Minority Staff Response

To the Majority Staff Report: "Executive Pay: Conflicts of Interest Among Compensation Consultants"

The Majority staff report, "Executive Pay: Conflicts of Interest Among Compensation Consultants," concludes that "compensation consultant's conflicts of interest are widespread" and that "there appears to be a correlation between the extent of a consultant's conflict of interest and the level of CEO pay." This conclusion is based on the assumption there is a fundamental flaw in the way corporate executives are paid and assumes that everyone in the process is a potential bad actor. It presumes corporate boards are wholly beholden to management interest, and so are third party compensation consultants.

However, the Majority merely asserts, without substantiation, that these agents have been "captured" by management. The only supporting argument offered is the assertion that compensation consultants are similar to auditors who certify financial accounting statements of public companies. However, this analogy was rejected by the SEC during deliberations on the 2006 Executive Compensation rules. But to read the Majority's report is to think that the SEC did not institute sweeping reforms, as the new SEC reporting requirements and their impact on executive compensation are wholly ignored.

Moreover, without providing evidence, the Majority assumes that anytime a firm provides executive compensation advice, and has another business contact with a public company, a conflict of interest automatically arises. However, this overly broad definition fails to account for measures that the firm or the company has instituted to preserve independence and provide unbiased advice. For example, in testimony before the Oversight and Government Reform Committee today, Towers Perrin outlines policies and procedures specifically designed to avoid conflicts of interest. Hewitt Associates provides similar information about their business practices to protect client interests and prevent conflicts and tainted advice. However, the Majority simply ignores the existence of these policies designed to avoid conflicts of interest in their analysis. This deliberate omission is irresponsible. So is the failure to note that the ultimate responsibility for determining executive compensation lies solely with the Board of Directors and/or their Compensation Committee. These individuals are free to accept or reject the advice given to them by compensation consultants just as they are free to seek a second opinion.

The Majority's report ignores other factors that economists agree have led to a growth in executive compensation. For example, there is no discussion of the risk premium that must be paid to executives to compensate for the personal liability that the CEO must accept every time he or she certifies the company's financial statements. There is also no acknowledgement that as CEO tenure becomes less certain, their contracts may be all they have to hang on to, so they negotiate the best deal possible going in.

The Majority spent the last six months investigating the six largest compensation consultants that advise the largest 250 publicly traded companies in America. Yet, despite access to nonpublic confidential information, billing records and multiple staff interviews, they concede, "The correlations between consultant conflicts of interest and the levels of CEO pay suggest, **but do not prove**, a possible causal relationship. Numerous factors beyond the use of compensation consultants with conflicts of interest may affect CEO pay." (emphasis added) To concede this point defeats the central premise of the report and renders the entire analysis specious and unreliable.

Public companies are the backbone of American entrepreneurial success and play an important role in distributing new wealth to a variety of investors and workers. Moreover, despite some troubling headlines, the underlying health of the American system is evidenced by the fact there are currently 15,000 public companies based in the United States, which are owned by 84 million investors. The value of these companies is an astounding $37 trillion dollars. Over the last 15 years, participation in the market by U.S. households has increased 156% - from $3.89 trillion in 1992 to $9.98 trillion in 2006. In the same timeframe, the average annual return on the S&P 500 index was 11.98% per year. Domestic investment in public companies comes in the form of pension funds, 401Ks, and individual investments.

Moreover, there is evidence that company boards are acting as good agents of the shareholders, and getting rid of underperforming CEOs. According to a recent survey by Booz, Allen, and Hamilton, since 1995 annual CEO turnover has grown 59% and performance-related turnover has increased by 318%. While in 1995, only one in eight departing CEOs were forced from office – in 2006, nearly one in three left involuntarily. Similarly, in 1995, underperforming CEOs stayed in office as long as high performers, but by 2006, a CEO who delivered above-average returns was almost twice as likely as one delivering sub-par returns to remain CEO for more than seven years. What this means is that CEOs who deliver below-average investor returns don't remain in office long. Corporate America does not need Congress's "wisdom" in this regard.

Taken together, this empirical evidence suggests that the current market for executive talent is fully functioning and American investors and workers are benefiting. Moreover, the U.S. system of corporate governance has had more reform in the past five years than in the previous 50, and those reforms are working. Boards are more independent, have taken significant steps to increase performance metrics, align CEO pay with shareholder interests, and replacing CEOs that fail to produce results. Congress should not act hastily to intervene in a functioning marketplace when there is little evidence of a market failure and before the dust has had a chance to settle on previous reforms. The evidence offered by the Majority's report simply doesn't rise to the level necessary to justify further intervention.

Finally, the Minority staff is very concerned with the decision of the Majority to release proprietary information that the consulting companies provided in an effort to be cooperative with the investigation. While these disclosures might make the report more newsworthy, this is not sufficient justification for the disclosure of such closely held information.