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SENATOR NORM COLEMAN
RANKING MINORITY MEMBER
SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
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Executive Stock Options: Should the IRS and Stockholders Be Given Different Information?
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Thank you for attending today's hearing. I want to thank this Subcommittee's Chairman, Senator Levin, for initiating this investigation and I want to commend him on his many years of dedicated focus on this issue. Today's hearing continues your long effort to ensure that investors in America's publicly traded companies have full access to important information regarding executive compensation.

For the past 25 years, the pay checks cashed by America's top executives have grown exponentially. During the 1990s in particular, executive pay exploded to unprecedented levels, and by 2002, the average American worker earned in a year what the average CEO took home every evening. Last year alone, CEOs at America's 500 largest companies earned an average of $15.2 million apiece--a staggering increase of almost 40 percent from just the year before.

It seems inconceivable that in 2006 CEOs earned almost 400 times the wage of the typical rank-and-file employee. And while it is often said that exceptional performance demands exceptional pay, it is troubling when mediocrity is rewarded with a king's ransom. There are far too many examples of excessive pay for poor performance, of executives and their families receiving millions of dollars in undisclosed company perks, and of exorbitant severance packages paid to executives who have been ejected from their companies under the cloud of scandal. Such excess robs shareholders of earnings that are rightfully theirs and draws on the retirement savings of America's hard-working families.

Without a closer link to performance, extraordinary CEO pay packages threaten to undermine the average investor's trust in our markets. More than 80 percent of Americans and 90% of institutional investors—including pension and retirement funds—think CEOs of large companies are overpaid. More disturbing, 60% of corporate directors—the very people who determine executive pay—believe CEOs of large companies make more than they deserve.
Warren Buffet once argued that CEO pay "remains the acid test" to judge whether corporate America is "serious" about reform. If so, the results so far are anything but encouraging. Ultimately, some semblance of reality must be restored to executive pay.

I am concerned by the widening loss of confidence in the business community. Charles Denny, who is a former CEO, noted in an article that ran yesterday in one of my home town newspapers, the *Star Tribune*, that "[o]ur nation's great wealth is the product of free-market capitalism operating within, and ultimately governed by, the political system of democracy." As a former CEO, Denny offers unique insight in concluding that if current corporate excesses "continue unchecked, the electorate's support of the political/economic concept of democratic capitalism will be severely tested." I share Mr. Denny's concern, and if the business community doesn't do something soon, companies are going to get more pressure from the federal government and from Congress in particular.

So how did we get here? Obviously, a number of factors have propelled executive salaries into the stratosphere. First, it cannot be overlooked that, as CEO salaries have grown over the past 25 years, so too has the average size of large American companies. Indeed, the companies that will testify today exemplify this important point—as they have all produced substantial increases in profits over the past 15 years, much to the benefit of their shareholders. Moreover, the competition for high-performing CEOs is higher than ever, and the costs associated with recruiting and retaining top managers have bid up the compensation packages for all executives. That said, the pink elephant in the room is the stock option. When one considers the numbers that Senator Levin mentioned in his opening—that in 2004, stock options resulted in a book-tax gap of $43 billion—it becomes clear that the impact of stock options on executive compensation cannot be overstated.

In fact, for much of the last 15 years, executive pay has been defined by the option. In 1992, for example, S&P 500 companies issued only $11 billion in options. In 2000, when option compensation reached its peak, companies issued options worth more than $119 billion. And although somewhat abated, companies still issued tens of billions of dollars worth of stock options last year.

To be clear, stock options are valuable and legitimate incentive tools. And the increased use of stock-based compensation reflects a logical attempt by publicly traded companies to align the self-interests of their executives with the best interests of their shareholders. By replacing cash with long-term incentives, stock options are meant to make managers think like owners and ensure that executive pay is linked to company performance. And, during the early 1990s, options worked as intended--executive pay increased as shareholders profited.

But in the overvalued market of the late 1990s, it became clear that the link between performance and pay had grown tenuous at best. As the bull market charged, it seemed that executives got rich just by showing up for work, and investors began to deride stock options as "pay for pulse." Worse, executive decision making seemed more short-term than ever. Earnings manipulations at Enron, Worldcom, and elsewhere underscored what many investors already feared; stock options provided company managers with perverse incentives to personally profit from artificial, even fraudulent, inflation of share values.

The intent behind stock-based compensation—to align managers' and shareholders' interests and to reward and retain high performing executives—is noble, but anything can be destructive in excess. The meteoric rise in executive pay, especially where undeserved, has caused shareholders to complain that companies issued far too many stock options on terms that were far too generous. Options often vest too quickly, rarely include true performance hurdles, and upon exercise, shares can too frequently be sold without restriction.

Regrettably, Congress must take some of the blame for this excessive, and at times unwarranted, executive compensation. In 1993, Congress attempted to rein in executive pay by enacting Section 162(m) of the tax code. This section limits to $1 million the tax deductions companies' can take for the salaries of their top executives. Congress did not, however, extend this cap to stock option pay, and almost immediately companies shifted to this fully deductible, and therefore cheaper, form of compensation. As a result, when the stock market booms, as it did during the 1990s and in the last few years, total executive compensation skyrockets, often regardless of executive performance.

To make this point more clear: consider that in 1994, one year after Section 162(m) was passed, the average CEO earned about $1.7 million in total compensation, including approximately $680,000 from stock option exercises. By 2004, average CEO compensation had risen by more than 400%, to more than $7 million annually. Notably, nearly three-quarters of that compensation, or more than $5 million, came from stock options. In other words, Congress' attempt to limit executives' salaries has had just the opposite effect. As Chairman Cox of the SEC, which will testify later this morning, recently told another Senate committee, Section 162(m) "deserves pride of place in the museum of unintended consequences." For the record, I agree with Chairman Cox, as long as that museum is the hall of fame.

So where do we go from here? Well, the good news is that the climate surrounding executive pay is already beginning to change. FAS 123 R, a recent change to the accounting rules for stock options, has provided long overdue reform. Before FAS 123 R became effective in 2005, accounting rules—contrary to economic logic—did not require companies to report the costs of stock options to their investors. Under the new rule, companies must now subtract the total value of stock option compensation from their financial earnings. This corrects a long standing, and poorly conceived, policy that required companies to hide the true cost of stock option compensation from their investors, while reporting that amount to the IRS in order to claim a tax deduction.

This point bears repeating. As Senator Levin stated earlier, most companies that report large book-tax gaps for stock options do so simply because different tax and accounting rules require them to do so. Although it is still too early to assess the full impact of FAS 123 R, it is already clear that companies are issuing fewer stock options, requiring longer vesting and holding periods, and hopefully setting truer performance benchmarks. Moreover, although differences between the tax rules and accounting rules governing stock options remain, now that every option issued represents a direct hit to the company's bottom line, the $43 billion book-tax gap that existed in 2004 should narrow significantly.

I am concerned, however, that while the book-tax gap for stock options is closing, the information gap for executive pay remains. Too often, shareholders are left in the dark regarding how much their top executives really make. And even when this information is disclosed, shareholders still have little, and usually no, input into executive compensation. Equally troubling, shareholders often perceive that the so-called independent directors who set executive salaries have cozy relationships with the CEO, often to the detriment of the investors they are supposed to represent. In an environment that allows collegiality to trump independence, investor confidence is undermined.

It is therefore imperative that companies take steps to ensure that top executives' pay is fair and deserved. In so doing, I encourage the industry that often reminds us that the market, not the government, should set prices, to practice what it preaches. This requires that companies open their compensation decisions to shareholder scrutiny. Companies must provide clear, plain-English, disclosures of CEO pay to their investors, and encourage more contact between independent directors and shareholders. Moreover, companies should consider submitting executive pay to shareholder votes, or even allowing shareholders to vote on the directors themselves. In this way, the interaction between investors and directors will take place before lawsuits and proxy fights, and in the form of constructive negotiation rather than costly litigation.

I should add that I am encouraged by the SEC's new rules that require proxy statements to include summary tables and plain-language disclosures of top executives' pay. But more work remains to ensure that investors receive full, easily-digestible disclosures of executive compensation. Shareholders cannot be left to believe that the executive pay game is rigged against them. Executive pay must be determined by those it affects, and where poor governance has distorted compensation, companies must act quickly to put things right. If they don't, I can assure that this will not be the last Congressional hearing on executive pay.

In closing, I would like to thank each of the witnesses that are here today. I look forward to your testimony.

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