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CEO COMPENSATION IN THE POST–ENRON ERA

HEARING

BEFORE THE

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

MAY 20, 2003

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SENATE COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

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CEO COMPENSATION IN THE POST–ENRON ERA

TUESDAY, MAY 20, 2003

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
Washington, DC.

The Committee met, pursuant to notice, at 9:33 a.m. in room SR–253, Russell Senate Office Building, Hon. John McCain, Chairman of the Committee, presiding.

OPENING STATEMENT OF HON. JOHN MCCAIN, U.S. SENATOR FROM ARIZONA

The CHAIRMAN. Good morning. Thank you all for joining us today for this hearing on CEO compensation. Over the past three years, shareholders have lost an astonishing $7 trillion in stock value. Meanwhile, corporate profits have plummeted hundreds of companies have gone bankrupt, and shareholders were devastated by these circumstances, but they were not the only ones impacted. Since the year 2000, approximately 3 million Americans have lost their jobs and our unemployment rate is at the highest it has been in a decade.

Despite these dismal economic statistics, the median pay of CEOs has continued to increase and we continue to see many examples of enormous pay packages awarded by boards to top executives. For example, according to media reports one CEO last year made over $100 million in total compensation despite the fact that his company was the subject of multiple Federal probes. Purportedly, most of his compensation was from stock sales made prior to the Federal investigations.

Another CEO was reportedly paid a million-dollar bonus and granted millions of dollars worth of free stock in 2002, the same year that his company lost over a billion dollars, eliminated thousands of jobs, and saw its stock price collapse. That CEO later announced that he was voluntarily reducing his compensation significantly, but only after considerable pressure from the public and from his company's employees.

Another CEO reportedly made hundreds of millions of dollars from a stock option exercise and sale in 2001. Shortly thereafter, the company made a downward revision in its financial forecasts and the stock sank sharply.

There are many other examples of similar CEO compensation packages and practices. There appears to be a disconnect between CEO pay and performance at many of America's corporations. Warren Buffett and many others have pointed to excessive CEO com-

pensation as a crucial problem for corporate America. Indeed, Mr. Buffett has called executive compensation "the acid test for corporate reform."

So what do we do about concerns over excessive CEO compensation and the popular perception that the corporate system seems to have put the interests of top managers above those of shareholders employees. My hope is that this hearing will begin to answer these questions.

I should point out that some seem to believe that the question of CEO pay is one best left to boards and executives negotiating behind closed doors. We invited several CEOs to testify at this hearing. Not one accepted the invitation to appear today and join us in this important discussion. Private discussions may have been appropriate at one time, but today, with over half of American households invested in the stock market, CEO compensation and other issues of corporate governance have become crucial matters of public concern. They are issues that must see the light of day to help inform individual investors about the very companies that they count on to fund their children's education and their retirement.

Discussing CEO compensation and other matters of corporate reform is much more than fair game for public debate. It is an essential step towards empowering shareholders and returning investor confidence to our equity markets, which are a critical component of our vibrant system of capitalism, in which I strongly believe.

I look forward to an informative hearing this morning and again thank the witnesses for appearing today. Senator Breaux.

STATEMENT OF HON. JOHN B. BREAUX,
U.S. SENATOR FROM LOUISIANA

Senator BREAUX. Thank you very much, Mr. Chairman. It is really an appropriate and timely hearing, really very interesting, too, about what is the Government's responsibility to the private sector when they decide to hire people to work for them? Is it the Government's responsibility to say that something is out of kilter or is it the shareholders who own the company who are responsible for running it to wave a red flag and say: Wait a minute, something is wrong here.

It seems to me that there is something wrong when sometimes you see corporations which are losing money increasing the compensation packages for the people who run the company. It is really sort of like Congress passing a tax cut when we have a $400 billion deficit. It does not make a lot of sense in the private sector. We do the same thing sometimes in the Congress with how we manage the country.

But I think that we argued last week on the floor of the Senate about attorney fees and there was an effort for Congress to limit privately negotiated attorney fees between plaintiffs and defendants, and some of our colleagues said: Well, they are getting too much. The response is that this is something that was negotiated and approved by the courts.

The argument here is that compensation packages are negotiated between employers and employees and sort of approved by the shareholders. Then it is interesting to find out, what is the role of the Congress. I am very open to trying to find out the extent of the

problem and potential solutions to it, and I think this hearing can be very helpful.

Thank you.

The CHAIRMAN. Thank you, Senator Breaux.

Senator Allen.

STATEMENT OF HON. GEORGE ALLEN,
U.S. SENATOR FROM VIRGINIA

Senator ALLEN. Thank you, Mr. Chairman, and I thank our witnesses for coming today and look forward to their testimony.

One aspect of this debate that I see that might arise has to do with stock options and whether or not stock options ought to be expensed. I would share with my colleagues, Senator McCain and Senator Breaux, that on May 8th Senators Boxer and Cantwell and I joined Senator Enzi for a two-hour roundtable discussion with CFOs, CEOs, academics, analysts, and also Bob Herz, who is Chairman of the Financial Accounting Standards Board, on the issue of whether we should mandate the expensing of stock options.

I came away from that discussion feeling, number one, that the chairman already had made up his decision that they are going to expense stock options. If he were a judge, I think people would ask him to recuse himself for having already made a determination and only wanted to get on to the sentencing phase, already having determined what was going to happen.

I also came away from that hearing, not only with that concern, but the reality that broad-based stock options are good. I think it is good for employees in small businesses to be able, in start-up companies, to be able to have stock options. I think it is good that employees care about the future of a company. It helps companies attract officers, directors, and also motivate and keep employees.

So to the extent we get into that issue, I am one who thinks that, first of all, there is no proven value that can be assigned to, accurate value for stock options, and I will be pleased to hear the various comments of individuals, having read some of their testimony and some of the statements.

When you get into executive compensation, it is one thing to be concerned about executive compensation, but in the effort to curtail executive compensation do not harm the ability of small start-up companies, technology companies and others to attract officers, directors, and most importantly, do not take away this opportunity for employees to own a part of the company.

So I look forward to the testimony and thank you for the hearing, Mr. Chairman.

The CHAIRMAN. Thank you, sir.

Our witnesses are: Mr. Peter Clapman, Senior Vice President and Chief Counsel for Corporate Governance, TIAA–CREF; Brian J. Hall, Associate Professor at the Harvard Business School; Damon Silvers, Associate General Counsel, American Federation of Labor and Congress of Industrial Organizations; Joseph E. Bachelder, Founder and Senior Partner of the Bachelder Fund—is that the proper pronunciation?

Mr. BACHELDER. The Bachelder Firm.

The CHAIRMAN. Bachelder Firm. And Mr. Sean Harrigan, President of the Board of Administration of CalPERS.

We will begin with you, Mr. Clapman, and welcome to all the witnesses.

STATEMENT OF PETER C. CLAPMAN, SENIOR VICE PRESIDENT AND CHIEF COUNSEL, CORPORATE GOVERNANCE, TIAA–CREF

Mr. CLAPMAN. Thank you very much and good morning. Mr. Chairman and Members of the Committee: I am pleased to have this opportunity to express TIAA–CREF's views on corporation governance issues here today, particularly concerning executive compensation practices in the United States. My name is Peter Clapman. I am Senior Vice President and Chief Counsel for Corporate Governance at TIAA–CREF, a large financial services company with approximately $262 billion in assets under management serving nearly 3 million education and research employees at 15,000 institutions. TIAA–CREF is widely recognized as a major voice for shareholder rights and improved corporate governance.

Today I will focus on three key issues: TIAA–CREF's approach to corporate governance, problems within the current system for determining executive compensation, and suggested improvements.

For many years now, TIAA–CREF has had a proactive corporate governance program. We identify and focus on timely critical issues affecting all shareholders, be they individual investors or large institutional investors like TIAA–CREF. Quiet diplomacy is TIAA–CREF's preferred course of action in addressing corporate governance concerns at portfolio companies. In dialoguing with portfolio company managements, we discuss not only the problems but also potential remedies.

However, when the dialogue is unproductive TIAA–CREF is prepared to file shareholder resolutions and in fact we have received high votes in favor of our positions, often a substantial majority of the issues voted—of the shares voted.

TIAA–CREF has been a strong advocate for increased director independence, greater board accountability, and much higher standards of boardroom vitality and effectiveness. This means that directors must have the requisite courage and tough-mindedness to challenge management and to say no when necessary, and that brings us directly to the issue of executive compensation and the need for reforms.

TIAA–CREF has long believed that executive compensation is in a very real sense a window into the company's broader corporate governance character. Executive compensation is an important barometer of corporate conduct. Employees, especially highly paid individuals, respond to the incentives and motivations given or allowed by the system.

For example, the current system provides great incentives focusing on the current short-term share price of a company. Is it any wonder that some executives have abused the system by cashing out short-term gains from options while at the same time encouraging or fostering accounting aggressiveness or even fraud to keep earnings high enough to support the high share prices at which they cashed out? Regrettably, that is the state of affairs today for executive compensation at too many companies.

Currently, the typical option is fixed price and wide. Not only do the current accounting rules not impose expensing for such options, but, even worse, they require expensing for better forms of equity compensation such as performance-based options or restricted stock. All of the compensation consultants we have heard from say this accounting discrepancy is responsible for crowding out these better forms of compensation.

This year TIAA–CREF has filed shareholder resolutions calling for performance-based options with a substantial holding period for holding stock after exercise. This would produce a better alignment between management and shareholders.

Now I will go to our top priorities for executive compensation reforms. First, we need better performance from board compensation committees. Under new stock exchange rules, only independent directors may serve on compensation committees. This is a good first step, but not a panacea. Directors must act in a truly independent fashion and be sufficiently educated to understand what executive compensation is all about and, as I said earlier, have the toughmindedness to say no on occasion.

Second, it is crucial for independent directors to retain truly independent, outside consultants rather than rely on consultants selected by management. Consultants will promote the interests of whoever hires and pays them. Compensation committees must take on that role rather than management.

Third, compensation committees must reverse the ratcheting effect of seeking to position CEO compensation levels between the 50th and 75th percentiles, a statistical impossibility if all do it.

Fourth, we must strongly urge the system to stop rewarding failure. The public is outraged by excessive severance payments to failed CEOs. Individual shareholders and large institutional investors alike have registered their anger by supporting shareholder resolutions urging shareholder approval of compensation payments that exceed reasonable performance-based parameters.

Fifth, we believe that Congress must take care not to politicize this issue and it should permit FASB to deal with this issue on its intrinsic message—merits.

In the final analysis, shareholders have been more than forebearing, even in the face of stock market losses and compensation abuses. However, shareholders want future management rewards to be based on real management performance, not short-term share prices. Shareholders want management to hold real stock as opposed to primarily stock options and thus bar the down side risk that shareholders bear, and we cannot let them down.

I have given you a brief overview of TIAA–CREF's approach to corporate governance and discussed some of the issues at the root of most of the executive compensation excesses. Finally, I have suggested some remedies that we hope will lead to improved corporate governance best practices and the restoration of investor trust and confidence. We assure you that TIAA–CREF will continue to press for these reforms.

Thank you for giving me the opportunity to comment on these matters and I will be pleased to answer any questions you might have as to my testimony, including some that have been alluded to earlier by some of the Senators. Thank you.

[The prepared statement of Mr. Clapman follows:]

PREPARED STATEMENT OF PETER C. CLAPMAN, SENIOR VICE PRESIDENT AND CHIEF COUNSEL, CORPORATE GOVERNANCE, TIAA–CREF

I am pleased to appear before the Senate Committee on Commerce, Science, and Transportation to discuss issues of corporate governance, particularly as they apply to current concerns about executive compensation practices in the United States. I will focus on TIAA–CREF's philosophy and approach to corporate governance; executive compensation principles; and suggested ways to achieve "best practices" for corporate governance.

TIAA–CREF Philosophy and Approach

In my capacity as Senior Vice President & Chief Counsel, Corporate Governance, I manage a staff of 6 professionals who are dedicated to TIAA–CREF's efforts on behalf of shareholders. TIAA–CREF has been a leader in trying to improve corporate governance, both domestically and globally for over 20 years. Our organization is a full-service financial services provider with approximately $262 billion in assets under management. Our main asset base goes to support the pensions of nearly 3 million individuals at nearly 15,000 institutions in the educational and research field. As such, TIAA–CREF is uniquely independent compared with other large institutional investors because it works solely for the benefit of its participants.

TIAA–CREF's broad focus is to seek higher favorable investment returns for the millions of stakeholders in the same companies in which it invests. The TIAA–CREF investment strategy is long-term buy and hold—a significant percentage is quantitatively managed or indexed, and for that reason TIAA–CREF does not "vote with its feet". In addition to its public activities with individual portfolio companies, TIAA–CREF works at the policy level with groups such as the Financial Accounting Standards Board (FASB), New York Stock Exchange (NYSE), National Association of Securities Dealers Automated Quotations (NASDAQ), Securities and Exchange Commission (SEC) and internationally at the International Accounting Standards Board (IASB).

Our corporate governance program seeks to enhance our investment operations by taking on issues that further the long-term interests of shareholders. Although TIAA–CREF is a large shareholder, the interests it seeks to advance are those of concern to all long-term investors, both large and small.

TIAA–CREF has an active corporate governance program that identifies companies where we see problem areas. We enter into a dialogue with these companies in an attempt to correct the situation. Although "quiet diplomacy" is our preferred course, we are prepared to file shareholder resolutions on a number of issues and, in fact, have received high votes in favor of our positions, often a substantial majority among all votes cast by shareholders.

We have been strong advocates for more director independence, board accountability, and much higher standards of boardroom vitality. As shareholders we cannot micromanage our portfolio companies, but must rely instead on the directors performing in practice what is their duty in legal theory—to be the fiduciaries for the long-term shareholders. In actual practice, this means that the directors must be willing to oversee and monitor the senior managements of companies, and if necessary, be willing to say "no" when appropriate.

Executive Compensation Principles

This brings us directly to the current problems with executive compensation in the United States. We have long believed that executive compensation in a real sense is a "window" into broader corporate governance issues at a company. If the directors do not get executive compensation right, they probably will fail shareholders in other areas as well. Disclosure rules applicable to executive compensation are not fully adequate in many respects. For example, disclosure is obscure for retirement benefits and executive perquisites. Nevertheless, shareholders are able to glean through executive compensation to make reasonable assumptions as to how the directors are doing—or not doing—their job.

Executive compensation has its own importance in other ways. Individuals respond to the incentives and motivations given by the system. If those incentives and motivations are the wrong kind, we should not be surprised to find that wrong actions are the result.

For example, if the current system provides great incentives for focusing on the current short-term share price of a company, is it any wonder that some executives abused the system by cashing out short term gains from options while at the same

time encouraging or fostering accounting aggressiveness or even fraud to keep earnings high enough to support the high share prices at which they cashed out?

Regrettably, that today is the state of affairs for executive compensation at too many companies. The typical option today is fixed-price, and why? The current accounting rules not only impose no cost of compensation for such options, but even worse require expensing for other forms of equity compensation such as performance-based options or restricted stock. We have heard from all of the compensation consultants that this accounting discrepancy is responsible for crowding out those forms of compensation that would be better for shareholders—more acceptable to shareholders—solely because of the accounting rules.

TIAA–CREF filed shareholder resolutions this year challenging these practices, calling for performance-based options with a substantial holding period for holding stock after exercising the options. The main point argued by proponents of equity compensation is that such compensation will produce alignment between management and shareholders. The overemphasis on options, however, and our experience under that approach, is that the alignment for option holders is only with other option holders.

Top Priorities for Executive Compensation Reform

So what executive compensation reforms are needed, and where will they come from? First, we will need better performance from compensation committees. Under the new NYSE rules only independent directors may serve on compensation committees. This is a good first step, but not a panacea. The fact that directors are nominally independent does not necessarily equate to their acting independently. Will directors become more educated as to what compensation is all about—and abide fully by the intent of the new accounting rules?

Secondly, will directors retain truly independent consultants? In the past, all too often directors relied on the consultants selected by incumbent management. This has got to change since the entity that hires and pays the consultant is the entity that will motivate the consultant's advice. That entity has got to become the compensation committee and not the management.

Third, what objective is being sought in executive compensation? We see the ratcheting effect of every company seeking to position its CEO compensation between the 50–75th percentiles, a statistical impossibility.

Fourth, we must strongly encourage the system to stop rewarding failure. The public has seen and is outraged by the high levels of severance payments to failed CEOs. Such executives have also received service credit for time not served, a semantic twist of words that convey total cynicism for the purpose of the grant. This season we have seen the response by shareholders as they have supported shareholder proposals attempting to introduce some rationality into this process, requiring shareholder approval of severance payments that exceed reasonable formulas. The question again is how boards could have given such contracts if they were truly representing the interests of shareholders.

Fifth, we need to better link compensation with long-term performance goals. There are two problem areas with the current system: (1) reliance on fixed-price options and (2) absence of substantial holding periods for stock after exercise of options. In analyzing the situation recently, the Conference Board identified one of the current barriers to proper management of these issues—the absence of accounting neutrality regarding treatment of different forms of equity compensation. Until the properly authorized expert independent organization, FASB, acts to correct this problem, many companies will hide behind differing earnings treatments and disdain performance-based options even while recognizing that they are the better approach to executive compensation. Congress should be careful not to politicize this issue and should permit FASB to take on this issue on its intrinsic merits. The recent support of the FASB by SEC Chairman Donaldson is encouraging as to the view at the SEC.

In the final analysis, shareholders have been more than reasonable on this issue. Despite large stock losses, despite revelations about executive compensation excess, despite reasonable concerns about board performance, shareholders have been patient and understanding. Shareholders are willing to support improvements in the process of determining executive compensation, believing that the excesses will be squeezed out if the process improves.

The need now is to make the expectations of the new stock exchange rules work. The culture in the boardroom must undergo change so that the directors are truly accountable to the shareholders and not the management. With that change in board culture, the right accounting changes, and the generally improved corporate governance practices, hopefully the excesses in the system can be corrected. Con-

gress needs to strongly support these reforms to restore investor and public confidence in the system.

The CHAIRMAN. Thank you very much.

Mr. Hall, welcome.

STATEMENT OF BRIAN J. HALL, ASSOCIATE PROFESSOR, HARVARD BUSINESS SCHOOL

Mr. HALL. Thank you. Chairman McCain and distinguished members of the Committee: Thank you for inviting me to provide testimony on this important topic.

In the recent two decades we have seen dramatic changes in the way that American CEOs are paid. There has been about a sevenfold increase in the inflation-adjusted median level of CEO pay since 1980, which far outstrips the increases seen by rank and file workers.

As important, there has been a dramatic shift in the composition of CEO pay. As recently as 1984, the median option grant to CEOs of large American companies was zero, which implies that fewer than half of the CEOs received any option grants at all. In recent years, option grants have represented about two-thirds of total CEO pay. Options became the icing on the cake for CEOs in the mid-1980s. Today the icing has become the cake.

The option explosion is clearly the central and most controversial development in CEO compensation. I will therefore focus most of my testimony on what is good and bad about the CEO option explosion for the American public. Let us start with what is good. In the 1970s and early 1980s, American CEOs received very little equity-based pay and as a result had very weak ownership stakes in the companies they managed. Although I am simplifying a bit, their main financial incentive was to increase the size of their companies in terms of revenues, assets, and employees, while virtually ignoring the company's owners.

American CEOs were largely protected from shareholders and had financial incentives to do something they already enjoyed doing, making their companies bigger and expanding their empires. They responded in kind. CEO companies became larger, but, absent meaningful incentives for top executives to make decisions consistent with raising shareholder value, there were essentially zero returns to shareholders on an inflation-adjusted basis for more than a decade.

The financial incentives facing U.S. executives changed dramatically following the shareholder rebellion that began in the 1980s. The increase in takeovers removed the inappropriate way in which CEOs were insulated from the wishes of company owners, while appropriately lessening their job security. Moreover, management buyouts, which virtually always led to large increases in the ownership stakes for top managers, increased dramatically and were typically quite successful in raising efficiency, productivity, and profits.

The use of equity-based pay then began to spread throughout corporate America and became mainstream following the rise of institutional investor influence and the subsequent entrepreneurial wave of the 1990s. Although the move towards equity-based pay created new problems and abuse, it had many benefits, the most

notable being that top executives, who now owned significant amounts of stock and options, began to focus more on creating value for shareholders and society. Many top executives began to think and act like owners, at least relative to the period before the option explosion. The incentives created by ownership are at the core of a well-functioning market economy and are fundamental to long-run economic prosperity.

In my view, one of the risks of the recent corporate scandals is that they may create an excessive backlash against equity-based pay, even though well-designed equity-based compensation is the central tool for aligning the incentives of owners and managers.

Now to what is bad. The problem with the option explosion is that it has too often led to excess and abuse. In specific cases, option plans have been poorly designed, leading to perverse incentives and huge payouts to top executives. But even for the typical or average CEO, the option explosion may have indirectly caused total compensation to become excessive.

Now, some argue that, even though there are clearly specific instances where CEOs seem to have been overpaid, CEO is not excessive in general. This argument is based on the logic of efficiency of markets: CEOs are simply getting what the market will bear. If companies are willing to pay a price for CEOs, who is to say that the market price is wrong?

Unfortunately, a close examination of the pay process for CEOs reveals some serious doubts that the CEO labor market is particularly well-functioning, one which in my view gives weight to the argument that the overall level of top executive pay is excessive. The most crucial problem is that boards are often too weak and too cozy with top executives. CEOs are quite powerful in most American boardrooms. They typically chair the board and have a large influence over who is selected on the board. In such circumstances most directors feel pressure to please the CEO and one of the ways that they do this is by providing generous compensation.

Second, the compensation determination process has become dominated by the use of surveys whereby pay is determined by benchmarking against other CEOs of comparable size and in similar industries. The key problem here is that very few boards want to pay their CEOs below the median of this distribution, while a very large percentage of boards believe that their above-average executive should be paid above-average compensation.

But when boards consistently pay above median levels while using peer benchmarking to determine the median, the uncompromising laws of mathematics imply pay ratcheting over time, and this is precisely what we have observed.

Finally, the dramatic increase in the use of options led to an upward bias in CEO pay, since many boards perceive options to be much cheaper than their true economic cost to shareholders. Indeed, many boards incorrectly view options to be free or costless.

The false view that options are inexpensive is the result of three reinforcing factors: First, the current accounting rules allow companies to treat options as free from an accounting perspective; second, options require no cash expense up front; and third, option valuation is inherently complex, leading many people to refer to option costs in terms of the number of options, which often seems much

smaller than the expected dollar cost of options. In my view, these three factors have led to upward biases in CEO pay.

Thus, CEO pay is probably significantly higher than what we would see in a well-functioning labor market where well-informed owners spend their own money to attract, retain, and motivate high-quality executives.

For similar reasons, I have serious doubts that the specific design of most CEO pay packages is the optimal result of a well-functioning market. The way in which some top executives have been able to get huge payouts preceding huge declines in stock prices represents the most egregious example of poorly designed equity pay plans.

The solutions to the executive pay problem involve strengthening shareholder rights and corporate governance while also requiring companies to appropriately account for all compensation expenses, including stock options, on their accounting statements. More generally, solutions that take the form of improving the underlying problem are much preferable to trying to micromanage the pay process or pay outcomes through Federal legislation. Such legislative micromanagement is likely to be ineffective in solving the problem and may well have harmful and unintended consequences.

The best example of this is the 1993 rule aimed at curbing executive pay. The so-called million-dollar rule disallowed companies from deducting non-performance-related pay above $1 million for corporate tax purposes. At best, these changes were ineffective. At worst, they distorted pay towards options while contributing to CEO pay excesses. Indeed, a quick glance at the pay trend makes it look as if the 1992–93 changes were passed with the intention of accelerating, not curbing, CEO pay increases.

There are many specific ways in which boards can better design packages. For example, in my view aligning CEO incentives with long-run shareholder value creation would require longer vesting periods, stronger and more widespread ownership requirements, and automatic clawback of payouts following accounting restatements. But such specific changes are not easily legislated and if these are good ideas and boards become stronger and more empowered they will happen naturally.

Finally, one of the important ways in which Congress can act to curb excesses and distortions to executive pay is to encourage, rather than to discourage FASB to begin expensing options. Much of the current debate regarding the expensing of stock options is about whether expensing will help investors value companies more accurately. While I agree with many opponents of option expensing that this will not improve information flows, this largely misses the key point. The main problem with the current accounting treatment is that it distorts the compensation decisions made by boards and executives. Very few boards are willing to design or even consider equity pay packages that create an expense on the income statement when they can give out free options instead. As a result, boards grant options even though options may not be the most beneficial form of compensation.

An example that likely illustrates the distortion created by the current accounting rules involves the infrequent use of restricted stock. As noted earlier, the main rationale for paying executives in

the form of equity is to create ownership incentives. But since shareholders hold stock, why do boards primarily pay executives in options instead of stock? There are many good reasons to pay in stock instead, but they are rarely considered.

Despite these advantages, many boards rarely consider stock because of the current accounting rules. Requiring an expense for options will level the accounting playing field, leading to fewer distortions in the way that executives are paid. Combined with rules that give shareholders more influence in boardrooms will also curb many of the excesses in pay levels, especially with regard to many of the large outliers that we have seen.

To summarize, although we must not forget the large benefits of the option explosion, there are good reasons to believe that there is an executive pay problem. But the executive pay problem is best solved by addressing its underlying causes, governance, and accounting, rather than by attempting to regulate pay directly.

In addition to improving the accounting, making managers and boards more accountable to shareholders will make the executive pay process sounder and less prone to abuse and excess. Currently, there are a host of mechanisms that disempower shareholders. Poison pills, staggered boards, and proxy voting rules serve to weaken the ways in which boards and managers are held accountable to the company's owners. Although appropriate changes to governance and accounting rules are best accomplished through the exchanges, the Delaware courts and other courts, and regulatory bodies such as the SEC and FASB, Congressional support of these changes would well serve the interests of the American public.

I thank you for this opportunity to provide testimony.

[The prepared statement of Mr. Hall follows:]

PREPARED STATEMENT OF BRIAN J. HALL, ASSOCIATE PROFESSOR, HARVARD BUSINESS SCHOOL

Chairman McCain, and distinguished Members of the Committee, thank you for inviting me to provide testimony on the topic of CEO compensation.

In the recent two decades, we have seen dramatic changes in the way that American CEOs are paid. Although the press and media have often sensationalized the issue in ways that misinform the public, there has been about a 7-fold increase in the inflation-adjusted median level of CEO pay since 1980, which far outstrips the increases seen by rank-and-file workers. As important, there has been a dramatic shift in the composition of CEO pay. As recently as 1984, the median option grant (valued at the time of grant by standard option pricing models[1]) to CEOs of large American companies was zero—which implies that fewer than half of the CEOs received any option grant at all. In recent years, option grants have been (on average) about twice as large as cash-based pay, representing about two-thirds of total CEO pay. Options became "icing on the cake" for CEOs in the mid 1980s. Today, the icing has become the cake.[2]

The option explosion is clearly the central and most controversial development in CEO compensation. It has dramatically affected the level of pay, the composition of that pay and, crucially, the incentives that top executives face to create or destroy value. As a result, I will focus most of the remainder of my testimony on what is good and bad about the CEO option explosion for the American public.

Let's start with what is good. In the 1970s and early 1980s, American CEOs received very little equity-based pay and, as a result, had a very weak ownership stake in the companies they managed. Although I am simplifying a bit, their main financial incentive was to increase the size of their companies (in terms of revenues, assets and employees) while virtually ignoring the company's owners. American

[1] Such as Black-Scholes or binomial models.
[2] See Figure 1 for details.

CEOs were largely protected from shareholders and had financial incentives to do something they already enjoyed doing—making their companies bigger and expanding their empires. They responded in kind. U.S. companies became larger, but absent meaningful incentives for top executives to make decisions consistent with raising shareholder value, there were essentially zero returns to shareholders on an inflation-adjusted basis for more than a decade.[3]

The financial incentives facing U.S. executives changed dramatically following the shareholder rebellion that began in the 1980s. The increase in takeovers (and takeover threats) removed the inappropriate way in which CEOs were insulated from the wishes of company owners, while appropriately lessening their job security. Moreover, management buyouts[4]—which virtually always led to large increases in the ownership stakes for top managers—increased dramatically and were typically quite successful in raising efficiency, productivity and company profits.[5] The use of equity-based pay then began to spread throughout corporate America, and became mainstream following the rise of institutional investor influence and the subsequent entrepreneurial wave of the 1990s. Although the move toward equity-based pay created new problems and abuse, it has had many benefits, the most notable being that top executives—who now hold significant amounts of stock and options in the companies they manage—began to focus more on creating value for shareholders and society. Many top executives began to think and act like owners, at least relative to the period before the option explosion. The incentives created by ownership are at the core of well-functioning market economies and are fundamental to long-run economic prosperity and dynamism. In my view, one of the risks of the recent corporate scandals is that they may create an excessive backlash against equity-based pay, even though well-designed equity-based compensation is the central tool for aligning the incentives of managers and owners.

The problem with the option explosion is that it has too often led to excess and abuse. In specific cases, option plans have been poorly designed, leading to perverse incentives and huge payouts to top executives following (or preceding) poor performance. But even for the typical (or the median) CEO, the option explosion may have indirectly caused total compensation to become excessive.

Some argue that CEO pay is not excessive in general, even though there are clearly specific instances where CEOs seem to have been overpaid. This view is generally based on the logic of the efficiency of markets—CEOs are simply getting what the market will bear. If companies are willing to pay a price for CEOs, who is to say that the market price is "wrong"?

Unfortunately, a close examination of the pay process for CEOs reveals some serious doubts that the CEO labor market is not a particularly well-functioning one, which, in my view, gives weight to the argument that the overall level of top executive pay is excessive.[6] The most crucial problem is that boards are often too weak and too cozy with top executives, and as a result, fail to adequately represent shareholders when negotiating CEO pay packages. CEOs are quite powerful in most American boardrooms. They typically chair the board and have a large influence over who is selected to be on the board. In such circumstances, most directors (and the compensation consultants advising them, who desire to please their client) feel pressure to please the CEO and one of the ways that they do this is by providing generous compensation, even in relatively well-functioning boardrooms.

Second, the compensation determination process has become dominated by the use of surveys, whereby pay is determined by benchmarking against other CEOs of comparable size and in similar industries. The key problem is that very few boards want to pay their CEO below the median of this distribution while a very large percentage of boards believe that their "above average" executive should be paid "above average" compensation. But when boards consistently pay at above median levels while using peer benchmarking to determine the median, the uncompromising laws of mathematics imply pay ratcheting over time. And this is precisely what we have observed.

Finally, the dramatic increase in the use of options has led to an upward bias in CEO pay since many boards perceive options to be much cheaper than their true economic cost to shareholders.[7] Indeed, many boards incorrectly view options to be

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[3] Of course, macroeconomic and other factors also contributed to the poor performance of U.S. companies at this time. But lack of meaningful ownership stakes for U.S. executives was likely a major factor.

[4] These are also called leveraged buyouts, since the transactions are often done with high levels of bank and other debt financing.

[5] See Palepu (1990) and Kaplan (1989).

[6] See Bebchuk, et al. (2002).

[7] Hall and Murphy (2002, 2003).

"free" or "costless." The false view that options are inexpensive is the result of three reinforcing factors. First, the current accounting rules allow companies to treat standard options as free from an accounting perspective since there is no required expense on the income statement. Second, options require no cash expense up-front, even though the dilution cost is economically equivalent. Third, option valuation is inherently complex, leading many people to refer to option costs in terms of the number of options, which often seems much smaller than the expected economic dollar cost of options. In my view, these three factors—especially in combination—have led to upward biases in CEO pay. Thus, CEO pay is probably significantly higher than what we would see in a well-functioning labor market where well-informed owners spent their own money to attract, retain and motivate high-quality executives. For similar reasons, I have serious doubts that the specific design of most CEO pay (as opposed to the level of pay) packages is the "optimal" result of a well-functioning market. The way in which some top executives have been able to get huge payouts (from selling equity and/or exercising options for a profit) preceding huge declines in stock prices represent perhaps the most egregious example of poorly designed equity-pay plans.

The "solutions" to the executive pay problem involve strengthening shareholder rights and corporate governance while also requiring companies to appropriately account for all compensation expenses (including stock options) on their accounting statements. More generally, solutions that take the form of improving the underlying problem (involving the incentives of the involved parties and the information they have) are much preferable to trying to micromanage the pay process or pay outcomes through federal legislation. Such legislative micromanagement is likely to be ineffective in solving the problem and may well have harmful and unintended consequences. The best example of this is the 1993 rule aimed at curbing executive pay.[8] This so-called "million dollar rule" disallowed companies from deducting non-performance-related-pay above $1 million for corporate tax purposes. Around the same time, the SEC passed new regulations creating greater executive pay disclosure on company proxy statements. At best, these changes were ineffective. At worst, they distorted pay towards options (which automatically count as performance-based pay) while contributing to CEO pay excesses. Indeed, a quick glance at the pay trend in Figure 1 makes it look as if the 1992/1993 changes were passed with the intention of accelerating, not curbing, CEO pay increases.

There are many specific ways in which boards can better design CEO pay packages. For example, in my view, aligning CEO incentives with *long-run* shareholder value creation would require longer vesting periods, stronger and more widespread ownership requirements (which require executives to hold specific amounts of stock) and automatic clawback of payouts following accounting restatements (that is, executives would be required to pay back any payouts that preceded accounting restatements combined with stock price declines). But such specific changes are not easily legislated and would happen anyway (if they are good ideas) if boards became stronger and more empowered representatives of shareholders.

One of the important ways in which Congress can act to curb excesses in, and distortions to, executive pay is to encourage rather than discourage FASB to begin expensing options. Much of the current debate regarding the expensing of stock options is about whether or not expensing will help investors value companies more accurately. While I agree with many opponents of option expensing that requiring expensing will not significantly improve the information flows to investors, this largely misses the key point. The main problem with the current accounting treatment is that it distorts the compensation decisions made by boards and executives. Very few boards are willing to design (or even consider) equity-pay packages that create an expense on the income statement when they can give out "free" options instead. As a result, boards (and managers) grant options, even though options may not be the most cost-effective and beneficial form of compensation.

An example that likely illustrates the distortion created by the current accounting rules involves the infrequent use of restricted stock (stock that vests slowly) relative to options. As noted earlier, the main rationale for paying top executives in the form of equity is to create ownership incentives. But since shareholders hold stock, why do boards primarily pay executives in options instead of stock? The likely answer is the distorted accounting treatment of equity (which requires an expense for restricted stock but not options), not the inherent superiority of options as a compensation and incentive tool. Indeed, there are many advantages to stock relative to options. Stock is simpler and easier to value, which helps incentives while also curbing abuses. Stock does not have the huge underwater problem that plagues options (underwater options undermine ownership incentives, create retention prob-

[8] This is section 162 (m) of the Internal Revenue Code.

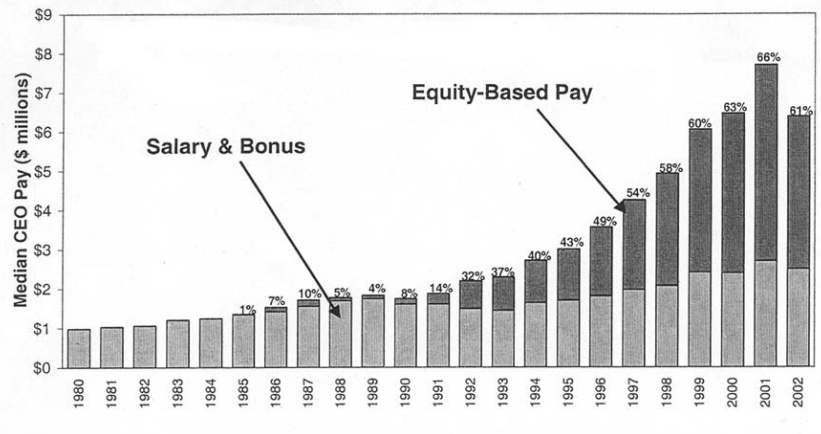
lems and lead to perverse pressures to reprice options or grant large "refresher" grants following stock price declines)[9] since stock cannot fall underwater. Stock also better aligns shareholder and executive decisions regarding dividends (and sometimes risk-taking[10]).

But despite these advantages, many boards rarely consider stock—or other types of pay that create an accounting expense—because of the current accounting rules. Requiring an expense for options will level the accounting playing field, leading to fewer distortions in the way that executives are paid. Especially combined with rules that give shareholders more influence in board rooms, this will also curb many of the excesses in pay levels—especially with regard to many of the large outliers paid to CEOs, virtually all of which involved abuses of "inexpensive" and "hard-to-value" option grants.

To summarize, although we must not forget the large benefits of the option explosion, there are good reasons to believe that there is an executive pay problem. But the executive pay problem is best solved by improving governance and accounting, rather than by attempting to solve the problem directly without addressing its underlying causes. In addition to improving the accounting, making managers and boards more accountable to shareholders will make the executive pay process sounder and less prone to abuse and excess. Currently, there are a host of mechanisms that disempower shareholders including poison pills, staggered boards and proxy voting rules that serve to weaken the ways in which boards and managers are held accountable to the company's owners and other stakeholders. Although appropriate changes to the governance and accounting rules are best accomplished through the exchanges, the courts (especially the Delaware courts) and regulatory bodies such as the SEC and FASB, congressional support of these changes would well serve the interests of American public.

I thank you for this opportunity to provide testimony on this important issue.

Figure 1: Median CEO Pay from 1980-2002 (in 2002 dollars)



Source: ExecuComp and data derived and spliced together from Hall-Liebman (1998) and Hall-Murphy (2002, 2003).

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[9] See Hall and Knox (2002) for evidence on the significance of the underwater options problem.
[10] Especially when options fall underwater.

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The CHAIRMAN. Thank you very much.
Mr. Silvers.

STATEMENT OF DAMON A. SILVERS, ASSOCIATE GENERAL COUNSEL, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS (AFL–CIO)

Mr. SILVERS. Thank you, Mr. Chairman, and good morning. My name is Damon Silvers and I am an Associate General Counsel of the American Federation of Labor and Congress of Industrial Organizations. On behalf of the AFL–CIO, we would like to thank you for your leadership on the issue of executive compensation and for the opportunity to appear before you today.

The AFL–CIO is the federation of America's unions, representing more than 66 national and international unions and their membership of more than 13 million working men and women. Of the 1,000 shareholder proposals filed in the 2003 proxy season, more than 380 were filed by union members and their benefit funds. 75 percent of those 380 proposals dealt with the issue of executive compensation. So far, at last 15 of these proposals have won majority support from shareholders at major companies and at seven additional companies, including GE and Verizon, worker funds' shareholder proposals have led to agreements to phase out extraordinary executive retirement plans.

Since 1997, the AFL–CIO has sponsored the PayWatch web site, *www.paywatch.org,* where workers and investors can track CEO pay at the companies they care about, compare it to their own compensation, and take action to reform executive pay practices. Over 2 million people have visited PayWatch since its launch.

There are companies where executive pay matters in the simplest possible way. It has grown to a level where it is materially and directly affecting companies' economic performance. But the more common problems involving runaway executive pay are that: one, it is structured to create perverse incentives; two, it corrodes organizational cultures; and three, it is a symptom of an unaccountable CEO and a weak board. A couple of examples of each problem.

First, perverse incentives. As several of my colleagues on this panel have mentioned, stock options that can be exercised after three years give the CEO an interest in both increased share price and increased volatility. If the stock price is falling, the CEO begins to develop a rational interest in taking risky decisions that shareholders, particularly long-term shareholders such as our pension funds, do not share. In addition, short-term equity-based compensation, whether options or stock, creates a strong incentive to manipulate companies' stock prices through massaging accounting statements or other disclosure manipulations.

Second, organizational culture. Consider recent events at American Airlines. That company was seeking concessions from its employees in the name of business survival, including cutbacks in retirement benefits. The employees had narrowly voted to accept

these cutbacks when it was revealed that the CEO was secretly increasing his retirement benefits at the same time.

Not only was this grossly unfair, it jeopardized the approval of the agreements the company had said were necessary to avoid a bankruptcy filing. It shows that treating people unfairly has consequences.

Finally, executive compensation as a symptom. I hope that you have seen the previous witness Professor Hall's list of the top paid CEOs of 1999 and noticed the overlap with the corporate villain list of 2001 and 2002. This strongly suggests that when pay is out of control other things are likely to be as well.

But scandalous levels of executive pay are neither a permanent feature of the American economy nor a necessary byproduct of prosperity. In 1964, at the end of the greatest period of economic performance in this country's history, CEO pay stood at roughly 25 times that of the average employee, a level comparable to that of the other major industrialized countries of the time and the other major industrialized countries' CEO pay levels today. Of course, in the United States today CEO pay stands at over 500 times the pay level of the average worker, and the pay of the median CEO continues to rise even though by most measures corporate performance is falling.

We believe real change requires the enactment of two reforms, reforms that are under discussion at the agencies that have the power to enact them, but which face serious political opposition. These reforms are the expensing of stock options and the democratization of corporate board elections, a democratization which is central and really the only way to achieve what Professor Hall was talking about in terms of strengthening the board's hand in dealing with the CEO.

I address stock options first. Frankly, the only reason why option expensing is an issue at all today is because in the mid-1990s, FASB's efforts to require expensing, as the professionals at FASB have been urging for as long as they have been around, were thwarted by political pressure. Similar pressures are now being brought to bear as FASB once again tries to do its job.

The AFL–CIO strongly supports FASB Chairman Bob Herz' efforts to restore credibility to GAAP in this area and commends the Chairman and Senator Levin for their leadership in supporting FASB's independence.

In our opinion, there is more at stake here than just option accounting or executive compensation, if that was not enough. Our markets will be damaged if after the events of the last two years it appears that our accounting standards are still being held hostage to the very political dynamics that prevented effective regulation in the 1990s.

Part of the reason the AFL–CIO supports option expensing is that we believe with a level playing field companies will, in part due to investor pressure, choose better forms of executive compensation such as restricted stock. However, we are skeptical of mechanical approaches to executive compensation in general. Any mechanism, any one metric, can be gamed. I think the history of the 1992 attempts at reform shows that this is true in spades.

A model executive compensation program in our opinion would include a thorough evaluation by the board of both quantitative and qualitative performance measures aimed at assessment the executive's contribution to the long-term health of the business. But such a multi-factor approach requires boards that are genuinely independent from the CEO and accountable to long-term investors.

That is why last week the AFL–CIO filed a rulemaking petition with the Securities and Exchange Commission asking the commission to democratize the director election process. The petition asks the commission to adopt rules giving long-term significant investors in public companies the right to have short slates of directors they nominate listed on management's proxy along with management board candidates and thereby create a possibility of moving board of director elections away from the North Korean model.

We suspect that access to the proxy as an option, while it will be rarely used, will make dialogue between boards and investors much more substantive. In particular, it is only through this type of reform that boards will become independent enough to really negotiate CEO pay packages.

The SEC has announced a review of the issue of shareholder access to the proxy and in particular shareholder involvement in director selection. The staff of the SEC has been asked to report to the commission on this issue by July 15th. But the reality is that CEOs will oppose this reform as strongly as they are opposing option expensing, but without it, it would be impossible to prevent further abuses of executive compensation.

FASB and the SEC have the power and the tools to do something about runaway executive pay, to foster precisely the kind of private sector fixes that Senator Breaux alluded to in his opening remarks. However, both bodies need the support of Congress. The AFL–CIO is grateful to this Committee for its commitment to this task and we would be pleased to assist the Committee in any way as you continue your work in this area.

Thank you.

[The prepared statement of Mr. Silvers follows:]

PREPARED STATEMENT OF DAMON A. SILVERS, ASSOCIATE GENERAL COUNSEL, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS (AFL–CIO)

Good morning Chairman McCain and Senator Hollings. My name is Damon Silvers, and I am an Associate General Counsel of the American Federation of Labor and Congress of Industrial Organizations. Thank you for your leadership on the issue of executive compensation and for the opportunity to appear before you today.

The AFL–CIO is the federation of America's labor unions, representing more than 66 national and international unions and their membership of more than 13 million working women and men. Union members participate in the capital markets as individual investors and through a variety of benefit plans. Union members' benefit plans have over $5 trillion in assets. Union-sponsored pension plans account for over $400 billion of that amount. Worker-owners and their benefit funds have become increasingly active participants in corporate governance in the last fifteen years. Of the 1000 shareholder proposals filed in the 2003 shareholder season, more than 380 were filed by unions. Seventy-five percent of these union-sponsored proposals dealt with the issue of executive compensation.

So far, worker fund proposals on executive compensation have won majority votes at companies like Alcoa, Apple, Delta (2), Hewlett Packard, International Paper, PPG, Raytheon, Sprint, Tyco, Union Pacific, U.S. Bancorp (2), Weyerhaeuser, and Whole Foods. At Adobe, Airborne, Coca-Cola, Exelon, General Electric (2) and Verizon the AFL–CIO or an affiliate union recently negotiated agreements to phase

out extraordinary executive pensions. Of particular note, building trades unions' funds have led the fight to get companies to expense stock options at dozens of public companies, following up on their success last year in winning auditor independence proposals.

The AFL–CIO has been involved in the effort to reform executive compensation since well before the corporate scandals of the last several years. Since 1997, the AFL–CIO has sponsored the PayWatch website (*www.paywatch.org*), where workers and investors can track CEO pay at the companies they care about, compare it to their own compensation, and take action to reform executive pay practices. PayWatch is a very popular web site, with over 2 million people visiting since its launch and over 400,000 visits in 2002.

Executive compensation should be a key part of the web of relationships that make up the corporate governance process. It should contribute toward getting companies to make smart, long term focused decisions that lead to sustainable benefits for all who participate in the company. Unfortunately, executive compensation has become the best-known symptom of the breakdown of that process. This year 277 of the approximately 1000 proposals filed at companies pertained to reining-in executive compensation.

We believe executive pay matters. Amazingly, there are companies where executive pay matters in the simplest possible way—it has grown to a level where it is materially and directly affecting companies' economic performance. But the more common problems involving runaway executive pay are that (1) it is structured to create perverse incentives, (2) it corrodes organizational cultures, and (3) it is a symptom of an unaccountable CEO and a weak board.

A couple of examples of each problem. First, perverse incentives. Stock options that can be exercised after three years give the CEO an interest in both increased share price and increased volatility. If the stock price is falling, the CEO begins to develop an interest in taking risky decisions that shareholders, particularly long-term shareholders, do not share. In addition, equity based compensation, whether options or stock, that can be converted to cash during the executive's tenure creates a strong incentive to manipulate company stock prices through massaging accounting statements or other disclosure manipulations.

Second, organizational culture. Consider recent events at American Airlines. The company was seeking concessions from its employees in the name of business survival, including cutbacks in retirement benefits. The employees had narrowly voted to accept these cutbacks when it was revealed that the CEO was secretly increasing his retirement benefits at the same time. Not only was this grossly unfair, it jeopardized the approval of the agreements the company had said were necessary to avoid a bankruptcy filing. Treating people unfairly has consequences.

Finally, executive compensation as a symptom. You have seen Professor Brian Hall's list of the top paid CEOs of 1999, and noticed the overlap with the corporate villain list of 2001–2002. This suggests that when pay is out of control, other things are likely to be as well.

But scandalous levels of executive pay are neither a permanent feature of the American economy nor a necessary byproduct of prosperity. In 1964, at the end of the greatest period of economic performance in this country's history, CEO pay stood at roughly 25 times that of the average worker, a level comparable to that of the other major industrialized countries. Today of course it stands at over 500 times the pay level of the average worker, and the pay of the median CEO continues to rise even though by every measure corporate performance is falling.

Yet, solutions to runaway executive pay have been elusive in more recent American history. CEO pay increased throughout the 1980's, to the point where in 1992 Congress felt it had to take action to tie pay to performance. Then pay really took off. We should learn from these experiences that in the absence of effective corporate governance, mechanical measures to rein in pay are unlikely to be successful—CEOs and their consultants can and will game these rules if they control the processes by which their pay is set. For example, today we are seeing executives shift from stock options to SERPs and other retirement plans as stock options become both controversial and relatively unprofitable.

So we believe that solutions to the problem of executive pay require at a minimum good disclosure to investors and the public and real accountability on the part of corporate boards, accountability that will result in real bargaining between boards and CEOs.

Specifically, this requires the enactment of two reforms—reforms that are under discussion at the agencies that have the power to enact them but which face serious political opposition. These reforms are the expensing of stock options and the democratization of corporate board elections.

Stock options need to be expensed so they can be managed and so they can be on a level playing field with other types of executive compensation that are better suited to aligning executive interests with the long-term interests of their companies. There is no good reason not to expense options. But there are a number of bad reasons. These bad reasons include the spurious assertion that options cannot be valued, that options turn up in earnings per share calculations, and that options vary in value after they are granted.

Options can be valued using Black-Scholes and a variety of other pricing methods related to Black-Scholes. Though these values are estimates, so are the values used for numerous other line items on corporate financial statements, including depreciation, amortization, and inventory-related adjustments. Options do vary in value after they are granted—but so do a variety of payments and agreements made by companies—for example payments made in foreign currencies or long-term commodity contracts. No one would suggest they should be left off the companies' financial statements. Finally, the inclusion of options in the creation of the fully diluted earnings per share figure does not treat options as a cost, which in fact they clearly are.

Frankly, the only reason why option expensing is an issue at all is because FASB's efforts to require expensing have been thwarted in the past by political pressure. Similar pressures are now being brought to bear as FASB tries once again to do its job. The AFL–CIO strongly supports Bob Herz's efforts to restore credibility to GAAP in this area, and commends the Chairman and Senator Levin for their leadership in supporting FASB's independence. In our opinion, more is at stake here than just option accounting or executive compensation. Our markets will be damaged if after the events of the last two years it appears that our accounting standards are still being held hostage to the very political dynamics that prevented effective regulation in the 1990's.

Part of the reason the AFL–CIO supports option expensing is that we believe that with a level playing field companies will, in part due to investor pressure, choose better forms of executive compensation such as restricted stock. But we are skeptical frankly of mechanical approaches to executive compensation in general. Any mechanism, any one metric, can be gamed. A model executive compensation program, in our opinion, would include a thorough evaluation by the board of both quantitative and qualitative performance measures aimed at assessing the executive's contribution to the long term health of the business.

This kind of process can only work though when the board is genuinely independent from the CEO and accountable to long-term investors. That is not the reality of today's corporate boards. That is why worker pension funds and other institutional investors are looking to make long-term investors a real counterbalance to management power in the board room. Last week the AFL–CIO filed a rulemaking petition with the Securities and Exchange Commission asking the Commission to democratize the director election process. The petition asks the Commission to adopt rules giving long-term significant investors in public companies the right to have short slates of directors they nominate listed on management's proxy along with management board candidates. This proposal for access to the proxy is designed to give long-term institutional investors voice, not to facilitate takeovers. We suspect that access to the proxy, while rarely used, by its very availability as an option will make dialogue between boards and investors much more substantive. In particular, it is only through this type of reform that boards will become independent enough to really negotiate CEO pay packages.

The SEC has announced a review of the issue of shareholder access to the proxy, and in particular shareholder involvement in director selection. The SEC staff has been asked to report to the Commission on the issue by July 15. But the reality is that CEOs will oppose this reform as strongly as they are opposing option expensing, and that without it, it will be impossible to prevent further abuses of executive compensation.

FASB and the SEC have the power and the tools to do something about runaway CEO pay. But not if they succumb to Congressional and company pressure to continue business as usual. One would think that after the last couple of years it would not be necessary to say this.

Ultimately, the crisis in executive compensation is a microcosm of the crisis in corporate governance that brought us Enron and WorldCom and HealthSouth and so many others. Only by getting disclosure right and giving institutional investors the power to act on what they know can we get executive pay under control. But the long term health of our economy and the basic principles of fairness demand we do so. The AFL–CIO is grateful to this Committee for its commitment to this task and we would be pleased to assist the Committee in any way as you continue your work in this area. Thank you.

The CHAIRMAN. Thank you, Mr. Silvers.
Mr. Bachelder.

STATEMENT OF JOSEPH E. BACHELDER, FOUNDER AND SENIOR PARTNER, THE BACHELDER FIRM

Mr. BACHELDER. Mr. Chairman and distinguished Members of the Committee: I very much appreciate the opportunity to speak with you this morning on the subject of executive compensation and in particular the focus of today, CEO pay. I am a founder and senior partner of the Bachelder Law Firm in New York City. I have concentrated in matters associated with executive compensation for over two decades. I have represented many prominent chief executive officers and other senior level executives of United States corporations. I have also represented boards of directors and compensation particulars. I write a regular column, "Executive Compensation," which provides current commentary on the subject of executive pay for the New York Law Journal.

By way of introduction, I would like to note that a recently completed study of 437 companies out of the S&P 500 shows that, taking into account salary, bonus, and long-term incentives, including stock options, the average CEO pay is down approximately 24 percent in 2002 from 2001. This same survey, based on these 437 companies out of the S&P 500, is down by about 10 percent. I think that what goes up does indeed come down, and other surveys do indicate that CEO pay in 2002 is down from 2001.

I would like to make some observations on CEO pay today. First of all, I believe that the market of CEO pay is a free market, much in the way that the stock market is a free market or the real estate market is a free market. None of these markets are perfect, but it is basically that. In order to get a CEO to move from company A to company B, for example, company B must do what it takes to get him or her to move. If company A wants to keep that CEO from accepting the offer from company B, it must pay what it takes. It is a bargaining process, much of which goes on in other free markets.

If asked, the vast majority of directors of the approximately 15,000 public companies in the United States would likely say that the single most important factor to a company's success over the next several years is the CEO. This is one reason why CEOs have the leverage they command in negotiations over their pay.

For major U.S. corporations, CEO pay represents a very small portion of the value of the companies they run. If for example Jack Welch received over his career a billion dollars of value—and the publicly available information that I have reviewed indicates it to be significantly less than that—this would be approximately one-quarter of 1 percent of the company's total market capitalization as of September 2001 when he retired. You will pay more than that as a percentage of most transactions to your stockbroker. If you sell your house, you will pay something like 6 percent to your real estate broker.

From a different perspective, Jack Welch's pay for his entire career would probably equal less than 10 cents per share of GE stock, currently priced at approximately $28 per share, with approximately 10 billion shares outstanding.

CEO salaries and bonuses have increased, but not to an egregious degree, over the past 50 years, averaging between 5 and 6 percent. Adjusted for inflation, this rate is about 2 percent. In fact, the rate of increase in CEO salaries and bonuses trailed the rate of increase in pay of production workers during the 1950s, 1960s, and 1970s.

So why the extra fuss over CEO pay today? To a very significant degree, it is due to stock options, and this in turn is due in large part to the way we report stock options as compensation. For the moment I am addressing the issue of reporting CEO pay and not the issue of whether options should be expensed for accounting purposes, a very important and separate issue, but not the subject of this testimony that I am giving.

Much of the reporting of the huge CEO pay gains in the 1990s was based on values attributable to the awards of stock options using the financial model called Black-Scholes. Black-Scholes' initial applications were to freely tradable short-term options, meaning options for periods of less than a year, frequently in the range of only three to six months. Applied to ten-year executive stock options, Black-Scholes is like planning a long drive through traffic by taking a one-time look in the rear view mirror.

Let us compare an executive stock option to one of those short-term options traded on the Chicago Board Options Exchange. An executive stock option cannot be sold. It usually cannot be exercised for a significant period of time. If the option is exercised, the sale of the stock may be subject to SEC insider restrictions. If the executive quits, the option is probably forfeited.

Even if the executive continues on during the full option term, how does one forecast the consequences of wars, recessions, and the growth or collapse of particular employers over that period?

To report one dollar of such highly speculative value as the equivalent of one dollar of salary paid today is debatable, to say the least. Notwithstanding the foregoing, many U.S. surveys report side by side dollars of theoretical option value with dollars of salary paid as if they were equivalent. These surveys then compound the sin by adding the two together.

Many billions of dollars of supposed option value evaporated during and after the 1990s. There are cases of executives reported to have received hundreds of millions of dollars of option compensation during the past ten years whose options are now underwater.

In a study of CEO pay over an approximately ten-year period ending in 2001, the Bachelder Firm found 210 CEOs, out of a much larger group of CEOs, who were employed as CEOs by the same company for the entire period of approximately ten years. The ratio of stock option gains to salary and bonuses for these 210 executives over the approximately ten years was a little over one to one. By option gains, I mean both realized and unrealized gains.

To the vast majority of CEOs in the United States, the 1990s were a rewarding period, with rewarding results to shareholders, but not the bonanza of extravagance suggested by the media.

I have a few suggestions. Let us adopt a consistent yardstick for valuing stock options in reporting CEO pay. I am speaking of surveys and reports on options, not at this moment accounting for options, which, as I said, is a different issue. I suggest using gains

both realized and unrealized, rather than the theoretical Black-Scholes value at the time of option grant.

Second, let us stop focusing on the outliers who attract headlines and distort the overall picture of CEO pay and instead focus on the average or median CEO pay when discussing that subject.

Third, it would be very helpful if there was at least one common database of companies that we all could refer to, like the S&P 500. Throughout each proxy season we go from surveys that in some cases cover 50 or fewer companies in a limited number of industries to surveys concerning much larger numbers of companies in many industries. When that is combined with differences in valuation methods and differences in the use of terminology, it becomes very difficult for the public to get an accurate picture of what really is happening to CEO pay.

Finally, when CEOs and other executives exercise stock options it would be reasonable to require that a specified percentage of the stock attributable to the spread at time of exercise, net of shares needed to pay taxes incurred as a result of the exercise, be held for a minimum period of time.

Thank you very much, Mr. Chairman and members of the Committee, for the opportunity to testify today.

[The prepared statement of Mr. Bachelder follows:]

PREPARED STATEMENT OF JOSEPH E. BACHELDER, FOUNDER AND SENIOR PARTNER, THE BACHELDER FIRM

A. Introduction

A recently completed study (reported by Equilar, Inc.) of 437 companies out of the S&P 500 shows that, taking into account salary, bonus and long-term incentives including stock options, the average CEO pay is down 23.6 percent in 2002 from 2001.

Looking farther back, over the past fifty years, CEO pay (salary and bonus) has grown an average of approximately 5.8 percent a year. That compares to the S&P 500 total shareholder return (stock price growth plus dividends deemed reinvested) of approximately 12 percent a year over the same fifty-year period. It is noteworthy that during the 1950s, the 1960s and into the 1970s, the rate of increase in CEO pay (salary and bonus) trailed the rate of increase in production workers' pay.

Another way of looking at CEO pay is to compare it as a percentage of employer revenues over a period of time. Looking at over 230 U.S. corporations that are in the current S&P 500 and that were in the same index a decade ago, salary and bonus paid to the CEOs of those companies represented approximately 0.035 percent of their revenues a decade ago and represents approximately 0.029 percent today.

What about stock options? In the early 1980s, after approximately 15 years of almost no growth in the stock markets, stock options were encouraged as a favored form of long-term incentive award. Consultants, investors and academics looked favorably on stock options. Why? Because they wanted to tie CEO pay to increase in shareholder wealth. What better way to do that than with stock options? If the markets went up, the CEO shared in the growth. If the markets went nowhere, the CEO made nothing.

What happened? The stock markets exploded! From the early 1980s to the end of the 1990s, the stock markets rose 1400 percent. In a September 2002 report, the Conference Board indicated that approximately 80 percent of the increase in CEO pay over the period 1992 to 2000 was attributable to gains in stock options. The stock market had its remarkable success in the 1980s and 1990s and so did stock options for many CEOs in that same period. In a sense we got what we asked for: we tied CEO pay to increasing shareholder wealth and shareholder wealth overall increased dramatically.

B. Some Observations on CEO Pay Today

1. Free Market

First, let's recognize that the market of CEO pay is a free market, much in the way the stock market is a free market, or the real estate market is a free market. In order to get a CEO to move from Company A to Company B, Company B must

pay what it takes. If Company A wants to keep that CEO from accepting the offer from Company B it must pay what it takes. It is a bargaining process, much as goes on in other free markets.

2. The Market Value of CEOs

If asked, the vast majority of directors of the approximately 15,000 public companies in the United States likely would say that the single most important factor in a company's success over the next several years is the CEO. This is one reason why CEOs have the leverage they command in negotiations over their pay.

There are not a lot of people who possesses the qualities necessary to be a successful CEO. To succeed, they must:

- Master the business operations—most frequently global in scope—of companies with hundred of millions, and in some cases hundreds of billions, of dollars of revenues and market capitalization.
- Have the vision and leadership to keep their companies ahead in developing and marketing new products and services, improving existing products and services, and in marketing those products and services.
- Understand and oversee increasingly complex financial structures (and we all know the tragedies associated with leadership that either, willfully or neglectfully, fails to do this).
- Attract, motivate and retain talented people—frequently tens of thousands and, in some cases, hundreds of thousands.
- Work effectively and productively with multiple constituencies including employees, shareholders, directors, Wall Street analysts, the media, Federal, state and local governments and, frequently, foreign governments as well, and the citizens of the communities of which they are a part.

Individuals who effectively combine these skills, with the energy, commitment and personal sacrifices required, do indeed command a premium in today's market.

Ironically, institutional shareholders criticize CEO pay and yet many of them have been a force in increasing CEO pay. Representing some of the greatest concentrations of stock wealth in the history of our country, institutional shareholders have provided constant pressure for increasing stock prices. CEOs respond to this pressure. With or without stock options, the pressure would have been there. Did the 1990s produce too much in the way of institutional shareholder gains? Where were many of the institutional shareholders just a few years ago on the subject of Enron? On the subject of Worldcom? I am not sure I would look to institutional shareholders as the oracle on CEO pay.

3. CEO Pay Versus the Value of the Companies They Run

For major U.S. corporations, CEO pay represents a very small portion of the value of the companies they run. If, for example, Jack Welch received over his career a billion dollars of value, and the publicly available information that I have reviewed indicates it to be significantly less than that, this would be approximately 0.25 percent of the Company's market value as of September 2001 when he retired. You will pay more than that as a percentage of most transactions to your stockbroker. If you sell your house, you will pay something like 6 percent to your real estate broker. From a different perspective, Jack Welch's pay for his entire career would probably equal less than ten cents per share of GE stock currently priced at approximately $28 per share, with approximately 10 billion shares outstanding.

C. Stock Option Gains and the Black-Scholes Bugaboo

As already noted, CEO salaries and bonuses have increased—but not to an egregious degree—over the past 50 years. As also already noted, the rate of increase in CEO salary and bonus trailed the rate of increase in pay of production workers during the 1950s, the 1960s and into the 1970s. So why the extra fuss over CEO pay? To a very significant degree, it is due to stock options. And this, in turn, is due in large part to the way we report stock options as compensation. (I am addressing the issue of reporting CEO pay and not the issue of whether options should be expensed for accounting purposes, a separate issue that is not the subject of this testimony.)

Much of the reporting of huge CEO pay gains in the 1990s was based on values attributed to the awards of stock options using the financial model called Black-Scholes. Black-Scholes seeks to value an option based on a number of factors, including the current stock price, the option exercise price and the historic volatility of the stock to which the option applies. Other elements of the model include the term of the option, the dividend yield and the risk-free interest rate. Black-Scholes' initial applications were to freely tradable short-term options—meaning options for periods of less than a year, frequently in the range of only three to six months. Ap-

plied to ten-year executive stock options, Black-Scholes is like planning a long drive through traffic by taking a one-time look in the rear view mirror.

Let's compare an executive stock option to one of those short-term options traded on the Chicago Board Options Exchange. An executive stock option cannot be sold. It usually cannot be exercised for a significant period of time (typically it becomes exercisable in tranches over several years). If the option is exercised, the sale of the stock may be subject to SEC insider restrictions on sale or to employer-imposed blackout periods. If the executive quits, the option is probably forfeited. If the executive is fired, the option is generally forfeited unless it is vested. If the executive dies, the post-termination exercise period is generally limited to one year. Even if the executive continues on during the full option term, how does one forecast the consequences of wars, recessions and the growth or collapse of particular employers over that period? To report one "dollar" of such highly speculative value as the equivalent of one dollar of salary paid today is debatable, to say the least.

Notwithstanding the foregoing, many U.S. surveys report—side-by-side—dollars of theoretical option value with dollars of salary paid as if they were equivalent. These surveys then compound their sin by adding the two together. Many billions of dollars of supposed option value evaporated in the 1990s. There are cases of executives reported to have received hundreds of millions of dollars of option compensation during the past ten years whose options are now underwater.

In a study of CEO pay over an approximately ten-year period ending in 2001, the Bachelder Firm found 210 CEOs (out of a much larger group of CEOs of major public companies) who were employed as CEOs by the same company for the entire period of approximately ten years. The ratio of stock option gains to salary and annual bonuses for these 210 executives over the approximately ten years was a little over 1 to 1! (By option gains I mean both realized and unrealized gains, the latter being represented by the spread in options held at the end of the period less the spread at the beginning of the period.) Over half of the gains of this group of 210 CEOs was attributable to just 11 executives (some of whom are founders or co-founders at companies like Oracle, Dell and Sun Microsystems). To the vast majority of CEOs in the United States, the 1990s were a rewarding period (with rewarding results to shareholders) but not the bonanza of extravagance suggested by the media.

D. Some Suggestions

1. Let's adopt a consistent yardstick for valuing stock options in reporting CEO pay. (I am speaking of surveys and reports on options, not accounting for options, which is a different issue.) I suggest using gains, both realized and unrealized, rather than the theoretical Black-Scholes value at the time of grant. In this connection, we should recognize that when a long-term award pays out or a stock option grant is exercised, it normally represents compensation attributable to a number of years of service, not compensation for just that one year.

2. Let's stop focusing on the outliers who attract headlines and distort the overall picture of CEO pay and instead focus on the average CEO when discussing CEO pay.

3. It would be very helpful if there was at least one common database of companies that we all could refer to—like the S&P 500. Standard and Poor's and Equilar, Inc., for example, provide such databases. Throughout each proxy season we go from surveys that in some cases cover 50 or fewer companies in a limited number of industries to surveys concerning much larger numbers of companies in many industries. When that is combined with differences in valuation methods and differences in the use of terminology, it becomes very difficult for the public to get an accurate picture of what really is happening to CEO pay.

4. When CEOs and other executives exercise stock options, it would be reasonable to require that a specified percentage of the stock attributable to the spread at time of exercise, net of shares needed to pay taxes incurred as a result of the exercise, be held for a minimum period of time.

The CHAIRMAN. Thank you, Mr. Bachelder.

Mr. Harrigan, welcome.

STATEMENT OF SEAN HARRIGAN, PRESIDENT, BOARD OF ADMINISTRATION, CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

Mr. HARRIGAN. Good morning. Mr. Chairman and Members of the Committee: It is my pleasure to be here and provide the per-

spective of an institutional investor in regards to executive compensation. I also have some suggestions where Congress could take action to help support reform on executive compensation.

I am Sean Harrigan. I am the President of the Board of Administration of the California Public Employees' Retirement System. CalPERS is the largest public pension fund in the United States, with approximately $125 billion in assets. We have long been a leading voice in corporate governance and an advocate for better alignment of interests between shareholders, the owners of companies, and management.

Executive compensation is a critical issue to investors. Compensation is truly a powerful tool that will drive behavior. Unfortunately, it can drive the wrong kind of behavior, if proper checks and balances are not in place or if the compensation schemes are just poorly constructed.

CalPERS and I believe most investors are not anti-compensation. In fact, we believe in paying competitive salaries for managerial talent and we believe it is an important tool to motivate that management. But we feel strongly that pay should be linked to long-term sustainable performance in a very, very significant manner.

Something has gone wrong with executive compensation in the United States. It is absolutely unconscionable to see that CEO pay has swollen to 400 times that of the average production worker. If I had to identify one issue that is at the heart of the problem with compensation in the United States, I would point to accountability, more appropriately perhaps lack of accountability. This is an area where we can make reform with the support of Congress.

As public market investors, we rely upon boards of directors to represent us, the owners. In the case of compensation, the compensation committee is charged with representing the shareholders. It is clear to me that a major contributing factor to this problem with executive compensation is that compensation committees are not accountable to shareholders. They obviously do not feel that approving abusive compensation packages will cost them their jobs. Rather, it appears that not approving what the CEO wants will in fact cost them their jobs. This represents the central conflict of interests inherent in the problem of executive compensation today.

Unless this fundamental issue is solved, we will continue to have widespread abuse in compensation practices. However, while the absolute levels of pay are a concern, perhaps the most troubling element of executive compensation is the "heads you win—I win, tails you lose" attitude of corporate executives. CalPERS is deeply concerned over what appears to be an attitude of entitlement in the executive suite of corporate America. Perhaps some of the more offensive entitlements are the so-called forms of stealth compensation: lavish severance packages complete with perks for life that are absolutely fit for a king. The message is that we do not have to respect you as owners and we do not feel accountable to you as owners.

We do, however, feel that there are concrete steps that can be taken to help rein in the abuse in executive compensation. Shareholders must take a more active role in overseeing directors of com-

panies in which we invest, with the goal of increasing the absolute level of accountability of the directors to the shareholders.

Executive compensation packages. CalPERS amended its U.S. corporate governance core principles and guidelines recently to call on companies to formulate executive compensation policies—and I repeat, executive compensation policies—and seek shareholder approval for those policies. Currently compensation particulars issue a statement in the proxy to briefly describe the company's compensation philosophy. The shareholder's role in this process is relegated to a distant back seat.

We believe it is a completely appropriate role for owners of corporations to approve broad policies in relation to executive compensation. Perhaps most importantly, it would force compensation committees to face shareholders with a plan and how they will use it, use it in all forms of compensation in terms of managing the corporation. This will help to shift the accountability back to where it belongs, to the owners.

Action item 1: Congress should support these recommendations and call upon the SEC and the exchanges to consider requirements that shareholders approve executive compensation policies. We believe that executive compensation policies should provide the following at a minimum: the company's desire to a mix of base, bonus, and long-term incentive compensation; the company's intended forms of incentives and bonus compensation, including what types of measures will be used to drive incentive compensation. Again, we believe companies should construct incentive plans with a significant portion of performance-based components. The parameters by which the company will use severance packages, if at all, should also be included.

Quantitative model, web site application as a research tool. CalPERS is also dedicating a portion of its web site to executive compensation issues. In the near future we will post a catalogue of extensive research available in the executive compensation arena.

Greater performance-based metrics is another major effort. We are pushing for greater use of performance-based metrics in the executive compensation plans. CalPERS recently co-sponsored a shareholders' proposal at General Electric calling for the company to make a significant portion of their option grants to top executives performance-based. The company adamantly opposed that resolution. One can only suspect that it was really because they do not want to be held to the true measure of outperformance to obtain the highest level of incentive compensation.

The CHAIRMAN. Did the measure fail?

Mr. HARRIGAN. Yes, it did.

Shareholder approval of executive compensation. CalPERS is also lobbying hard to help ensure that shareholders have the right to approve any executive-based compensation plan. While shareholders have fought the New York Stock Exchange and NASDAQ for years over this issue, it has finally come to pass that a proposed change to the listing standards includes greater shareholder approval of equity-based compensation plans.

But the fight is not over. Despite the fact that the proposed changes to the listing standard were developed last summer, the SEC has yet to implement this change. We believe this can be the

shortest rule the SEC will ever be able to issue and it can be stated in a single sentence: Any new equity-based compensation plan or material change to the existing plan must be shareholder approved.

Action item 2: Congress could join shareholders in supporting shareholder approval of all equity-based compensation plans without exception.

Finally, I would like to mention one remaining reform we are advocating and that is shareholder access to the proxy. This would provide that shareholders who meet minimum ownership thresholds could nominate directors to corporate boards through the management's proxy. While this may not appear to be particularly relevant to executive compensation at first glance, it has everything to do with accountability.

Action item 3: Congress could join shareholders in seeking fair access to the proxy.

Thank you and I would be glad to answer any of your questions.

[The prepared statement of Mr. Harrigan follows:]

PREPARED STATEMENT OF SEAN HARRIGAN, PRESIDENT, BOARD OF ADMINISTRATION, CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

Mr. Chairman, Senator Hollings and Members of the Committee, it is my pleasure to be here today and to provide the perspective of an institutional investor in regards to executive compensation. I also have some suggestions where Congress could take action to help support reform in executive compensation.

I am Sean Harrigan, President of the California Public Employees' Retirement System (CalPERS) Board of Administration. CalPERS is the largest public pension system in the U.S., with approximately $125 billion in assets. We have long been a leading voice in Corporate Governance, and an advocate for better alignment of interests between shareholders and management.

Executive compensation is a critical issue to investors. Compensation is a truly powerful tool that will drive behavior. Unfortunately, it can drive the wrong behavior if the proper checks and balances are not in place, or if the compensation schemes are just poorly constructed. CalPERS and I believe most investors are not anti-compensation. In fact, we believe paying competitive salaries for managerial talent is an important motivational tool. But, we feel strongly that pay should be linked to long-term sustainable performance in a very significant manner.

Something has gone wrong with executive compensation in the United States. It is unconscionable to see that CEO pay has swollen to 400 times that of the average production worker. It is shocking to see example after example of top executives insulating themselves from any risk in their own compensation, and ensuring their own financial security at the same time employees are being asked to shoulder the burden of cuts, and shareholders are losing value.

At American Airlines shareholders and employees were shocked to find out that the company made a $41 million dollar payment to a fund designed to protect the pensions of executives if the company filed bankruptcy. This fact was not disclosed during negotiations to secure $1.8 billion in wage concessions despite the fact that the payment was made months before.

If I had to identify one issue that is at the heart of the problem with compensation in the United States, I would point to accountability. More appropriately perhaps to a lack of accountability. This is an area where we can make reform with the support of Congress.

As public markets investors we rely upon boards of directors to represent us. In the case of compensation, the Compensation Committee is charged with representing shareholders. It is clear to me that a major contributing factor to the problem with executive compensation is that Compensation Committees are not accountable to shareholders. They obviously do not feel that approving abusive compensation packages will cost them their job. Rather, it appears that not approving what the CEO wants is what they feel will cost them their job. This represents the central conflict of interest inherent in the problem of executive compensation today. Until this fundamental issue is solved, we will continue to have widespread abuse in compensation practices.

In the last five years alone, CEO compensation has doubled according to compensation consultants Pearl Meyer & Partners. In 1996, the average CEO at the largest 200 companies made about $5.8 million. By 2001, that figure jumped to $11.7 million.

The following table compares the trends in specific components of CEO pay to the performance of the S&P 500 for 2001 and 2002.

	2001	2002
Median base salary	Up 10.1	Up 4.2
Median cash bonus	Down 17.6	Up 8.8
Median stock option grant	Up 43.6	Down 18.6
Average restricted stock	Down 21	Up 1.3
Median overall compensation	Up 26.7	Down 10.9
Total return S&P 500	Down 11.88	Down 22.09 percent

Source: compensation data—calculated for CalPERS by Equilar (includes only CEOs that were in the position for the entire three year period); S&P 500 returns—Bloomberg

We think this shows a disconnect between compensation and performance on a broad scale. Part of our concern is that it appears companies shifted compensation from cash to options in 2001, then from options to cash in 2002—most likely due to the bear market. It is also important to note that the value of the option grants declined at least in part due to lower overall stock prices. It appears that a similar number of options are still being granted (median number of options declined only 9 percent in 2002). This was the only factor driving the median total compensation down in 2002.

However, while the absolute levels of pay are a concern, perhaps the most troubling element of executive compensation is the heads I win, tails you lose attitude of corporate executives. CalPERS is deeply concerned over what appears to be an attitude of entitlement in the executive suite of corporate America. This attitude manifests itself in many forms.

Perhaps some of the more offensive entitlements are the so called forms of "stealth compensation." Lavish severance packages complete with perks for life that are fit for a king, guaranteed pension benefits far outstripping the value of benefits provided to employees, enormous loans to executives that are eventually forgiven, and provisions providing that the company shall pay all the taxes due (including gross-up provisions) should the executive incur a tax liability all send a clear message to shareowners. The message is that we do not respect you as owners, and we do not feel accountable to you as owners.

In other examples demonstrating a lack of respect for shareholder's capital:

> Delta Airlines, Leo Mullin will be credited with 22 years of service toward his pension upon termination, plus two additional years in a Supplemental Retirement Benefit. The company also put $25.5 million in a protected pension trust for him according to press accounts.
>
> Home Depot has an employment contract that includes a $10 million loan with predetermined criteria for forgiveness in addition to base salary, 2,500,000 stock options (plus annual increments of no less than 450,000 more options), a target bonus of between $3,000,000 and $4,000,000, deferred stock units (750,000 in 2002), pension benefits and change in control provisions that include (if the executive leaves for good reason or for any reason within 12 months) $20,000,000, immediate vesting of options, and immediate forgiveness of any outstanding loans and payment of the gross-up for taxes.

We do however feel that there are concrete steps that can be taken to help reign in abusive executive compensation. Shareholders must take a more active role overseeing directors at the companies in which we invest with the goal of increasing the absolute level of accountability of directors to shareholders must be increased. There are also several improvements to the structure of compensation programs that we believe can have a dramatic effect on rationalizing executive pay. Let me briefly go over the steps CalPERS is taking in the area of executive compensation and mention some of the specific proposals we have made to improve the alignment of interests.

Executive Compensation Policies

CalPERS amended its U.S. Corporate Governance Core Principles and Guidelines recently to call on companies to formulate executive compensation policies and seek shareholder approval for those policies. Currently, Compensation Committees issue

a statement in the proxy to briefly describe the company's compensation philosophy. Shareholders role in this process is relegated to a distant back seat. In discussions with companies about this issue, they often state emphatically that only the board has the right and the expertise to manage the affairs of the company and particularly the issue of compensation. Companies state that the Compensation Committee must have the flexibility to attract and retain executives and that shareholders should essentially trust them to do the right thing. Yet the behavior of corporate America in regards to executive compensation indicates otherwise.

We believe it is a completely appropriate role for owners of a corporation to approve broad policies in relation to executive compensation. Perhaps most importantly, it would force Compensation Committees to face shareholders with a plan on how they will use compensation of all forms in managing the corporation. This will help to shift the accountability back to where it belongs, to the owners.

Action item 1: Congress could support these recommendations and call upon the SEC and the exchanges to consider requirements that shareholder approve executive compensation policies.

We believe that executive compensation policies should provide the following, at a minimum:

The company's desired mix of base, bonus and long-term incentive compensation;

The company's intended forms of incentive and bonus compensation including what types of measures will be used to drive incentive compensation. Again, we believe companies should construct incentive plans with a significant portion of performance based components;

The parameters by which the company will use severance packages, if at all.

Quantitative Model—Website Application as a Research Reference Tool

CalPERS is also dedicating a portion of its website to executive compensation issues. In the near future we will post a catalog of extensive research available in the executive compensation arena. We are also developing a quantitative model that we will apply to our U.S. indexed holdings to help identify on a more systematic basis where compensation abuses are occurring. The model will be used to identify companies where performance and compensation diverge by analyzing peer relative and market relative compensation measures along with performance data. It is our intent to use our website to highlight cases of egregious compensation much in the way we have used public means in our Focus List of under-performing companies.

Greater Performance Based Metrics

In another major effort, we are pushing for greater use of performance based metrics in equity compensation plans. Standard at-the-money fixed price options—those with the strike price set at the current market value of the stock on the day of the grant—have been used extensively in the United States, and have become the largest single component of CEO pay. While fixed price options do have some merit as an alignment tool, they are inferior in many ways to performance based plans. Yet companies have been reluctant to say the least to adopt performance based equity plans. CalPERS recently co-sponsored a shareholder proposal at General Electric calling for the company to make a significant portion of their option grants to top executives performance based. The company adamantly opposed the resolution, they said because not many companies are using these types of equity grants. One can only suspect that it was really because they do not want to be held to true measures of outperformance to obtain the highest levels of incentive compensation. It is easy to see why shareholders and management differ on these issues.

Shareholder Approval of Equity Based Compensation

CalPERS is also lobbying hard to help ensure that shareholders have the right to approve any equity based compensation plan. Under current exchange rules, companies are not required in certain circumstances to obtain shareholder approval to adopt equity-based compensation plans. In other words, companies are allowed to unilaterally dilute the equity owners of the corporation. It is ridiculous to think that an owner should not have the right to decide if he or she is willing to dilute their equity, no matter what the purpose. It is even more ironic when you consider the fact that boards and management have a significant self interest in adopting equity based compensation plans.

While shareholders have fought the NYSE and NASDAQ for years over this issue, it has finally come to pass that the proposed changes to the listing standards include greater shareholder approval of equity based compensation plans. But the fight is not over. Despite the fact that the proposed changes to the listing standards

were developed last summer, the SEC has yet to implement this change. Most troubling of all, the exchanges are seeking a number of exceptions to shareholder approval that would continue to let companies unilaterally dilute equity owners. We are opposed to these exceptions. We believe this can be the shortest rule the SEC will ever be able to issue, and it can be stated in a single sentence: Any new equity based compensation plan or material change to an existing plan must be shareholder approved.

Action item 2: Congress could join shareholders in supporting shareholder approval of all equity-based compensation plans without exception.

Shareholder Access to the Proxy

And finally I would like to mention one remaining reform we are advocating, shareholder access to the proxy. This would provide that shareholders who meet minimum ownership thresholds could nominate directors to corporate boards through management's proxy. While this may not appear to be particularly relevant to executive compensation at first glance, it has everything to do with accountability. With responsible yet meaningful reforms to the SEC rules governing access to the proxy, shareholders will be given greater ability to hold directors accountable for poor performance. As I mentioned earlier, we believe this has a material impact on their behavior and on the quality of their representation of shareholder's interests. This has an obvious impact on our ability to right the ship when it comes to compensation.

Action item 3: Congress could join shareholders in seeking fair access to the proxy.

Thank you, I would be glad to answer any questions that you may have.

The CHAIRMAN. Thank you, Mr. Harrigan. Would one of the reasons why your measure was not approved, was it because of proxy voting?

Mr. HARRIGAN. Yes, I believe it was.

The CHAIRMAN. One question for the entire panel. Is the issue of executive compensation, excessive executive compensation, having a negative effect on investor confidence? Beginning with you, Mr. Clapman?

Mr. CLAPMAN. Yes. I started off by saying that executive compensation in a sense is a window into broader corporate governance issues. I testified before a House Committee last year at a time right during the Enron scandals, pre-WorldCom scandal, and really strongly advocating reform in the corporate governance system of the United States, much of which was eventually promulgated in stock exchange rules, which I share with my colleagues on this panel the SEC should approve as quickly as possible.

But I put it in the context of investor confidence because when investors see, as they have seen, articles from responsible business organizations saying you bought, they sold, and the whole issue of executive compensation essentially communicating to the investing public that in effect you were foolish to rely on the markets, you were foolish to think that the accounting integrity of the numbers that you relied on was something that a prudent person should—so I think broadly speaking executive compensation is one component, albeit a very major component, in restoring investor confidence in the whole corporate governance mechanism in this country, and until we do that we are as a large investor—I said earlier 3 million people rely on us for their pension benefits and for their savings, and we have a fiduciary responsibility to those people. That is why we have the proactive corporate governance program that we have. And until that confidence is restored, I think all of us have a problem, the Congress and all the people on this panel.

The CHAIRMAN. Mr. Silvers?

Mr. SILVERS. Mr. Chairman, I think I would certainly agree with what Peter just said. I would add to that that executive compensation and the pressures that CEOs place on their corporate governance structures have proven to be an enduring feature of our corporate economy. I think last year and two years ago we saw the events at Enron, the events at WorldCom. In the last few months we have seen the events I alluded to in my testimony at American Airlines, at Sprint, where the whole—in many of these companies, the whole corporate governance structure was warped essentially by CEO pressures to get more compensation, frankly. At Sprint——

The CHAIRMAN. And they want Congress to leave that issue alone. Yet in the case of the airlines, they will come to Congress for billions of dollars in bailout. So there seems to be a little bit of double standard here.

Mr. SILVERS. No question about it, Mr. Chairman.

I would just add that what you are seeing here, for example at Sprint, is that the outside audit function was compromised at that company by their involvement in creating tax-favored executive comp packages. That has consequences for investors' perception of the auditor as an independent watchdog, which is absolutely at the heart of any investor confidence.

Finally, as I mentioned in my testimony, to the extent that CEO pay and the political dynamics surrounding CEO pay appear to be compromising our accounting system, the system of GAAP, we run the risk as a financial marketplace of being viewed as having a culture of non-transparency and insiderism that is not correctable. That perception came to dominate the market's views of a number of countries in the late 1990s, much to their detriment, countries in East Asia that were viewed as darlings of investors, who then the global marketplace viewed as simply unable to correct themselves. With the continuation of executive comp-driven scandals that impugn auditors and suggest that our executives are not accountable and the possibility that our accounting system will continue to be influenced by the ability of executives and their representatives to essentially warp the judgments of accounting professionals, we run the risk of being perceived just as those Asian tigers were.

The CHAIRMAN. Mr. Hall?

Mr. HALL. I do not have anything much to add, other than to agree with what has been said and add that the silver lining is that, even though investor confidence has been—has taken a big hit, the good news is that this has also led to an impetus for change, particularly in the area of accounting. So I think actually investors have reason to be hopeful as long as these changes are carried through.

It is very hard to do anything in a period like 1999 or the year 2000. It is just very hard to make changes in a period of asset bubbles.

The CHAIRMAN. Mr. Bachelder.

Mr. BACHELDER. CEO pay has not been immune from criticism for very long at any time over the——

The CHAIRMAN. My question was: Is the present issue of CEO compensation having a negative effect on investor confidence today?

Mr. BACHELDER. I doubt that it does, and I doubt that CEO criticism over the past 50 years has had much effect on the ups and downs of the stock market.

The CHAIRMAN. Thank you.

Mr. HARRIGAN. I would agree with my three colleagues to the far right, my far right. I think it has had and continues to have an impact on investor confidence. I mean, every day you read about abuses in the newspaper—American Airlines, WorldCom, Global Crossings, etcetera, etcetera. But it is not just the abuses we read about in the newspaper. It is the level that executive compensation has gotten to, the fact that it has increased from 40 times the average pay of a production worker in 1980 to over 400 times. Some statistics indicate it is up to 575 times that of a production worker today, and it continues to rise.

Mr. Bachelder in his comments indicated that executive compensation actually dropped in 2002. While that is true on the average, at the S&P companies it dropped by 23 percent, when you figure out what the median was, because there is a few at the very top that dropped, actually the median executive pay in the year 2002 rose by 14 percent while the S&P was down 22.1 percent.

So this behavior just continues and continues and continues. Until compensation committees and boards actually become accountable to the owners, to the shareholders of companies, I do not see any end in sight and I do not see any alleviation of the real breach that has occurred between boards and investors.

The CHAIRMAN. Mr. Bachelder, I know you want to respond. Let me just say while you do, Mr. William McDonough, the President of the New York Federal Reserve Board and newly named head of the SEC's Accounting Industry Oversight Board, called current CEO pay levels, quote, "terribly bad social policy and perhaps even bad morals." That is Mr. William McDonough, who is one of the most respected men I know in America, who has just received a very significant appointment.

But I also want you to respond to Mr. Buffett's statement, quote: "One of the arguments was that options are too hard to value." This is Warren Buffett: "That is nonsense. I have bought and sold options for 40 years." So Mr. Buffett is able to figure out the value of options. He says: "I have bought and sold options for 40 years and know their pricing to be highly sophisticated. It is far more problematic to calculate the useful life of machinery, a difficulty that makes the annual depreciation charge merely a guess. No one, however, argues that this imprecision does away with a company's need to record depreciation expense. Believe me, CEOs know what their option grants are worth. That is why they fight for them."

I would be glad to hear your response to Warren Buffett, Alan Greenspan, Paul Volcker, and a broad variety of most highly respected men in America, but especially Mr. Buffett, who deals with this, who trades, he has bought and sold options for 40 years. Go ahead.

Mr. BACHELDER. Mr. Chairman, could I just add one note to my prior statement. I think we need to distinguish those relatively iso-

lated cases, important and terrible as they are, of corruption in major U.S. corporations from the question of CEO pay. CEO pay exists and it exists in terms of statistics as well as individual cases, and on the whole I do not believe CEO pay has grown outrageously, and I think stock options at the present time based on Black-Scholes valuation are a very misleading factor as to the level of CEO pay.

With regard to Mr. Buffett and the question as to whether or not you can value a stock option, Mr. Buffett was referring to having been in the business of trading options. I do not disagree that if you are in the business of trading options that you can put a value on an option that is freely tradable three months, six months out. But try to value an option that is out for ten years. It is virtually impossible to forecast all the various elements that are going to happen in a decade and will impact on that option to put any kind of realistic value on it.

The CHAIRMAN. I guess Mr. Buffett's response is it is just as hard or harder to calculate the useful life of machinery.

Go ahead, Mr. Hall, and then I will go to Senator Breaux.

Mr. HALL. I was just going to say that a standard accounting principle is that even when things are hard to measure we do not call them zero. We just never do that. There are many other things that are hard to value. Another one, for example, is stock. Stock is not freely traded, so you cannot just use the market value. It may be forfeited because it is vested, and it could also fall in value. In fact, it could fall all the way to zero if a company goes bankrupt, in which case the accounting statements would have been incorrect along the way.

We never seem to use the principle of saying something is difficult to measure, therefore we call it zero, and I do not see any reason why we should use it here.

I agree with the points that Senator Allen made earlier about options being a fantastic device in many ways for corporate America, and the only question is that we should account for them correctly, not that we should quit using them.

The CHAIRMAN. Senator Breaux.

Senator BREAUX. Thank you, Mr. Chairman, and thank all the panel members for a very informative set of testimony from all of you.

I agree with Mr. Harrigan's last comment that until compensation committees and shareholders get involved in what is happening in their own companies we are never going to solve this problem. I mean, that is their first line of responsibility, is making sure the company is being run properly and that people are being paid properly. That is their job, that is their responsibility. That is why they are what they are, and they in many cases are not living up to that responsibility.

Mr. Clapman, you talked about on page 6 of your testimony, after you made a number of very helpful recommendations, you say: "Congress should be careful not to politicize this issue and should permit FASB to take on this issue on its intrinsic merits." I guess probably you are speaking of the question of expensing options. Are you saying that Congress should stay out of it and FASB should do it, or should we be involved from your standpoint?

Mr. CLAPMAN. Senator Breaux, you have it exactly correct. As you know, a number of years ago the issue arose, so this is not a new issue, the issue of expensing stock options, and at that point it became politicized and FASB backed off from dealing properly in our eyes with that issue.

I think people have seen—there is a difference now, obviously, between 2003 and 1993 in terms of our experience, and I think our experience now tells us that we really are trying to analyze this issue in terms of future implementation of compensation programs and that is the true relevance of this issue. We can all hash out the past and try to explain it, but finally our task, all of us here, yours and ours, is to find effective means to deal with the issue of executive compensation and corporate governance in the future.

I think the most important point I tried to make is that a true alignment between shareholders and management is something that relies on performance measures, not just the vagaries of short-term stock performance, but long-term alignment, holding stock and having performance hurdles. And until FASB or the accounting regulators get the issue of expensing right, you will crowd out all of the better forms of alignment methodologies and rely only on the short-term stock effect. So that is why that issue is so critical in terms of what it will mean for the future.

Senator BREAUX. Your recommendation, though, is that Congress should butt out of it and let them do it?

Mr. CLAPMAN. Yes.

Senator BREAUX. Mr. Bachelder, you tried to make the point in the first page of your testimony, in comparing CEO pay, compensation packages, as a percentage of revenues, and that you point out that—I guess you are making the argument that actually CEO pays and bonuses and salaries are less today than they were ten years ago as a percentage of revenues.

Mr. BACHELDER. Yes.

Senator BREAUX. Is that also true of employees as well as the CEOs?

Mr. BACHELDER. I think that it is true of employees as well as CEOs. I think the point is that the CEO pay relative to the growth of U.S. corporations, whether measured by revenues or measured by market capitalization, has not been out of line. These gentlemen and women who are the CEOs of these corporations are custodians and fiduciaries of enormous masses of capital and revenues, and the pay relative to those, to that capital and those revenues, has not changed significantly.

Senator BREAUX. What do you say when you see CEO compensation packages that have actually increased by huge amounts by companies that are losing revenues?

Mr. BACHELDER. It depends upon what you mean by the CEO pay package. If one is referring to stock options, say an executive is a CEO of a company today that is in 2002 losing, has lost money. That individual may have stock options dating back ten years and those options may be exercised in that year. That person may realize substantial gains for having held the options for ten years. That is not attributable to the performance of the company in 2002.

Senator BREAUX. Yes, but we are also seeing examples where CEOs have gotten enormous increases, not in options but in sala-

ries and bonuses, for companies that are going in the downhill direction.

Mr. BACHELDER. Generally speaking, salaries have a consistent rate of increase and over the past 50 years, after taking into account inflation, it has been about just under 2 percent. You are speaking to the bonuses then. Bonuses vary. It depends—I do not know of a case where a company has had a significant loss for the year in which an executive, a chief executive, has received a large bonus unless it was contractually bound prior to that year. And in some cases a new chief executive officer, such as one going into Tyco or in other instances, when they go into the company they may have a right for a year or two to have a bonus. That is a guaranteed bonus.

Generally speaking, annual bonuses follow the performance of the company.

Senator BREAUX. I am sure Mr. Hall or Mr. Silvers could give us some examples of those situations. But I mean, we have clearly seen executive compensation packages that seem to me to have very little to do with performance. I mean, I think when a company does well the employees should do well; when the company does bad, the employees, including the CEOs, have to participate and not get huge increases.

Mr. BACHELDER. If I might just respond, when you use the term "packages" that is a very important term of reference, because so many spokesmen, so many media commentators and others refer to a CEO package which is on different tracks, whether it is a salary, annual bonus, long-term incentives, stock options, and they put the package together and say this person received $50 million this year and the profits went down. Well, most of that may well have come from exercising an option that that individual had held for years.

Senator BREAUX. My final question. Thank you. Mr. Silvers, you talked about the AFL–CIO filing a rulemaking petition with the SEC asking commissioners to democratize the director election process, and Mr. Harrigan I think talked about the fact that directors have got to wake up, particularly people who run compensation packages, and it is too much of a collusion between the CEOs and the directors and the compensation committee members.

How do we do that? I mean, thou shall pass a law that says thou shall have democratically elected boards? What is the process here? How do we accomplish this?

Mr. SILVERS. Fortunately, Senator, I do not think it is necessary for you to pass a law. The question here is really the control of the proxy form itself by management. In a company, in a public company of any size, it is prohibitively expensive for shareholders who hold small fractions of that company to themselves nominate and run a director election contest and send out their own proxy. In a large cap company, any of the familiar names to the average person, the costs of doing so run into the millions of dollars.

Management is spending corporate treasury money to run its slate of candidates. The SEC has the rulemaking authority and has used it to require that that proxy that management creates include in certain circumstances shareholder proposals. Those shareholder proposals, however, are generally not binding.

It is our opinion that the SEC by rulemaking could require in certain circumstances management to include shareholder-nominated director candidates on that proxy and offer shareholders the choice of voting for management's slate or a shareholder-nominated slate. We believe it is very important—we believe, A, that that is very important to be done, that if we are going to make boards real there has got to be some meaningful way of shareholders affecting what is on the boards.

However, we do not think that this ought to be done in such a way as to essentially subsidize corporate takeovers. If you want, someone wants to do a corporate takeover, they should have to spend money to do it. The trick is to create a mechanism that gives shareholders some voice, and a particular kind of shareholder—large, long-term institutional holders whose interests are closely aligned with that of the company going forward, as corporate law defines the company's interests, the long-term interests of the company and its shareholders.

We believe that can be done and our rulemaking petition asks for that to be done by requiring companies to place on their proxy form shareholder-nominated directors for a minority of the seats up for election, what is called a short slate, but only to do it if asked by a significant block of shareholders. Now, we suggest in our rulemaking petition 3 percent of the company's shareholders have to ask. Others have suggested higher numbers, 5 percent, 10 percent. Because of the Williams Act that governs takeovers and shareholder action, those higher thresholds have some complexity, some complex issues associated with them.

But the basic notion is that you have to require a block of shareholders that is a real block, not a gadfly, not somebody who is doing this for a hobby, but a real block of large investors. You require that they have held the stock for some time, so this does not become a vehicle for people coming in and out of the company and trying to game the system. Also, you give them the opportunity to run on an economical basis short slate that would give voice to long-term investors on the board.

We believe that if that rulemaking petition were adopted by the SEC—once again, it does not require Congressional action; the commission can do it by rulemaking—that that would change the board's dynamics around executive pay, that it would make comp committees much more attentive to the desires of shareholders like TIAA–CREF, like CalPERS, like our large pension funds, and less deferential to the desires of the CEO.

Only by doing that can you create a real market. And I respectfully disagree with Mr. Bachelder; I do not think in general we have a real market here.

The CHAIRMAN. Senator Allen.

Senator ALLEN. Thank you, Mr. Chairman.

I think we all agree, at least I believe we do and I certainly believe, that we must continue to enforce the laws, we need to improve corporate accountability, and we need to provide investors with an accurate depiction of the financial condition of corporations, and that is whether it is an individual investor or large ones like TIAA–CREF or CalPERS or any others.

I have enjoyed listening to the testimony. I will make a few observations and ask a few of you some questions, and some are very logical on aspects—the issue of stock options, I would say to Mr. Hall, is not so much—it is not an issue of expensing, because I do think it is very difficult to determine what the value is of a stock that is going to be or the exercise of an option ten years down the road. They are not traded like the Board of Options. There is only one person, and that is the person it is granted to, that can exercise it. It is not freely traded. It is really a matter of dilution and how you accurately depict that dilution when and if they are actually exercised.

Mr. Harrigan talks about a certainly reasonable consideration and that is performance-based compensation. I like that concept. That is the way it ought to be. It would seem to me, though, that long-term stock options would be a method by which that performance long-term—not these three-month, six-month, which probably ought to be expensed because those can be. Those do have a value that you can determine, but not something five or ten years down the road.

Now, in looking at how you—you brought up American Airlines and that, Mr. Silvers, in your comment and others. Well, that CEOs misdeeds, poor judgment, and egregious behavior, there was reaction. The board of directors removed him, and so there were consequences, and I applaud the American Airlines board for acting.

The idea that you cannot figure out the cost of options because they are inaccurate, but, gosh, there are other inaccuracies in determining depreciation of machinery or equipment. Well, with machinery and equipment you know what you paid for it. Maybe somebody paid $30,000 for some machinery or equipment. The IRS says you could depreciate that equipment, say it is some types of equipment, three to five years. Others are ten to fifteen years. But there is an actual value to it.

Now, Mr. Silvers, you mentioned in your testimony, written testimony, that there is a crisis in executive compensation that is a microcosm of the crisis in corporate governance that brought us Enron, WorldCom, and HealthSouth and so many others. Let me add a couple other names to your list of corporate wrongdoers: Union Labor Life Insurance Company, where union leaders created a scheme to give themselves $6.5 million while costing millions of workers their pension funds they were entrusted to and invested in in this Union Labor Life Insurance Company. I will put this into the record, an article from the *Wall Street Journal* on that.

[The information referred to follows:]

Wall Street Journal, August 20, 2002

REVIEW & OUTLOOK—BIG LABOR'S ENRON

AFL–CIO chief John Sweeney is having a high old time with business scandals, condemning "corporate greed" and capitalist "thieves." Yet his acute moral antennae have somehow missed the shenanigans at Union Labor Life Insurance Co., or Ullico, a labor-owned insurance company that looks like Big Labor's Enron.

Last week the National Right to Work Legal Defense Foundation asked the National Labor Relations Board to investigate if Ullico's board members—all top union officials—profited at the expense of rank-and-file union members in a dubious stock-

selling scheme. A federal grand jury and the Labor Department are also probing those stock transactions.

Ullico was founded in 1925 as a way to provide low-cost life and health insurance to union members. The insurer is privately held, and to ensure labor control it allows only unions, as well as officers and directors, to buy its stock. For years a share of Ullico was fixed at $25.

In the go-go 1990s, however, Ullico decided to join the pursuit of stock-market riches. In 1997 the company invested $7.6 million in a modest little venture known as Global Crossing. By May of 1999, when Global Crossing's stock peaked, Ullico's stake was worth $2.1 billion—almost 10 times what all of Ullico was worth when it first invested.

As Ullico's investment grew, it decided to cut its stockholders in on the windfall. It abandoned its old fixed valuation of $25 a share and began adjusting its share price annually, as determined by a year-end accountant's review. The board would ratify the new price, and then Ullico would repurchase shares to allow investors to realize gains. And so in May of 1999, the Ullico board ratified a share price of $53.94, and went ahead with a plan to buy back as much as $15 million worth of shares from investors.

But here's where things get Enron-esque. In December of 1999 Ullico's chairman, Robert Georgine, sent a confidential letter to the company's senior officers and directors offering to let them buy as many as 4,000 Ullico shares at the $53.94 price. But two weeks later, a year-end audit pointed to a higher price of $146, which the board ratified in May 2000. Those insiders were in effect ratifying nearly a tripling in value of their own Ullico investments.

By then, however, the telecom bubble had begun to burst. By November 2000, Ullico's investment had fallen dramatically (Global Crossing's shares had dropped below $25 from a high of $64.25), but the Ullico directors authorized another stock buyback—and at the same $146 price.

That buyback was technically open to all shareholders. But it was crafted so that large shareholders—mainly the unions—faced restrictions on how much they could sell. Meanwhile, those with small holdings—officers and directors—were allowed to sell back all of their shares. And the board agreed to extend the sell deadline by five months. As a result of prices and buyback rules that they themselves had set, a handful of directors made a windfall estimated at $6.5 million.

These weren't just any old union members, either. Among those who sold back shares were Martin Maddaloni, president of the plumbers union; William Bernard, former head of the asbestos-workers; Jacob West, former ironworkers' chief; carpenters' president Douglas McCarron; and Morton Bahr, president of Communications Workers of America.

So at the same time that the value of Ullico was falling like a rock, these insiders made out like, well, Andrew Fastow. These union bigshots insist they've done nothing wrong, but that's what Enron executives also say. "These leaders have damaged millions of workers' pension funds which were entrusted to and invested in Ullico," says National Legal and Policy Center President Ken Boehm. Mr. Georgine and Ullico decline comment.

Mr. Sweeney has said that he himself did not sell any shares, and he publicly called on Mr. Georgine to appoint an outside investigator. (Former Illinois Republican Governor James Thompson is leading the probe). But what Mr. Sweeney hasn't done is turn his moral indignation loose on his labor peers as he has so often against corporations.

As long as we're talking about blind eyes, we might also mention the quiet in Congress. Perhaps it's a coincidence that Ullico is a big political donor, especially to Democrats, and that Ted Kennedy, who runs the Senate labor committee, was also an Ullico donee his last re-election. More alarming is the fact that Iowa Democrat Tom Harkin is insisting on language in an appropriations bill that would block greater public disclosure by unions. In the wake of the Ullico fiasco, that's a scandal in its own right.

We look forward to the result of the Labor and Thompson probes, especially given that 10 of the current Ullico board members also sit on the AFL–CIO's executive council. If it turns out there was corporate abuse, no doubt Mr. Sweeney will deal appropriately with the "thieves."

Senator ALLEN. I would also like to mention another corporate scandal, one where the American Federation of Teachers failed to maintain oversight of the Washington, DC Teachers Union—this is just a recent story—resulting in the theft of more than $5 million

by union leaders. And I will ask that these be put as part of the record.

[The information referred to follows:]

Labor Watch, March 2003

TEACHERS UNION SCANDAL IN THE NATION'S CAPITAL

WASHINGTON TEACHERS UNION OFFICIALS EMBEZZLE MILLIONS, SULLY CITY POLITICS

By Patrick J. Reilly

Summary: Last month we reported on the Ullico scandal, a major embarrassment to AFL–CIO president John Sweeney who had publicly ridiculed Enron executives for their ethical lapses. Once again we find that a vocal critic of Enron is embarrassed by scandal in her own ranks. Sandra Feldman and the American Federation of Teachers failed to maintain careful oversight of the Washington Teachers Union, resulting in the theft of more than $5 million by union leaders. Here we take a look at the unfolding story and the characters who play major roles.

Sandra Feldman, president of the American Federation of Teachers (AFT), thinks the corporate scandal at Enron highlights what's most admirable in public education and what's most lacking in private schools.

"Unlike the private sector, public agencies and their employees received systematic monitoring and oversight," Feldman told AFT delegates to the union's annual convention last summer. "And that's a good thing. Just look at Enron."

But when Feldman repeated her rant against Enron in her January 15 "Where We Stand" column, a paid advertisement that is placed in newspapers nationwide, her hypocrisy was obvious even to AFT members. By that time they knew of the major scandal uncovered at AFT's affiliate in Washington, DC and caused in part by AFT's failure to enforce its own oversight rules.

The day after Feldman's Enron column appeared, AFT appointed an administrator to run the Washington Teachers Union (WTU)—the first forcible takeover of a local union since AFT's founding in 1917. It was an embarrassment the likes of which AFT has never seen, and the scandal just keeps unfolding daily.

Millions Misspent

WTU officials might still be plundering the union were it not for a single mistake made by WTU president Barbara Bullock last April. Bullock told District of Columbia finance officials to withhold $160 in union dues from special paychecks sent to teachers as part of a newly contracted pay raise. But teachers actually owed only $16, resulting in an overcharge of more than $700,000.

No one may ever know whether the overcharge was a mistake or intentional. But about the same time, Bullock paid about $700,000 to AFT to cover national dues payments that were years late.

It was then that teachers began to complain about the overcharge, prompting AFT to take notice and initiate an internal audit of WTU's finances.

AFT should have known there was a problem years prior to the audit. Indeed, AFT rules require affiliates to conduct internal audits every two years, but WTU had not done so since 1995. AFT repeatedly requested an audit but took no action against the union, which reportedly had not even employed an accountant since 1996.

By last year, WTU was in financial trouble. The union had to settle a lawsuit filed by its landlord for failure to pay rent on its downtown DC headquarters. Many bills were late or unpaid, including companies providing employee health benefits. The dues overcharge only made matters worse: recently the union had to take out a $250,000 loan to reimburse teachers, saddling the union with repayment of the loan plus interest. (AFT later announced that it would pay off the loan.)

The results of AFT's audit were stunning. Auditors found that at least $5 million in union funds had been misappropriated by WTU officials, including president Barbara Bullock, her special assistant Gwendolyn Hemphill and treasurer James Baxter. The three had boldly used union credit cards and cashed checks for thousands of dollars that were used for personal expenses.

A week before Christmas, FBI officials raided the homes of the WTU leaders and their family members, seizing business items and an astonishing array of personal clothing, jewelry, and household items allegedly purchased using WTU credit cards and other funds.

On December 27, Nathan Saunders, a history teacher at Anacostia Senior High School, filed suit in U.S. District Court against WTU and AFT claiming fraud and negligence due to the union's failure to conduct audits required by AFT. He asked

the court to dissolve the WTU's executive board and establish an independent body to oversee the union and hold new board elections.

Two other teachers—Alfred Hubbard and Roland Ashby-Rier—also filed suit asking the federal judge to ensure that teachers continue to have some role in overseeing the union. Last month, another four teachers filed suit seeking class-action status on behalf of all DC teachers.

The scandal continues to grow as District and federal investigators uncover not only the theft of WTU funds but inappropriate meddling by union officials in District politics and city government. The allegations are causing major headaches for the District's mayor Anthony Williams just as he begins his second term.

As the scandal unfolds, it's difficult to piece together the story of what may be one of the worst cases of union corruption in many years. But a review of the major players in the scandal offers a glimpse of how far-reaching the investigation has already become.

Barbara A. Bullock

Barbara Bullock was WTU president for almost a decade, beginning in 1994. For almost the same period of time, she allegedly stole more than $2.1 million from the union's members.

An FBI search warrant filed in U.S. District Court alleges that Bullock charged WTU for personal goods and services worth more than $1 million, including a $57,000 Tiffany sterling silver set and several hundred thousand dollars on expensive clothing and jewelry. But WTU's internal audit identifies more than $1.8 million in personal charges to the union's American Express account and more than $381,000 in union checks applied to personal expenses. The auditors' report also says Bullock issued more than $1.5 million in union checks with the intention of laundering money. Bullock reportedly admitted to auditors that "most of her charges to the American Express charge account were for personal items."

Over the span of two weeks in August 2000, Bullock made four contributions totaling $9,000 to the Democratic National Committee. The final gift of $5,000 was assigned to non-federal campaigns, possibly in the District of Columbia. That same year she gave $2,000 to Hillary Rodham Clinton's U.S. Senate campaign. All of the payments, according to WTU's internal audit, were charged to the union's American Express account.

Labor Watch has also identified a previously unreported contribution of $1,000 that Bullock made to the Gore 2000 presidential campaign in June 1999. Although the source of the funds is unknown, Bullock allegedly was stealing from the union at the time.

Ironically, Bullock seized the presidency in 1993 because of the troubles of then-president Jimmie Jackson. Jackson won reelection that year over Bullock, but the AFT declared the count invalid because of "many irregularities" in the voting procedures. Bullock won the second election.

Bullock's emphasis on politics earned her tremendous clout in the District. In an internal memo to WTU members dated August 26, 2002, Bullock urged them to help Mayor Williams' write-in campaign, noting that "Williams' support was critical in getting your 19 percent raise and the prepaid legal plan for which several council members were also in line with their support." The promise of payback at the polls was genuine: all of the WTU-endorsed candidates—including Williams, DC Delegate Eleanor Holmes Norton and six members of the DC Council—won their races last November.

The benefits to the union were apparent to all. The prize Bullock sought throughout her term as WTU president was a huge increase in District teachers' pay to bring it in line with salaries in the Maryland and Virginia suburbs. Williams was not shy about publicly supporting Bullock's proposal, which she eventually won with a contract last year that increased teacher salaries by 19 percent over three years. At Bullock's urging Williams pushed for the plan, even though he had already forced the District school board to trim its budget by $30 million, pulling $15 million away from much-needed repairs of the city's dilapidated school buildings.

Even one of Williams' appointees to the school board lamented the salary increase as "a terrible message to be sending to our students."

"The price that we are paying for this contract is going to be at the expense of our students," said board member Laura Gardner to the *Washington Post*. "And I think that we constantly, constantly send a message to our students when we do this that everyone except them is worthy of some consideration."

But Williams' involvement didn't end there. The school board intended to meet its cost-cutting goal partly by eliminating $1.1 million in personal legal assistance to District teachers, a special benefit that was also taken off the bargaining table in contract negotiations—or so school officials thought. After WTU and public school

negotiators shook hands on the contract, Williams' chief of staff Kelvin Robinson and deputy chief of staff Gregory McCarthy reportedly demanded that school officials write the benefit into the formal contract.

Gwendolyn M. Hemphill

A major player behind Bullock's political success and her scheme to steal millions from the union was her special assistant, Gwendolyn Hemphill.

It was in large part because of Hemphill's many years of experience as a DC political insider that WTU was able to hold sway over District officials. She first got involved in DC politics in 1963, when she joined activist Marion Barry—later DC mayor and a disgraced felon—in a civil rights demonstration. She later worked for the Federal Government and the American Federation of State, County and Municipal Employees (AFSCME) before chairing former mayor Walter Washington's campaign in 1974. Subsequently Hemphill was Mayor Barry's labor liaison for three of his four terms and retired from city service in 1996 to assist Bullock at WTU.

When Anthony Williams became mayor in 1998, Hemphill quickly became a key advisor. Williams appointed her to his Finance Committee and Employee Appeals Board, and she became executive director of the DC Democratic State Committee. In 2001, Hemphill hosted a lavish party at her home to welcome Williams' new chief of staff Kelvin Robinson.

Stories of Hemphill's influence in DC politics are numerous. Mayor Williams allegedly instructed Mark Jones, then his chief of staff, to hire Hemphill's husband, Lawrence Hemphill, as director of the DC Office of the Public Advocate and later director of the Office on Community Outreach. (Williams fired him in January because of the WTU scandal.) Jones also says the mayor told him to prevent the firing of Michael Bonds, a community service representative who worked with Lawrence Hemphill, noting that "Barbara [Bullock] and Gwen [Hemphill] don't want him fired." Jones is currently suing Williams over his firing after he allegedly solicited money from nonprofit organizations for Williams' reelection campaign.

In hindsight, Hemphill's spending beyond her means and her repeated proximity to scandal might have indicated that problems were brewing. The same woman who threw lavish parties already had a history of financial trouble, including bankruptcy in 1986 and a 1984 appeal to the District's emergency mortgage assistance fund. Federal investigators are now asking why Hemphill used a WTU credit card to pay $20,000 to the caterer for her 2001 party in honor of Kelvin Robinson, just the beginning of a long list of alleged misuses of WTU funds.

According to WTU's internal audit, Hemphill made unauthorized personal charges to the union's American Express account exceeding $311,000 and wrote checks for unauthorized expenses totaling $181,000. She allegedly used the funds to purchase a $13,000 plasma television and other luxuries for herself and family members.

Like Bullock, Hemphill made political donations during the period of embezzlement, but the source of funds is unknown. *Labor Watch* has discovered a $250 contribution last year to EMILY's List, a political action committee that supports female abortion-rights political candidates. Hemphill and her husband Lawrence also gave $1,000 to Al Gore's presidential campaign in May 2000.

Hemphill was co-chairman of Williams' reelection campaign last year, overseeing most day-to-day operations during a period when the campaign collected hundreds of fraudulent signatures, a scandal that kept Williams' name off the Democratic primary ballot and forced him to fight for reelection with a write-in campaign. Hemphill resigned from the campaign soon after the scandal became public, and although she was called to testify before the DC Board of Elections and Ethics, no charge of impropriety was ever filed against her.

But the DC inspector general is reportedly investigating Hemphill's use of WTU funds to pay for expenses incurred last year by William's reelection campaign. Hemphill claims that she acted under the impression that Kelvin Robinson, the mayor's chief of staff, wanted the union to cover the $2,000 bill when he told her to "take care of" it. But Robinson says he expected Hemphill to use campaign funds to pay for the DC voting rights t-shirts and other items distributed at the Democratic National Convention in Los Angeles.

The *Washington Post* also cites an anonymous former employee in Williams' office who claims Hemphill gave the mayor a $5,000 check in 2000. The check drawn from WTU funds was allegedly used to sponsor Christmas parties organized by For the Children, a nonprofit charity. The DC Office of Campaign Finance has ruled that the mayor's office violated city rules by soliciting money for the organization and not disclosing the gifts. Also, funds intended for children's parties were allegedly diverted to pay for a reception for Williams' supporters.

In January, the DC Office of Campaign Finance opened a new investigation to determine whether the Williams campaign failed to report contributions from WTU.

The campaign did not report use of WTU's telephone banks to get out voters as an in-kind contribution. Also under scrutiny is Hemphill's work for the campaign while a full-time employee of WTU, an arrangement that would ordinarily be considered an in-kind contribution from the union. WTU's alleged $5,000 donation for the For the Kids Christmas parties will also be investigated, as will two Williams fundraisers hosted by WTU attorney Curtis Lewis in 1998 and 2002 for which expenses were allegedly charged to a WTU credit card. The Williams campaign has turned over to federal prosecutors copies of checks totaling $33,025 that Hemphill allegedly failed to deposit for several months, far beyond the five-day limit imposed by city election laws.

Hemphill is implicated in an incident disclosed on January 17 by Philip Pannell, Democratic chairman for the District's Ward 8, to shocked listeners of a WAMU radio talk show. Pannell claims Hemphill talked to him in August 2001 about arranging for funds to support his reelection campaign. On the day of the vote, Pannell says a car pulled up, and he was handed an envelope filled with $2,500 in cash—just as Hemphill had promised, he says. Hemphill denies Pannell's account, which he presumably disclosed out of concern that he might have spent WTU funds on his campaign.

Despite her resignation from WTU and the DC Employee Appeals Board, Hemphill remained executive director of the DC Democratic State Committee until December. Even after submitting her resignation letter to committee chairman Norman Neverson, he kept the letter secret and allowed committee members to debate Hemphill's fate for three weeks before announcing her departure. Neverson seemed to be searching for a way to keep Hemphill on board, telling the *Washington Times*, "The party would be extremely impoverished without Gwen's outreach" and "We would be shortsighted to ask her to step down."

Local reporters seemed at a loss to explain Neverson's actions, but they may be just another example of a Hemphill attempt to benefit from her vast network of cronies. Hemphill and Neverson are close neighbors and have been friends for 35 years. In 1998, Hemphill convinced Neverson to return from retirement and help elect Williams mayor, an effort that landed Neverson the chairmanship of the DC Democratic State Committee.

Vice chairman Pat Elwood has requested an audit of the committee's finances, and Neverson has agreed. Although party officials say they don't expect the audit to turn up any irregularities, former committee treasurer Robert Artisst told the *Washington Times* that he had some concerns about the committee's use of a separate series of checks of which he had no knowledge. Artisst said he had noticed some checks that were not dually signed by the treasurer and another executive committee member.

Leroy Holmes

Bullock's chauffeur Leroy Holmes is perhaps the most colorful player in the WTU scandal. For his trouble driving Bullock on her shopping trips and collecting union cash from the bank, Holmes was awarded a salary of $105,000 and more than $7,000 toward expenses for his Cadillac, about four times more than a typical driver's salary in the nation's capital. He has now pleaded guilty to a federal charge of conspiracy to launder proceeds of an unlawful activity.

Holmes reportedly told WTU auditors that he routinely went to Independence Federal Bank in the District and cashed union checks made out to him, allegedly totaling more than $1 million from 1997 to 2002. The amounts were usually just under $10,000, the minimum required for currency transaction reports, but sometimes more. He allegedly would often call ahead to ensure that sufficient cash was available, cash a check, then stuff his pockets full of bills as he walked out the bank. Most of the cash would be handed over to Bullock or Hemphill—some he deposited directly in Bullock's personal account—and he would keep the rest for himself to the tune of about $100,000 a year, according to prosecutors.

James O. Baxter III

Asked in October to resign from WTU with Bullock and Hemphill, the union's treasurer James Baxter has not been the focus of much media attention. But his unauthorized charges to the union exceed Hemphill's, according to WTU auditors. Baxter is accused of charging more than $311,000 to the union's American Express account and writing union checks for $270,000 for personal use.

Court documents cite evidence that Baxter failed to accurately report his union income to the IRS and the Labor Department. He allegedly joined with Bullock and Hemphill to hire an accountant to help them hide their misconduct.

In 1997, Baxter was hired by Mayor Marion Barry to serve as director of the DC Office of Labor Relations and Collective Bargaining while also serving as WTU's

treasurer. Although the dual role was a conflict of interest in violation of District law, Baxter remained in that post for 16 months after Williams took office in 1999. Baxter was fired by Williams in spring 2000 because of the violation, but only after Bullock and Hemphill reportedly used their clout to frustrate several attempts to remove him.

Anthony A. Williams

DC Mayor Anthony Williams was confronted with the WTU scandal just weeks after his reelection campaign struggled its way to victory despite submitting fraudulent signatures to the elections board and failing to get on the Democratic ballot.

During Williams' first run for office in 1998, the WTU stood by Williams when every other city labor organization shunned him. Williams, a former chief financial officer for the District, had fired more than 200 city workers during his tenure, acts not easily forgiven by union leaders. But WTU's Bullock made a shrewd calculation that supporting Williams, who had little experience with DC schools and needed the union's help, could significantly increase the union's clout if he defeated DC Council member Kevin Chavous. WTU's endorsement is credited with solidifying Williams' victory, just as the union had ushered the infamous Marion Barry to the board of education in 1971 and the mayor's seat in 1979.

The endorsement was particularly important because Chavous was the city council's education committee chairman and an early favorite to win the race. Chavous later said WTU "gave the mayor momentum at the time because I was the education chair . . . It cut into what should have been my base. I think the mayor always felt he owed them politically."

William's close relationship with Bullock and Hemphill is now costing him dearly. He has responded testily to questions about the scandals and has attempted to distance himself from WTU.

Curtis Lewis

Last September, the former director of the DC Office of Human Rights filed a $55 million lawsuit against Mayor Williams, claiming that he was fired for refusing to violate DC contract-procurement laws. Charles Holman said WTU president Bullock pressured him in 2001 to award a $296,500 contract for handling human rights filings to the law firm Curtis Lewis & Associates. Although Holman initially refused, he says William's acting chief of staff Joy Arnold pushed the contract through. The city says Holman was fired because of worker complaints including accusations of racial discrimination.

What makes this especially interesting is that Curtis Lewis is James Baxter's brother. His firm was hired by Bullock to handle the union's legal affairs. According to WTU's internal audit, the union made "large payments to and improper health insurance premium payments of approximately $55,000" to Lewis' firm.

The *Washington Post* reports that an anonymous former official of the DC Office of Boards and Commissions says Hemphill provided Mayor Williams a list of nominees for various boards, many of whom were appointed. The official says Hemphill recommended Lewis to chair the DC Alcohol Beverage Control Board and was outraged when the official told her that Lewis was not qualified for the position.

In a January 16 editorial, *Washington Post* editors suggest that Lewis was also the reason for Mayor Williams' alleged insistence last year that DC school officials award free or low-cost legal assistance to teachers as a $1.1 million benefit—*after* contract negotiations had already ended.

"But why would the mayor intervene in a negotiation that had already given union members handsome pay increases totaling 19 percent over three years?" the editors ask. They suggest that Curtis Lewis & Associates, then representing WTU, would have also represented union members and would have collected the $1.1 million. Given union leaders' close relationship with the firm, they may have lobbied for the benefit partly to enrich Baxter's brother.

Michael & Cheryl Martin

Hemphill's daughter Cheryl Martin and her husband Michael Martin, operations manager at the DC Health Department's HIV/AIDS office, also have been named in court documents as participants in the WTU embezzlement scheme. Their home and Michael's office were raided by FBI agents in December.

The FBI has filed court documents alleging Martin personally received more than $20,000 in WTU checks signed by Bullock and Baxter. The union also allegedly paid more than $400,000 to Expressions Unlimited, a company owned and operated by Martin and business partner Errol Alderman, who also works in the District's HIV/AIDS office. The FBI says there is "probable cause" that Martin's business did not provide many of the services for which it was paid. Court documents suggest that funds from the Expressions Unlimited account were paid to Bullock and Hemphill.

On January 23, the DC inspector general announced a review of millions of dollars spent by the District HIV/AIDS office to ensure that Martin and Alderman did not misappropriate the funds.

Cheryl Martin reportedly was temporarily hired by Esther Hankerson, general vice president under Bullock, and received a union paycheck. Details of the employment have not been reported.

Gwendolyn Clark

Bullock's sister Gwendolyn Clark has been identified in court documents as a coconspirator in the looting of WTU, but her exact role is not yet known. Her home was among those raided by the FBI in December.

Independence Federal Savings Bank

One of the nation's largest minority-owned thrifts with assets of $260 million, Independence Federal Savings Bank is suffering serious problems, now much worse in the wake of the WTU scandal.

Now the U.S. Attorney's Office is considering charges against the bank for aiding the fraud at WTU by cashing forged checks and violating the Bank Secrecy Act by failing to report suspicious transactions. The WTU's internal audit suggests that three of the bank's employees colluded with union officials. Last month federal prosecutors subpoenaed account records from the bank.

WTU, Mayor Williams' 2002 reelection campaign, and the DC Democratic State Committee all have bank accounts at Independence Federal.

Often the original names on the checks cashed by the chauffeur Holmes were scratched out and replaced with Holmes' name. The bank accepted the checks because the changes appeared to be initialed by the check signer—usually Bullock or Baxter—but auditors say the handwriting does not appear to match that of the signers. WTU auditors say bank personnel failed to file suspicious activity reports although most of the checks cashed were just under $10,000, the minimum required for currency transaction reports. Even more suspicious, the bank has not turned over any transaction reports for four checks over $10,000, auditors say. They also accused bank officials of failing to cooperate with the investigation.

Esther S. Hankerson

Esther Hankerson, WTU's general vice president since 1994 under Bullock, automatically assumed the union presidency when Bullock resigned last October. The union's bylaws require that the general vice president fill the vacancy until members elect a new president.

But members raised concerns that Hankerson should have known about the illegal activity. More than 150 teachers gathered at a District school on January 13 for an unsanctioned emergency meeting at which they voted no confidence in Hankerson and WTU's 21-member executive board. Hankerson didn't last long enough for the members to oust her at a monthly meeting scheduled for January 27—the AFT took control of the union on January 22, suspended the union's constitution, canceled the membership meeting and assigned a temporary administrator.

Although Hankerson is not mentioned in FBI court filings, she is reportedly under investigation for improper use of her union credit card. Hankerson has admitted reviewing her own expenses after the scandal broke and finding at least one inappropriate expense to cover her granddaughter's plane travel—a charge that Hankerson says was a mistake made by her assistant. The card also was charged for meals that Hankerson cannot account for, so she says that she voluntarily reimbursed the union about $1,500.

More serious questions linger concerning the extent to which Hankerson knew about the looting of WTU. In 1997, the Independence Federal Savings Bank notified Hankerson that her signature had been forged on an $8,000 check payable to Bullock, according to auditors. Hankerson reportedly confronted Bullock, who admitted the forgery and said she needed the money and would repay it. Auditors say Hankerson never reported the incident to other WTU officials and the check was never repaid.

Hankerson also should have known about missing contributions to employees' pension funds. For the past two years, WTU's executive board approved pension fund contributions equal to 11 percent of staff salaries, but much of that money reportedly was never deposited to the funds. Hankerson was a member of the executive board that approved the contributions, and in her dual role as a union employee, she should have received routine statements showing the status of the pension funds. She claims that she never knew of a problem.

Nevertheless, Hankerson's dual role as an executive board member and WTU employee seems to have violated the union's constitution. Hankerson received a salary

throughout her eight-year tenure as general vice president—$90,000 a year before her promotion to president in October. But except for the president and treasurer, the union's bylaws prohibit payments to members of the executive board to avoid conflicts of interest.

Implications for DC Schools

The actions of WTU's leaders will have a harmful impact on DC public schools for many years to come. Had Bullock and her team focused their energies on teacher development and quality, the future for many DC children might not be so bleak.

But bleak it is. Only six percent of the District's eight graders perform math at grade level, according to the 2000 National Assessment of Educational Progress (NAEP). The 1998 NAEP found that 10 percent of the District's fourth graders read at grade level. Yet DC public schools spent $10,477 per pupil in 2000–2001, far above the national average of $7,483, and only 43 percent of the system's 11,000 employees teach.

If lawmakers take note of DC's plight, it may be an opportunity for reform. Syndicated columnist Walter Williams, an economics professor at George Mason University in Fairfax, Virginia, has seized on the WTU scandal as yet another reason why the District of Columbia should embrace vouchers that allow children to escape to private or other public schools. Vouchers would empower teachers to establish their own schools and would break unions' stranglehold over education.

"Teachers, rather than administrators and union officials, would be in control and set the agenda," Williams wrote in his January 12 column. "Parents would be empowered through choice. Students would get a much better education. Finally, taxpayers would be less burdened."

A few days following Williams' column, Scripps Howard columnist Deroy Murdock also called for more public support for President George W. Bush's plan to fund voucher experiments in Washington, DC and other cities.

"It's hard to imagine a place that more urgently needs school choice than the District of Columbia Public Schools," Murdock wrote.

Other school policy proposals may have a better chance of approval with a weakened teachers union. In her inaugural address on January 7, DC board of education president Peggy Cooper Cafritz called for literacy tests for all teacher's aides and competency tests for all new teachers. Perhaps emboldened by WTU's problems, she dismissed the union's opposition to any form of testing teachers, saying "I would much rather offend an adult than damage a child."

Such positive reforms would be an appropriate response to the WTU scandals. But absent school reform and serious change at WTU and city hall, Washington, DC will remain what *Washington Post* columnist Colbert King has dubbed "The District of Corruption."

Fox News, January 17, 2003

DC TEACHERS' UNION PLAGUED WITH SCANDAL

By Liza Porteus

A 46-page audit released Thursday night at the request of parent group the American Federation of Teachers alleges that three former union officers looted more than $5 million over the last seven years and used the money to buy items such as flat-screen TVs, fur coats and silver.

"The massive misappropriation of union funds and the betrayal of the members that are outlined in our audit are reprehensible and sickening," said AFT president Sandra Feldman. "The individuals responsible must be held accountable, and the AFT will do everything in its power to see that these funds are returned to the WTU and its members."

With audit in hand, the AFT filed a lawsuit in Federal District Court in Washington under the Racketeer Influenced Corrupt Organizations Act and other federal and state statutes. The group is seeking restitution on behalf of the nearly 5,000 members of the WTU for the misuse, misappropriation and conversion of union funds.

The lawsuit alleges that eight individuals, including former WTU President Barbara Bullock, elected union president in 1994; James Baxter, the WTU's former treasurer; and Gwendolyn Hemphill, former assistant to Bullock, "in their positions as union officers, agents, representatives and employees, or through their relationships with union officers, agents, representatives and employees, aided and abetted, participated in, and used the union as part of their conspiracy to embezzle and convert funds of the union."

The lawsuit and audit detail a scheme to defraud the union and its members, embezzle WTU funds and convert those funds for personal use. The complaint charges that defendants defrauded the union by forging checks, illegally converting them or using checks without authorization and that some of the individuals made "substantial unauthorized purchases" with union credit cards.

"In summary, due in large part to the deliberate override of the system of internal controls at the WTU, Bullock, Hemphill and Baxter appear to have systematically diverted millions of dollars in WTU funds to themselves, family members, and others for personal benefit," the forensic examination states.

A WTU receptionist on Friday told Foxnews.com that he was not aware of any lawsuit and no one was available to discuss the charges. An open letter from interim WTU President Esther S. Hankerson in December said she was "shocked and angered" by the allegations leveled against Bullock, Baxter and Hemphill.

"It is very upsetting to see the worst of our fears possibly coming true, and to realize that perhaps those in whom we placed our confidence have violated their trust, abandoned their personal and professional responsibilities and severely abused their position of authority," she wrote nearly a month before the charges were filed.

Auditors began scouring two years of the local union's books in July after the AFT was alerted by a WTU member to an overcharge of union dues. What they found was a long trail of forged signatures and altered checks, as well as $1.5 million in "inappropriate" personal charges on a WTU credit card. Another $948,000 is labeled "questionable." The audit also unearthed nearly $700,000 in "undocumented expense reimbursements."

While union rent and utility bills often went unpaid and union teachers allegedly weren't receiving promised services, the AFT investigation concludes that Bullock wrote $381,000 in checks to herself, Hemphill diverted at least $492,000 through unauthorized credit-card charges or unauthorized checks and Baxter diverted at least $537,000 to buy himself art, clothing and sports tickets.

The three also allegedly made $12,000 in political contributions—charged to the WTU's American Express credit card—to the Democratic National Committee and to the 2000 senatorial campaign of Hillary Clinton, D-N.Y. Other political donations charged to that account totaled $4,200, made to groups including the National Political Congress of Black Women and the (former DC) Mayor Marion Barry Constituent Services Fund.

Both the DNC and Clinton's campaign have since reimbursed AFT with the funds.

Then there's the $1.2 million allegedly paid to the Bullock's chauffer, Leroy Holmes. Auditors say he kept some of that cash and gave the rest to Bullock or Hemphill, who also co-chaired District of Columbia Mayor Anthony Williams' reelection campaign. Holmes said he thought his 2001 salary was $105,000, but $150,000 was noted on his tax forms. Holmes said the WTU also paid for expenses related to his three Cadillacs.

The *Washington Post* reports that Washington's Office of Campaign Finance this week began investigating whether Williams' re-election campaign failed to report in-kind contributions from the union. The mayor and his staff have denied any wrongdoing.

"This is a perfect example of why workers need to have the freedom to choose for themselves when it comes to union membership," said Dan Cronin, legal director for the National Right to Work Foundation.

Cronin's group argues that this kind of union corruption could be minimized if workers weren't forced to pay union dues in order to get jobs.

Included in the WTU's bylaws is a section saying the District of Columbia Board of Education recognizes the WTU as the "sole and exclusive bargaining representative" in negotiating for teachers' wages, rights and other job-related issues.

"If workers have the freedom to leave the union and stand on their own . . . then you would be forced to be more responsive to the workers," Cronin said. "Compulsory unionism breeds corruption—they go hand and hand."

The *Post* reports that the AFT is considering placing the 5,000-member WTU in an "administratorship," which would dissolve local leadership for as long as 18 months. A two-member, AFT-appointed panel held a hearing Thursday with the local union's executive board and AFT could vote on a takeover, the *Post* reported.

Senator ALLEN. Now, Mr. Silvers, two Rutgers University professors testified on May 8th at the roundtable on stock options that expensing will do nothing to constrain executive pay, which is the general purpose here and stock options kind of get blasted in the midst of it. Indeed, their research indicates that researching stock

options will lead to the concentration of stock options among the most senior executives and, more importantly—and this is what I care most about, is the elimination of broad-based plans which distribute options to rank and file workers, whether they are secretaries or wherever they may be in that company.

So the point is expensing stock options will not solve the executive pay problem, but it will harm rank and file workers, who lose out when broad-based plans are reduced. Now, is that a result, Mr. Silvers, that you would support?

Mr. SILVERS. Senator, let me begin in response to your questions by talking about ULLICO. You correctly identified that there were a number of insiders that profited at ULLICO and that ULLICO, the Union Labor Life Insurance Company's parent, is owned by union pension funds.

The president of the AFL–CIO demanded an investigation into that matter a year ago. He resigned from the board when that investigation was not followed. He led the majority of shareholders two weeks ago, together with President Terry O'Sullivan of the Laborers Union, in a successful effort to throw out both the CEO who led that effort and the board majority that supported it. The incoming CEO, Terry O'Sullivan, led a board majority that voted to demand that the money be repaid and that the independent investigation be complied with. That vote occurred last week.

The management, the new incoming management of ULLICO, is currently investigating each and every aspect of executive pay at that company. Key aspects of executive pay at that company that have been the focus of this issue have been frozen. The current CEO of ULLICO is serving without pay.

I defy you to find a single example in all the annals of corporate America of any significant repayment to the shareholders absent Government action, in fact any significant repayment at all. The only thing I can think of, frankly, is the WorldCom settlement announced yesterday. There is no example that I know of, of significant repayment absent government action in corporate America, and no example, really with the exception of American Airlines that you mentioned, of action being taken to remove people.

The labor movement stands by its record in responding to what went wrong at ULLICO and stands by President Sweeney's statement at the beginning of this matter that we intended to hold ULLICO to the same standards that we held corporate America to. We said we would do it and we did it.

With respect to the two Rutgers professors, the issue of stock options in the non-executive context is a significantly different issue than the issue in the executive context. The reason for that is because the perverse incentives I alluded to in my testimony are rather difficult to act on for the average employee. Therefore, we view as investors options as an inferior way of compensating executives and would prefer to see them replaced by restricted stock.

We view options as a somewhat inferior way of compensating employees as well, but for a different reason, which is that they create risks when they are part of an employee's base pay package which the typical employee is ill-suited to bear. The typical CEO, whose base compensation—Mr. Bachelder could tell us the exact numbers since he is very focused on the base—the base compensation is in

the millions of dollars, has an ability to absorb risk that the typical employee does not. When options become a central feature of the average employee's pay package, that employee often, as I said, is taking a risk they cannot afford to take.

That being said, we do not think that options are sort of a non-starter for the typical employee. However, there is just no getting around the fact that options are a real cost. You are paying with a right to the profits of the company and the returns on equity for labor. Frankly, the bizarre accounting treatment, that is the result of a political distortion of the accounting standards-setting process, has led to distortions in terms of the use of stock options both for executives and for line employees, in ways that have harmed the average working person because they are being paid in essentially a debased currency because companies like to pay in debased currency because they do not have to expense it.

But we are not going to take the position, which we could be inconsistent. We could say we would like to see executive stock options expensed, but do not expense everyone else's. That might be kind of convenient in away. But there is just no getting around the fact these are expenses of the company. They should be expensed and they can be valued.

This talk about Black-Scholes not applying far in the future is frankly unpersuasive to me. At least where I learned finance, Black-Scholes was applied to options of any duration. There is, of course—everything becomes more uncertain as you go far into the future, every accounting measure becomes more uncertain.

The CHAIRMAN. Mr. Silvers, you have got to shorten your answer, please.

Mr. SILVERS. I am finished.

The CHAIRMAN. Go ahead, take a couple more minutes, please.

Senator ALLEN. All right. Thank you, Mr. Chairman.

The point I was trying to make is that if you require the expensing of stock options it will be the end of broad-based stock options. Yes, they probably will have the restricted stock and all sorts of different things for the executives. And for the investors here, whether CalPERS or TIAA–CREF, Mr. Clapman, Mr. Harrigan, you undoubtedly have invested in companies over the last ten years that use stock options. Some of them are these start-ups, innovative companies. Some of them are no longer with us. Others are still with us.

Now, in the event—just look back. Just look back in the last ten years. Using the Black-Scholes method, how many of those—using the Black-Scholes method of expensing, how many of those would have been accurate or not, and what impact would that have had on those, especially the start-up companies? And I like ESOPs as well. I like employee stock ownership. But I like the idea of employees caring about the long-term future of a company. It helps keep people with them.

What would be the impacts, Mr. Clapman, on some of the companies that undoubtedly TIAA–CREF have invested in in the last decade?

Mr. CLAPMAN. Senator Allen, we did not include in your materials the TIAA–CREF policy statement on corporate governance, which has our voting guidelines on management option plans, but

it is accessible. We can send it to you. It is also accessible on our web site.

But what we do in there is have variable standards for when we will vote in favor of option plans, taking into account just the issue you are addressing of the broad-based plans. So that we would for younger companies have much higher guidelines for when we will support such plans, and we have different standards for more mature companies.

So we certainly agree that a certain amount of discretionary analysis about that, to recognize that there are certain companies where it is much more important in terms of compensation.

But in terms—I mean, basically the Black-Scholes or a similar methodology, which means effectively you value something at grant, as opposed to valuing something in terms of whether it made money or lost money, frankly is something that corporate America will be supportive of more than the alternative of valuing depending on subsequent stock movement. The reason for that is that earnings will be much more volatile if you do not do it at grant, and you will recall that about 250 companies have agreed to expensing, and they do it on a grant basis because it will have less impact on their accounting statement, and their earnings record, than if they chose some other methodology.

But that is again only part of it. You said earlier you were supportive of performance-based options as a better way to go. The problem in America today is that compensation committees disregard performance-based options because they are expensed and they have been expensed for a long period of time. So it is the crowding out of something that is a far better compensation alignment between management and shareholders that is the dilemma of the current system. So that is why expensing of all options will put matters on par.

One final thing about——

Senator ALLEN. But do you not think expensing of all options would reduce the number of options granted broad-based to employees?

Mr. CLAPMAN. We do not think so. We do not think it will be a reduction.

Senator ALLEN. Have you listened to many companies that use this that say this will be the death knell of broad-based stock options, because they will not feel comfortable even signing as a CFO, signing, here is the figure, which is an estimate—even by those who are advocates, it is an estimate—and then five years, ten years down the road, that shows to be somehow wrong?

Mr. CLAPMAN. Candidly, we think, Senator, a lot of the people that want to preserve the current system are trying to use scare tactics in terms of the effect of expensing. Just one final word on that. The footnote——

Senator ALLEN. It is their business, though.

Mr. CLAPMAN. I realize it is their business. But currently if you look at the footnotes of any company, you will see the effect of expensing there. So that sophisticated institutional investors can get the effect even of fixed price options today. The people what are not the beneficiaries of that kind of analysis are individual shareholders who rely on what the reported earnings in the financial

sheets are. But investors can do their own expensing calculations even today, and I would say that most significant sophisticated investors are already taking into account the true cost of those options even before expensing, and it is only the general public that is being misled on that issue.

Senator ALLEN. Let me ask, Mr. Bachelder, what is your view of the impact of mandatory expensing on the use of broad-based stock option plans?

Mr. BACHELDER. I think it would curtail it. I think it would curtail it not only on a broad-based basis, but I think the lifeline of American business are the young, new businesses that are started up all the time, just as we saw in the age of the development of Internet and high tech companies. Whether it is Silicon Valley or Route 128 or other locations in other industries, these young companies need to have the opportunity to grant options without having them a charge against earnings.

In fact, I think a very good argument can be made that those companies, if not other larger companies, in fact are transferring to those who receive the options the opportunity to acquire equity in the company, and that is a transfer of capital. Legitimate arguments can be made that this is a transfer of capital and not an expense.

Senator ALLEN. Thank you, Mr. Chairman. I know I went over. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator ALLEN. Thank you, gentlemen.

The CHAIRMAN. Could I just quote again from Mr. Buffett: "Why then require cash compensation to be recorded as an expense, given that it too penalizes earnings of young, promising executives? Why not have cash compensation as a footnote? Indeed, why not have these companies issue options in place of cash for utility and rent payments and then pretend that these expenses as well do not exist? Berkshire will be happy to receive options in lieu of cash for many of the goods and services that we sell corporate America."

Senator Lautenberg.

Senator ALLEN. Mr. Chairman, can I——

Senator LAUTENBERG. Very good, Mr. Chairman. Excellent meeting, if I may——

The CHAIRMAN. Go ahead.

Senator ALLEN. The very reason someone would not take a stock option for payment of electricity or anything else is because they have no idea of what it is worth.

The CHAIRMAN. Mr. Buffett says he knows what it is worth and he would take it. So perhaps you and Mr. Buffett have a different opinion. I think I would go with his record versus yours.

Senator Lautenberg.

Senator ALLEN. I think he is talking about—I think he is looking at a different kind of option.

STATEMENT OF HON. FRANK LAUTENBERG,
U.S. SENATOR FROM NEW JERSEY

Senator LAUTENBERG. Thank you very much, if I might, if the Senator from Virginia—you have run several very good, interesting Committee hearings, Mr. Chairman. I want to commend you.

The CHAIRMAN. We have made a lot of friends, too, have we not?

Senator LAUTENBERG. I think that this panel is a very, very good one. It demonstrates the attitude that we ought to be looking at. I came here 20 years ago and I had been one of the founders and CEO of a company called ADP. We started with nothing and I am going to wind up with nothing if I spend a few more years here.

But the fact of the matter is that I came in and I think I took the trophy for having given up the highest compensation package to come to the Senate, which before me was held by Percy from Illinois. I guess it was Bell and Howell that was his company. My compensation was about 450,000, which at the time was pretty rich. But now when we look at things, we see it quite different. That was on $60 million worth of after-tax earnings. Now it looks like an executive can get $60 million worth of compensation for $450,000 worth of revenues. There has been a huge reversal out there.

[Laughter.]

Senator LAUTENBERG. But I want to say, I think we have an attitudinal crisis here in terms of corporate governance. I am on the board of the Columbia Business School. Mr. Hall, you are perhaps one of your leaders in the field, but we are talking about competitive schools in a way. And I just gave a chair in corporate governance to Columbia Business School because I think that there is a lot of things that are so wrong, that have created attitudes supported by incredible greed out there.

Mr. Bachelder, with all due respect and I liked hearing from you, when I look at Jack Welch and you compared the growth of the company's value to his compensation, he does not own the company. One of the things, the mistake we made here—and I am sorry the Senator from Virginia has left the room. He said: Who are the owners? Well, who are the owners are not simply the guy sitting at the top reaping the harvest from a lot of people's efforts, from a lot of people's ideas.

I am a member of the Information Processing Hall of Fame. That entitles me to nothing except the fact that I have seen lots of companies started with good ideas, that had sudden stock value bursts, took their packages, and went home like a ballplayer. The problem is that there is not enough long-term obligation. This is now the seduction of CEOs. Bring someone in who has got a good record and give them a pretty fat package, and if he is there three years, what the hell, he makes $30 million or $50 million, and so things did not work out quite the way they were supposed to.

The most egregious example, not just those companies that we have seen go down the tubes, but those that are negotiating for bankruptcy proceedings and taking out huge packages of compensation and asking—and discharging employees and asking those that are there to take less in pay. What has happened in America?

When I see Mr. Welch—and I hardly know him, but I have read an awful lot about him—and to see that in the final insult to corporate opportunity was the fine wines and the dinners that had to be included on top of it, I think it was about a $300 million retirement package, after hundreds of millions had already been paid in

compensation. He got paid amply for his work. He is not running a casino and if you hit he gets more money.

I think it is time we started looking at the—it is not as much in my view the CEOs, but it is the board of directors who are conspirators in these things. It has got to be changed. And American confidence—your question, Mr. Chairman, was an excellent one: Are these things destroying American confidence in these companies? Absolutely, absolutely.

First of all, there is, in my view, there is an attempt to conceal lots of things. I do not know how the term "EBIDTA" came up or when it came up, but, boy, if that is not a smokescreen. It is earnings before taxes, interest, and depreciation. What is the significance of that? I hear now people comparing their companies. You have to pay your taxes, you have got to pay interest on the loans that you have got, and the depreciation. If the equipment that you are using to make a product is wearing out, why should you not account for the fact that you are going to have to replace it one day?

I am sorry, Mr. Chairman. Please excuse the lengthy introduction. I want to put my statement in the record as if read, my opening statement.

The CHAIRMAN. Without objection.

[The prepared statement of Senator Lautenberg follows:]

PREPARED STATEMENT OF HON. FRANK LAUTENBERG,
U.S. SENATOR FROM NEW JERSEY

Mr. Chairman,

I commend you for holding today's hearing on executive compensation. It's a subject I happen to know something about. At the time of my election to the United States Senate in 1982, I was the highest paid CEO to cross over to the public sector. The year that I was first elected, ADP—the company I helped to found with two friends in 1949—had 750 million dollars in revenues and posted 60 million dollars in profit. I made 450,000 dollars.

Today, it seems that some companies are making 450,000 dollars in profit and paying their CEOs 60 million dollars!

Executive compensation is out of whack. Too many CEOS and other top executives see their pay go up and up while their companies' stock goes down and down. Too many CEOs and other top executives are insulated from poor performance and even bankruptcy while employees and share-holders lose their jobs, their pensions, and their retirement savings.

The system for determining executive pay is broken: greedy CEOs appoint each other to their boards so they get to determine each other's compensation. I don't know whether to call that a "conflict-of-interest" or a "confluence-of-interest" but either way, it stinks.

The Congressional Research Service (CRS) has issued a report comparing the total compensation of top executives to the average earnings of non-managerial private sector employees. According to the report, which is based on *Business Week* surveys, top executives made *45* times as much as workers in 1960. In 2000, they made *531* times as much.

The ratio has come back down; now, top executives are "only" making 282 times as much as their employees—largely because so much executive compensation takes the form of restricted stock and stock options, and the stock market has plunged. But the gap is still much too wide.

Supporters of the status quo will argue that this changing ratio is proof that the executive compensation "market" is undergoing a self-correction. That's true.

They will further argue that attempts to legislate on the issue will fail and cause unintended consequences. That's true, too.

But I do think there is something useful that Congress *can* do in this realm of private contracts: *mandate* that *total compensation* for the CEOs and other top executives of publicly-held companies be made public in annual reports in a way that is comprehensive, transparent, and understandable.

As Supreme Court Justice Louis Brandeis said, "Sunlight is the best disinfectant." Give share-holders *all* of the information they need to determine whether executive compensation is reasonable. Companies that bury the true cost of such compensation in dense text spread throughout obscure parts of an annual report obviously feel they have something to hide.

The only way to assess whether CEOs and other top executives are doing their job is to know how much they are being compensated—no more "stealth wealth."

Right now, public confidence in our markets has been shattered—with good reason. People need to have faith in financial statements. People need to have faith that analysts are objective. People need to have faith that brokers are looking out for them. People need to have faith that the Securities and Exchange Commission is up to the job. And people need to have faith that top executives are running companies to meet sound, long-term objectives.

If we want to encourage the resurrection and expansion of the "investor class," we have to restore the public's confidence that our markets are on the "up and up," and not just a game that's rigged to benefit the very few. It's going to take a lot of work to rebuild that confidence but our economic prosperity depends on it.

Thank you, Mr. Chairman.

Senator LAUTENBERG. I want to ask a couple of questions. What would happen—first of all, I think that we have to—when people are hired at the top of these companies, there has to be a longer term commitment. One of the things that I worried about as we discussed the dividend debate here was whether or not a CEO would look at the company and say: Hey, if I pay dividends and they are tax-free, it inures to the stock value, it gets to my pocket; what do I care about ten years from here? I have a chance to make 100 million bucks in the next few years. Why do I want to fool around with plant and machinery and running the risk of building new terminals or things of that nature? Let me boost the earnings for now and let the devil take the hindmost.

What would be wrong—that is Lautenberg's view. Forgive me. I want to bring you up to date with ADP. It is a company I started with two other guys, two other fellows. Their father and my father worked in the silk mills in Paterson. It was common labor. We started with nothing. We started a long time ago, over 50 years ago.

The company this last year did $7 billion, had $7 billion in revenues and $1.1 billion after tax and paid taxes of about 30 percent or 40 percent on that. Pretty good performance. That CEO now gets about $7 million and took a decrease in compensation because we did not grow at the 10 percent that we had grown for the first 41 years that we were listed on the exchange.

What would be wrong to encourage the CEOs, the senior executives in the company, to say your vesting period and exercise period is deferred for a long time? So you know, even if you leave the company if things have not gone right, you have got a package out there, but the work you have done will help this company deliver its value, deliver its product, for lots of years to come. Anything wrong with that, Mr. Clapman?

Mr. CLAPMAN. Well, as starters the TIAA–CREF shareholder resolution in the area of equity compensation not only calls for performance-based options, but substantial long-term holding periods for holding stock. That is why—and I believe other members of this panel had a similar view—that stock is really a far superior linkage of shareholder concerns, interests, and management interests.

Hitting exactly the point that you are raising, it is the short-term pervasive way that stock option cashing out can be manipulated in

the current system that is one of the root causes of the problem. The long-term holding of stock, our resolution really did not—and we thought we were giving deference to management on this, to say that you should have a substantial holding period, for a substantial period of holding your stock, and even that was opposed by most managements that we came into contact with. So we would agree certainly on your basic thrust, that long-term holdings, perhaps for a senior top executive not to be able to cash out until they leave the company. This is all really getting to the heart of the difference between the long-term and the short-term in terms of incentives.

Senator LAUTENBERG. Anybody else? Mr. Harrigan?

Mr. HARRIGAN. I think that would also be consistent with CalPERS policy. We obviously think at least a great portion of executive compensation should be based on long-term, sustainable performance, and that ties right into the comments that you made. So that seems to be—in terms of designing an executive compensation program, your suggestion certainly would make sense to CalPERS in terms of a component of that.

Mr. HALL. I would just add that I too think it is a great idea. The one thing we have to ask is, why does it not happen? The answer comes back to corporate governance. You know, when Joe Bachelder, who is a very effective negotiator, goes and negotiates a package for a CEO, typically they want something shorter; Joe gets it for them. They want to have cliff vesting at the time that they leave; Joe gets that for them, too. And then all of a sudden we have very short vesting.

So fundamentally, assuming Congress is not going to begin passing rules about the vesting periods of restricted stock or something like that, fundamentally what we have to do is reform corporate governance and give shareholders a greater say.

I just want to point out how remarkable it is that the AFL–CIO is supporting a proxy—a set of ideas that are so shareholder friendly in terms of making—enabling shareholders to actually get their potential candidates on the board. That would be a dramatic change in corporate governance, and people who believe in stronger shareholder rights, as I do, in academia have been making arguments like this for a long time. I just find it pretty remarkable that this issue could actually bridge a very wide political spectrum, in large part because the members of the AFL–CIO hold lots of assets in their pensions and so they become very concerned about this.

The CHAIRMAN. We should let Joe, I think. Since your name was mentioned freely, you want to respond there?

Mr. BACHELDER. Right, right. I think that the problem with delayed vesting and delayed exercisability, meritorious as it is, is the very fact that we do have relatively speaking a free market in compensation, and if you do at company A decide that we are going to delay the exercisability on our options and make it five years cliff or six, seven, eight years, and then you are trying to attract a new executive from another company and in order to get that executive, where that company does not have a wait of five, six, seven, or eight years, what do you do? I certainly think——

Senator LAUTENBERG. Give them cash. The expense—in all due deference, Mr. Bachelder, the expense has to be recorded and that

is the problem. It is the dishonesty that we see where the greed takes over, clouds the judgment on what you do to run a business, and suddenly now we are figuring out all kinds of ways to make sure that our calf is fat and the devil with the rest of them.

I think if all of these things start to get recorded it will be a little different transition. But CEOs are not ballplayers. They do not have a limited life of five years or eight years or something like that to fill the stands. It is a different world out there, and we have lost sight of what the CEOs responsibility is.

Mr. BACHELDER. Senator, I do believe that, in further response, that we seek to have the companies of this country led by CEOs who will seek to develop new ideas, new products, to maximize profits, to maximize growth. The individuals who make up the senior levels of management in this country are people that are driving for that goal, which we all want, to increase the profitability of our corporations and to enhance the value of the investments of the institutional investors of this country.

You do not have people who are doing that who are not going to be trying to drive to improve their own compensation packages. I agree that boards of directors need to take an objective look at any CEO proposal. But I do believe that there is more of an objective look at CEO pay than we are giving credit to.

The CHAIRMAN. Senator Breaux had a comment if that is all right.

Senator BREAUX. I would just make a comment that I think fits in with what Senator Lautenberg is saying and also Mr. Bachelder. The argument is made that you have to really compensate CEOs in large companies in order to get the very best and the very brightest to do the very best job. I have got a list of the CEO compensation, the top 100 compensation packages for CEOs of large revenue companies in the United States in the last year. Honeywell, the CEO was compensated at over $68 million when the stock of the company's value was going down 27 percent.

I look over the top 100. The largest company in the world, Wal-Mart, is not even in the top 100. I mean, there is a real fallacy and a breakdown in this argument that somehow you have to be compensated millions and millions of dollars regardless of the performance of the company in order to have a good company. The facts do not bear that out.

Senator LAUTENBERG. There is a mythology out there. In order to have a decent CEO. You look at the brown company, United Parcel, and see, they have got a CEO there that has come out of the worker ranks. I am not advocating that the CEO must come from the worker ranks, but the fact is that there is a very modest compensation package there for a huge company, and lots of companies do it.

My old company, with its $1.1 billion of profit after tax, probably paid with any bonuses, etcetera, about $15 million to the CEO. The fact that he was hand-picked by me 20 years ago—he was the number two guy. But that is the way we regard the company as having an obligation to its shareholders. We try to make it very clear what it is about what we are doing.

Now, if you look at the proxy statements, you can hardly wade your way through it. You cannot get enough people to understand

what it is they are looking at to want to be excited about voting their proxy. It is not beguiling, there is no interest at all there.

Mr. Clapman, you must have views on these things, or Mr. Silvers, about what ought to be in a proxy statement beside the very strict recitation of what the expenses are and what they are going to be?

Mr. CLAPMAN. Well, in my written comments, Senator Lautenberg, I indicated that current disclosure rules are inadequate to really understand fully about executive compensation. We are partly an insurance company and when we look at the what is called supplemental employee retirement whatever—SERP's is the acronym for them—and try to value them, even with actuaries we cannot do it.

It took a divorce proceeding to disclose fully the Jack Welch retirement package. It was not disclosed in any proxy statement, which I guess shows the benefit of long-term marriages to avoid having that problem to deal with.

Senator LAUTENBERG. A deferred expense.

Mr. CLAPMAN. But I agree fully with your point that disclosure is inadequate. In fact, you raised an earlier accounting issue which, just to make a brief reply to: Institutional investors have a pretty sophisticated investment analysis process. We do all our own investment management. We do not hire outside managers. We look at, "pro forma earnings" or reported earnings with great skepticism in terms of how we value stocks. We have our own methodologies for all of that, and that is a commentary on the state of disclosure in general at the present time, and it is something clearly the SEC has got to address.

It is a problem in executive compensation, but it is a problem in the much broader securities analysis area as well. So I agree with your point. We could start very—first of all, the SEC had a project a couple of years ago to get better disclosure on executive compensation. Unfortunately, it did not go far enough.

Mr. SILVERS. Senator, I will make two points that I hope you will find responsive. First, there is a kind of—there are two sort of fallacies that have been floating around in this discussion that go to this question of whether disclosure is adequate and whether investors and the general public really understand what is going on.

I will give you one example. It has been raised in this discussion that some of these annual pay numbers that seem so large are in fact not, are in fact misleading, that some of it is just the sale of stock into the marketplace, that it was accumulated in the past. Well, it may be that—whether or not you want to count that as annual compensation, the fact that that is a major component of executive comp should be very, very disturbing, because what you are essentially seeing when you see executives selling into the market built-up options, exercising and then selling the underlying stock into the market while their stock price is declining and the corporate performance is declining is that essentially that executive is betting against themselves. They are saying: I know something that is not in the marketplace that tells me I ought to dump right now and, by the way, I am not going to tell you, the rest of you, what that is; I am just going to exercise it.

It is in fact worse than simply paying them for bad performance. It is you are watching somebody gaming the system.

Secondly, the argument has been made here that American executives are people that are trying to do their best by their companies. I would not necessarily disagree with that as a generalization. I think my sense is that is generally true of most of us, that we are trying to do the best in the roles we find ourselves in life.

But that does not entitle any of us to infinite compensation for that effort. If you talk to a construction worker or a Government employee or a driver at UPS and say to them—you know, if that person comes to work one day and says, you know, I work very hard, I produce a lot of value for this company, I would like $100 million, please, because my net contribution to this company is positive, that is the end of that person's career. It also ought to be the end of an executive's career who does the same.

Senator LAUTENBERG. I will conclude, Mr. Chairman, with just two quick things. One is, since our distinguished Chairman quoted Warren Buffett so frequently, I will quote him once more. He says; "The more taxes I pay, the more I have left over." So I think that is probably a good end.

Lastly, you know what I think as I am listening to the discussion? You are a very good panel and, Mr. Bachelder, I include you. That is that we ought to—the proxy statement, the first thing on the first page beside the name of the company ought to be what the executives sold in terms of shares in the past year, to give you some flavor as to where this company is going.

Thank you, Mr. Chairman. Excellent, excellent idea for this.

The CHAIRMAN. Thank you. Thank you, Senator Lautenberg, and thank you for the benefit of your experience.

It seems to me that this hearing reinforces the argument that we need greater stockholder involvement and we need greater transparency, and I am not sure you can have one without the other.

I am not sure that Congress is prepared to act legislatively at this time. Maybe around the edges—we have got a new SEC head and we have got a new man, Mr. McDonough, and Mr. Donaldson and others, so perhaps we need to exercise some patience here.

But I am convinced—I am looking at the report from some time ago that the Tyco CEO spent $6,000 for a shower curtain. He did not pay for that, it was paid for by the stockholders of Tyco. Then I am intrigued to see that the new CEO of Tyco is compensated $62 million. Was that really—in order to get a replacement for Mr. Kozlowski you had to pay compensation of $62 million, Mr. Bachelder? They could not find somebody who could do the job without, especially with the track record of the flagrant expenditure of stockholders' money, including $11 million for antiques, $18 million for a Fifth Avenue duplex, $2 million trip to the Italian island of Sardinia? All that was not paid for by Mr. Kozlowski. It was paid for by the stockholders of Tyco.

So then we see Tyco hiring a new CEO and we cannot get somebody for less than $62 million annual payment?

Senator LAUTENBERG. They could have gotten me. I would have stopped in.

[Laughter.]

The CHAIRMAN. I am sure they did not know you were available.

Senator LAUTENBERG. I did not know it either until I heard $60 million.

The CHAIRMAN. Life is anecdotal. It is anecdotal about politicians and our misdeeds and our misdemeanors. Life is anecdotal about $6,000 shower curtains. I get a laugh at every speech that I give where I say; "I would like to have gone over there and taken a shower; I have never seen a $6,000 shower curtain." But you laugh and you cry, and a lot of the audiences I speak to have seen their 401(k)s decimated while this kind of excessive pay, benefits, retirement.

Mr. Bachelder, I think you only made one mistake in your testimony today, bringing up Mr. Welch's package, because no one understands that retirement, those benefits on retirement. No one can understand that, that even flowers are paid for. Maybe you can, but I do not think many other people can believe that when someone is no longer performing they should get that kind of benefit.

As Mr. Clapman pointed out, if it had not been for his divorce we would have never known about it. And I am a great admirer of Mr. Welch and the outstanding job that he did leading this corporation.

So I guess my conclusion is that we will be looking at this issue and looking at and seeing what happens with the SEC and other oversight agencies. But I also think you may reach, depending on what happens to the economy, some kind of a critical point here and then Congress does act, and I am not sure that Congress always acts in the wisest fashion. That is why I have always been reluctant to see Congress act.

But these kind of excesses are making a lot of Americans angry. They certainly are in my State and the places where I go and speak.

You all have helped a lot today. It would have helped, frankly, in this hearing if at least one of the many CEOs we invited to come and testify would have accepted our invitation. And that is hard to understand, why people who are doing such great work would not come before this Committee and justify the compensation they receive for it.

So I thank the panel and I would like to ask if you have one more comment, closing comment, advice and counsel for us, beginning with you, Mr. Clapman?

Mr. CLAPMAN. Again, the focus should be on the future and not just to try to explain the past, and to really get it right for the future. Certainly TIAA–CREF as a shareholder, a proponent of shareholder rights and better corporate governance, is going to be pressing compensation committees, pressing on board independence.

But I think it is essential to let FASB do its job properly on the issue of expensing, because it is not just this value and that value. I think too often we focus too much on that. The real issue is it crowds out better forms of equity compensation and true performance and long-term shareholding, and it is only that will finally get it right.

The CHAIRMAN. Mr. Silvers?

Mr. SILVERS. I will just echo what Peter said and again commend you for your leadership on the stock option issue. I think it is the

central place where this matter is really being fought right now. Again, Congressional action is not needed, frankly. The regulators have the powers to fix this, both on the accounting side and on the corporate governance side. They need to be given the space to do it.

My last comment, and I am sorry Senator Allen is not still with us, is that I know that some of his constituents feel that the large option packages they have received cannot be valued. Anyone who truly believes that, I have ten dollars for them; I would like their options.

The CHAIRMAN. Thank you, Mr. Silvers. I will relay that to him.

Mr. HALL. Thank you, Senator. I guess I would just like to conclude by saying that the argument about broad-based option plans probably going away is overstated, but it probably is correct that broad-based option plans would be decreased if we expensed options.

The CHAIRMAN. What has been the experience of the corporations that have already announced that they are now expensing stock options?

Mr. HALL. Unfortunately, the vast majority of those corporations give very little stock options.

The CHAIRMAN. So we have no lessons to learn yet.

Mr. HALL. There are no profiles in courage there for much data to be gleaned.

But I guess what I would say in response to that is, if we are giving stock options to lower level workers in broad-based plans because of the distorted accounting, we should not be doing it. So in some cases they will do it because it was a good reason to start with and the accounting will not get in the way, and in other cases they will stop giving stock options and they will give stock or other things that employees like, like cash. So I really do not think the argument for broad-based option plans going away is a very good one.

Thank you for letting me testify.

The CHAIRMAN. Thank you.

Mr. BACHELDER. I think that I would strongly endorse the point of view that this is not an area where legislation will provide the answer. I think we found that in connection with the excise tax on change of control agreements and with the $1 million cap in the tax code. I do believe that encouraging transparency and more active shareholder participation in the process would all be positive encouragements.

The CHAIRMAN. Thank you.

Mr. HARRIGAN. Yes. First of all, I want to begin by thanking you for asking me on behalf of CalPERS to be here.

I think this whole issue about executive compensation, executive compensation is a serious problem and does have an impact on investor confidence in the markets in this country. But it is really about transparency and accountability, and the comments that I made really focused on those issues. It is about really having independent board members and independent compensation committees who really are accountable, not to the CEO but the owners of the company.

The only way that that is going to occur is if compensation plans are required to be submitted to the shareholders for approval and the shareholder votes are binding. It is only going to happen if compensation committees are truly accountable to the owners, meaning that shareholders have access to the proxy as was discussed by Mr. Silvers earlier.

The problems that we face in terms of the lack of confidence in our markets and corporate America today I think really are, the fundamental basis of that is just a lack of transparency and a lack of accountability. CalPERS, I think along with TIAA–CREF and the AFL–CIO, will continue to be active in the area of corporate governance and try to bring more accountability and transparency. But we need your leadership and the leadership of members of this Committee to make sure that the regulatory agencies act and act properly.

Thank you very much.

The CHAIRMAN. Thank you and I thank the witnesses.

This hearing is adjourned.*

[Whereupon, at 11:39 a.m., the Committee was adjourned.]

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*The HR Policy Association, submitted a paper entitled, Restoring Reasonableness to the Sarbanes-Oxley Loan Ban. The paper has been retained in Committee files.