to be asking--I think it is certainly entirely appropriate to ask, do you have other businesses relations with the firm as part of the decision-making process. But to restrict it seems to me you are hamstringing corporations' ability to get information, and I'm not sure that's our job.

Mr. ELSON. I'm not really sure you're restricting it. You are simply disclosing it.

Obviously, the director is free to use a conflicted director or not--conflicted consultant or not. I think the key is a wise director, in my view, in this day and age, given investor pressure and certainly given what we are seeing coming out of the legal system, would be well advised to seek out independent advice or uncompromised or unconflicted advice. Clearly, as director, you can weigh conflicted advice one way or another, but to do your job effectively for the investor I think you'd want the best possible advice, which in my view is nonconflicted.

Mr. DAVIS OF VIRGINIA. Do you really think the reason corporate salaries are so high is because of these compensation consultants or do you think there are a lot of other factors?

Mr. ELSON. Oh, I do think there are a lot of other factors, but I do think they are a factor. Clearly, a compensation consultant misused by a passive, management-dominated board will create--and combined with overreaching executives will create pay unrelated to performance.

It is all part of the picture. You have to solve all the elements. One is, management will always have an incentive to ask for more, but certainly a board, if it is independent of management and owns stock in the company, advised by a nonconflicted advisor is going to do a better job in my opinion than a board of directors--let's say a director who was appointed by management, has no independence and has no stake in the company.

Mr. DAVIS OF VIRGINIA. Let me just tell you, the way the laws work now, it is hard to get good corporate directors because of the liabilities involved. The fiduciary duties of corporate directors at this point--I talk to people in the private sector. There's a huge reluctance on the part of a lot of talented people to go on and make cases because of the opportunity of being sued. So you're going to be asking these things, it seems to me, if you are any kind of wide-awake director. Do you not think that culture is changing--or not?

Mr. ELSON. Well, I chair nominating governance committees of two publicly traded companies, and so I'm on the search for directors all the time. And I don't think that there is a shortage in supply of directors because of the concerns about compensation, a compensation issue or whatnot.

I think the job of the director has become much more complex today because, obviously, in the old days you were simply an advisor of management, and today you are expected to be a monitor for the shareholders, and there is more required, more time involved, and certainly the potential of liability is greater the more you do.

I don't think there is a shortage of people who are willing to go on board, and I certainly wouldn't believe that changing disclosure compensation consultant conflicts would have anything to do with the ability to recruit effective directors. Frankly, as a director, I would want to be on a board where you have as clean a governance package as possible, because that makes it much less likely that I will be successfully sued.

Mr. DAVIS OF VIRGINIA. I don't know that I disagree with that. The question is, should Washington mandate it or should the corporate boards have the ability to mandate it? And my experience has been you are better off probably not mandating it. There are a lot of unintended consequences.

Let me move ahead with it. A full-services consulting firm that provides nonexecutive consulting services for a client company is going to be I think by definition more familiar with the operations of that company than a smaller single-purpose boutique firm that specializes just in executive compensation. If you would limit executive compensation consulting work to such boutique firms you would be depriving compensation committees of advice that reflects a more complete understanding of respective companies. Now your argument is you don't believe that they should be restrictive, you just think it should be disclosed, is that fair?

Mr. ELSON. I'm a believer in the market, and I think the market itself is pushing us towards using the boutiques, but I wouldn't have a government regulation that said you couldn't use a full service firm. No, I believe the solution is disclosure.

Mr. DAVIS OF VIRGINIA. Ms. Miller, do you think the solution is disclosure or should there be a ban?

Ms. MILLER. I think that, as the first step, we should start with disclosure, but in the event that investors continue to have concern about escalating executive comp or the quality of the disclosure, I think we ought to seriously consider a ban.

I'm reminded of concerns we had about the auditor issue back in 2000, prior to Enron, when the SEC promulgated the first wave of rules and they were weak. And then we had a number of scandals and then they had to issue new rules.

So I think that this issue is an iterative process, and I think it is going to take some time to work through it, but I would say that in the very first instance we need the SEC to revisit this and require disclosure.

Mr. DAVIS OF VIRGINIA. Thank you.

Mr. Shadab, do you think that the analogy between compensation consultants and accounting firms is an accurate one?

Mr. SHADAB. I think to some extent it is accurate, but it is accurate in a way that--you have a third party coming in and providing services to management, that could have a potential conflict of interest. But I don't think it is accurate in the way perhaps some advocates have disclosure or prohibitions on not providing the core services that the company provides, whether it be auditing or compensation services.

It is an accurate analogy for the reasons I stated in my oral testimony, namely that is there is no good evidence, in fact, better evidence in the opposite direction showing that potentially conflicted auditors reduce audit quality where in fact the empirical studies show that to whatever extent there is an actual impact from allegedly or potentially conflicted auditors there wasn't improvement in audit quality.

Now, that analogy I think, to the extent it carries over to consultation consultants, could also be the case that a compensation consultant providing noncompensation services also has, as you are referring to, more knowledge about the company and therefore can make more accurate compensation packages for executives that do serve the interest of shareholders.

Now, taking a step back, I think it is important for all of our concerns to be driven by empirical data and so, first of all, concerns about what services should be prohibited and what types of services that company--

Mr. DAVIS OF VIRGINIA. Let me ask you this. An audit report out there, shareholders are going to rely on an audit report, not just directors, right?

Mr. SHADAB. Correct.

Mr. DAVIS OF VIRGINIA. Put an audit report out.

Shareholders don't rely on that. The directors rely on that in setting compensation and use that as one of several factors, including the marketplace, to determine bringing someone in. Maybe you want a CEO in. Whatever the compensation, if you want the right guy, he can negotiate his own price notwithstanding--

Mr. SHADAB. Correct. So there is a disanalogy between audit services and compensation services, and the primary consumer of financial statements are investors, where the primary consumer of compensation advice is the board.

Mr. DAVIS OF VIRGINIA. So the question for us from the policy perspective is, are we here to protect the board or are we here to protect investors? And it seems to me that we have a duty to protect investors out in the marketplace, but I'm not sure we have a duty to protect board members.

Mr. SHADAB. Surely you don't, correct.

Mr. DAVIS OF VIRGINIA. Mr. Pedrotty, let me ask you, do you favor disclosure or would you like to have a ban on these kind of conflicts?

Mr. PEDROTTY. Congressman Davis, we think disclosure is a good start. Clearly, from the report this morning, disclosure is a long way from being adequate for investors. We think that separating the role of consultant advising the board and advising the company is the best practice already. We have already found companies like Proctor & Gamble, Wachovia and Verizon taking that lead. So we think that if that's the best practice and you have other institutions like the National Association of Corporate Directors and the conference board leading in a similar direction, we think others should follow.

Finally, Congressman Davis, we think that a vote is appropriate here.

To go back to you earlier question about the auditor issue, for our markets to be at their competitive best, information is key. We don't have information and, much like the auditor, shareholder confidence in pay and pay for performance is eroding. So I think from an investor protection standpoint we have a long way to go. Disclosure is the first step, but there are other steps.

Mr. DAVIS OF VIRGINIA. But the compensations are disclosed, aren't they?

Mr. PEDROTTY. The compensations are disclosed, but we still--on comp consultant independence and conflicts, we still have a way to go.

Chairman WAXMAN. Thank you, Mr. Davis.

I want to now recognize Mr. Danny Davis.

RPTS MCKENZIE

DCMN HOFSTAD

[11:00 a.m.]

Mr. DAVIS OF ILLINOIS. Thank you, Mr. Chairman.

Many Americans have no idea what a compensation consultant does and what kind of impact they have on the explosion in CEO pay. Some may understand that if you need a consultant to determine your pay that you're doing pretty good. But few people outside of the investment world really understand what they do.

Experts on corporate governance are different. They understand who these consultants are and what role they play. And there is a consensus among these experts that conflicts of interest are a serious issue. The Conference Board, the National Association of Corporate Directors, the Business Roundtable and the New York Stock Exchange have all expressed concerns. Yet they all express the view that corporate boards should strive to avoid hiring consultants who have been awarded lucrative contracts by CEOs they are supposed to be evaluating. Despite the recommendations of these experts, the report released today found that over 100 of the Fortune 250 companies are using consultants with conflicts of interest.

Professor Elson, you are active on corporate boards. Have corporate boards been too slow to respond to this red flag? And if so, why do you think so?

Mr. ELSON. I think for a long time people really didn't think about it. I think several factors were at play.

Number one, a lot of boards were dominated by management. And, frankly, the compensation consultant legally was a great thing to have for a director, because it protected you legally. The problem with the use of compensation consultants really comes from sort of a legal view that the use of the consultant protects the director from a State law challenge against the director's actions. The fact that you had a third-party advisor was considered helpful to you legally. And that explained the proliferation.

And I think that initially a lot of directors, obviously dominated by management, were happy to have that protection and, frankly, didn't question it. And I think what's happened now, as we began to think about it and look at compensation under the microscope and following the scandals of the last couple of years, realize that we really do have a problem vis-a-vis managerial--I've got to say in many companies, some companies--managerial integrity. There's a real concern. And based on that concern, there's a real re-examination of all processes that boards go through, including compensation. And obviously, given investor concern, there's a heightened interest in it. And I think that's why it explains the shift.

I think also, legally, the courts of Delaware, for instance, are beginning to shift in their definition of independence and the use of independent advisors. That's why I included in my testimony the comments of the chief justice of Delaware on the necessity of an independent advisor to the comp committee.

And as a director, having an independent advisor I think is not only smart from an investor's standpoint, it's smart from a legal standpoint. And I've got to tell you, as a director, to knowingly, intentionally keep on a conflicted comp consultant in the presence of investor pressure would be almost moronic. There's absolutely no reason to do it. And I think, at that point, we've begun to see a shift in practice, and I think it's a valued shift. But I think, for a long time, people didn't think about it.

Mr. DAVIS OF ILLINOIS. Thank you very much.

Mr. Pedrotty and Ms. Miller, what are your views? And are corporate boards acting responsibly when they hire compensation consultants, knowing that there are conflicts of interest?

Mr. PEDROTTY. Go ahead.

Ms. MILLER. Thank you, Dan.

I do believe that corporate boards are not acting responsibly when they're hiring compensation consultants when they know that there's a disproportionate monetary tie to the management side and that they're supposed to be consulting to the committees in the best interest of both the company but also of shareholders. And the board members are supposed to represent shareholders' interests. And so, that conflict can't work well for our interests, the investors to be represented.

I think that, in our study, when we approached the 25 top companies, we engaged the compensation committee chairs. And when we brought to their attention this issue and the concern about the conflict of interest that investors had, they were willing to positively address the issue of independence. I think that it is surprising there has been a lag within compensation committee chairs of corporate America.

But I do believe that brought to their attention, through a required disclosure, we can really get away from really hoping that the market will take care of this and hoping that this will just be a best practice. I don't think we, as investors, can tolerate this issue to just continue to be a best practice. I think that we cannot tolerate conflicts of interest and definitely need a disclosure standard.

Mr. PEDROTTY. Just to follow up, Congressman Davis, I think the situation is getting better. I mentioned some companies that were engaging in best practices. But we still have a long way to go.

And something that was pretty representative for us is we joined with the investor coalition led by Connecticut and sent letters to directors, asking for more disclosure. A number of companies in the S&P top 25 didn't even respond to the letter. So I think we've got a challenge in making directors more aware that this is part of their fiduciary duty and educating companies.

And we're interacting with companies almost on a one-on-one basis by filing shareholder proposals, but we continue to see glaring and egregious examples. One was last year at Wal-Mart, which, from our standpoint, is a pay-for-failure company, a pay-for-pulse company. The company was surprised at our outrage at the fact that their management hired the comp consultant and not the board. They didn't understand why we would be concerned about that as a potential conflict.

So there are leaders, but we still have a long way to go, just getting that information and then having the standard brought up through the SEC.

Mr. DAVIS OF ILLINOIS. Thank you very much.

Thank you, Mr. Chairman.

Chairman WAXMAN. Thank you, Mr. Davis.

Mr. Westmoreland?

Mr. WESTMORELAND. Thank you, Mr. Chairman.

And, Mr. Pedrotty, you made a comment a while ago about the executive pay, the majority staff report, the executive pay. That was embargoed until 10 o'clock this morning, and you were sitting there at 10 o'clock this morning. How did you get a copy of that?

Mr. PEDROTTY. Mr. Westmoreland, I was reacting to the comments of the Chairman on the information within the majority staff report.

Mr. WESTMORELAND. Okay. So I guess it wasn't embargoed to the public? Or did he just want to give it to the witnesses to--would that bias your statement in any way, that you got a copy?

Mr. PEDROTTY. No. The statement I brought--

Mr. WESTMORELAND. It wouldn't? Even though you commented on it and quoted from it?

Mr. PEDROTTY. I think that adds further concern on the part of investors. And there was a Corporate Library study that looked at comp consultants and companies and found that companies that retained these consultants paid higher than the median without better performance. I think this is a different cut on that, so I was accentuating information I already had in my statement.

Mr. WESTMORELAND. I'm wondering, Mr. Chairman, whether we could get a copy of who all got advanced copies of the report.

The other thing: Mr. Pedrotty, you are the director of the investment office for the AFL-CIO. Is that correct?

Mr. PEDROTTY. That's right.

Mr. WESTMORELAND. It says here that the union-sponsored pension plans holds more than $450 billion in assets.

Mr. PEDROTTY. That's right.

Mr. WESTMORELAND. Do you have a compensation plan? Or could I ask how much you make?

Mr. PEDROTTY. How much do I make? Actually, Mr. Westmoreland, I think we practice what I preach, in that what I make is not just publicly available--it's a little bit over $110,000--but every single employee in every single labor union has disclosed what their salary is to the Department of Labor. So if we had commensurate disclosure at companies, it would be, you know, quite an improvement.

Mr. WESTMORELAND. Is that based on performance of what these assets do?

Mr. PEDROTTY. It's based on advising our pension plans around best practices in corporate governance. And we feel like we've got a long way to go. We've been successful at some companies like Pfizer and Home Depot and Verizon, so I think we feel good about our success, but there's lots more challenges and initiatives that we need to take up.

Mr. WESTMORELAND. Okay. But, I mean, are you going to get any type of bonuses for doing better? Or if you don't do well, are they going to take any money away from you? I mean, is this just a package that you agreed with--

Mr. PEDROTTY. And just to clear up on any confusion on your part, I don't actually manage money on behalf of the union.

Mr. WESTMORELAND. Oh, okay.

Mr. PEDROTTY. I'm, as my role here today, in more of a policy role and advising trustees who do manage our members' money.

Mr. WESTMORELAND. Okay. Do they get compensated?

Mr. PEDROTTY. Does who get compensated?

Mr. WESTMORELAND. The trustees.

Mr. PEDROTTY. The trustees are not paid. I think their expenses are picked up, but they're not paid themselves for managing funds.

Mr. WESTMORELAND. But the AFL-CIO, from reading your testimony, has had some success with Verizon. I think you made the point that they went to a stockholders meeting with Verizon, put together these votes and actually got Verizon to change their policy about the compensation. Is that not true?

Mr. PEDROTTY. That's right, both on the say on pay and compensation.

Mr. WESTMORELAND. It says you also had success with

General Electric, Home Depot and Sara Lee.

Mr. PEDROTTY. That's right.

Mr. WESTMORELAND. So do you think the free market system works?

Mr. PEDROTTY. In relation to disclosure?

Mr. WESTMORELAND. Yeah.

Mr. PEDROTTY. No, I don't think it works. I think a certain few companies are responding--

Mr. WESTMORELAND. You all had some success with it, didn't you?

Mr. PEDROTTY. We had success. But, Mr. Westmoreland, a handful of companies doing right by their investors doesn't mean the free market's working.

Mr. WESTMORELAND. But other investors in these companies could do the same thing and have the same success that you've had, right?

Mr. PEDROTTY. And they increasingly are. But they can't be able to vote in an informed fashion on CEO pay or know about the conflicts that exist if the information isn't there. A basic premise that I operate under is markets operate well under good information. We don't have good information, let alone the tools to hold people who act on that information accountable.

Mr. WESTMORELAND. Okay. Well, you know, we, on our march to socialism, you know, we just tend to interfere in business. You know, we started out at the bottom and working our way up with minimum wage, and now we're starting at the top, working our way down. It's going to be interesting what happens when we get to middle management and supervisors.

But, you know, talking about pay for performance, I think if you looked at the 110th Congress, if we got paid for our performance, we'd be making about $1.98. So let's just thank God that we haven't gotten to--

Mr. PEDROTTY. What about the prior Congresses?

Mr. WESTMORELAND. --where we make sure everybody's getting paid for performance.

But I yield back the balance of my time.

Chairman WAXMAN. Do you yield back the balance of your time or the balance of your salary?

Mr. WESTMORELAND. Well, either one is fine.

Chairman WAXMAN. Mr. Murphy?

Mr. MURPHY. Thank you very much, Mr. Chairman.

I want to welcome Ms. Miller here today. The Office of the Treasurer in the State of Connecticut has been for a very long time an outspoken advocate for the investor community in general and, as you can see by Ms. Miller's testimony here today, a leader in this Nation in looking out for investors' rights.

And I wanted to just talk specifically about the issue of the SEC actions that took place about a year ago in terms of the new regulations and rules that were promulgated and how far we still have to go. We've talked a little bit about it here today, but obviously we've at least uncovered the fact that the SEC can do more, at the very least to require disclosure about what kind of other work these consultants are doing.

I wanted to just to give you, Ms. Miller, the opportunity to talk a little bit more about the adequacy of the SEC regulations in the first year of promulgation and whether there are other avenues in addition to trying to look at what other work these consultants are doing for the company that we should be advocating for as we ask the SEC to pursue this issue further.

Ms. MILLER. Thank you very much for that question.

As many of the people in this room know, this is the first year that the SEC had new disclosure rules, and they inserted a new portion called the Compensation Disclosure and Analysis, which we refer to as the CD&A. And both the public's analysis, investor analysis, consultants' analysis, and even the SEC's analysis of the performance of the reporting by companies in that first year determined that it was woefully inadequate. And so, the problems were that a lot of the compensation committees did not provide clear information.

And so the SEC actually tried to deal with this issue by doing a targeted review, where it sent out over 300 letters to companies saying, "You need to do better reporting on a number of issues." what was noticeably lacking in the staff's questioning of the companies was, again, this issue of disclosing whether compensation consultants were independent. And then even furthermore, once the staff sort of went through the first few hundred of the letters, they recently issued a document that's on the SEC Web site called "Staff Observations on the Compensation Disclosure and Analysis." And, again, in there, on their observations, they do not guide companies to better disclose on the compensation consultant conflict.

And so, there are so many opportunities here that we've had with the SEC to pay attention to this issue. They've ignored investor comments on this. The treasurer wrote a letter generally about it when they first proposed rules. She wrote another letter just focusing on the compensation consultant conflict. The Council of Institutional Investors and many more organizations commented from the investor point of view about the importance of this issue. And the SEC has continued to ignore it and decide that it's in the best interest for us that the compensation committees make a determination about what is independence.

And I think when we just see this recent action by the SEC, I think it shows that there is tremendous need to bring to their attention the investor community's concerns and now the empirical data from the Chairman's report.

Mr. MURPHY. Thank you.

And just one other question to the whole panel. Other than potentially being a step toward our unending march toward socialism, would increased disclosure from the SEC on these particular points--do you see any downside? We've talked a lot about the upsides, but do you see any downside to asking the SEC to pursue disclosure at an increased level going forward?

And I will just ask for everybody to comment very briefly on that.

Mr. ELSON. I can't imagine there would be a downside. You're not talking about, you know, vital corporate secrets that if you disclose will destroy the corporation. I think it's effective. Look, we disclose the auditors' conflicted transactions, and there's no damage done. I can't imagine any damage by disclosing the other forms of services that are offered. There are routine personnel issues that I don't think go to the heart of the strategy of the business, in my view.

Ms. MILLER. I don't think there's any downsides from the investor point of view. I do understand the impact that it may have on the industry, on the consulting industry, which they may view as a downside because of the organizational change. But I think that in the long run, in the long-term interest, this would be a good move for all parties interested.

Mr. SHADAB. I think a potential short-term downside is having companies disclose information which may not be material to the choice of whether or not to purchase or sell securities or to the value of securities. That's the short-term potential downside. And because investors only want information that is actually material to the price of the securities. Other information that's not relevant would just be confusing and flood the marketplace with information that's irrelevant.

A second, more long-term potential downside is setting the precedent for further mandatory disclosures on the Federal level of information which is also not relevant to the choice to invest or not.

Mr. PEDROTTY. I think more information and better disclosure on conflicts is necessary and important, and I don't see any downside.

What we are sensitive to is ensuring that companies, when they disclose their benchmarks and how they're paying and who they're comparing to, that that not put competitive information out in the market. So we think retroactive disclosure in some cases, in terms of their peer group, is important.

In terms of the march to socialism, I should just comment that I think we're to the right of some of our Republican friends, in that there's an interesting contrast: When it's the taxpayers money, there's outrage over how it's spent, but when it's the shareholders' money being given to an undeserving CEO, somehow that seems okay.

So thank you, Congressman Murphy.

Chairman WAXMAN. Thank you, Mr. Murphy.

Ms. Foxx?

Ms. FOXX. Thank you, Mr. Chairman.

I really wonder why we are here today. There is a tremendous amount of work to be done in this Congress, which we are not doing. And to me, this has to be the most far afield hearing that I have seen since I have been in the Congress in the last 3 years.

I spoke to the Chairman recently and said, you know, I really got on this committee because I wanted to do something about the way the Federal Government operates. I want it to be more consumer-friendly. And I really want us to do our job. The title of this committee is Government Oversight and Reform. And here we are meddling in the private sector in a place we have absolutely no place being. This is not our responsibility.

I think that it's an indication of how detached from the real world some of our friends are. They've been in

Washington way too long. They have no idea how the private sector works. And I think it's really a sham. And I'm sorry that we are even doing this and wasting the time of these people and our time on it. I just find it unbelievable.

But I want to point some things out. I think that if shareholders were upset about this issue, they'd be coming to us. I, frankly, have not gotten a single letter from any shareholder saying, "This system isn't working. Why don't you fix this system?"

And I find it very difficult to believe, Mr. Elson, that you say you believe in the market. Well, if you believe in the marketplace, then you wouldn't be trying to destroy business and industry in this country, as you are.

We have more and more firms moving offshore in large part because of Sarbanes-Oxley and the rules that have been put in place. And we're going to see more of that. The more you try to restrict the marketplace, the more you try to make this a socialistic country, the more businesses are going to move. And I'm terribly distressed by this. We are the most successful country in the world, and it is in large part because of our capitalistic system.

I want to ask Mr. Pedrotty--Pedrotty?

Mr. PEDROTTY. Pedrotty. You got it.

Ms. FOXX. Thank you, Mr. Pedrotty. I want to ask you a couple of questions.

The first one is, did you say, did I hear you say Wal-Mart is a pay-for-failure company?

Mr. PEDROTTY. That's right. Or pay-for-pulse, depending on your preference.

Ms. FOXX. Or pay-for-what?

Mr. PEDROTTY. Or pay-for-pulse. Pulse.

Ms. FOXX. Okay. Undeniably one of the most successful companies this country's ever seen, you say it's pay-for-failure.

Mr. PEDROTTY. And that's not us speaking, Congressman Foxx. That's an institution like the Corporate Library that puts out a pay-for-failure report that looks at the total shareholder return, the value delivered to institutional investors, including our funds. And they've characterized Wal-Mart as such.

Ms. FOXX. Okay. Well, let me ask you this. In your description of your job, it sounded like you do several different things, right? You said you advise the trustees. Could you name, like, the three or four major aspects of your position?

Mr. PEDROTTY. Sure. It's primarily advising our union pension funds and affiliates on corporate governance initiatives and strategies. Also doing a significant amount of work in front of the Securities and Exchange Commission on regulatory issues, everything from private equity to equal access to the proxy to CEO pay. So it's a fairly diverse policy platform.

Ms. FOXX. Well, why shouldn't we demand, then, that the AFL-CIO restrict you to one aspect of your work? I mean, why should you be allowed to be working sort of two or three sides of an issue? I mean, if you want to stop the private industry from doing that, why shouldn't you be stopped from doing that?

Mr. PEDROTTY. I don't think we want to stop private industry from doing that. I think we want the advice they provide to our representatives of the board to be free from conflict. If there's some suggestion that, you know, I'm conflicted in any way, I would be interested in hearing that. But I think that's the basis on which our recommendation emerges.

And, Congresswoman, it's also the basis for why companies themselves are following this system. If this was so egregious and burdensome, why are right-wing outfits like the Business Roundtable and the National Association of Corporate Directors making these recommendations?

Ms. FOXX. Okay. Another question is, don't you see a conflict of interest in your role in negotiating labor contracts with companies and also investing in those companies? Isn't that a conflict of interest and much worse than what you are describing for these consulting companies?

Mr. PEDROTTY. Congresswoman, we don't see any conflict at all. In fact, our goal is the same. Our goal is to both own and negotiate with companies that are creating long-term value, that can both provide substantial returns to our pension funds and employ our members. So those goals are the same.

Chairman WAXMAN. Thank you, Ms. Foxx.

Mr. Welch?

Mr. WELCH. Thank you, Mr. Chairman.

As I understand it, the reason for our hearing is to see whether there are some policies that could wisely be promoted in order to protect shareholders and preserve corporate accountability. And we obviously have a debate about whether that's a valid purpose, but my view is that it is.

Mr. Elson, one of the questions I have, the point's been made about the importance of having independence in compensation consultants. In materials we've seen, oftentimes the consultants get $1 in payment for compensation advice and they have $11 in services for other contracts, and they're being hired for those other contracts by the executives whose pay for performance they're reviewing.

Is it your view that for many of these firms that do multiple services, that executive compensation is, in effect, a loss leader?

Mr. ELSON. Yes, I believe so. Executive comp is, frankly, a way into the executive suite, if you will, to access, you know, high-level folks at the company. So that as the other work would come in, I would assume--I mean, not having been a comp consultant, I would assume that the large amount of money that they make is not related to compensation consultants but the other services that they're in. And compensation, particularly when go in at the CEO level, puts you in a place, a very high point of visibility, a high point of contact within the organization that enables you to make those contacts to make the other businesses happy. I wouldn't suppose real money has been made. It's probably not on consulting but certainly on the other services. In fact, if you look at the income of these companies, the bulk of their revenue is coming from the other part.

Look, I'm not attacking comp consultants. I think they provide a very valuable function to the comp community. I think they're actually quite helpful, in many circumstances. I think you just have to tweak a little bit how their advice is being given or the parameters under which their advice has been given to a committee.

Mr. WELCH. The loss is generally, whether it's Wal-Mart or executive compensation firms, that you offer a good price for providing other services. And my understanding, if I'm listening to your testimony correctly, is that for some of these firms, the opportunity to provide the compensation service gives them access to the management people who then make the hiring decisions on the other $11.

Mr. ELSON. Well, that explains why a lot of consultants--the trend has now been to using independent consultants--have peeled off of the large firms and went and set up their own boutiques. The nice thing about getting a boutique player today is that most of them are graduates of these large firms. And the firms themselves chose to keep the other work.

Mr. WELCH. Thank you.

Ms. Miller, I want to ask you a question. There's been some back and forth here about whether the labor organization has some agenda that interferes with capital.

Your responsibility is to the pension holders, which are workers and others in the State of Connecticut. Correct?

Ms. MILLER. Yes.

Mr. WELCH. So your bottom line is to have the maximum return to your pension holders and the minimum cost to your taxpayers. Is that correct?

Ms. MILLER. Yes.

Mr. WELCH. So do you have any--just explain to me briefly what the policy basis is for your view about executive compensation needing some rules or regulations that will protect the interest of the people that you represent as the deputy treasurer.

Ms. MILLER. Sure. Thank you.

My testimony includes some empirical data from The Corporate Library that Dan also referred to that shows the losses that shareholders incur when executives are paid excessively while at the same time companies are performing poorly. And the losses over time accumulate to be significant amounts, which obviously impact a pension fund such as the State of Connecticut's.

Even more recently, we saw the losses due to the subprime mortgage problem that many companies have incurred while their exiting CEOs were paid handsomely and, in some cases, you know, total packages that were astounding.

So I think that our goal--the treasurer is the sole fiduciary, principal fiduciary of the Connecticut $26 billion pension fund. And in that regard, she moves on these issues, which is really your question, because she has a fiduciary responsibility not only to vote her proxies and to monitor them but to engage in corporate governance activities, whether it be directly with companies or on a policy level that can enhance the value of our investments.

Mr. WELCH. Thank you.

You know, my friend Congresswoman Foxx said that she hasn't heard much from shareholders, and I have to say I haven't heard from shareholders either. Yet you've indicated that on behalf of your pension holders, you have been an advocate for some reform.

What impediments have you run into when you've made efforts to try to get greater oversight and independence on this executive compensation?

Ms. MILLER. Well, the SEC has totally ignored investor comments. There's a public record of comments submitted when the SEC proposed rules, where investor coalitions, the Council of Institutional Investors, which is the largest consortium of public funds and private funds, weighed in on this issue as well. And so the impediment is that we cannot seem to get the attention of the SEC throughout any of its work in this area or any of its oversight on the quality of the reporting of companies on compensation.

Chairman WAXMAN. Thank you, Mr. Welch.

Mr. WELCH. Thank you, Mr. Chairman.

Chairman WAXMAN. Mr. Souder?

Mr. SOUDER. Thank you, Mr. Chairman.

I was watching earlier in my office because we can have wall-to-wall committees on in our committee C-SPANs.

Mr. Elson, I thought I heard you say you serve on several boards?

Mr. ELSON. Yes, sir.

Mr. SOUDER. Could you name them?

Mr. ELSON. Currently on the board of HealthSouth

Corporation and AutoZone Corporation.

Mr. SOUDER. How much do you get compensated on those boards?

Mr. ELSON. I think the AutoZone, I think it's $3,000 stock options a year and I think $40,000-some in cash that can be taken in company stock.

Mr. SOUDER. Have you exercised any of those stock options?

Mr. ELSON. No, sir.

Mr. SOUDER. On the HealthSouth, what did you say your--

Mr. ELSON. I think it's about--we have a half-stock, half-cash retainer system--about, oh, $100,000 in cash which may be converted to company stock and then another, oh, I'd say about $80,000, $90,000 in restricted stock.

Mr. SOUDER. Did I understand you to say that you felt board members were idiots?

Mr. ELSON. No, sir. I think a board member who would ignore the demand of a shareholder or shareholders and knowingly willingly hire a conflicted consultant in the face of a serious investor opposition and with the changed legal environment, it would be acting problematically for them, from their own standpoint.

Mr. SOUDER. So you think that any company such as Verizon, until they got under--that the reason companies are switching is because they're being smeared. It isn't because of a stockholder opposition. It's because you and others are smearing them in the general public, and it becomes difficult.

Now, the question is, you in effect just said that every board in the country that hires one of these consultants aren't acting in the interest of their shareholders, that they're more or less idiots, and smeared them, when you yourself sit on different boards, earn an incredible amount of money, have potentially multiple different conflicts in what you are saying here and how what you say here influences. The answer of the representative from the AFL-CIO was laughable.

You do have a conflict of interest. That's what businesses deal with on a daily basis. When I went to undergrad and grad school and went through case work, trust departments and banks have inherent conflicts of interest because people who are on their boards sit on companies that the presidents of the banks and the vice presidents sit on companies, then they make investment decisions. Every day they have to decide which stock do they dump first based on information, who do they know. You have conflicts of interests in country clubs. You have conflicts of interest in how you do cost accounting.

Government can't fix every ethical lapse. We try to have clarity. These things try to get supported. But you have come here today and smeared multiple companies.

And, Mr. Chairman, in your opening statement I heard you say that you didn't have any evidence that--what you said was, you said what we have in front of us is compensation going up and executive consultants being involved in this process who, in your opinion, have conflicts of interest, not understanding apparently divisions in companies and rules that exist in the division of companies. And though you didn't have any evidence, you said the evidence was compensation is going up and consultants exist. That's not evidence. That's what you said in your opening statement. That's what this so-called Democratic report states.

There's no facts. We've had one person here talk about economics today and three witnesses talk about politics. And you can go back to George Mason and talk to other economic people and capitalists, and this is why they mock Congress. We have a hearing that's supposed to be about economics. And instead it of economics, you are the only one who talked about how the markets actually work. Everything else has been political today, about opinions.

Do you think the AFL-CIO has a conflict up here today talking about Wal-Mart when you picket them all over the country, when you attack them? Look, companies can or can't unionize. But you have a conflict of interest in smearing Wal-Mart. You quoted some organization that I don't know, may have reflected one annual survey where they did, you know--and then put your editorial comment, implying that that organization said that Wal-Mart has either basically dead people or reward false, you know, reverse compensation. Now, nobody in this country believes that Wal-Mart would be the best--the fastest-growing company in the United States or in the world if, in fact, their management was, as you stated, quoting your interpretation of one year's probable report of a company we don't know about that claims that they reward deadweight. If they rewarded deadweight, Wal-Mart would disappear. There is a market that's holding Wal-Mart accountable, not you.

And I find, quite frankly, this hearing one of the most appalling, embarrassing hearings I've ever had--that we've had in this committee. Instead of oversight like we did under the past, Chairman, we are having repeated hearings where we release some dramatic statement, then no facts come at the hearing. The committee is embarrassed. Anybody who watches the details of the hearing--the hearings themselves don't match the allegations. And it's been an embarrassing process. As a senior member of this House who has been through under four or five chairmen, this is just embarrassing. I'm just sorry.

Chairman WAXMAN. The gentleman's time has expired, but Mr. Elson ought to have an opportunity, I think, to respond to the statements made.

Mr. DAVIS OF VIRGINIA. Mr. Chairman, can I just make one comment on George Mason University? Not only is it economics, but we've produced two Nobel Prize winners out of our Economics Department at George Mason University.

Chairman WAXMAN. Mr. Elson, do you want to respond to the personal attacks on you?

The attacks on me I'll just ignore.

Mr. ELSON. Well, I think that, first of all, those companies that made the changes, I think they did it because it was the right thing to do. And I think they recognized that if you don't protect the investors, then the capital that is fundamental to our free market system disappears. If you don't respect the--

Mr. SOUDER. Mr. Chairman, he is not defending my attack on him. He is continuing to talk like he's been talking--

Chairman WAXMAN. Mr. Souder, you can't evidently accept the fact that anybody disagrees with you. You made a statement about him, and do you think he should not have a chance to respond?

Mr. SOUDER. He is not responding about himself. He's just giving--

Chairman WAXMAN. You don't like his response, but do you think he ought to have a chance to respond?

Mr. SOUDER. No, I didn't attack him personally any more than he attacked all the other people.

Chairman WAXMAN. You attacked him as saying he's smearing capitalism, he should go back to his university and whatever else you had to say.

Do you feel you have anything else to say, Mr. Elson, because we do have to--

Mr. ELSON. I am a free-market capitalist and happy to be so.

Chairman WAXMAN. You are. Thank you.

We'll now turn to Mr. Cummings.

Mr. CUMMINGS. Thank you very much, Mr. Chairman.

In light of what Mr. Souder just said, I want to remind all of us that it was the Conference Board, the National Association of Corporate Directors, the Business Roundtable and the New York Stock Exchange that expressed concerns about conflicts and wanting those conflicts to be revealed. And I don't know that those are but so much political folk, I don't know, but the fact is that they are reputable and they expressed concerns.

Experts and some of our panelists today note that the consultant conflict we are discussing is analogous to the conflict faced by audit firms prior to passage of the Sarbanes-Oxley reforms. One of the lessons of Enron was that when auditors have multiple business relationships with a company, their independence is questionable. Arthur

Andersen, which was one of the most distinguished audit firms in the Nation, signed off on Enron's books. An independent auditor should not have done this. But in Arthur Andersen's case, it was being richly paid by Enron to provide a range of consulting services.

To prevent these kinds of abuses, the Sarbanes-Oxley law said that auditors have to be independent. Compensation consultants appear to have similar conflicts. Like auditors that were motivated to cross-sell more lucrative nonaudit services, compensation consultants are selling more lucrative services beyond executive compensation, and this is where the real money is. As the committee report shows, the fees for these other services far exceed those earned for pay advice.

Professor Elson, is the conflict that we see with compensation consultants similar to the auditor conflicts that were pervasive before Sarbanes-Oxley?

Mr. ELSON. It is extremely similar. And that's why I think Congress's response on the auditor conflicts on Sarbanes-Oxley makes perfect sense on disclosure of the conflicts that we have in this situation. It's almost identical.

Mr. CUMMINGS. Mr. Pedrotty and Ms. Miller, what is your view on this? And have regulators and investors been able to resolve similar situations involving conflicts in the past?

Mr. PEDROTTY. Congressman, we have. And that's why we think Verizon's a good example. Verizon responded not to a smear campaign but to the vote of a majority of investors, including large mutual funds and recommendations like you cited--NACD, NYSE and Business Roundtable--and agreed to ban work for both advising the committee and also advising the company.

But that's why we got here, Congressman. The consultant at Verizon had done a half-a-billion dollars' worth of business for the company at the same time they were advising the board. That's why we think, despite the performance suffering, the CEO's pay went up.

So we think it's sort of a good-news/bad-news tale, that companies are responding now, they're following best practices, but we have much farther to go. And that includes going beyond just naming the consultant, as required by the SEC right now. We need, A, better disclosure so we can take these conflicts into account, but, B, we should have the tools to hold them accountable, just like we can vote increasingly on the CEO's pay and just like we can vote on the auditor. So that's why that analogy is pertinent.

Mr. CUMMINGS. Ms. Miller?

Ms. MILLER. Yes, thank you, Congressman.

The study that Treasurer Nappier led, where we approached the 25 top U.S. companies, resulted in showing that 12 of those compensation committees did pass formal policies in the recent disclosure addressing the issue of compensation consultant independence. This confirms and underscores Dan's remarks that a lot of the companies, when brought to their attention, are willing. And the letters that they wrote back to the treasurer affirmed that they are in agreement with us, these compensation committees, that indeed there is a potential conflict of interest, whether it be actual or just perceived, that it's important that they address it. And we are very much aligned in that. Eleven of the 25 companies have an outright ban on the use of compensation consultants who work for management of the same company.

I just wanted to address your point about the auditor and whether this hearkened back--

Mr. CUMMINGS. And while you are answering that, would you let me know whether you think that Congress should be considering legislation to eliminate this conflict, like we did with Sarbanes-Oxley?

Ms. MILLER. Thank you.

I think that we should first take the step to urge the SEC to revisit this issue and to require disclosure by the compensation committees about the potential conflicts. And then we should take a hard look at that, and if the best practice hasn't spread rapidly throughout corporate America, we should seriously consider legislation that would prohibit the use of conflicted consultants.

I just wanted to mention that, prior to the passage of Sarbanes-Oxley, the SEC ignored investor comments to have a strong ban against auditor consulting work. They passed a rule. And after that rule was when Enron and the other companies' corporate scandals occurred. And that is what caused the passage of--in part, the passage of Sarbanes-Oxley.

We're exactly on the same path here with the SEC, where they are ignoring investor comments and concerns about this issue. And should they pass something, we would hope that it would be strong enough not to have to lead to legislation, like we ended up with Sarbanes-Oxley.

Chairman WAXMAN. Thank you, Mr. Cummings.

To conclude the questioning of this panel, I wanted to recognize Mr. McHenry.

Mr. MCHENRY. I thank the Chairman.

Mr. Shadab, this is directed to you. I'm on the Financial Services Committee. We've had a lot of discussion about the cost of Sarbanes-Oxley, the raw cost. And that is directly passed on to the investors, and the cost of separating consultants and auditing and everything else.

Now, it seems to me that others on this panel from the majority's witnesses contend that this is, you know, very good; we should sort of expand Sarbanes-Oxley to consultants of all sorts; that you only can consult on one issue area and that's it.

So can you talk about--let's talk about the cost to this. Because we've done a number of hearings on the Financial Services Committee and on this committee in the last Congress on the cost of Sarbanes-Oxley. So if you could touch on that.

Mr. SHADAB. Sure. Several studies have shown very high compliance costs with Sarbanes-Oxley. And those are pretty well-known. There are other studies and there are some conflicting reports out there about the cost to American competitiveness or the capital markets, the extent to which companies are either going private, staying private or going public elsewhere in response to not only just Sarbanes-Oxley but other regulatory issues that are unique to the American legal structure, such as plaintiff lawsuits and other forms of regulatory burdens unique to American companies.

In addition, several studies, such as one of my own, has shown that Sarbanes-Oxley seems to have reduced the risk-taking activity by public companies and reduced their incentives and ability to undergo innovation activities and create more new products and services for consumers than they otherwise would have.

So those are some of the costs of Sarbanes-Oxley.

Now, specifically with respect to the issue of nonaudit services and auditors, Sarbanes-Oxley is a really poor example of legislation that was based upon actual--the benefiting the investors based upon economic evidence with respect to whether or not there is an actual conflict of interest when auditors provide nonaudit services. In fact, that aspect of Sarbanes-Oxley and many others were really rushed through Congress not based on empirical evidence but, actually, to the contrary, most of the empirical data that shows any impact on investors when auditors provide nonaudit services, consulting services for example, shows that it actually improves audit quality.

So we shouldn't sit here and I urge the committee not to draw the wrong lesson from Sarbanes-Oxley, especially with respect to the issue of auditors and conflicts of interest and try to analogize to compensation consultants on their potential conflicts of interest. Certainly, there are potential conflicts of interest throughout the business community, but potential conflicts of interest are not actual conflicts of interest. And we shouldn't assume them to be so, especially when we at least perceive to be trade-offs and benefits from providing noncompensation consulting services.

Thank you.

Mr. MCHENRY. Thank you. I appreciate you touching on that.

Now, Mr. Pedrotty from the AFL-CIO, now, looking at your testimony, it says, "Today's compensation consultants perform lucrative consulting work unrelated to the investor protection role they're supposed to play." Now, so, with that, the consultant has a fiduciary responsibility to the investor; is that your contention?

Mr. PEDROTTY. We think that when a consultant is at the same time advising the board on how to strike the best arm's length deal but also doing a significant amount of business for the company itself, in some cases hired by the person whose pay they're weighing in on, that presents a concern for us. And at the very least, we need better information. It's much like--

Mr. MCHENRY. All right. But let me ask this. Does a consultant have a fiduciary responsibility to the investor?

Mr. PEDROTTY. No, but they should.

Mr. MCHENRY. Okay. No, but they should. Under your testimony, you said "unrelated to the investor protection role they are supposed to play." It's the board that has the fiduciary responsibility.

Mr. PEDROTTY. Fiduciary. Right.

Mr. MCHENRY. Thank you for correcting me. I've got a cold, so I'm having a hard time getting words out.

Not the consultants. It is the board that makes the decision. Is that correct?

Mr. PEDROTTY. It is. But we see--

Mr. MCHENRY. The condition is that everyone who does any consulting work for any company has to have fiduciary responsibility?

Mr. PEDROTTY. No. I think the problem at the very beginning, though, is the board is relying on advice that may be conflicted. Investors should know about that conflict, and they don't. And we even have boards making almost an admission of failure. Two-thirds of boards are saying that, you know, CEO pay is out of control; they're having trouble controlling it.

Mr. MCHENRY. That's a different issue. What you are trying to do is actually take consultants who provide market information--which is what the AFL-CIO does to a good extent, as well. You provide market information on pay and you want to raise people's pay, but you actually want to lower executives' pay, which is an interesting conflict.

Mr. PEDROTTY. That's not what we're saying. We're not saying that--

Mr. MCHENRY. Let me finish here, sir.

Chairman WAXMAN. Well, the gentleman's time has expired.

Mr. MCHENRY. If I may finish this thought, Mr. Chairman.

Chairman WAXMAN. Okay.

Mr. MCHENRY. You know, the interesting thing here is your contention is, if you are a consultant advising the board, yet your contention is they may have a conflict of interest because they have another part of their business that does work for the company. So your contention is that maybe they're charging a much higher rate than they should, thereby deriving--that's what a conflict is really about. So if they have another line of business that is charging this company extra money, thereby pocketing money for the consultants, that the board's too dumb to actually realize it.

And that's something that I just think is flat wrong. It's a failure to understand the fiduciary responsibility of the board and let them make the best judgment call, not have Congress dictate to them what they shall and shall not do.

Mr. PEDROTTY. We want consultants to drive the best bargain we can in negotiating with CEOs. The board drives that bargain. They rely on advice from consultants.

If the consultant knows that enormous amount of business, a multiple of what they're earning for advising the board is with the company itself, if the consultant knows that the CEO has hired them, are they want to alienate that person and not be in a position to be hired--

Chairman WAXMAN. The gentleman's time--

Mr. MCHENRY. Mr. Chairman, this is really about executive compensation and not about consultants. So I think it's a valid hearing to have about executive compensation. But the consultants are simply providing information. It's the boards that are really making the decisions.

So with that, I will be happy to yield back.

Chairman WAXMAN. You have no time to yield back. But the gentleman's time has expired. I want to thank you for your comments.

I want to thank this panel for your presentation and answering the questions of the Members.

We are going to have to recess to respond to votes on the House floor. So we will return and start with the next panel at 12:20. Thank you very much.

[Recess.]

Chairman WAXMAN. I would like to reconvene the hearing.

For our second panel I would like to welcome Donald Lowman, the managing director of Towers Perrin Executive Compensation and People Advisory consulting services; Charlie Scott, president of Mercer's human capital consulting business, which handles executive compensation matters for the company. Michael Powers is the global practice leader for executive compensation and corporate governance for Hewitt Associates. George Paulin is the chairman and chief executive officer of Frederick W. Cook & Company. James Reda is the managing director and founder of the James F. Reda & Associates, an executive compensation consulting firm.

We're pleased to have you with us today. Your prepared statements will be in the record in their entirety.

Before I ask you to make an oral presentation, it is the practice of this committee that all witnesses that testify before us do so under oath. So I would like to ask you if you would stand and raise your right hand.

[Witnesses sworn.]

Chairman WAXMAN. The record will indicate that all of the witnesses answered in the affirmative.

I mentioned all your prepared statements will be in the record in full. We'd like to ask, if you would, to try to limit the presentation to around 5 minutes. We'll have the clock there. It will be green, and then it will turn yellow, indicating 1 minute left, and then red, indicating the 5 minutes have expired.

Mr. Lowman, why don't we start with you? There's a button on the base of the mike. Be sure to press it.

STATEMENTS OF MR. DONALD LOWMAN, MANAGING DIRECTOR, TOWERS PERRIN; MR. CHARLIE SCOTT, PRESIDENT OF HUMAN CAPITAL CONSULTING, MERCER; MR. MICHAEL POWERS, GLOBAL PRACTICE LEADER FOR EXECUTIVE COMPENSATION AND CORPORATE GOVERNANCE, HEWITT ASSOCIATES; MR. GEORGE PAULIN, CHAIRMAN AND CEO, FREDERICK W. COOK & COMPANY; MR. JAMES REDA, MANAGING DIRECTOR, JAMES F. REDA & ASSOCIATES

STATEMENT OF DONALD LOWMAN

Mr. LOWMAN. Thank you, Chairman Waxman. Good afternoon to all the committee members, and thank you for inviting Towers Perrin to participate today in this discussion.

My name is Don Lowman. I am managing director of Towers Perrin and also a member of our board of directors. I've been with the firm 25 years, have held various leadership positions in addition to my consulting experience. And I hope my comments today will address many of the issues that are of greatest importance to the committee.

First, a few words about Towers Perrin's executive compensation consulting practice. We certainly recognize, as many others have commented, that there's a perception of and also the potential for conflict of interest in compensation consulting, indeed in all consulting. Our executive compensation practice, which is delivered by a separately identified line of business, is built around strong and effective processes and protocols which preclude conflict issues and which allow us to achieve our goal of providing input, sound and objective advice to our clients.

And among these protocols are the following. First, we perceive that our client is always the company. We are not agents for the CEO. We don't consult to, nor advocate for, any individuals. And, indeed, we're not paid by the CEO. Second, our fees are unrelated to any level of executive pay. Our fees are not a function of the size of any given executive's compensation package. Third, our consultants receive no direct reward for promoting or selling other services provided by our firm. Fourth, our code of business conduct, which has been in place for nearly 15 years, clearly articulates the firm's commitment to providing clients with services that are impartial and objective. Lastly, we have operating procedures, such as independent peer review. We wall off individuals who serve as board-appointed consultants from other client-related work.

This committee has expressed a concern about a firm providing both executive compensation consulting services and other consulting services to the same company. We don't believe a firm's ability to deliver sound, objective and conflict-free advice is compromised simply because other people in the same firm may also provide other consulting services to the client. Precluding executive pay consultants from other company engagements will not resolve what I believe this committee's fundamental concern with CEO pay is and the so-called wage gap. In fact, there's evidence that where executive pay consultants do no other work for a company, the result has often been the highest levels of executive pay. I will refer to the Corporate Library report later on during the question period.

I would like to talk a little bit about what we see as some of the possibilities for improving the processes around setting executive compensation. As the committee considers this issue, it's important to keep in mind that a company's compensation committee and board are vested with responsibility for pay decisions. There are, indeed, egregious examples in the areas of corporate governance and executive pay that don't represent the overwhelming majority of companies and boards nor the professionals who advise them.

Moreover, we have seen significant changes and reforms which have been implemented to enhance transparency, strengthen corporate boards and increase shareholder rights, among them improvements in governance resulting from Sarbanes-Oxley; shareholder activism coupled with new proxy disclosure requirements; stock option expensing requirements; directors who have become smarter, more committed, better prepared and, for the most part, unafraid to ask tough questions; compensation committees that focus on what's right for their company today; and the challenging of outmoded elements of historical conventional wisdom.

All of what I just talked about is good, and it should be given a chance to work. Corporate America has never been more conscious of executive pay and the implications for not getting it right. Indeed, I would just submit to this committee that the fact that you've asked for this information, that it's been provided to you, has actually raised the awareness of this issue in corporate board rooms and compensation committees around the country. We've been asked to testify to and reaffirm our independence, and we've done that in all cases. And in a majority of cases, there has been no change.

While no ready-made formula exists to satisfy all interested parties, certain enduring principles are receiving increased emphasis in board rooms across the country. These include good governance. It all starts with good governance. In today's environment, duty of loyalty and duty of care define the commitment and responsibility the board members have to the shareholders they serve.

More committed and courageous board members make a difference. These days, compensation committees are taking an increasingly active role. Polite and predictable give-and-take has given way to far more searching analysis and negotiation. Testing scenarios help ensure sound design. The relatively recent use of what we call tally sheets helps ensure that virtually all scenarios are explicitly contemplated by the compensation committee. We believe that survey data should be used judiciously with a host of other information to inform, but not determine, how much a particular executive should be paid.

Talent management and succession planning make for more affordable pay. Increased emphasis on thoughtful talent management and succession planning can reduce the need to buy expensive outside talent.

Towers Perrin clearly recognizes the critical importance of the role we play in ensuring good corporate governance. We take this role very seriously. And, again, I want to thank you, Mr. Chairman, for inviting us to be with your panel today.

[Prepared statement of Mr. Lohman follows:]

******** INSERT 2-1 ********

Chairman WAXMAN. Thank you very much, Mr. Lowman.

Mr. Scott?

STATEMENT OF CHARLIE SCOTT

Mr. SCOTT. Mr. Chairman, Ranking Member Davis and members of the committee, my name is Charlie Scott, and I am president of Mercer's Human Capital Consulting business.

We welcome this opportunity to describe for you the nature of our working relationship with executive compensation clients, our consulting framework for promoting responsible executive pay, and the steps we take to give our clients objective, unbiased advice and help them discharge their responsibilities.

Mercer's executive compensation consultants help compensation committees in two primary ways. First, our consultants help the committee establish a philosophy regarding executive pay that provides the backdrop for specific programs. Second, they provide a context of objective and expert analyses, advice and information to assist the committee in its decision-making role.

Mercer and its affiliates also provide a wide variety of products and services in the consulting, outsourcing and investments arenas to clients, their benefit plans and to employees.

Mercer's aware that some have raised concerns that providing executive compensation services as part of a diversified business model could present a potential conflict of interest. The critical issue, which your committee has identified, is whether potential conflicts of interest are prudently and effectively managed and disclosed. Mercer has recognized this and other potential stresses on executive compensation decision-making and elected to take market-leading position on the need for a more reasonable approach to the process.

In 2005 Mercer developed and implemented our Global Business Standards. These standards are the central governing document for our executive compensation consulting business. These standards are provided to all of our clients. They enhance transparency, establish a framework for the effective management of these issues, and allow Mercer consultants to provide high-quality, unbiased advice.

Mercer's Global Business Standards address three areas: first, managing the consulting relationship; second, ensuring the quality of consulting services; and third, structuring our business to manage potential conflicts of interest.

Let me first discuss how we manage the consulting relationship. A clearly defined client relationship provides the foundation for ensuring the objectivity and integrity of our advice. This begins with an engagement letter that documents the key elements of the assignment and relationship. It sets forth responsibilities, scopist services, fees, time frame and client reporting relationships, including how and to whom information and recommendations are communicated. Engagement letters with a compensation committee include disclosure of any other financial relationships Mercer has with a company.

Now let me talk about the second element of our Global Business Standards, which is ensuring the quality of our advice. Executive compensation consulting services are performed only under the direction of a human capital business principal. These individuals are Mercer's most senior consultants. Mercer's professional standards require that all consulting advice be peer-reviewed before it is rendered.

Mercer has also developed a framework for working with clients in four critical areas: remuneration, performance, regulations and governance. This framework helps clients avoid focusing on pay competitiveness at the expense of performance against peers and prudent governance of the programs.

Let me turn to the final element of our Global Business Standards, how we structure our business. Our executive compensation consultants are not paid based upon client revenue from other Mercer lines of business. Furthermore, our client relationship managers and other sales-focused employees do not evaluate performance or determine compensation for executive compensation consultants. This is done only through our human capital leaders.

Our Global Business Standards also require our consultants to seek advice from the human capital business leadership if there's ever any question that our objectivity or integrity is at risk of being comprised.

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[12:38 p.m.]

Mr. SCOTT. Consultants have the authority to discontinue relationships in cases where potential conflicts cannot be resolved.

Finally, Mr. Chairman, for clients that need the depth and breadth of resources that Mercer can provide but also want an additional review, we suggest an independent oversight model. Under that model, clients retain a separate outside advisor to provide oversight and review of our recommendations. This advisor would have no other relationship with the company. We believe that these elements provide a best-practices approach to our work.

Thank you.

[Prepared statement of Mr. Scott follows:]

******** INSERT 3-1 ********

Chairman WAXMAN. Thank you very much, Mr. Scott.

Mr. Powers?

STATEMENT OF MICHAEL POWERS

Mr. POWERS. Good afternoon, Chairman Waxman and members of the committee. I'm Michael Powers. I am our global practice leader at Hewitt for executive compensation and corporate governance consulting. Thank you for the opportunity to appear before you today.

I will be discussing our role in the executive compensation decision-making process, as well as the policies and safeguards we follow to ensure that we provide objective and unbiased counsel.

Hewitt takes very seriously its obligation to provide sound, informed, independent advice. Companies and boards of directors engage our services because of our strong and long-standing reputation for both quality and objectivity.

It is important to note that our role in determining executive compensation is strictly as an advisor. It is up to each company's compensation committee, as part of their fiduciary responsibility to shareholders, to decide on the process it will follow, the input it will consider and, ultimately, the final design and amount of executive compensation arrangements.

Compensation committees have a complex task in managing executive pay decisions. They often review a wide variety of information. This might include data on both what and how other peer organizations pay, the company's recent or long-term financial performance, the returns generated for shareholders, the company's perspective leadership needs and the demand for talent in that industry. They may also rely on input from senior management, legal counsel, executive recruiters or other consultants.

By working with a multi-service consulting firm, Hewitt's comp committee clients have access to perhaps the broadest array of global resources, comprehensive market data, and design and technical experts. The information and advice Hewitt provides are just one of many sources that a board's comp committee may draw on to meet its fiduciary obligation to make appropriate pay decisions.

Hewitt employs a number of practices and procedures to ensure the independence of our executive compensation services. These safeguards have evolved over time, and we certainly adopt new ones in an ongoing process of establishing and improving best practices.

Hewitt's executive compensation consulting services are a separate business unit. As part of that structure, our executive pay consultants are paid solely based on the results of that unit and their own individual performance.

Our additional safeguards are also recognized as best practices. These would include establishing distinct engagement agreements directly with our comp committee clients that detail our role and responsibilities as the committee advisor; proactively providing summary disclosures to our comp committee clients detailing all Hewitt services provided to the company; adhering strictly to internal and external confidentiality requirements regarding all client information; strictly following Hewitt's code of conduct and professional standards prohibiting public disclosure and discussion of client-specific information; enforcing a policy prohibiting a Hewitt employee from directly investing in the client organizations they serve; and establishing separate overall account management by professionals who are not involved in executive compensation consulting.

In our experience, most compensation committees have both thoroughly and regularly reviewed perceived and potential conflicts-of-interest issues and have arrived at informed conclusions tailored to their unique situations. In some cases, boards have chosen to require exclusive relationships with their executive compensation consultants. Other boards have taken different approaches to ensure they are receiving high-quality, independent advice, including evaluating the advice given, monitoring fees paid, restricting the provision of additional services, and the use of the two-consultant model.

To conclude, we provide information and perspectives to help our clients design effective executive pay programs. Our approach enables our clients to make decisions based on the best available data and advice.

But at the end of the day, we believe executive pay levels are driven primarily by global market forces. The competition for the talent pool of qualified men and women who are capable of effectively leading and managing complex organizations has intensified. Increasingly, companies are bidding for the services of this same cadre of talented executives, a trend which is expected to continue.

Our role as compensation consultants is to help our clients attract, retain and motivate the leaders they need to run successful global companies and to advise compensation committees on best practices.

Thank you for this opportunity to discuss Hewitt's executive compensation practices and safeguards. And we're happy to take questions from committee members.

[Prepared statement of Mr. Powers follows:]

******** INSERT 3-2 ********

Chairman WAXMAN. Thank you very much, Mr. Powers.

Mr. Paulin?

STATEMENT OF GEORGE PAULIN

Mr. PAULIN. Thank you, Mr. Chairman, members of the committee. My name is George Paulin. I'm the chairman and CEO of Frederick W. Cook & Company. Our firm has about 60 employees.

Currently, we are independent advisors on executive compensation to the board compensation committees at 27 of the Fortune 100 companies. We've got a number of other clients with which we work directly with board compensation committees or, in fewer cases, separately with management. Our services include analyzing and recommending compensation levels and compensation program design. We advise on how much to pay and how to pay--the whole gamut of executive compensation.

We provide no other services except executive compensation consulting. We are 100 percent owned by our senior consultants. We have no outside equity or reciprocal financial relationships. We don't sell any services or products other than executive compensation consulting.

And this has been the model of our firm by design since it was founded in 1973, 35 years ago. And I have been with the firm 26 of those 35 years. We designed it this way with the specific purpose of avoiding business conflicts that would potentially compromise our objectivity in advising on sensitive executive compensation matters.

There are two overriding reasons, in my mind, why board compensation committees need their own source of independent expert counsel on executive compensation. The first is a legal reason. I'm not a lawyer, but my understanding of Delaware law is that outside directors are bound by a duty of care. The duty of care includes the exercise of due diligence, where the use of expert advisors has been encouraged, as recently demonstrated by the decision in the Disney case. If those advisors aren't independent or are deemed to have a conflicting interest, then the directors could be at risk for not fulfilling their responsibility to the shareholders in terms of the duty of care.

The other reason is a practical one. It's the need to balance resources available to and beholden to management, which are not only vast but inherently less than objective. Compensation committees don't have any staffs. They meet three or four times a year to make complex and often contentious decisions. As a matter of routine, they should have credible, unbiased, professional support that they can trust, in the same way that audit committees rely on outside accountants.

Basic economics inevitably creates business conflict with regard to advising compensation committees and providing other services to the same corporations, especially when these other services are financially more lucrative. And any of my colleagues here will agree that revenues from actuarial consulting, insurance commissions, human resources, outsourcing services, pay-survey databases can be tens of times executive compensation consulting revenues.

To avoid such conflict, we believe that consultants chosen to be the independent advisors to board compensation committees should, in fact, be independent from management. They shouldn't be allowed to conduct other business with or provide other services to those same organizations.

A simple solution can be taken right from the New York Stock Exchange rules, which would be to apply the same definition of independence to the compensation consultants in their firms that already apply to the directors who serve on the compensation committees.

Assuming a definition of independence for compensation committee advisors similar to the one for directors in the New York Stock Exchange rules were adopted, then there'd be a question of what's the appropriate relationship between the independent consultant and management. Should the independent consultant merely serve in an audit capacity, reviewing analyses and recommendations prepared by management and its advisors, or should it work cooperatively with management in developing the analyses and recommendations?

Based on many years of experience, we believe that the latter approach provides a better-informed and more effective governance process. There is conflict, maybe, but any potential we feel can be controlled here by simply having a sensible process where the compensation committees would hire and fire the independent consultant; make clear that the consultant's sole responsibility is to the committee and that any interaction with management is on behalf of the committee and as the committee's agent; approve the scope of the consultant's involvement that doesn't go beyond direct support for the committee; act directly with the consultant in identifying peer companies for competitive benchmarking to finding the pay philosophy and setting CEO pay; meet regularly with the consultant in executive session without management; and fully disclose the relationship and the fees to shareholders in the proxy statement.

Thank you for the opportunity to make these comments and for the committee's concern with improving the fairness and effectiveness of executive compensation practices, which are an important element of the American economy.

[Prepared statement of Mr. Paulin follows:]

******** INSERT 3-3 ********

Chairman WAXMAN. Thank you very much, Mr. Paulin.

Mr. Reda?

STATEMENT OF JAMES REDA

Mr. REDA. Good afternoon, Mr. Chairman, Ranking Minority Member Tom Davis and other members of the committee. My names is James Reda, and I'm founder and managing director of James F. Reda & Associates, based in New York City.

I'm an independent compensation advisor to numerous publicly traded corporations, with over 20 years of executive compensation consulting experience. I'm the author of over 20 articles and two books. My most recent book, entitled, "The Compensation Committee Handbook," is now in its third edition. In addition, I was a member of the National Association of Corporate Directors' Blue Ribbon Commission entitled, "Executive Compensation and the Role of the Compensation Committee."

I am in favor of providing corporate board members with a higher standard of disclosure to verify the independence of compensation advice they receive from consulting firms. This recommended disclosure would be similar to that found in the audit committee report so crucial in making the audit process independent of senior management. Such an added disclosure could help remedy the negative perception executive compensation holds with shareholder groups, the public and the media.

Like the audit firms before Sarbanes-Oxley, providers of compensation advice, which I will refer to as diversified human resources consulting firms, have significant economic incentives to provide additional services which are oftentimes more lucrative and beyond executive compensation. These other services include human resources consulting, business process outsourcing, information technology consulting, risk and insurance underwriting, and actuarial consulting.

We estimate that compensation consulting services represent .5 percent to 2 percent of the diversified HR consulting firm revenues. A large part of the other 98 percent to 99.5 percent of revenues comes from the same companies who also use compensation consulting services. When you combine the access and impact that executive compensation consultants have on a client with the need to sell other services, you have a prescription for heavy cross-selling activities where executive compensation consultants lead the charge and as a result are conflicted.

Consider for a moment: If the firm providing advice to the board of directors on CEO and VP of HR pay is also providing other service to the CEO and VP of HR, how can the board ensure the consulting firm's recommendations are independent and objective? Even if the compensation consultant is not providing other services to management but has the potential to provide such services, the public may perceive a direct conflict of interest and lack of independence.

While some diversified HR consulting firms may also use a Chinese wall or a firewall to separate their compensation advice from other consulting services, there remains the perception that a conflict of interest exists. A Chinese wall or firewall simply does not work, as shown in other areas such as accounting and investment banking.

There are a growing number of independent firms like my firm made up of experts that formerly worked at large, diversified HR consulting firms. These independent experts continue to offer compensation advice but without any potential or perception of conflict of interest. The use of independent consulting services can only help quiet the critics of executive compensation, provide additional transparency to shareholders, and benefit American business.

In my letter to the SEC of April 2006, I recommended that the Commission take action to shed light on this issue and improve the independence of competition committee operations by requiring further disclosure on compensation consultant independence. The recommended disclosures include, among other items, a table presenting fees paid to compensation consultants for executive compensation consulting services and all other fees paid to the consultant's firm or affiliated firms for other services. But as it stands today, the SEC disclosure rules stop short of requiring a detailed list of duties and fees. This reinforces the public perception that the compensation consulting profession is not helping and perhaps even exacerbating problems with executive pay.

We seek to change this. My independent advisor colleagues and I offer no additional unrelated services to management. We view the compensation decision-making process as crucial and in the best interest of shareholders and American business. In this way, U.S. Corporations can implement executive compensation programs that truly pay for performance and will help improve our companies' credibility at home and abroad.

Thank you for the opportunity to testify on this important issue.

[Prepared statement of Mr. Reda follows:]

******** INSERT 3-4 ********

Chairman WAXMAN. Thank you very much, Mr. Reda. I appreciate your testimony.

I'm going to start off the questioning.

Mr. Scott, as I understand your testimony, you're the head of executive compensation at Mercer Consultants, one of the largest executive compensation firms. And your view is you defend current practices and have said that firms like yours can provide both executive compensation advice and other services to a company without a conflict of interest.

But my understanding is that your own company takes a very different approach to executive compensation. I would like to ask you about this apparent double standard.

My understanding is that Mercer Consultants is a subsidiary of a larger publicly traded firm, Marsh & McLennan. Is that right?

Mr. SCOTT. Marsh & McLennan, yes.

Chairman WAXMAN. I's like to read for you--I have a copy of their annual meeting and proxy statement for 2007, and here's what it says in the report: "the committee has engaged an independent compensation consultant, Towers Perrin. The independent compensation consultant reports directly to the committee and does not do any work for management."

In other words, your own company insists on hiring executive compensation consultants without conflicts of interest. Why does your parent company have this policy in place?

Mr. SCOTT. Our parent company has that policy in place so that they, like many other firms who are concerned that their shareholders be confident that they are getting an outside review of the pay practices they intend to follow for their executives has been given.

Chairman WAXMAN. Well, doesn't this say that your company's board understands the problems that can occur with the use of a consultant with a conflict of interest, and they want to assure that there is not going to be a conflict of interest?

Mr. SCOTT. I can't interpret the statement that way. I can interpret it as them wanting to assure shareholders that an independent review by someone who does no other work with the company is in the best interest of shareholders.

Chairman WAXMAN. Do you advise your clients that this approach, hiring an independent compensation consultant, is the best approach to executive compensation decision-making?

Mr. SCOTT. When we're working with clients and it's clear to them that they do have a worry about that, that that's something that concerns them, that they want to be able to demonstrate to shareholders that independent review does occur, we do. And we do, as a matter of policy, recommend to them, as in our statement, an independent oversight model where there is someone who is not Mercer, who does no other work with the company, work with them.

Chairman WAXMAN. So you have clients that utilize your company's executive compensation services and they also hire Mercer to do other work for management, but before they do that, you inform them that you're doing both tasks. So, therefore, they're deciding whether they want a separate, independent consultant only on compensation.

Mr. SCOTT. Yes, Chairman. In 2005, well before a lot of the discussion and requirement, we instituted with all of our executive compensation relationships the requirement that, whether they liked it or not, we were going to tell them how much money we received over the last 3 years for executive compensation advice and how much money we received over the last 3 years for work we had done for management.

Chairman WAXMAN. And if they want an independent consultant, you would refer them elsewhere? Is that how you handle it?

Mr. SCOTT. No, we don't refer them, but we certainly suggest that they consider that option. And we are happy to bow aside or to work with that other consultant, but not as the independent overseer, which is a role we won't take for a company.

Chairman WAXMAN. And, Mr. Reda, you operate an independent firm. What are your views on this subject? Do you think problems can arise when a consulting firm is cross-selling other services to a client?

Mr. REDA. It's been my experience that it can arise, yes.

Chairman WAXMAN. And how about you, Mr. Paulin? What do you think about it?

Mr. PAULIN. They can. They don't always, but it's certainly there, potential conflict.

Chairman WAXMAN. Well, it's difficult for me to understand how a company like Mercer can claim that compensation consultant independence is not important. Its own board of directors obviously believes it is. There's an old adage, you can learn more by watching what someone does than you can by listening to what someone says.

How do you respond to that, Mr. Scott? Doesn't it sound like your company is telling that they care about having independent consulting and that you, on the other hand, are not following that practice?

Mr. SCOTT. Chairman, I would respectfully disagree. I think, in fact, what Marsh & McLennan Companies does is an exact demonstration of the way that we do work with clients, which is we allow them to decide how and if they want to use us and in what way. And if, in this particular case, Marsh & McLennan felt in order to assure its shareholders that it's receiving independent review that it retained Towers Perrin, who has no other relationship with Marsh & McLennan--and we have other clients that would similarly make those kinds of decisions.

On the other hand, if they don't have a shareholder concern and they feel that using Mercer is the best option for them for whatever reason, then we'll work with them in that fashion. Again, going back to our global standards in which we'll work with them, but only on the basis they understand that there is going to be complete transparency in the relationship--

Chairman WAXMAN. Pursuant to transparency, do you think the shareholders know that there is this potential conflict situation and they're agreeing to it?

Mr. SCOTT. In the cases of--

Chairman WAXMAN. Of the shareholders.

Mr. SCOTT. At Marsh & McLennan?

Chairman WAXMAN. No, the shareholders for the company where you're doing the consulting work, do they know that you're doing both the compensation part of the effort as well as other activities for that company?

Mr. SCOTT. Sure. What we can do for that process is we can make sure that the compensation committee has that information, which we insist they do.

Chairman WAXMAN. The compensation committee at the corporation?

Mr. SCOTT. That's correct.

Chairman WAXMAN. But not the investors.

Mr. SCOTT. In some cases, we have clients who are going above and beyond the SEC requirements and they are sharing that with investors, and in other cases they're not.

Chairman WAXMAN. So, in other cases, they're not.

Mr. SCOTT. Right.

Chairman WAXMAN. Okay. So we don't know--it's hard to say that all of them know.

Mr. Lowman, in your written statement you say that your executive pay consultants do not receive any compensation for selling other work to their corporate clients. This is one of the ways in which you attempt to manage the conflict of interest, by trying to make sure your pay consultants aren't cross-selling other services and, thus, dependent on the executives whose pay they provide advice on.

But job postings from your company seem to contradict your position. They show that you do place a premium on cross-selling. I believe we can display an exhibit, and we'll ask our staff to hand it to you.

Mr. LOWMAN. Thank you.

Chairman WAXMAN. This is a recent Towers Perrin job notice for an executive compensation consultant, and it lists the job responsibilities. It says, "The applicant will be cross-selling consulting and other Towers Perrin services to existing and new clients." It also says, "Minimum revenue generation from all sources, i.e., not just executive compensation services, goal of $750,000 in the first 12 months would be expected," end quote.

So that's confusing to me. You've told the committee you don't encourage cross-selling other services to management because this could impede your independence, yet this job notice indicates that cross-selling is a critical part of the job of compensation consultant. How do you explain this conflict?

Mr. LOWMAN. The job posting--the $750,000 is an important number because that indicates that it's a fairly junior position in Towers Perrin. Typically, someone that's consulting to a board, someone that's consulting to senior management would be responsible for many more millions of dollars in services. This is a junior-level position that would not be advising on senior--

Chairman WAXMAN. But it does say you expect them to cross-sell--

Mr. LOWMAN. Yes, let me explain.

Chairman WAXMAN. --as part of their responsibilities.

Mr. LOWMAN. I'll continue my answer, Mr. Chairman. This is a junior-level position. They would be responsible for working inside an organization in support of whatever kinds of incentive design might be done for middle management, perhaps for sales, compensation and so forth. It is not for a position that would be advising the CEO or advising the chairman of the compensation committee.

Actually, I want to reaffirm what I said in the written testimony, which is that our board-appointed compensation consultants do not get involved in cross-selling services for any other part of Towers Perrin.

Chairman WAXMAN. They don't.

Mr. LOWMAN. They don't.

Chairman WAXMAN. But the company does.

Mr. LOWMAN. I'm sorry?

Chairman WAXMAN. Those consultants don't, but the company does.

Mr. LOWMAN. We have a broad-based consultancy, and we work in a number of different areas. Other people within our organization will have responsibility for selling services to various clients, whether they're executive compensation clients or not.

Chairman WAXMAN. Mr. Paulin and Mr. Reda, do you have any comments on this? You've had long experience in the field. Do you think cross-selling occurs at firms like Towers Perrin and other multi-service consultants, even though they have different people doing different jobs, or is there still the same problem?

Mr. PAULIN. My sense of the work that's done by executive compensation consultants, those people who are very senior and who are advising boards of large companies, is that they are not paid directly to cross-sell to those companies, as a policy. I believe that to be true.

I also believe that there are corporate rewards. So Mr. Scott probably receives stock options in the stock of Marsh & McLennan that reflects the overall economics of the organization. And I think those are part of the overall compensation program for the senior people.

Chairman WAXMAN. Mr. Reda, do you have any comment?

Mr. REDA. Well, it's been my experience that, say, maybe 3 years ago, maybe 4 years ago, it was a free-for-all, that you did see cross-selling from the compensation consultant that was advising the board, and it was pretty blatant. That now, for these firms here, has been restricted to some degree.

But do you have to see that these consultants are part of a bigger organization. They hold stock in the actual organization that they're a member of. So, depending on how well they do selling--and you heard that there's goals for people to sell and to do and so forth--it's all economic, that the more they sell, the more they earn their retirement and increase their wealth.

So my feeling is that these Chinese walls and firewalls do not work because of the economic interest of the people who work for the firm, they are essentially tied at the hip economically, and it's impossible to break that tie.

Chairman WAXMAN. Thank you very much.

Mr. Davis?

Mr. DAVIS OF ILLINOIS. I'll pass to Ms. Foxx.

Chairman WAXMAN. Oh, okay.

Ms. Foxx?

Ms. FOXX. Thank you, Mr. Chairman.

I'm going to ask one question of each of you.

And, Mr. Reda, if you would start, and then just go down the line. This just requires a yes or no answer.

Do you believe that your firm has adequate safeguards to address Chairman Waxman's concerns?

Mr. REDA. Yes.

Mr. PAULIN. Yes.

Mr. POWERS. Yes.

Mr. SCOTT. Yes.

Mr. LOWMAN. Yes.

Ms. FOXX. Okay. Thank you.

I have another question then. Mr. Lowman, this one's for you. In Daniel Pedrotty's testimony, he said your organization advised Merrill Lynch board of directors compensation committee, has advised them since 2003, but that you also provide other consulting services to Merrill Lynch that are not related to executive compensation.

Do you believe this dual role endangered the impartiality of your compensation consultants? And explain. If you say yes, then explain why. If you say no, you can explain why not.

Mr. LOWMAN. I suspect you're not going to be surprised to hear my say no, I don't believe it endangered our objectivity. What I'd like to do is just expand on that a bit, if I may.

I think there is an underlining assumption, make assertion, that somehow having a so-called independent advisor--and I say so-called because I believe that all of us can operate and do operate independently--but to have a so-called independent advisor who does no other work elsewhere in the organization will either result in better pay, lower pay. Maybe there's an assumption that he who pays least pays best.

But, indeed, going back to Mr. Pedrotty's repeated references to the Corporate Library report, I thought it was interesting that he did something that we advise our consultants never to do, if you're going to be objective and if you're going to be responsible, and that's to cherry-pick data. Mr. Pedrotty cherry-picked probably the least important piece of data in that report, which was base salaries. As anyone on this panel will tell you, if a CEO is making $15 million, probably half or more of that is in stock options or in stock compensation. And referring to that very report which Mr. Pedrotty cherry-picked from, on page 7 of that report it talks about the biggest piece of compensation, which is the stock piece, and the top four firms there that are the greatest percent above median stock option value are Radford, Frederick W. Cook, Pearl Meyer and Compensia.

So if the assertion is that what you refer to as an independent advisor who does no other work of any sort is going to result in lower pay or somehow better pay, this report that's continually referenced by Mr. Pedrotty would suggest that's patently untrue.

Ms. FOXX. And a follow-up, if I might, to that. I believe you said in your prepared testimony that the report from Corporate Library shows, indeed, that independent compensations determined by, again, those so-called independent consultants are higher than those that are recommended or set by what I would call comprehensive firms or firms that do multiple tasks.

Mr. LOWMAN. Yes, ma'am. If I may, I don't want to give too much credence to this report, because, again, I would defer to my colleagues on this panel. I can't testify to the credibility and validity of this report. But if we're going to reference it, then we should reference what's in it fully and not cherry-pick the information.

I think that it's a very important point that not one of us on this panel has their integrity for sale. The reputations of our company are not for sale. We operate with integrity. We consult to compensation committees of the board. Occasionally we consult to management. The compensation committees need to make the decisions--indeed, do make the decisions--about executive pay. We provide advice. They may choose to accept it; they may choose not to. And at times I don't know why they don't accept some of the advice I give them because I think it's a lot better than what they adopt, but they do what they do.

Ms. FOXX. Thank you, Mr. Lowman. I appreciate your pointing out again in an indirect way that the decisions these corporations are making are made freely. Stockholders buy stock freely. Boards make their decisions. As you say, you may give them advice, but nobody is holding a gun to their head to make them do this.

Mr. Powers, I'd like to ask you one additional question. There has been an analogy made between compensation consultants and accounting firms. Do you think that's an accurate analogy? And, again, whatever way you answer, please explain a little bit why you feel that way.

Mr. POWERS. Congresswoman Foxx, we do not agree that it's a completely analogous situation to the audit role. We think there are several significant differences between the role we provide as compensation consultants and the role that outside auditors provide to public companies. Some of those would include that public companies are required to have an outside auditor. It is also required that they report directly to the audit committee. They are approved by shareholders, and their primary function is to certify as to the veracity of the financial statements. Those financial statements are relied upon by third parties like investors and lenders.

On our side of the shop, there really aren't any specific GAAP-like standards for us to follow. And there is no report that we publish that investors or other third parties rely on.

Chairman WAXMAN. Thank you for your questions.

Mr. Davis?

Mr. DAVIS OF VIRGINIA. Thank you, Mr. Waxman.

On panel one, Professor Elson testified that most board members don't inquire about potential conflicts of interest among compensation consultants. Let me just ask each of you, do you agree with Professor Elson, based on your firm's interaction with board members?

Mr. Lowman?

Mr. LOWMAN. Compensation committees are very concerned about conflicts of interest of all types, not just whether or not you're doing work elsewhere in the organization. Yes, they are concerned, and they do inquire about it.

Mr. DAVIS OF VIRGINIA. Mr. Scott?

Mr. SCOTT. I would echo that, as well, and, in addition, point out that, even were they not to ask, through our global standards we require that they have that information.

Mr. DAVIS OF VIRGINIA. Okay. Thank you.

Mr. POWERS. I would agree with that as well, Congressman Davis. We regularly advise our clients to have that conversation. They are the ones who are both making pay decisions and also assessing whether the advice they're getting is objective or not. And they are certainly not required to have an advisor in this capacity. And I think if they weren't serious about finding out if we had conflicts that they were uncomfortable with, they would not be turning to us for this kind of advice.

Mr. DAVIS OF VIRGINIA. Mr. Paulin?

Mr. PAULIN. I think most large companies and their boards both recognize and accept that best practice is to have an independent consultant. And they would, in that definition, view potential business conflict as a concern.

When you get down into smaller companies--and I'm still talking about public companies, but middle-market, small-cap companies--the sophistication and resources sort of falls off. So I'm not sure I would make the statement as generally down there as I would for the S&P 500.

Mr. DAVIS OF VIRGINIA. And the compensation is not as large for the smaller companies.

Mr. PAULIN. I'm sorry?

Mr. DAVIS OF VIRGINIA. The compensation is not as great, either, for the small companies.

Mr. PAULIN. Yes, that's correct.

Mr. DAVIS OF VIRGINIA. Okay.

Mr. Reda?

Mr. REDA. It's been my experience that it's about 50/50. Half do; half don't. And I'm surprised to learn that there is a full disclosure at the time that the engagement is entered into. A lot of the board members I deal with haven't really had that full disclosure, to the best of my knowledge, in actual dollars, who was paid what, when and for what services. So, again, my experience is about half do and half don't.

Mr. DAVIS OF VIRGINIA. Let me ask this. You make recommendations on ranges, I gather, of what salaries and the package ought to be. How often do they take your suggestions verbatim, and how often do they make significant changes from that?

Mr. LOWMAN. That's hard to quantify, to be honest with you. I'm going to guess, I'd say more often than not they'll take our recommendations--not verbatim. You know, typically there's discussion. And I think--

Mr. DAVIS OF VIRGINIA. Ballpark basically. Is that--

Mr. LOWMAN. Yeah, I think it is really important to understand a couple of things here. I mean, I don't know how many--

Mr. DAVIS OF VIRGINIA. At these levels, it's basically negotiated at the end, isn't it? Don't usually they have the--

Mr. LOWMAN. This is what I want to get to.

Mr. DAVIS OF VIRGINIA. Yeah.

Mr. LOWMAN. You know, all of us have the experience of working with a lot of companies over may years and seeing how this works.

Mr. DAVIS OF VIRGINIA. I was general counsel to a public company before I came here.

Mr. LOWMAN. So you know a lot about it.

Mr. DAVIS OF VIRGINIA. I have any own reference point, but that's one company. I want to hear yours.

Mr. LOWMAN. So my experience is that we'll come in giving observations about competitive practice. We'll put that competitive practice in context, usually in the context of performance, corporate performance. And then there is a lot of discussion that the compensation committee members enter into, with respect to how did the CEO, him- or herself, actually perform the job, how did the corporation do, how did they follow through on various initiatives.

And so we can provide ranges of what we think some sort of reasonable practice might be, but the compensation committee will triangulate on a number. Typically it's not formula-driven. Typically there's a lot of reference to performance.

Mr. DAVIS OF VIRGINIA. Your recommendation is just one of a number of factors in the final product.

Mr. LOWMAN. Absolutely.

Mr. DAVIS OF VIRGINIA. Mr. Scott, is that your observation, as well?

Mr. SCOTT. That would be our observation, as well, that the process in fact is one where we're working together to find the right solution. And because part of what we're doing is hopefully asking the right questions about what industries they need to compete in and how competitive they need to be and whether they want to structure the package more to reinforce short-term or long-term performance, that through that question process we're going to eventually get down to a prescription, that then our job is to help--

Mr. DAVIS OF VIRGINIA. Well, let me ask this. Generally, at the level you're talking about, you're not talking about bringing somebody from unemployment that you're offering them a job. You're sometimes wooing them from other attractive jobs. Is that right? So it's very market-based.

Mr. SCOTT. Well, that is correct. Usually in those cases where you are heading outside to find a candidate, they are very comfortably paid and protected where they are.

Mr. DAVIS OF VIRGINIA. Mr. Powers, what's your observation? Similar?

Mr. POWERS. To your original question, Congressman, you had asked how often do our compensation committee clients take our advice, and I'd say they certainly use our advice, trust our advice as one of the important factors in determining executive pay. However, they really have their own process. We've seen a much better, I would say, corporate governance process over the last couple of years in particular, where we are seeing more robust debates about executive pay. The committee members are more informed about executive pay. They are asking us to provide more information as backdrop to their decision. But ultimately it is their decision on both how much and what form of pay.

Mr. DAVIS OF VIRGINIA. Let's ask the two--

Mr. PAULIN. It's pretty common for compensation committees not to act directly upon what I recommend. It's much less common for them to act on something that I seriously object to.

Mr. REDA. It's been my experience that what we provide to compensation committees and boards is very complex; it's a lot of numbers, statistics. And depending on how the information is prepared, you can point the committee in one direction or another. That was my first point.

And my second point, they typically use what we give to them as a guideline. And about three-quarters of it is approved, ultimately, in the form that we present it, at least in my experience.

Mr. DAVIS OF VIRGINIA. Thank you.

Chairman WAXMAN. Thank you, Mr. Davis.

Mr. Danny Davis?

Mr. DAVIS OF ILLINOIS. Thank you very much, Mr. Chairman.

Our first panel of experts today gave us one prescription for solving the problem of conflicts of interest among executive pay advisors, and that was disclosure for them. At the very least, investors and the public should know if a compensation consultant has a conflict of interest.

Mr. Scott, your testimony highlights the need for your company to have, and I quote, "a clear and transparent relationship with clients," end of quote. Do you believe that your clients, the Fortune 250 companies, should have the same relationship with their investors?

Mr. SCOTT. Congressman Davis, thank you.

We do provide that transparency to every single relationship, and I think they value that. And it helps them manage the potential conflict that they deal with--one of many potential conflicts they deal with all the time.

It's really not my position or Mercer's position to say whether their investors should have that same sort of transparency. I will tell you that several clients have voluntarily made the decision to do that.

Mr. DAVIS OF ILLINOIS. Well, by this standard, then, do you think that companies should be disclosing if their compensation consultant has a conflict of interest?

Mr. SCOTT. Congressman Davis, I would only disagree with what you were saying, because I make a distinction between a potential for conflict of interest and a conflict of interest. There are many potential forms of conflict. One certainly comes about when you have a relationship with a compensation committee and another part of your firm has a relationship with management. But there are other forms of potential conflict, as well, even if you only have a relationship with a compensation committee.

And I would say, in all of those cases, the transparency of the relationship is the thing that those in the decision-making role need in order to perform their role, which is to manage the potential for conflict.

Mr. DAVIS OF ILLINOIS. Thank you.

We heard from institutional investors earlier this morning that they actually want this information. We also saw that a wide range of experts on corporate governance say that this independence is critical.

If you would and if you could, I would like to ask if each one of you would answer these two questions for me with a yes or no, perhaps just beginning with you, Mr. Lowman.

If investors considered it important, shouldn't they have the right to know if a pay advisor is being paid for other work by management?

Mr. LOWMAN. I think if an investor wants to have that information, the investor should be provided the information.

I do want to--may I just add one clarifying remark to that? I think that, to Mr. Scott's point, there may be an apparent conflict but not necessarily a real one. And the other point I'd like to make is that simply providing a number does not necessarily provide insight into the nature of the relationship.

Mr. DAVIS OF ILLINOIS. Mr. Scott?

Mr. SCOTT. Congressman Davis, I'd like to answer--you mentioned two questions, though. I have the one about whether investors should receive that information about the fees. Was there a second?

Mr. DAVIS OF ILLINOIS. Well, I didn't mention the second one yet, but whether or not companies should be required to disclose when their consultant has a conflict of interest.

Mr. SCOTT. Okay. I can't answer those yes/no. I'll go ahead and answer them if you'd like me to, but they don't lend themselves to a yes/no answer.

Mr. DAVIS OF ILLINOIS. All right.

Mr. SCOTT. Would you like me to answer?

Mr. DAVIS OF ILLINOIS. Yes, go right ahead.

Mr. SCOTT. To your first question, again, I would say that it's not Mercer's and it's not a compensation consultant's role to make policy in investor relations with companies. And so, our answer there--that would be our answer there.

With regard to your second point about whether companies should disclose whether the consultants they use have conflicts, again, I cannot agree with the underlying question, because I don't think that the potential for conflict means there is a conflict.

Mr. DAVIS OF ILLINOIS. All right.

Mr. Powers?

Mr. POWERS. To your first question, Congressman, our position is really the SEC has evaluated that issue fairly carefully and has made a decision. Up until recently, there was no disclosure of the compensation consultant. With the new disclosure rules, for consultants who are involved in either determining or recommending executive pay, the company has an obligation to identify both the consultant, who engaged the consultant and some specifics about the roles and responsibilities.

We believe the SEC thought that was a reasonable balance between investors' needs in that context. But I think from a policy standpoint we believe, again, that the compensation committee is the body that really has to make a determination on whether they're getting credible, objective advice or not. And, again, our policy is to provide them with all the information they need to make that assessment, and then it's up to them to decide.

Mr. DAVIS OF ILLINOIS. Mr. Paulin?

Mr. PAULIN. Congressman Davis, I think it would be simple enough to give investors the confidence without any real regulatory baggage that compensation consultants are independent, the same way that members of compensation committees are independent, which is why I suggested in my testimony that the New York Stock Exchange independence test be used.

Now, I can say I'm independent because I don't provide any other services. But what if I'm advising General Electric and my brother-in-law is the CEO of General Electric or I'm a former employee who's getting a pension from them or who has stock options, that type of thing? All of this is covered by a simple rule, and it goes beyond just cross-selling services. And I think something like that could be very easily used to address this problem.

Mr. DAVIS OF ILLINOIS. Mr. Reda?

Mr. REDA. Well, as a starting point, I would say, yes, the fees for executive compensation consulting services should be disclosed, as well as all other services, including affiliated companies.

The second question is, yes, if there's any conflicts, including potential conflicts, which is the fee disclosure aspect to the answer to the question, yes, I think that should be disclosed. I don't think that the outside consultant should be called independent if they are providing substantial other services to the company.

Mr. DAVIS OF ILLINOIS. Thank you very much, Mr. Chairman.

Chairman WAXMAN. Thank you.

Mr. Tom Davis?

Mr. DAVIS OF VIRGINIA. Yes, I just have one question. And, Mr. Reda, I'll address it to you, and Mr. Paulin.

Large corporations, certainly like any company in the Fortune 250, are likely to have a host of subsidiaries, subdivisions, many of which are far removed, operationally speaking, from either the parent entity or each other.

In such large corporations, don't you think it's far less likely that a consulting firm that is providing non-compensation consulting services to a particular corporate subdivision would face any kind of conflict when it comes to also providing pay advice to the parent company's compensation committee and board?

Mr. REDA. I'll answer first.

Yes, I think if there was other compensation consulting services to a subsidiary in another country totally unrelated to compensation, I could see that that's not as conflicting. But it should be disclosed.

Mr. DAVIS OF VIRGINIA. Mr. Paulin, do you agree with that?

Mr. PAULIN. Yes. I mean, I think that there should be full disclosure of potential conflicts.

Mr. DAVIS OF VIRGINIA. But neither one of you would favor an absolute bar. If it's disclosed, that would be it, and then the board would be forewarned, and then they could appropriately make a decision?

Mr. PAULIN. Generally, to me, more important than disclosure would be some rule or definition for independence that could be applied. And if that were applied, then I don't know why additional disclosure would be necessary. If people knew that if I were the independent consultant I met certain independence tests, then maybe we wouldn't need disclosure.

Mr. DAVIS OF VIRGINIA. I mean, I'll just tell you, if I sat on a corporate board and I overcompensated somebody based on--I mean, I would be scared to death. We make it sound like being on a board is such a great thing, but with the lawsuits out there today, not everybody wants to serve on a board and subject themselves to that kind of potential liability. You put everything at risk. And I'm sure these questions are asked on a pretty consistent basis by wide-awake board members.

But I appreciate everybody's input into this thing. I think it's been illuminating to us. I don't see any reason for governmental intervention at this point. I think it's always important for the industry to come up with its own standards, and corporations, as they move ahead. But thank you very much.

Chairman WAXMAN. Thank you, Mr. Davis.

I want to thank the panel for your testimony.

I just want to conclude by saying there are millions of Americans, when they look at the soaring amounts that CEOs are getting paid in this country, they think the system's rigged. And I can't see what objection there would be that this potential conflict or apparent conflicts of interest at least be disclosed. As long as major companies hire consultants where there is no information to everyone involved, including the investors, that there's a potential or apparent conflict of interest, I think that cynicism of the American people will continue.

All right. Thank you all very much. We, I think, gave an airing to this issue, and your testimony was very helpful.

That concludes our hearing today, and we stand adjourned.

[Whereupon, at 1:32 p.m., the committee was adjourned.]

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