United States House of Representatives
Committee on Oversight and Government Reform

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March 7, 2008

Thank you very much for inviting me to appear today. I am very pleased that this committee is looking into this vital area of concern, and especially grateful to you for including on your panels not only the former chief executives but members of the boards of directors. It is not the executives, but the board members who are ultimately responsible for determining the levels and structure of executive compensation. The more regulators, shareholders, and legislators put the focus on the members of the board, the better we will be able to make sure that impediments to market forces are removed or at least minimized, and links between pay and performance are strengthened.

I am a passionate capitalist. I have helped to create three small businesses, and helped to sell the first two to large businesses. I know what it is to meet a payroll. More important, I know what it is to almost not meet one. Most important, I know what it is to be on the line of credit; nothing creates a more direct sense of personal responsibility. Over the past 20 years, my focus has been on corporate governance, particularly on strengthening the oversight by the board and the shareholders of public companies. My interest is in making sure that our capital markets are vital, vigorous, competitive, and credible.

At The Corporate Library, we rate board effectiveness at public companies for clients that include director and officer liability insurers, investors, search firms, universities, law firms, and journalists. Unlike other firms that award positive governance grades based on structural indicators like the number of "independent" directors and whether the company's governance policies are on their website, our grades are based on how effective the board is in making the most challenging decisions, including decisions about CEO pay. My colleagues and I have found that there is no more reliable indicator of investment, litigation, and liability risk than excessive CEO compensation. It may be that it is a symptom of poor oversight by the board. It may be that it creates perverse incentives. Possibly both. But over and over again, we find, unsurprisingly, that with executive compensation you get what you pay for and you pay for what you get. If you make the compensation all upside and no downside, that will affect the executive's assessment of risk – or, rather, it will make it clear to him that he can easily offload the risk onto the shareholders without much in the way of adverse consequences to himself. It is heads they win, tails we lose.

That is what happened with subprime mortgages. CEOs were guaranteed outsized exit and separation packages, regardless of how they or their firms

performed. And now that many of them have been shown the door, there is little hope that shareholders or directors could claw back any of that pay.

Over the last few years, CEOs at companies involved in the subprime mess received excessive compensation largely based on performance measurements linked to inflated earnings targets. For 2006, Angelo Mozilo's total actual compensation was valued at over $102 million. His annual bonus for that year was based on a performance target of diluted earnings per share, or "EPS." For Fiscal 2006, Countrywide Financial's reported EPS was $4.30, which was an increase of 4.62% over Fiscal 2005 EPS of $4.11, resulting in a cash incentive award of $20.5 million to Mr. Mozilo. These inflated earnings forced the company's stock up by 26%.

But by the end of 2007, when Countrywide finally revealed the losses it had previously obscured, shareholders lost more than 78% of their investment value. Meanwhile, in early 2007 Mr. Mozilo sold over $127 million in exercised stock options before July 24, 2007, when he announced a $388 million write-down on profits. On August 16, Countrywide narrowly avoided bankruptcy by taking out an emergency loan of $11 billion from a group of banks. Mr. Mozilo continued to sell off shares, and by the end of 2007 he had sold an additional $30 million in exercised stock options. Mr. Mozilo received more than $102 million in compensation and $157 million in exercised stock options, while total shareholder return was negative 78% over the same period. He is expected to receive another $58 million in non-qualified deferred compensation and supplemental pension benefits when he retires in connection with the Bank of America merger in 2008.

At Citigroup, Charles Prince received total compensation valued at over $25.9 million in 2006. His incentive awards for that year totaled more than $23 million and were based on multiple performance measurements. Specifically, the company stated that "revenues grew 7%, almost all of which was organic," "net income from continuing operations grew at about the same rate as total revenues (about 7% in each case)," "the 2006 return on equity was 18.8%," and "total return to stockholders was 19.6%." Then in 2007, the company announced its $24.1 billion write-down in connection with sub-prime lending. Soon after, Charles Prince announced his resignation and left the company with $40 million in severance. Shareholders lost 45% of their investment value by the end of the year.

At Merrill Lynch, former-CEO Stanley O'Neal received total compensation of more than $91 million for 2006. His incentive compensation was also based on multiple performance measurements. The company stated the following about the Mr. O'Neal's performance against objectives:

> The Committee considered performance against the CEO objectives determined at the beginning of the year and noted that all financial targets

were met or exceeded and all strategic and leadership objectives were met with distinction. This review included consideration of numerous objectives but focused in particular on the following achievements:

Financial Objectives

- Year over year Net Revenues increased by 26% to $32.7 billion (on an operating basis), significantly exceeding targeted growth;
- Pre-tax earnings growth of 44% (on an operating basis), a growth rate near the top of the Peer Group, with a year-over-year improvement in the Company's share of overall Peer Group Pre-Tax Profit; and
- Return on Equity of 21.6% (on an operating basis) for 2006 - an increase of 5.6 percentage points, nearly twice the Peer Group median increase.

In its discussion of ROE performance, the [Management Development and Compensation Committee] focused on the importance of this measure, which had been identified as a high priority for the CEO and the members of executive management. They noted that the improvement had been driven substantially by the achievement of record earnings of $7.6 billion (on an operating basis), which represented a 48% increase over the previous year's record. The Committee also noted that these record results reflected solid execution around several specific growth imperatives outlined to the Board over the past three years.

On October 24, 2007, Merrill Lynch reported an $8.4 billion subprime mortgage-related write-down. Just days later, Stanley O'Neal announced his retirement. He received more than $160 million in stock and retirement benefits in connection with his departure, while shareholder lost more than 41% of their investment value over the year. On January 17, 2008, Merrill Lynch took an additional $14.1 billion write-down, bringing its subprime mortgage-related losses to nearly $23 billion.

During 2006, management at New Century Financial Corp issued false and misleading statements about the company's financials to boost earnings, which allowed New Century stock traded at artificially inflated prices. On March 2, 2007, the company announced that it was the subject of federal criminal probes related to securities trades and accounting fraud. On April 2, 2007, the company filed for Chapter 11 bankruptcy. Over the three year period prior to filing for bankruptcy, Robert K. Cole, Chairman and CEO of New Century Financial Corp, received over $22 million in total compensation, most of which he received from exercised stock options that he sold at artificially inflated stock prices.

In 2006, management at Novastar Financial Inc. reported a rise in earnings after the company originated a record $2.8 billion in loans, boosting the company's stock price to inflated levels. Then in February 2007, the Novastar's stock fell by

42% after announcing fourth quarter and year-end 2006 results, and warned that NovaStar was expecting to earn little or no taxable income in the next five years. In November 2007, Novastar stock plunged after the subprime mortgage lender posted a $598 million third-quarter loss and said that bankruptcy was possible. Over the three-year period leading to the enormous losses, Scott F. Hartman, Chairman and CEO of Novastar, received more than $13.6 million in total compensation.

In January 2007, American Home Mortgage earnings soared 288% after the sub-prime lender originated a record $15.5 billion in loans during the fourth quarter of 2006. Just eight months later, on August 6, 2007, American Home Mortgage Corp filed for bankruptcy. The stock was at 44 cents a share, down from an annual high of $36.40. Total compensation awarded to Michael Strauss, Chairman and CEO of American Home Mortgage, over the three-year period prior to the bankruptcy was over $8 million, largely based on bonuses tied to inflated earnings targets.

There is an obvious disconnect between the performance of these CEOs and the compensation they received. They led the companies in a risky strategic direction that resulted in significant losses for investors across nations. Incentive compensation based on earnings and revenue increases is problematic in a situation like that of sub-prime mortgages. Principal officers, for themselves and in particular for those down the line who are similarly incentivized, can push “sales” without adequate concern for quality. There is a disconnect in that bonuses are “earned” as business is booked; only when it is clear that the business is defective – and that such defect should have been apparent at the outset – is the hit to earnings recognized. By that time, the CEO has been paid based on the inflated numbers.

The undue compensation awarded to these failed CEOs should be returned to shareholders. In addition, they should be liable for providing false and misleading statements to investors and held accountable for the impact of their poor strategic decision-making policies. That is first and foremost the responsibility of the directors. If they fail, it is up to the shareholders to replace the board and it is up to lawmakers and regulators to make sure they have the power to do that.

Thanks to Sarbanes-Oxley, and market forces, boards are doing a much better job than they did a few years ago. They're providing much more diligent oversight. But these kinds of anomalous results demonstrate that there is still something wrong. Executives and directors will shrug their shoulders and tell you that executive compensation is determined by market forces and that these downside-protected pay plans are necessary to attract top talent, which otherwise would go to the even higher-paid positions in private equity or hedge funds.

That is not true.

These all-upside, no downside pay plans may possibly attract top talent, but they then communicate very powerfully to the talent they attract that performance is not relevant. They are indeed incentive compensation, but the performance for which they provide incentives is contrary to long-term, sustainable creation of value for shareholders. The incentive they provide is for an “après moi, le deluge” focus on short-term tricks and a sort of financial reporting shell game – the bad news is always under the shell you don’t pick up, until it is too late. Harvard Business School professor Rakesh Khurana documents in his brilliant book, Searching for a Corporate Savior: The Irrational Quest for Charismatic CEOs the single most important factor in looking at corporate pay: it must be looked at like any other asset allocation, in terms of return on investment. On that basis, executive compensation is too often a poorer investment than a piggy bank.

Let me be very clear on this point. I understand opportunity costs. If there was any evidence that these pay packages produce the kinds of results they purport to be designed to, I would support them. But they do not. And I do not understand how compensation committees can continue to approve them. Compensation committees too often rely on comparables based on sectors and market capitalization. They too seldom rely on a results-based analysis of what actually works. They too often rely on compensation consultants whose continued employment relies on their proposing ever-increasing pay with ever-decreasing connection to performance. Those consultants are very good at making charts and PowerPoint presentations that can show a hundred different reasons why the CEO needs to be paid more, mostly by comparing him to other executives rather than by comparing the money invested in him to the money he adds to shareholder value. The question boards should ask is not “What will it take to get the person we want to accept the job?” but “What kind of pay plan will most effectively communicate the board’s strategic, operational, and reputational priorities?”

You can't do better than what Warren Buffett said at Salomon Brothers many years ago: "If you lose money for us, we will be forgiving. If you lose reputation for us, we will be ruthless." Boards must state their intentions clearly and back them up in the design of the compensation program. If there is any suggestion of bad behavior, the money must go back to the company. That's the only fair and credible way. Any CEO who will not accept the job on that basis is somebody we do not want to bet on because he is not willing to bet on himself.

The market failure here is that the consumers of executive compensation, the shareholders, have no effective way to respond to outrageously excessive pay packages approved by boards of directors. I do not expect the playing field to be level, but right now it is close to perpendicular. I do see some prospects for improvement.

First, there is a growing trend toward adoption of “majority vote” requirements for election of directors. I believe this will be the most significant of the post-Enron reforms. . Right now, under the law, a director who is unopposed can get elected with one vote because voters have only two options: to affirm a candidate or not to vote at all. Thus, it's not very meaningful to withhold a vote. But as companies adopt the rule that a director must receive a majority of the votes cast in order to win, directors will know they can be voted out. No director should be permitted to serve unless he or she receives a majority of the votes cast. This will permit shareholders to eject compensation committees who approve of excessive pay plans without undue cost or disruption.

Second, the SEC’s decision to require mutual funds to disclose their proxy votes is making it harder for money managers to ignore the importance of proxy voting as an investment decision. I would like to see ERISA fund managers have the same obligation and I would like to see the Department of Labor strengthen its oversight of this essential fiduciary obligation. And I would like to see the New York Stock Exchange move forward on its long-promised broker vote rule so that actual shareholders, or beneficial holders, will vote for directors. Currently, in many cases, large brokerages hold shares for individual investors and vote on their behalf without consulting with their clients; frequently, they join management in supporting their board slate and opposing shareholder resolutions.

Third, there is some support for better oversight by shareholders through access to the proxy or reimbursement for contested elections. This committee well understands the benefits of an election with more than one candidate.

Finally, the legislation that has passed overwhelmingly in the House that would give shareholders a non-binding “say on pay” would be a very important step in the right direction. Now, shareholders only vote on stock options and have no say over any other aspect of compensation. So directors have nothing to lose by approving pay plans that pay off like perpetual pin-ball machines, designed so that everything you hit rings a bell, and loaded up like a hot fudge sundae, with a topping for every category of achievement, including showing up (signing bonuses) and sticking around (retention bonuses). Just one more word on this problem: “retirement plans” are about income replacement, not about adding another tens of millions of dollars to the already over-stuffed bank accounts of failed executives.

One way or another, shareholder votes are going to become much more meaningful. If compensation committees start getting voted out for signing off on outrageous pay packages, then boards will start to do a better job. That is what I call a market test.

My long-time colleague Robert A.G. Monks says in his new book, Corpocracy:

> The simple face is that the CEO market that the business Roundtable loves to cite was contrived by the chief executive officers operating through their lobbying wing. It is a market that has been polluted by the secrecy that surrounds the cost of option grants, the lack of any disclosure of even the most enormous retirement benefits, and, recently, the obfuscation of the date when options were granted and became effective so as to fix a price.

Our shareholders, our employees, our communities, and the working people of this country deserve better. In our increasingly global markets, if they do not find credible business leadership here, they will send their capital elsewhere. If we want our capital markets to be credible and competitive, we must stop paying executives who destroy shareholder value.

My thanks again to the committee and staff for inviting me to participate in this hearing. I would also like to acknowledge my thanks to my colleagues Paul Hodgson, Alexandra Higgins, and the staff of The Corporate Library for their assistance in preparing this testimony. I would be happy to respond to any questions.