

**TESTIMONY OF BRANDON J. REES**  
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**AMERICAN FEDERATION OF LABOR AND**  
**CONGRESS OF INDUSTRIAL ORGANIZATIONS**  
**Before the**  
**COMMITTEE ON FINANCIAL SERVICES**  
**UNITED STATES HOUSE OF REPRESENTATIVES**  
**MAY 25, 2006**

Good afternoon, Mr. Chairman Oxley and Ranking Member Frank, my name is Brandon Rees. I am the Assistant Director of the Office of Investment for the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO). I am honored for the opportunity to participate in today's hearing on the agenda of the Securities and Exchange Commission. The AFL-CIO believes H.R. 4291, the Protection Against Executive Compensation Abuse Act, is essential to reform CEO pay.

The first problem with executive compensation is that CEOs are being paid too much relative to their individual contribution to their companies. No CEO is so talented that his or her compensation should be unlimited. Secondly, executive compensation is poorly disclosed to shareholders. Many forms of CEO pay such as pensions and perks are underreported, and CEO pay-for-performance targets are hidden from shareholders. Thirdly, today's executive compensation packages are creating improper incentives for executives. For example, stock options can create a strong incentive to manipulate company stock prices through creative and even fraudulent accounting.

By any measure, today's CEO pay levels are too high. A reasonable and fair compensation system for executives and workers is fundamental to the creation of long-term corporate value. However, the past two decades have seen an unprecedented growth in compensation only for top executives and a dramatic increase in the ratio between the compensation of executives and their employees. Today, the average CEO of a major U.S. company makes 431 times the average worker's pay, up from 42 times in 1980. This ten-fold increase in CEO pay is not sustainable, and is a prime cause of growing economic inequality.

Executive compensation abuse takes dollars out of the pockets of shareholders, including the retirement savings of America's working families. Union members participate in pension plans with over \$5 trillion in assets. Union-sponsored pension plans hold approximately \$400 billion in assets, and runaway executive pay has diminished returns for working families' pension funds. Moreover, a poorly designed executive compensation package can reward decisions that are not in the long-term interests of a company, its shareholders and employees.

Earlier this year, the Securities and Exchange Commission proposed new rules on executive compensation and related party disclosure (SEC File Number S7-03-06). The Commission and its staff should be commended for recognizing that excessive executive compensation has become a major corporate governance problem. The SEC's proposed

changes are the first major update of its executive compensation disclosure rules in over 14 years, and they will go a long way to improve the current regulation. While the AFL-CIO strongly supports the SEC's efforts to increase transparency and clarity in executive compensation disclosure, we believe the final rule should be made stronger. Companies should be required to disclose their executives' pay-for-performance targets, and every director's potential conflicts of interest.

More than any other executive compensation issue, shareholders are concerned about pay-for-performance. Year after year, shareholders learn of record CEO compensation packages that have little connection to executives' individual performance. Company proxy statements routinely provide only the most generic boilerplate descriptions about how CEO pay is established. To public shareholders, the executive compensation system appears entirely subjective and subject to influence by corporate insiders.

Shareholders should be told what performance targets are being established for senior executives, whether executives meet their performance targets, and what levels of compensation are tied to the performance targets. Without the disclosure of the quantitative performance targets, shareholders have no ability to evaluate a company's executive compensation strategy. While disclosure of performance targets will not guarantee pay-for-performance, at least shareholders will be able to have an informed dialogue with compensation committee directors about appropriate pay practices.

Under the SEC's proposed disclosure rules, companies are not required to disclose pay-for-performance target levels if companies consider that information to be competitive or proprietary in nature. This disclosure loophole is not justified, and the SEC should require the disclosure of pay-for-performance targets. The performance benchmarks for senior level executives are generally based on disclosed financials. At a minimum, disclosure could be made retroactively after the conclusion of the performance period.

The SEC has also proposed to loosen the disclosure threshold for directors' related party transactions from \$60,000 to \$120,000. This weakening of the disclosure standards for directors' potential conflicts of interest flies in the face of recent regulatory trends on director independence. Director independence is critical for an objective executive compensation process, and the absence of independent directors is a root cause of runaway CEO pay. For these reasons, we strongly oppose the SEC's proposed increase of the related party transaction disclosure threshold.

The AFL-CIO believes that shareholders should have a right to know their executives' pay-for-performance targets. Shareholders should also be told if their directors have potential conflicts of interest. We believe that the investing public shares our view. Using the AFL-CIO's Executive Paywatch website [www.paywatch.org](http://www.paywatch.org), approximately 20,000 individuals have commented on the SEC's proposed rulemaking – one of the highest totals in the 72-year history of the SEC, according to SEC Chairman Christopher Cox's April 25, 2006 testimony before the Senate Banking Subcommittee.

Under the current rules, many forms of executive pay are hidden from shareholders. For example, Harvard Law Professor Lucian Bebchuk has estimated that retirement benefits make up one-third of a typical CEO's total compensation. Yet the current proxy rules provide poor disclosure of executive retirement benefits. Because these benefits have been obscured, many shareholders have not paid attention to their growth. Shareholders shouldn't need the help of a Harvard law professor or an expert compensation consultant to decipher what retirement benefits have been promised to their CEO.

This poor disclosure has led to outrageous CEO golden retirements. Many CEOs have negotiated retirement benefits that promise a lifetime of income far exceeding what they would be entitled to under the retirement plans of their rank-and-file workers. The promise of a virtually guaranteed multi-million dollar annual pension—no matter what happens to the company or its stock price—dramatically undermines the goal of linking CEO pay to performance. Often times, companies sweeten their executives' retirement benefits with preferential terms such as unearned years of service credit or above-market interest rates that are guaranteed by the company.

Executives have received these extraordinary retirement benefits at the same time workers are being asked to bear increased risk for their retirement security. According to the U.S. Bureau of Labor Statistics, fewer than half of all workers receive any retirement benefits from their employers. Only 21 percent of private-sector employees are covered by defined benefit pension plans, and only 42 percent have defined contribution 401(k) plans. In contrast, a 2005 survey by Clark Consulting found that 69 percent of Fortune 1,000 companies offer Supplemental Executive Retirement Plans, and 91 percent offer Nonqualified Deferred Compensation Plans for senior executives.

Every American deserves a secure retirement. Yet increasingly, companies are terminating their employees' pension plans and transferring the risk of saving for retirement onto their employees. At the same time, many of these same companies have turned their executive pension plans into CEO wealth creation devices. As a result, many companies have a two-tier retirement system: one for the CEO and one for everybody else. The irony is that these preferential executive retirement benefits are also hurting the retirement savings of America's working families by undermining the goal of linking CEO pay to performance and by creating unfunded liabilities for shareholders.

Working with the Corporate Library, the AFL-CIO's Executive Paywatch website [www.paywatch.org](http://www.paywatch.org) has identified many of the largest CEO pensions. Leading the list is Exxon Mobil CEO Lee Raymond who accrued an annual pension of over \$8 million. On his retirement on January 14<sup>th</sup>, 2006, he opted for a lump-sum cash payment of \$98 million. Meanwhile, *Business Week* has reported that out of all U.S. corporations, Exxon Mobil's employee pension plans have the biggest funding deficit of \$11.2 billion ("Shortfall At Exxon: All Those Profits – But Underfunded Pensions," May 29, 2006).

Other CEOs' super pensions are equally disturbing. At Pfizer, CEO Henry McKinnell will receive an annual pension of \$6.5 million or a lump sum of over \$83 million. Meanwhile, Pfizer's stock price has fallen nearly 50 percent under his leadership as CEO.

Or consider UnitedHealth Group CEO William McGuire, who will receive over \$5 million a year in pension benefits. That is on top of his \$1.75 billion in accrued stock options, many of which were improperly backdated to maximize their value. IBM CEO Samuel Palmisano's pension is worth \$4.5 million annually despite IBM's recent announced pension freeze. Home Depot CEO Robert Nardelli will get \$4.6 million each year in retirement while his employees don't even have a defined benefit pension plan.

The Protection Against Executive Compensation Abuse Act and the SEC's proposed rulemaking on executive compensation disclosure will go a long way to expose these preferential executive retirement benefits. Both this bill and the Commission's proposed rulemaking will require companies to provide a dollar estimate of their executives' accrued pension benefits. They will also introduce many other needed reforms, including improved disclosure of executives' perks and golden parachutes, as well as require that companies disclose their executives' compensation in clear and simple language.

While the SEC's proposed disclosure improvements are important, more should be done. H.R. 4291 will require companies to disclose short and long term pay-for-performance targets. This type of pay-for-performance disclosure is critical to encouraging responsible executive compensation practices. Under H.R. 4291, companies also would be required to claw-back executive compensation that is awarded based on inaccurate results in the event of an accounting restatement. CEO pay that is based on financial results that are later restated downwards constitutes undeserved compensation and should be returned.

H.R. 4291 will amend the Securities and Exchange Act of 1934 to require shareholder approval of executive compensation plans. H.R. 4291 would also require that all companies submit their golden parachutes to a separate shareholder vote in the event of a change in control. Requiring shareholder approval of executive compensation plans is an important safeguard. In the United Kingdom and Australia, shareholders routinely vote on CEO pay packages. Today at the Home Depot annual meeting, shareholders are voting on an innovative proposal by the American Federation of State, County and Municipal Employees (AFSCME) to require an advisory vote on CEO pay.

While improved CEO pay disclosure is a necessary reform, disclosure alone will not be sufficient to end executive compensation abuses. Excessive CEO pay is fundamentally a corporate governance problem. When CEOs wield too much power in the boardroom, they are able to extract economic rents from shareholders—the CEO equivalent of monopoly profits. These rents are known as agency costs, and arise from the separation of ownership and control. The board of directors is supposed to protect shareholder interests and minimize these agency costs.

Excessive executive compensation is a red flag that there is a power imbalance in the corporate boardroom. At approximately two-thirds of U.S. companies, the CEO is the board's chair. When one single person serves as both chair and CEO, it is impossible for that person to objectively monitor and evaluate his or her own performance. Requiring that boards be chaired by independent directors will enhance the objective leadership of the board and result in a more balanced executive pay process. Ultimately, shareholders

have to be able to trust their boards of directors to provide vigorous oversight of CEOs and to set responsible CEO pay packages.

For this reason, CEO pay will be reformed only when corporate boards are made more accountable. Not surprisingly, many boards and their compensation committees are comprised of directors who are overpaid CEOs in their own right. Other directors have business or personal relationships with the company and its CEO that make them “too close for comfort.” The vast majority of director nominees are also hand-picked by the incumbent board with the tacit consent of the CEO. Under the proxy rules, it is cost prohibitive for shareholders to run their own director candidates.

To break this self-perpetuating system, shareholders must have greater voice in the election of directors. Under the plurality vote system at most companies, a director can be elected to a board even if a majority of shareholders withhold support from that director. This year, union-sponsored pension funds have filed over 150 shareholder proposals urging that directors be elected by majority vote. The AFL-CIO also strongly urges the SEC to give shareholders equal access to the proxy. Until then, CEOs will continue to influence the size of their own compensation, and CEO pay will continue to rise.