Testimony of Meredith Miller, Assistant Treasurer for Policy
Office of the Connecticut State Treasurer Denise L. Nappier
Before the Committee on Oversight and Government Reform, U.S. House of Representatives
Hearing on Executive Pay: The Role of Compensation Consultants
December 5, 2007

Good morning, Chairman Waxman, Ranking Member Davis, and Members of the Committee on Oversight and Government Reform. My name is Meredith Miller. I am Assistant Treasurer for Policy in the Office of Connecticut State Treasurer Denise L. Nappier. Treasurer Nappier is the principal fiduciary of the $26 billion Connecticut Retirement Plans and Trust Funds (CRPTF).

I applaud the committee and its staff for bringing attention to the potential conflicts of interest that may arise when compensation consultants perform work for both board committees and the management of the same company. My testimony will comment on the willingness of top U.S. companies to grant investor requests to adopt policies that promote compensation consultant independence and to exceed U.S. Securities and Exchange Commission (SEC) reporting requirements by addressing the issue of independence in the 2007 proxy statement. In present-day corporate governance, there should be no tolerance for potential conflicts of interests that arise from a lack of adequate disclosure on items that can be easily provided by companies. Compensation consultant independence has been the subject of shareholder resolutions, policy formulation by investor trade associations, comment letters to the SEC, and is now the focus of today's hearing. The SEC should no longer view this issue as a best practice, and should require uniform and detailed disclosure about all of the business relationships an outside advisor may have with a company. Without this information, investors cannot hold compensation committees accountable for the management of potential conflicts of interest, regardless of whether those conflicts are perceived or actual.

Corporate Governance, Executive Compensation and Compensation Consultant Independence

Since taking office in January 1999, the Treasurer has been actively involved in corporate governance issues through engagement with companies and in the public policy arena. Key among these issues is executive compensation, of which compensation consultant independence is an important element.

The Treasurer's interest in executive compensation as a priority corporate governance issue stems from her belief that executive compensation is a "window" into board accountability; that is, executive compensation sheds light on the quality of board decision-making and the implications of those decisions for strategically positioning the company for long-term sustainable growth and increased shareholder wealth. One of the ways in which executive compensation aligns management's interests with those of the shareholders is by linking pay to company performance.

Executive compensation that is not linked to performance can result in distorted pay practices and the kind of misplaced incentives that have become all too familiar in the governance scandals epitomized by Enron. Despite the attention paid to corporate governance in the wake of the scandals, there has been a persistent and blatant ratcheting up of CEO pay, even in the face of poor company performance. A recent study by The Corporate Library, "Pay for Failure II: The Compensation Committees Responsible,"[1] found that over a five-year period, compensation committees of twelve of the largest U.S. companies authorized payouts to CEOs of $1.26 billion, while shareholder value dropped by $330 billion. The companies chosen for the most pronounced gap between pay and performance realized negative shareholder returns over the last five years and underperformed their peer groups over the same period. More poignant for investors are severance packages like the one recently paid to ousted Merrill Lynch CEO Stanley O'Neal: $161.5 million worth of parting gifts, and an office and an executive assistant in the wake of $8.4 billion in losses following the sub-prime fallout.

Institutional investors, including the CRPTF, have been active on many fronts in their efforts to reign in excessive executive pay. Shareholder resolutions asking for an advisory vote on the pay package, referred to as "Say on Pay," have resulted in several high votes and some companies' voluntary adoptions. Congress has also taken the issue up with the House passage of a "Say on Pay" bill and similar legislation pending in the Senate. Like other activist institutional investors, the CRPTF has filed shareholder resolutions dealing with pay for performance, "Say on Pay," and backdating of options.

Fundamental to the success of initiatives such as "Say on Pay" is the ability of investors to make informed decisions about pay packages. To facilitate better reporting on compensation, the SEC issued disclosure rules effective for the 2007 proxy season that require companies to report details of the compensation program as part of a new section of the proxy, the Compensation Discussion and Analysis (CD&A). In promulgating the new rules for the CD&A, the SEC required limited disclosure on the issue of compensation consultant independence by only mandating disclosure of the point of hire, scope of work and identification of the consultant. Noticeably lacking is disclosure as to whether the consultant performs other kinds of work for the management of the same company and the respective fees associated with the board and management engagements.

It was the SEC's announcement of the new CD&A that prompted Treasurer Nappier in 2006 to urge compensation committees to be prepared for the enhanced scrutiny the new disclosure requirements would bring to committee decisions and policies. Treasurer Nappier was mindful of investors' requests to the SEC to require disclosure of auditor consulting work that fell on deaf ears even before Enron. With this history in mind, key among the list of issues about which the Treasurer cautioned committees was the issue of compensation consultant independence.

The Implications of Compensation Consultant Independence for Compensation Committees

The Treasurer's focus on the compensation committee reflects the potentially influential role a consultant may play in decisions on key elements of the compensation package. Consultants may provide input on important pieces of the compensation program, including the philosophy and the structure of the compensation program, types of pay, percentages of pay at risk, the choice of performance metrics and goals along with the identification of the peer group companies used to measure performance. Consultants with more lucrative engagements on the management side may be precluded from providing impartial data or advice than those with no monetary ties.

[1] The Corporate Library, "Pay for Failure II: The Compensation Committees Responsible," May 2007.

Harvard Professor Lucian Bebchuk and U.C. Berkeley Professor Jesse Fried addressed the potential conflict compensation consultants may encounter in recommending pay levels for the management that oversees them in a study, "Executive Compensation as an Agency Problem."[2] The authors noted,

> *Compensation consultants have strong incentives to use their discretion to benefit the CEO. The firm's human resources department usually hires the consultant, which is subordinate to the CEO. Providing advice that hurts the CEO's pocketbook is hardly a way to enhance the consultant's chances of being hired in the future by this firm or, indeed, by any other firm. Moreover, consulting firms often have other, larger assignments with the hiring company, which further increases their incentive to please the CEO.*[3]

Unfortunately, as the authors note, directors often rely on the recommendations presented by the compensation consultants due to time constraints in fulfilling their own commitments to the company.[4]

The Treasurer conveyed her concern about the importance of compensation consultant independence in a June 5, 2006, comment letter to the SEC on proposed rules for executive compensation and related party disclosure. Treasurer Nappier stated,

> *[M]ultiple business relationships within a company may compromise the independence of a consultant's recommendations and/or advice to the compensation committee, and such information is fundamental to any assessment by investors as to the independence of the advice and guidance provided by the consultant.*[5]

Other investor groups have joined the call for compensation consultant independence. The Council of Institutional Investors (CII) this year adopted language in its Corporate Governance Policies asking the compensation committee to construct a formal policy on the independence of compensation consultants, and to review and report on the nature of the consultant's engagement with management:

> *Individual compensation advisors and their firms should be independent of the client company, its executives and directors and should report solely to the compensation committee. The compensation committee should develop and disclose a formal policy on compensation adviser independence. In addition, the committee should annually disclose an assessment of its advisers' independence, along with a description of the nature and dollar*

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[2] Lucian Arye Bebchuk and Jessie M. Fried, "Executive Compensation as an Agency Problem," *Journal of Economic Perspectives* 17 (Summer 2003). Available at http://ssrn.com/abstract=364220. Dr. Bebchuk is the William J. Friedman and Alicia Townsend Friedman Professor of Law, Economics, and Finance and Director of the Program on Corporate Governance at Harvard Law School. Dr. Fried is a Professor of Law at the University of California, Berkeley, and Faculty Co-Director of the Berkeley Center for Law, Business and the Economy (BCLBE).
[3] Ibid. 10.
[4] Ibid. 5.
[5] Comment letter from Denise L. Nappier, Connecticut State Treasurer, to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, RE: Executive Compensation and Related Party Disclosure, File No. S7-03-06. 5 July 2006.

> *amounts of services commissioned from the advisers and their firms by the client company's management.*[6]

The link between independence and committee members' fiduciary responsibility was made in a 2006 Conference Board study, "The Evolving Relationship between Compensation Committees and Consultants."[7] The study concludes that compensation committees that utilize outside consultants could best meet their fiduciary duties if such consultants did no other work for management.

In its listing standards, the New York Stock Exchange (NYSE) underscores the importance of the compensation committee in deciding the terms of the compensation consultant engagement. In the listing standard dealing with the compensation committee, the NYSE suggests that a compensation committee charter should grant the committee "sole authority to retain and terminate the consulting firm, including sole authority to approve the firm's fees and other retention terms."[8]

Disclosure of compensation consultant independence was recently included among best practices in a RiskMetrics Group publication, which stated, "Companies should describe the role of any compensation consultants and specifically address their independence from management."[9] The report also stated that companies should include such disclosure in the CD&A portion of the annual proxy statement.

The Investor Coalition and the Compensation Consultant Initiative

As mentioned above, Treasurer Nappier first engaged on the issue of compensation consultant independence in April 2006, with an open letter to chairs of compensation committees. The letter was published by the National Association of Corporate Directors. This letter questioned how well-prepared compensation committee chairs were for the increased scrutiny expected in the wake of the new SEC executive compensation disclosure requirements. The Treasurer also sent two letters to the SEC, urging it to require boards to disclose whether consultants were performing work for both the board and management.

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[6] Council of Institutional Investors Corporate Governance Policies, page 8. According to the Council's website, the Corporate Governance Policies, "set standards or recommend practices that Council members believe companies and boards of directors should adopt to promote accountability, independence, integrity, rigor and transparency." Available at http://www.cii.org/policies/index.html.

[7] The Conference Board, "The Evolving Relationships between Compensation Committees and Consultants," January 2006.

[8] Section 303A.05 of the NYSE Listed Company Manual, pertaining to the compensation committee, contains commentary on the importance of compensation committee oversight and hiring authority of compensation consultants who are hired to provide guidance on executive compensation matters. The full text of the relevant portion of the commentary is as follows:

> [I]f a compensation consultant is to assist in the evaluation of director, CEO or executive officer compensation, the compensation committee charter should give that committee sole authority to retain and terminate the consulting firm, including sole authority to approve the firm's fees and other retention terms.

[9] The report continues, "In particular, the CD&A should identify any potential conflicts of interest that might compromise their independence and explain how the consultant or the compensation committee resolves those potential conflicts." See RiskMetrics Group, "Proposed Best Practices in Executive Compensation Disclosure," October 2007, page 7.

In October 2006, Treasurer Nappier led a coalition of institutional investors[10] representing $849.5 billion in assets under management in calling on 25 of the nation's largest corporations[11] in the S&P 500 to exceed SEC compensation reporting requirements in the CD&A for the 2007 proxy season by disclosing the nature of compensation consultant engagements, including whether the consultant was independent. The coalition sent letters to the companies describing the coalition's concerns about conflicts of interest arising from dual compensation consultant engagements, and asking them (a) whether compensation consultants worked for both the company's board compensation committee and management; and (b) whether the board would adopt a formal policy on compensation consultant independence and disclose it in the new CD&A portion of the 2007 proxy. The letter also emphasized that the 25 companies were chosen because they had the clout to set a best practice in this area.

The engagement efforts drew parallels to past concerns regarding audit firms receiving compensation for providing consulting work for the same corporations for which they served as external auditor, a practice that came under scrutiny in 2002 and was later directly addressed as part of the corporate governance Sarbanes-Oxley reforms in the wake of Enron and other high-profile corporate scandals.

Initial Findings of the Project

In January of 2007, the coalition released the preliminary results of the first 18 responses and identified the top ten[12] companies whose practices and/or policies represented a best practice.

The 18 responses showed that the majority of the compensation committees supported the issue of independence of consultants and believed that it was not only achievable but also desirable. In February 2007, the coalition again wrote to the top 25 companies acknowledging responses to the October letter (or lack thereof) and included the top ten best practice examples, urging each board to examine its practices and consider adopting policies if none existed.

Key Findings of the Project

Based on the 2007 proxy filings, the majority of compensation committees (23 compensation committees of the top 25 companies) chose to address the issue of compensation consultant independence directly and therefore exceeded the SEC's requirements to disclose only the name of the consulting firm and the nature of the agreement with the compensation committee. Twelve of

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[10] Investor coalition members include: Connecticut State Treasurer's Office, North Carolina State Treasurer's Office, CalSTRS, New York State Common Retirement Fund, City of New York Comptroller's Office, AFL-CIO Reserve Fund, SEIU Pension Fund, State of Illinois Board of Investment, F&C Asset Management, Walden Asset Management, International Brotherhood of Teamsters, Universities Superannuation Scheme Ltd, Central Laborer's Pension Fund Co Petroleum.

[11] Exxon Mobil Corporation, Microsoft Corporation, Bank of America, Citigroup Inc., General Electric, Pfizer Inc., Johnson & Johnson, JP Morgan Chase, Cisco Systems Inc., Verizon Communications, Conoco, Phillips, Wal Mart Stores Inc., Wachovia, Morgan Stanley, Goldman Sachs Group Inc., Motorola Inc., Home Depot Inc., Procter and Gamble Co., Hewlett Packard Co., Texas Instruments Inc., Occidental Petroleum, Dow Chemical, Lockheed Martin Corporation, AT&T Inc., Merck & Co., Inc.

[12] Cisco Systems, Inc., Wachovia Corp., Conoco, Phillips, Pfizer Inc., ExxonMobil, Goldman Sachs & Co., Motorola Inc., Lockheed Martin Corp., Procter and Gamble Co., and the Home Depot.

the 25 compensation committee reports included formal policies on compensation consultant independence in addition to the actions taken by the committee to consider consultant independence. In addition, eleven of the 25 companies reported that an independent consultant did <u>no</u> work for management of the same company.

Seven of the 2007 proxies, exhibited dramatic changes from the 2006 proxy disclosure in the degree to which practices and policies related to the independence of the compensation consultant were discussed and described in detail. ***Motorola*** and ***Lockheed Martin's*** 2007 proxies showed the most dramatic changes from 2006. ***Morgan Stanley*** and ***Verizon*** reported the hiring of new compensation consultants in an effort to start anew with an independent consultant that performed no work for management.

The 2007 proxy filings and correspondence with the top 25 companies provided information as to the variety of approaches boards take to address compensation consultant independence. Five compensation committees have adopted innovative approaches to independence. For example, ***Conoco*** has a policy that the compensation consultant must be independent, rotate every five years and attest annually to independence in a written disclosure to the committee. ***Goldman Sachs*** uses a third consultant to weigh in on advice given by two other consultants. ***Pfizer*** has a unique approach in that the committee spells out as a policy fairly detailed selection criteria for a consultant that includes independence as a key element in the screen.

Several boards, including *Pfizer*, ***Wachovia*** and ***Cisco*** have had written policies that have been in place for several years. *Lockheed*, ***Wachovia, Cisco, Procter and Gamble***, and *Verizon* have written policies prohibiting compensation consultants from doing <u>any</u> work for the management side of the company. Other boards have formulas for de minimus tests that allow some work to be performed for the management side, but such work must be pre-approved by the compensation committee. The formulas range from ***Home Depot's*** prohibition against work performed for management exceeding 2 percent of the consulting firm's revenues to *Morgan Stanley's* preapproval process of any fees greater than $25,000 by the compensation committee.

Overall, the initiative raised several important concerns about the role of the compensation consultant and consultant practices, which are addressed below.

<u>Business Relationships and Independence</u>

When the Compensation Consultant Initiative first began, it was not atypical to find full service consulting firms (those that provide both consulting and a range of services including actuarial/accounting functions and Human Resources consulting services) providing consultant advice for both the committee and the management. Depending on the company, it was possible for two different individuals to provide the same services such as compensation advice, or a mix of services such as compensation advice to the committee and actuarial/accounting advice to management. The contact for hiring also varied with some compensation committees solely in charge of the hiring decision while other companies delegated that function to human resources or even the CEO.

As we learned more about the various business relationships that consultants could have with a company and its board, it became clear that conflicts of interest were driven not by whether the consultant did any work for management but how much that consultant or the consultant's company earned from both engagements. The question was whether work performed for management is monetarily significant enough to influence the behavior of the consultant's work for the board committee and therefore create a conflict of interest.

Discussions with corporate secretaries as well as consultants confirmed that traditionally, a full service firm earns significantly more working for management by providing actuarial or accounting services related to employee benefit matters than a firm could earn working solely for the compensation committee. Even non-full service consulting firms (referred to as "boutiques") may provide compensation consulting for both the compensation committee and management and may also be conflicted when more fees are generated by services provided to management.

While the analogy is not perfect, there are some parallels to past concerns regarding the audit firms that receive compensation for providing consulting work for the same corporation. As noted above, the CD&As of *Morgan Stanley* and *Verizon* note that the compensation committees hired entirely new compensation consultants so as not to even give the appearance of conflict.

Best Practices

The overarching objective of the Compensation Consultant Initiative was to urge the top 25 U.S. companies to exceed the SEC reporting requirements and directly address the issue of compensation consultant independence in the 2007 CD&A. The original October 2006 request by the investor coalition stated that compensation committees should consider prohibiting a consultant from simultaneously working for management. The letter also requested that the committees adopt a formal policy to institutionalize this practice.

The responses received by the Initiative as well as the reporting on consultants in the 2007 CD&A began to build the broader elements of a best practice. Such elements included a formal policy that vests the hiring and oversight of consultants and, a ban against any work for management of the same company. If extenuating circumstances exist to provide for dual engagements, such as the need for certain compensation survey data, the compensation committee should have the final say according to a predetermined de minimis standard. De minimis work is best defined through a percentage-based formula or monetary threshold. Some committees invoked innovative arrangements described above to achieve the goals of compensation consultant independence. Additionally, a description of how the policy was put into practice for that reporting year would be important information for investors. Specific information, including the name of the consultant and the fees earned, should also be included in disclosures on consultants.

SEC Current Disclosure Rules

The SEC's current reporting requirement on compensation consultants does not provide adequate information for investors to evaluate the independence of the consultant. Even the SEC's most recent effort to encourage better reporting through its targeted review stops short of requiring full disclosure of business relationships with the company.

In conclusion, we believe that in order to understand how excessive executive compensation is so prevalent, investors must begin by examining how the data used by compensation committees to support pay packages is constructed. This data is more often than not supplied by outside compensation consultants. Eliminating concerns about compensation consultant independence allows investors to tackle the more difficult issues of whether such data/advice justifies the pay and whether incentives are built in to ensure pay for performance and long-term shareholder value creation. The compensation consultant project showed that as reported in the 2007 proxy statements, practices and polices supporting compensation consultant independence were achievable and desirable in the majority of the compensation committees included in our query.

As the Treasurer requested in her June 5, 2006, letter to the SEC, the Commission should require that companies disclose whether a compensation consultant employed by the board's compensation committee is also performing other work for the same company, the nature of that work and the fee arrangement for the services. While it is clear that some of the largest companies are willing to exceed the SEC reporting requirements, it is unclear how smaller companies are reporting on this issue. Without specific information about all of the business relationships a consultant may have with a company, investors must rely on the judgment of the compensation committee to determine if potential or actual conflicts of interests exist. The SEC took a step in the right direction by requiring expanded disclosure in the form of the CD&A. The question of whether a consultant has conflicting monetary relationships is no less important than other required items. As with all regulations, uniformity levels the playing field.

On behalf of the Office of Connecticut State Treasurer Denise L. Nappier, thank you for this opportunity to share our views with the Committee on these important issues. If we may be of further assistance to the Committee, please do not hesitate to contact us.