Testimony of
Steven N. Kaplan

on

"Empowering Shareholders on Executive Compensation"
and
H.R. 1257, the "Shareholder Vote on Executive Compensation Act"

Before the
Committee on Financial Services
United States House of Representatives

March 8, 2007

Are U.S. CEOs Overpaid?

by

Steven N. Kaplan*

March 2007

Abstract

Critics of U.S. corporate governance claim that public company (1) CEOs are overpaid; (2) CEOs are not paid for performance; and (3) public company boards do a poor job of compensating and monitoring CEOs. In this paper, I argue that the critics are wrong. While corporate governance and CEO pay are not perfect, a great deal of evidence suggests that CEO pay is largely determined by market forces. CEOs have been affected by the same forces that have increased income inequality. They have not done better than several similar groups. CEOs are strongly paid for performance. And boards do monitor CEOs. CEO tenures are lower than they have been since tenures have been measured in the 1970s; CEO turnover is more closely tied to stock performance than it has been since turnover has been studied in the 1970s. The increased transparency for CEO pay required by the new SEC disclosure rules should further reduce any remaining unwise compensation practices. The proposed bill to mandate a shareholder vote on executive compensation, H.R. 1257, is likely to impose costs while having little, if any, benefit.

* University of Chicago Graduate School of Business and National Bureau of Economic Research. Address correspondence to Steven Kaplan, University of Chicago Graduate School of Business, 5807 South Woodlawn Avenue, Chicago, IL 60637 or e-mail at skaplan@uchicago.edu.

1. Introduction

I am the Neubauer Family Professor of Entrepreneurship and Finance at the University of Chicago Graduate School of Business. One focus of my career and my research has been to study corporate governance, and to understand what governance arrangements lead to the best corporate performance.

In the last several years, corporate governance in the United States has come under great scrutiny and attack. The scandals of Enron, Worldcom and others early in this decade led to the Sarbanes-Oxley legislation. Since that legislation, the criticism of corporate governance has continued. CEOs are routinely criticized for setting their pay, being overpaid and for stealing when they can. Boards of directors are routinely criticized for paying the CEOs too much, not paying for performance, and being too friendly to management.[1]

Are the critics right? Is it true that the typical CEO is overpaid? Is it true that the typical CEO is not paid for performance? Is it true that public company boards are doing such a bad job? In the rest of this submission, I will argue the answers to these questions are no, no, no and no. While CEO and top executive pay practices are by no means perfect, they are nowhere near broken.

First, it is important to put the United States economy in perspective. Over the last 15 years, the period in which corporate governance and CEO pay have been criticized, the U.S. economy has done extremely well – both on an absolute basis and relative to other developed countries. Productivity growth in the U.S. has been unexpectedly good and, despite the tech bust, the stock market has performed very well over that period.

Second, are CEOs overpaid? While there have clearly been abuses and unethical CEOs, pay for the typical CEO appears to be largely driven by market forces. As CEO pay has increased substantially since the early 1990s, the pay of other talented and fortunate groups has increased by at least as much. For example, hedge fund, private equity, and venture capital investors have seen fees increase from less

---

[1] Jensen, Murphy and Wruck (2004) document the increase in CEO pay since the 1970s. Bebchuk and Fried (2003) and Bebchuk and Grinstein (2005) document a substantial increase in CEO pay accelerated after 1995.

than $5 billion to roughly $35 billion from 1994 to 2004, an increase of 7 times. These increases have translated into very high pay for those groups. By one estimate, the top 25 hedge fund managers earned more in 2004 than all 500 CEOs in the S&P 500. The number of professional baseball, basketball, and football players earning more than $5 million a year increased by a factor of almost 10 times from 1994 to 2004. Even top lawyers saw their pay increase by more than 2.5 times. In line with these other groups, the pay of S&P 500 CEOs increased by roughly 3 times over the same period (although it has declined since 2000).

In other words, while CEOs earn a great deal, they are not unique. Other groups with similar backgrounds and talents have done at least equally well over the last ten or fifteen years. The increase in pay at the top appears to be systemic. Rising CEO pay, therefore, appears to be part of (not the cause of) the general increase in economic inequality that we have seen in the last several decades. The compensation of the other groups, undoubtedly, has been driven by market forces. It is difficult to imagine that the increase in CEO pay is not largely driven by market forces as well.

Third, are CEOs paid for good stock performance? Critics contend that CEOs are not paid for performance. That is just not true. In some cases, the critics confuse theoretical pay – what the boards give to the CEOs as estimated pay – and actual pay. The key question is whether CEOs who perform better earn more in actual pay.

And the answer is yes. My colleague Josh Rauh and I looked at actual CEO pay in a given year. Firms with CEOs in the top decile of actual pay earned stock returns that were 90% greater than those of other firms in their industries over the previous 5 years. Firms with CEOs in the bottom decile of actual pay underperformed their industries by almost 40% in the previous 5 years. The results are qualitatively similar if we look at performance over the previous three years or previous year. There can be absolutely no doubt that the typical CEO in the U.S. is paid for performance.

Fourth, are boards today dominated by their CEOs? The evidence suggests no. My colleague Bernadette Minton and I studied CEO turnover in Fortune 500 companies. Turnover levels since 1998 have been substantially higher than in previous work that has studied previous periods. In any given year, one out of 6 Fortune 500 CEOs lose their jobs. This compares to one out of 10 in the 1970s. The CEO job is riskier today than it has been in the past. Second, CEO turnover is strongly related to poor firm stock performance – both poor performance relative to the industry and poor industry performance. These sensitivities have been stronger in the last eight years than in any other period since 1970.

Fifth, is there a market for CEOs? The critics contend that CEO pay is driven by consultants and board relationships, not by market forces. The factors I have just presented suggest that view is wrong. All of these factors suggest that the CEO job has become increasingly difficult and less pleasant. Although I hesitate to say it, one might argue that good CEOs are not overpaid, but underpaid. Fortunately, the New York Times has said it for me. In January, Andrew Ross Sorkin reported:

> "Chief executives are being lured by private equity-owned businesses, which offer higher pay and freedom from scrutiny of shareholders and regulators; executives at privately held firms secure ownership positions that can turn into bountiful riches when businesses are sold or go public again; private firms' willingness to pay big money may bolster the argument of defenders of corporate pay practices who contend that companies have been paying going rate in market to attract top talent …"

Last year saw an unprecedented volume of private equity activity. It is unlikely that the CEOs who did those deals would have chosen to go private and work for private equity investors if they were so overpaid as public company CEOs.

It also is worth pointing out that in hiring the CEOs at higher pay, the private equity investors cannot have felt the CEOs were overpaid. This is true because private equity investors are strongly motivated to make profits. Any extra compensation to a CEO reduces the profit of a private equity investor. In addition, private equity investors control the boards of their firms, so the negotiations are arms-length.

A prominent and interesting example is David Calhoun. Mr. Calhoun was a well-regarded vice chairman at General Electric (GE). He ran a unit that generates $47 billion in sales – about 1/4 of GE's sales. Undoubtedly, he would have been an attractive CEO candidate to a host of other public companies. Instead, he agreed to become the CEO of a private equity-funded company with only $5 billion sales, VNU Group (which owns A.C. Nielsen). If good public company CEOs were overpaid, it is difficult to understand why he would choose to run a much smaller private equity-funded company.

In addition to going to work for private equity funded companies, some of the more successful public company CEOs have gone to work for the private equity firms as investors or advisors. These include Lou Gerstner of IBM at Carlyle, Ed Artzt of P&G at KKR, Jack Welch of GE at Clayton Dubilier, and Jim Kilts of Gillette at Centerview. There is no doubt that many of these CEOs would be welcome as CEO by many public companies, yet they are choosing not to.

In other words, the regulation, criticism and hounding of public company CEOs may have a major cost. CEOs can and will leave public companies to do something else. And, it is the better CEOs who will tend to do so. The result may be more private companies that are less transparent and more public companies with less able CEOs.

Three other aspects of the current corporate governance system are worth commenting on. First, the SEC issued new rules for the disclosure of executive compensation that are in the process of being implemented. These new rules increase transparency for investors and for boards of directors. At the same time, board compensation committees have become increasingly independent. It is likely that this increased disclosure and independence will reduce any remaining inappropriate practices. And some companies will further increase the pay for performance they offer their CEOs. (If I am correct about the market for CEOs, however, the increased disclosure will not lead to reduced pay for the typical CEO.)

Second, if shareholders are or continue to be dissatisfied, they can withhold their votes from directors in elections for boards of directors. It appears that many companies will move to a majority-voting standard in which directors require a majority of votes cast to be elected. (This is a positive development that makes directors more accountable.)

Third, public company CEOs and boards face increased pressure today from activist shareholders and hedge funds.

Given all this, what do I make of the proposed H.R. 1257? Let's look at the current rules and what the proposed law will change. Under current rules, shareholders can ask a company to have a non-binding vote on executive compensation in its annual proxy. In fact, more than 50 such proposals have been submitted this year. Because the proposals require shareholders to act, they are generally based on some evidence of poor compensation practices.

The company that receives such a proposal has two choices. It can agree to a vote – like AFLAC – in which case the vote occurs. Or the company can disagree, in which case the company is likely to attract adverse publicity and attention. So, under current rules, when shareholders believe a company has compensation problems, shareholders can generate a vote or adverse publicity for that company. When no one believes a company has problems, nothing happens.

In contrast, H.R. 1257 would mandate a non-binding shareholder vote to approve the compensation of executives for every company every year. Companies with problems will have a vote and, presumably, will receive a negative vote. But this is almost exactly what happens under the current system. So, it is not clear to me that the new bill would create any benefits.

At the same time, the bill would mandate a vote for companies that do not have a problem. This has the potential to impose costs on those companies and boards that they do not incur today. It potentially subjects these boards and companies to increased pressure from interest groups that they do not incur today. One can imagine politically oriented shareholders attempting to make political statements in their votes. A shareholder vote for every company also is likely to make it more difficult to hire a CEO from outside the company.

In summary, the evidence strongly supports the view that CEO and top executive pay is largely driven by market forces. While there have been pay abuses (and the press has focused on them), those examples are not typical and are likely to become less common. On the margin, the proposed bill does not create clear benefits over the current system. It does impose clear costs. Furthermore, the proposed bill is likely to further reduce the attractiveness of being a public company CEO, particularly for good CEOs. That is not good for U.S. companies; it is not good for U.S. workers; and it is not good for the U.S. economy.

The rest of this submission details and expands on the statements above.

2. How have public companies in the U.S. performed?

Before talking about top executive pay, it is worth noting that the U.S. economy and, particularly, the U.S. corporate sector, have performed extremely well in the last 15 years, the period in which corporate governance and CEO pay have been criticized. During that period, the productivity of the U.S. economy has increased substantially, both on an absolute basis and relative to other developed countries. Furthermore, the U.S. stock market has performed extremely well. About a year ago, Berkeley economist, Brad Delong, noted that since Alan Greenspan's famous "irrational exuberance" speech in 1996, the U.S. stock market has not declined, but, rather, increased by 6% per year above inflation.[2] Rather than being irrationally exuberant, the U.S. stock market and U.S. companies have benefited from unexpectedly good productivity growth.

So, as one considers CEO and top executive pay, remember that one should start from a perspective that U.S. companies and their executives have been very successful on average in delivering productivity growth and shareholder returns.

3. How is CEO pay measured?

There are two ways to measure CEO and top executive pay. Unfortunately, these two measures are often used and confused in misleading ways.

The first measure is the estimated or theoretical value of CEO pay. This includes the CEO's salary, bonus, the value of restricted stock issued, and the estimated or theoretical value of the options issued to the CEO that year (usually calculated with Black-Scholes). This is a good estimate of what the board expects to give the CEO that year. It is not a measure of what the CEO actually gets to take home. The CEO takes his or her salary and bonus, but does not get to cash in the options. This measure, therefore, is inappropriate for considering whether CEOs are paid for performance.

[2] http://www.j-bradford-delong.net/movable_type/2005-3_archives/001805.html

The second measure is realized or actual CEO pay. This includes the CEO's salary, bonus, the value of restricted stock, and the value of the options the CEO exercised that year. Because it uses actual option gains (not the theoretical values), this second measure is a good measure of the amount of money the CEO actually takes home in a given year. This measure, therefore, is more appropriate for considering whether CEOs are paid for performance.[3]

. What are the facts about CEO pay?

CEO pay increased significantly from 1993 to 2000. Since 2000, however, CEO pay has not increased. By some measures, it has declined. Exhibit 1 reports the average and median total pay (estimated / theoretical) of S&P 500 CEOs from 1993 to 2005 (in millions of 2005 $). The exhibit shows that average CEO pay peaked in 2000 and has declined by roughly 1/3 since then. Median CEO pay peaked in 2001 and has declined slightly since then. Exhibit 2 reports CEO pay relative to median household income. Again, average CEO pay peaked in 2000 while median CEO pay peaked in 2001.

Nevertheless, the exhibits indicate that boards expected to pay CEOs well. In 2005, the median S&P 500 CEO received estimated pay of just under $8 million, roughly 150 times the pay of the median household. Although these numbers are large, they have declined since 2000, and are lower than some of the figures suggested by critics. The ratio was 71 times in 1994, so from 1994 to 2004, the ratio has increased by slightly more than two times.

Exhibits 3 and 4 present the analogous figures for actual CEO pay. Recall that this includes exercised options that were issued in the past. Exhibit 3 shows that average actual pay also peaked in 2000. Median pay has continued to increase and peaked in 2005 at a value of just over $6 million. Exhibit 4 shows a similar pattern relative to median household income.

4. Are CEOs unique or unusual?

---

[3] Because it measures realized gains, it also includes any benefits from backdating that lowered the exercise price of the options.

Although estimated and actual CEO pay has declined since 2000, it is clear that CEOs are highly paid and have done very well since the 1990s. The important question is why they have done so well? Are the increases driven by market forces? Or, as the critics argue, is much of the increase due to unethical behavior and cozy arrangements between CEOs and their boards? While such behavior has occurred and undoubtedly will continue to occur in some instances, the preponderance of the evidence points toward market forces as the driver of high CEO pay.

For example, Gabaix and Landier (2006)[4] argue that the increase in CEO pay can be explained by market forces. In a simple competitive model, they show that as firms get bigger, CEOs will get paid more. A talented CEO creates more value as a firm becomes larger. In a competitive market, CEO pay will be bid up as firms become larger. In their model, CEO pay increases over time at exactly the same rate as the size of the average firm in the economy. In other words, the larger size increases the returns to hiring a more productive CEO. They then show empirically that the market values of large U.S. firms have increased by a factor of 4 to 7 times since 1980. As predicted by their model, CEO pay has increased by a similar factor over this period.

The argument for market forces also implies that other, similar individuals should have done very well over the same period. My colleague Josh Rauh and I studied this issue and find evidence consistent with this.[5] While CEOs have done well, so have several other fortunate and talented groups. Several of those groups have done better than the CEOs. In other words, the increase in CEO pay is a factor in the increase in income inequality at the very top end of the income distribution. It is not, however, the driver of that inequality.

Exhibit 5 provides a good example. It presents the top 10 incomes in 2004 for three groups. The first is the top 10 highest paid hedge fund managers. The second group is the top 10 highest paid S&P 500 CEOs using actual pay. The third group is the top 10 highest paid S&P 500 CEOs using estimated /

[4] Xavier Gabaix and Augustin Landier, 2006, "Why Has CEO Pay Increased So Much?" working paper, New York University. See also Carola Frydman and Raven Saks, 2005, "Historical Trends in Executive Compensation, 1936-2003," working paper, Harvard University.
[5] Steven Kaplan and Joshua Rauh, 2006, "Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?" working paper University of Chicago.

theoretical pay. As the exhibit makes clear, CEOs are not the only fortunate group. In fact, the top 25 hedge fund managers earned more in 2004 than all 500 S&P 500 CEOs combined.

By the measure of estimated pay, public company CEOs are no more fortunate relative to others in 2004 than they were in 1994. Exhibit 6 reports the fraction of the top AGI income brackets comprised by public company CEOs tracked by the ExecuComp database in 1994 and 2004. The ExecuComp database covers roughly 1700 companies in both years. The exhibit shows that the top bracket (top 0.01%) increased a great deal, from \$3.1 million to \$7.2 million in that period. The share of ExecuComp CEOs of that top bracket, however, remained constant with the CEOs representing roughly 2% of the very top income bracket (top 0.01%) in both 1994 and 2004. Again, CEOs are not the only ones who are earning more.

Exhibits 7 to 12 provide an indication of other groups that have done extremely well over this period – Hedge Fund, Private Equity, and Venture Capital investors, investment bankers, professional athletes, and lawyers. Exhibit 7 documents the estimated increase in hedge fund fees over time. They have grown from \$2 billion in 1994 to \$20 billion in 2005. (By comparison, the total pay of S&P 500 CEOs grew from \$1.6 billion in 1994 to just under \$5 billion in 2004 using estimated or theoretical pay.) Because of lack of transparency, it is impossible to know exactly how those fees are divided among individuals. But as Exhibit 5 indicates, much of that increase has gone to a few fortunate and talented individuals.

Exhibit 8 documents the increase in expected fees to private equity and venture capital investors. According to these estimates, the fees increased from \$3 billion in 1994 to over \$18 billion in 2005. And our calculations likely understate total fees. Again, a lack of transparency makes it impossible to calculate exactly how these increased fees are divided.

Exhibit 9 compares our estimates of top investment banker pay to the pay of all top executives in the ExecuComp database. That means that we compare roughly 7,500 top executives of non-financial public companies to our estimate of 10,000 managing directors and highly paid investment bankers in 2004. (We exclude CEOs of financial companies because a number of the highly paid ones run investment banks.) Exhibit 9 indicates that the investment bankers comprise a greater fraction of the top 0.1% and top 0.01% of the income distribution.

Exhibit 10 provides a similar comparison of 1995 and 2004 for professional athletes in baseball, basketball, and football. In 1995, fewer than 40 professional athletes earned over $5 million. In 2004, over 350 did. Like the other groups, professional athletes increased their presence in the very top of the income distribution.

Finally, exhibits 11 and 12 show that lawyers also have done extremely well over the period from 1994 to 2004. According to the American Lawyer survey, the average partner at a top 50 law firm increased his or her income from $0.6 M in 1994 to over $1.2 million in 2004 (using $2004). And there were almost 50% more partners. As a result, we estimate that lawyers also increased their presence substantially in the top 0.1% of the income distribution.

The point of these exhibits is that while CEOs earn a great deal, they are not unique. Other groups with similar backgrounds and talents – particularly, hedge fund and private equity investors, investment bankers, and lawyers – have done at least equally well over the last ten or fifteen years. The increase in pay at the top appears to be systemic. Rising CEO pay, therefore, appears to be part of (not the cause of) the general increase in economic inequality that we have seen in the last several decades. The compensation of these other groups, undoubtedly, has been driven by market forces. Given those trends, it seems likely that the increase in CEO pay has been largely driven by market forces as well.

What are those market forces?   Our best guess is that changes in technology have allowed the most fortunate and talented to increase their productivity relative to others. This seems likely to provide some, if not much of the explanation for the increase in pay of professional athletes (technology increases their value by allowing them to reach more consumers) as well as Wall Street investors and CEOs (technology allows them to acquire information and trade large amounts more efficiently). Ben Bernanke discussed these issues and appeared sympathetic to this explanation in his recent remarks on economic inequality.[6]

5. What do boards do? Are they controlled by their CEOs?

According to the critics, boards are too friendly to management: they do not pay for performance and they do not fire CEOs for poor performance. The truth is, in fact, the opposite.

A. Are CEOs paid for performance?

Critics contend that CEOs are not paid for good stock performance. That is just not true. In some cases, the critics confuse theoretical pay – what the boards give to the CEOs as estimated pay – and actual pay. The key question is whether CEOs who perform better earn more in actual pay. And the answer is yes.

For each year from 1999 to 2004, my colleague Josh Rauh and I took all the firms in the ExecuComp database and sorted them into ten groups based on size. We did this because it is well-established that pay is tied to firm size. Bigger firms do pay more. Within each size group for each year, we sorted the CEOs into ten groups based on how much compensation they actually realized. We then looked at how the stocks of each group performed relative to their industry over the previous five years.

Exhibit 13 gives the results. Actual compensation is highly related to firm stock performance. Firms with CEOs in the top decile of actual pay outperform their industries by more than 90%. Firms with CEOs in the bottom decile of actual pay underperform their industries by almost 40%. The results are qualitatively the same if we look at performance over the previous three years or previous year.

There can be no doubt that the typical CEO in the U.S. is paid for performance.

B. Are CEOs fired for poor performance?

---

[6] Ben Bernanke, "The Level and Distribution of Economic Well-Being," Federal Reserve Board, February 6, 2007.

Critics contend that boards are too friendly to management. Is that true? Bernadette Minton and I study CEO turnover in Fortune 500 firms from 1992 to 2005.[7] We consider all turnover, both internal and turnover that occurs through takeover and bankruptcy. We then look at how turnover varies with firm performance.

Two patterns emerge. First, turnover levels since 1998 have been substantially higher than in previous work that has studied previous periods. The CEO job is riskier today than it has been in the past. Second, CEO turnover is strongly related to poor firm performance.

Exhibit 14 shows the likelihood a CEO loses his or her job in a given year from the 1970s through 2005. The exhibit does not include takeovers. The data for the 1970s and 1980s, are taken from Murphy and Zabonjik (2005). Not counting takeovers, 10% of CEOs turned over each year. We find a similar percentage through 1997. Since 1998, however, turnover has increased substantially. Not counting takeovers, 12.8% of CEOs turned over each year from 1998 to 2005.

When takeovers are included, the numbers are even greater. Exhibit 15 shows that since 1998, an average of 16.5% of CEOs of Fortune 500 companies lose their jobs each years. This means the average CEO can expect to have the job for only 6 years. Thirty years ago it was closer to ten years.

Next, we consider how CEO turnover is related to firm stock performance. We divide that performance into performance of the firm's industry and performance relative to the industry. We find that board-driven CEO turnover is strongly related to both. CEOs are more likely to lose their job when their firms perform poorly relative to the industry and when their industries perform poorly. And the relationships are meaningful. These relations have been particularly strong since 1998 – 2005. This result is not driven by the firms involved in scandals. I.e., the result is driven by boards, possibly pressured by institutional shareholders and hedge funds.

The bottom line. Since 1998, annual CEO turnover is higher than at any time since 1970. The job is riskier. And, turnover initiated by the board is significantly related to industry stock performance

[7] "How has CEO Turnover Changed? Increasingly Performance Sensitive Boards and Increasingly Uneasy CEOs," by Steven Kaplan and Bernadette Minton, working paper, Universtiy of Chicago, August 2006.

and firm stock performance relative to the industry. I.e., CEOs face significant performance pressure. This is consistent with corporate governance system / boards having performed better in their monitoring role from 1998 to 2005 than in any previous period.

6. What about pensions and severance payments?

Pensions received a great deal of attention last year when the large accumulated pension amounts of Hank McKinnell of Pfizer and Lee Raymond of Exxon were revealed. While the compensation numbers above do not include pensions, including pensions are unlikely to change the results appreciably for the typical CEO.

Sundaram and Yermack (2006)[8] study the value of CEO pensions for a sample of Fortune 500 companies. They find that the annual increment to pension value is less than 10% of total pay on average. The annual increment is smaller for the typical or median CEO. In other words, annual pension income increases the incomes estimated previous by a small amount for the typical CEO. In addition, it is not clear that these pensions have increased over time. Based on this evidence, McKinnell and Raymond appear to represent extremes on the distribution of pensions.

It also is likely that in the future, boards will make less use of these types of pension plans when they are not appropriate. The adverse shareholder reaction and the improved disclosure of top executive pay that the SEC now requires will likely lead to such a result.

The compensation numbers above also exclude severance agreements. The media and shareholder activists have focused on some of the more egregious examples of these agreements. Again, the average or median case is quite different from the extremes. Yermack (2005) looks at severance agreements in 179 instances of CEO turnover in Fortune 500 companies.[9] The mean separation payment is \$5.4 million (compared to average pay of \$8.1 million) while the median is \$0.7 million (compared to

[8] Rangarajan Sundaram and David Yermack, "Pay Me Later: Inside Debt and Its Role in Managerial Compensation," working paper, New York University, 2006.

[9] David Yermack, "Golden Handshakes: Separation Pay for Retired and Dismissed CEOs," working paper, New York University, 2005.

median pay of $4.8 million). Most observers would be surprised that these numbers are not larger. The disparity between the mean and the median indicates that the mean is driven by a few large (and well-publicized) separation payments.

Furthermore, as is the case with pensions, it seems probable that boards will respond to adverse shareholder reaction and improved disclosure to make less use of severance when it is not appropriate.

7. Is it better in the UK?

The UK is sometimes cited as a model for CEO pay. Shareholders are supposed to be more active in the UK. And since 2003, UK shareholders have been allowed to cast advisory votes on executive compensation packages in public companies. It is not clear what difference this has made.

One academic study by Conyon, Core and Guay looked closely at similar sized UK and US companies in 1997 and 2003. They use the estimated or theoretical value of CEO pay – i.e., the pay the board expected to give in those years. They find that the pay of the US CEOs increased by less than 25%, from $3.6 million to $4.5 million in that period. At the same time, the pay of UK CEOs increased by almost 100% from $1.3 million to $2.5 million.[10] I.e., CEO pay increased by more in the UK than in the US. According to a recent Wall Street Journal article, the trend may have continued.[11] The article reported that from 2003 to 2005, CEO salary and bonus increased by 35% in the UK (ISS UK) versus 14% in the US (Mercer).

8. If public company CEOs are so overpaid, why are they leaving public companies?

At this point, I have presented the following facts:

- Average CEO pay has declined or been flat since 2000 / 2001.

[10] "How High Is US CEO Pay? A Comparison with UK CEO Pay," by Conyon, Core, and Guay, working paper, University of Pennsylvania, 2006.

[11] "Shareholders Push for Vote on Executive Pay," Erin White and Aaron Patrick, Wall Street Journal, February 26, 2007.

. While CEO pay has gone up a great deal since 1994, CEOs occupy roughly the same place in the overall income distribution as in 1994. Pay of other similarly fortunate and talented individuals has gone up at least as much since 1994.

. Actual CEO pay is strongly related to stock performance.

. CEO turnover is up substantially. The CEO job is less secure than it has been since at least 1970.

. CEOs face more performance pressure from their boards than they have in any period since 1970.

. U.S. CEO pay appears to have gone up by less than pay for U.K. CEOs since 1997.

At the same time, CEOs and boards have had to implement the new Sarbanes-Oxley regulations. A number of CEOs and directors have complained that the costs involved in some aspects of Sarbanes-Oxley exceed the benefits. According to some, Sarbanes-Oxley has lead to more bureaucracy and compliance at the expense of strategy and value creation.

All of these factors suggest that the CEO job has become increasingly difficult and less pleasant. Although I hesitate to do so, one might be tempted to argue that good CEOs are not overpaid, but underpaid. Fortunately, the New York Time presented exactly this argument in January. Andrew Ross Sorkin reported:

> "Chief executives are being lured by private equity-owned businesses, which offer higher pay and freedom from scrutiny of shareholders and regulators; executives at privately held firms secure ownership positions that can turn into bountiful riches when businesses are sold or go public again; private firms' willingness to pay big money may the bolster argument of defenders of corporate pay practices who contend that companies have been paying going rate in market to attract top talent … "[12]

Last year saw an unprecedented volume of private equity activity. With the recent deals for Equity Office Properties and TXU, that activity has not abated. While liquid financial markets are playing an important role, this activity would not be occurring without the active participation of public company CEOs. If they were so overpaid as public company CEOs, it is difficult to explain why so many

[12] New York Times, January 8, 2007

CEOs have chosen to go to work for private equity-funded companies – either by taking their own companies private or by leaving their companies to work for other ones.

It also is worth pointing out that in hiring the CEOs at higher pay, the private equity investors cannot have felt the CEOs were overpaid. This is true because private equity investors are strongly motivated to make profits. Any extra compensation to a CEO reduces the profit of a private equity investor. In addition, private equity investors control the boards of their firms, so the negotiations are arms-length.

A prominent and interesting example is David Calhoun. Mr. Calhoun was a well-regarded vice chairman at General Electric (GE). He ran a unit that generates $47 billion in sales – about 1/4 of GE's sales. Undoubtedly, he would have been an attractive candidate to become the CEO of GE or a host of other public companies. Instead, he agreed to become the CEO of a private equity-funded company with only $5 billion sales, VNU Group (which owns A.C. Nielsen). If good public company CEOs were overpaid, it is difficult to explain why he would choose to run a much smaller private equity-funded company.

And Calhoun is not the only example. Mark Frissora left his CEO job at publicly traded Tenneco to run Hertz. The CFO of Circuit City left last month to become the CFO of a private equity funded retailer.

In addition to going to work for private equity funded companies, some of the more successful public company CEOs have gone to work for the private equity firms as investors or advisors. These include Lou Gerstner of IBM at Carlyle, Ed Artzt of P&G at KKR, Jack Welch of GE at Clayton Dubilier, Larry Bossidy of Honeywell at Aurora, and Jim Kilts of Gillette at Centerview. There is no doubt that many of these CEOs would be welcome as CEO by many public companies, yet they are choosing not to work for public companies.

In other words, the criticism and hounding of public company CEOs may have a major cost. CEOs can and will leave public companies to do something else. And, it is the better CEOs who will tend to do so. This leaves more private companies with less transparency and leaves public companies with less able CEOs.

9. Is a law to require a non-binding shareholder vote a good idea?

The facts reported call into question the claims that CEOs are overpaid, that CEOs are not paid for performance, and that boards are dominated by their CEOs. In fact, the evidence indicates that good CEOs in U.S. companies may be underpaid at this point. Furthermore, the performance of the U.S. economy and the U.S. stock market is consistent with a system that has performed well, not one that has performed badly.

Now, let's look at the current rules and what the proposed law will change. Under current rules, shareholders can ask a company to have a non-binding vote on executive compensation in its annual proxy. In fact, more than 50 such proposals have been submitted this year. Because the proposals require shareholders to act, they are generally based on some evidence of poor compensation practice.

The company that receives such a proposal has two choices. It can agree to the proposal in which case the vote occurs. Or the company can disagree, in which case the company is likely to attract adverse publicity and attention. So, under current rules, when shareholders believe a company has compensation problems, shareholders can generate a vote or adverse publicity for that company. When a company has no problems, nothing happens.

In contrast, H.R. 1257 would mandate a non-binding shareholder vote to approve the compensation of executives for every company every year. Companies with problems will have a vote and, presumably, will receive a negative vote. But this is almost exactly what happens under the current system. So, it is not clear what the benefits of the new bill would be.

At the same time, the bill would mandate a vote for companies that do not have a problem. This has the potential to impose costs on those companies and boards that they do not incur today. It potentially subjects these boards and companies to increased pressure from interest groups that they do not incur today. One can imagine politically oriented shareholders attempting to make political statements in their votes.

A shareholder vote for every company also is likely to make it more difficult to hire a CEO from outside the company. While the board and CEO candidate may agree that a compensation contract is at a market rate, the uncertainty about the shareholder vote and attendant publicity has the potential to scare off some candidates.

So, the proposed bill would impose clear costs without generating clear benefits.

Two other aspects of the current regime are worth commenting on. First, the SEC issued new rules for the disclosure of executive compensation that are in the process of being implemented. These new rules increase transparency for investors and for boards of directors. It is likely that this increased disclosure will reduce or eliminate inappropriate practices that remain. If I am correct about the market for CEOs, however, the increased disclosure will not lead to reduced pay for the typical CEO.

Second, if shareholders are or continue to be dissatisfied, they can withhold their votes from directors in elections for boards of directors. It appears that many companies will move to a majority-voting standard in which directors require a majority of votes cast to be elected. (This is a positive development that makes directors more accountable.)

So, in sum, I see that H.R. 1257 addresses a problem that is not the systemic problem that critics claim it is. In fact, it may be a greater problem that some of the best public company CEOs do not want to be public company CEOs any longer. The flight of top executives and companies to private equity (and hedge funds), both in the U.S. and in Europe, suggests that these kinds of concerns are real. CEOs and top executives appear to operate in and are paid by a market.

It is hard to see that H.R. 1257 will generate appreciable benefits over the current system. At the same time, H.R. 1257 will generate additional costs. On the margin, this bill also will further reduce the attractiveness of being a public company CEO, particularly for good CEOs. That is not good for U.S. companies; it is not good for U.S. workers; and it is not good for the U.S. economy.

Exhibit 1:

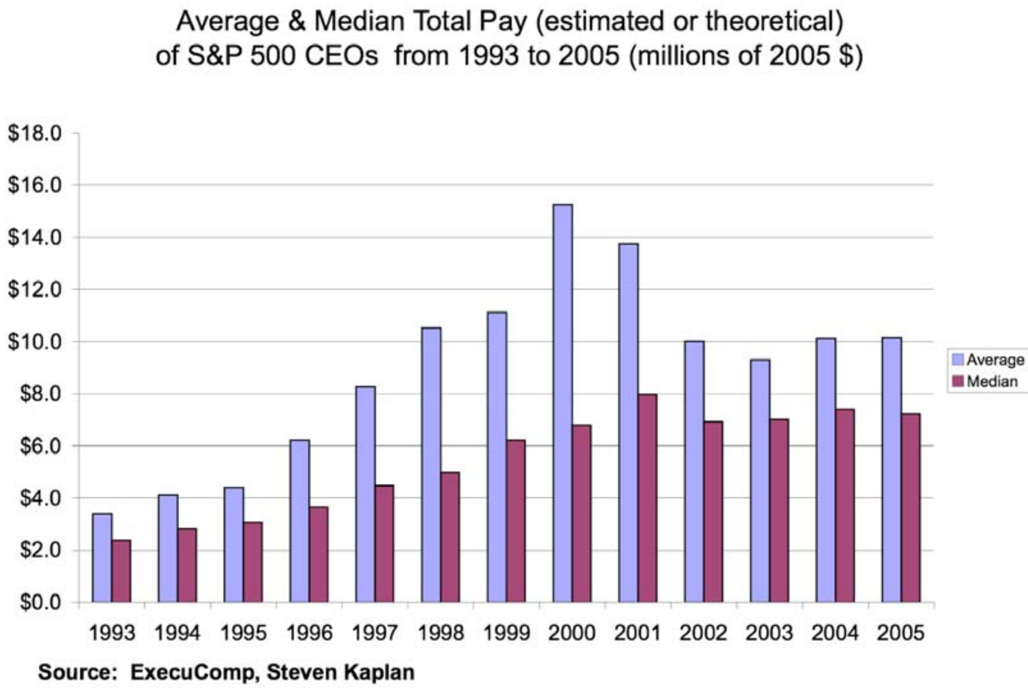


Exhibit 2:

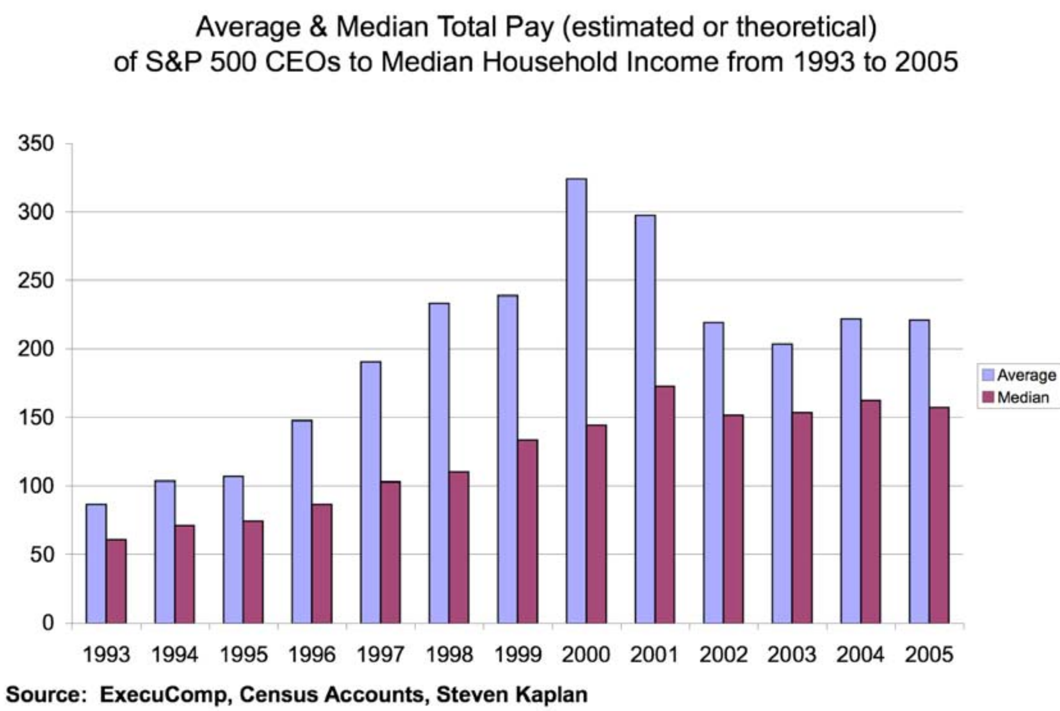


Exhibit 3

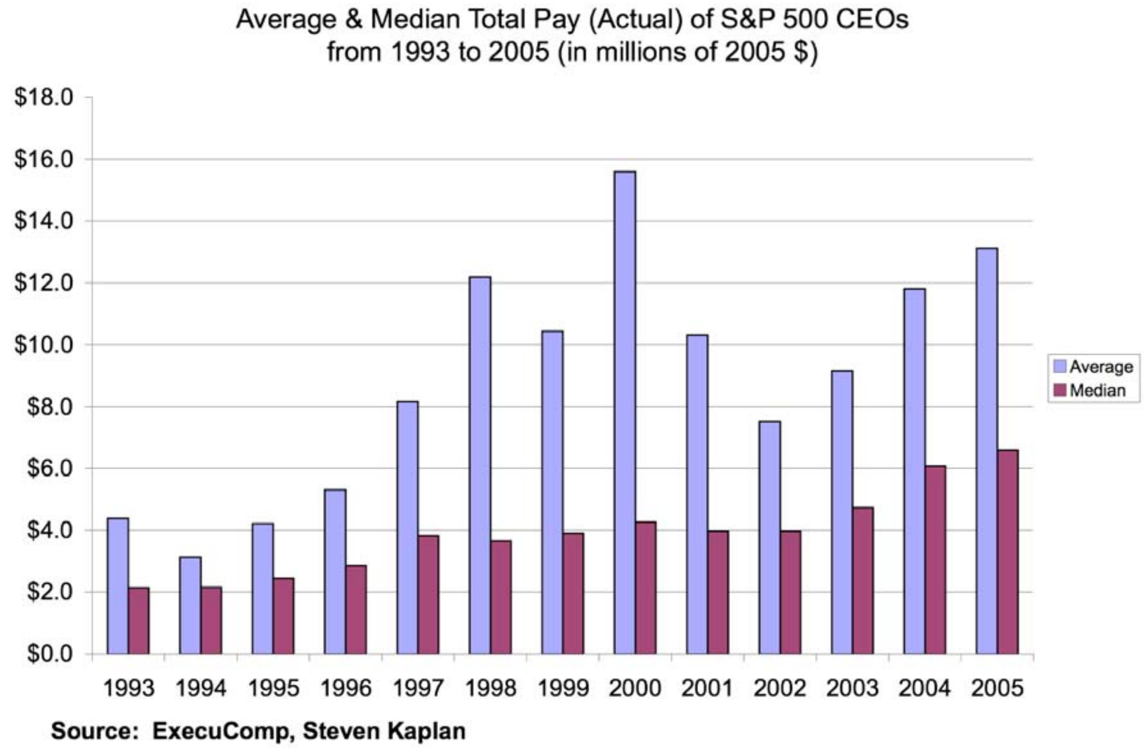


Exhibit 4

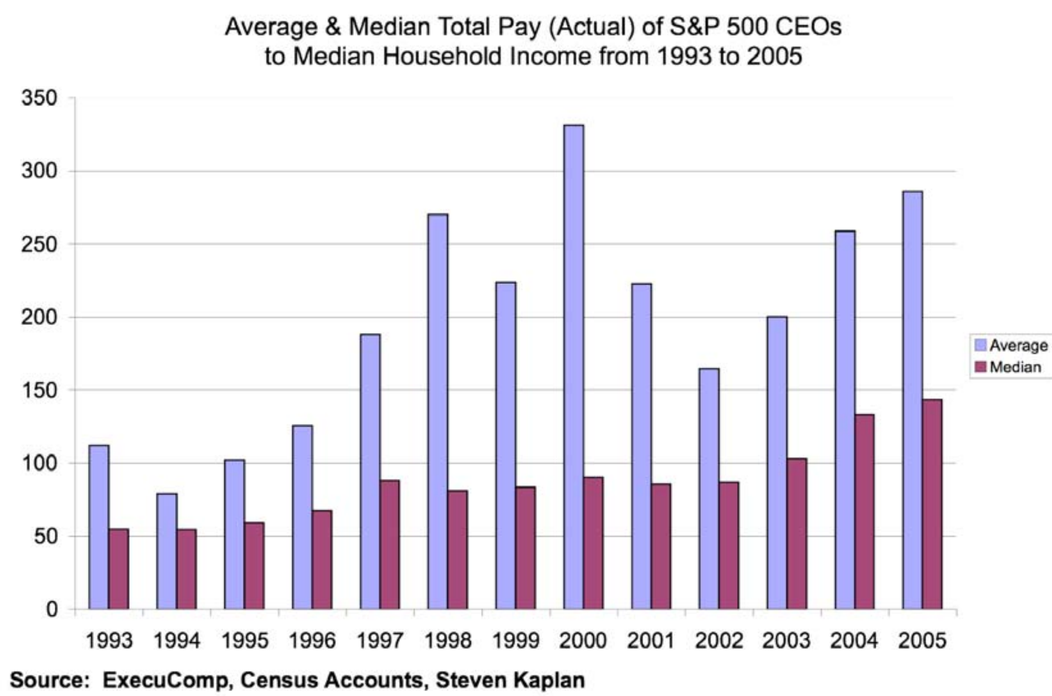


Exhibit 5
2004 Pay of Top Hedge Fund Mangers and S&P 500 CEOs in $ millions

Top 10 Hedge Fund Managers	Top 10 S&P 500 CEOS Actual Pay	Top 10 S&P 500 CEOS Estimated / Theoretical Pay
$1,020	$231	$120
$670	$125	$88
$550	$110	$59
$450	$89	$55
$420	$89	$52
$305	$82	$47
$300	$79	$40
$240	$75	$39
$225	$75	$38
$205	$72	$38

Total Pay Top 25 Hedge Fund Managers	Total Actual Pay 500 S&P 500 CEOs	Total Estimated Pay 500 S&P 500 CEOs
$6,270	$5,743	$4,923

Source: Institutional Investor Alpha 25, ExecuComp

Exhibit 6

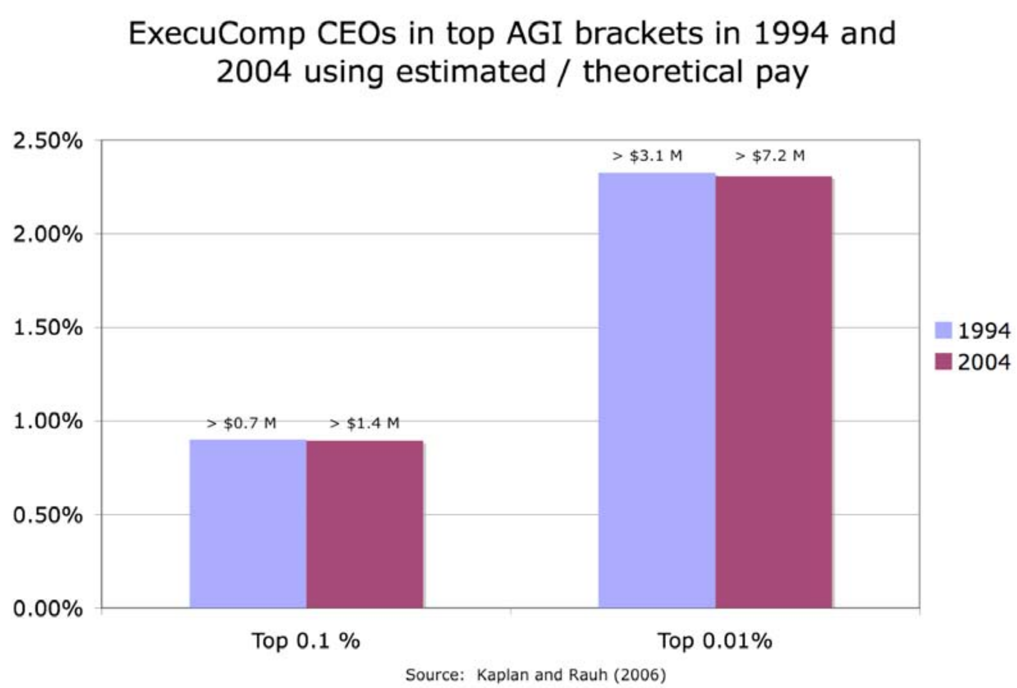


Exhibit 7

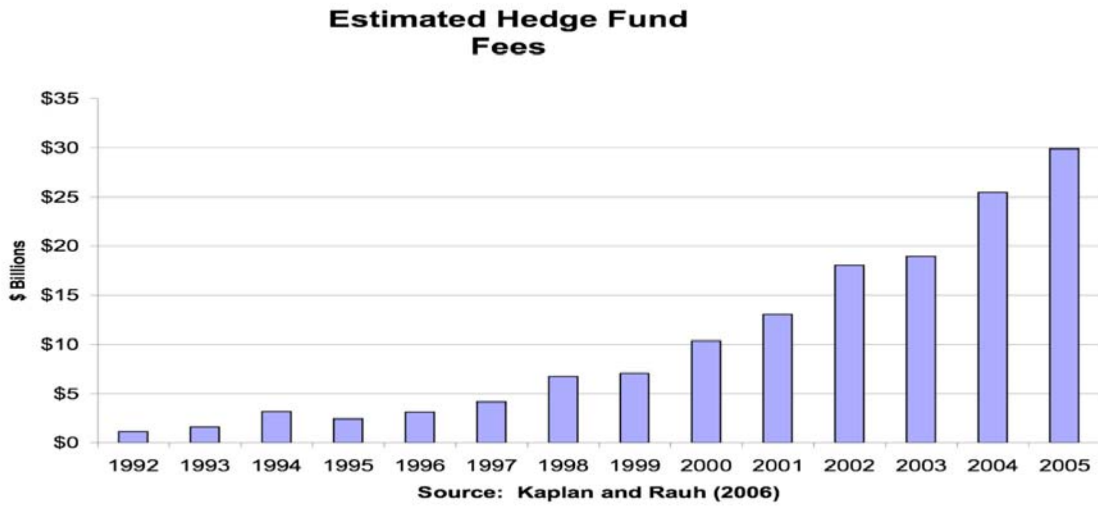


Exhibit 8

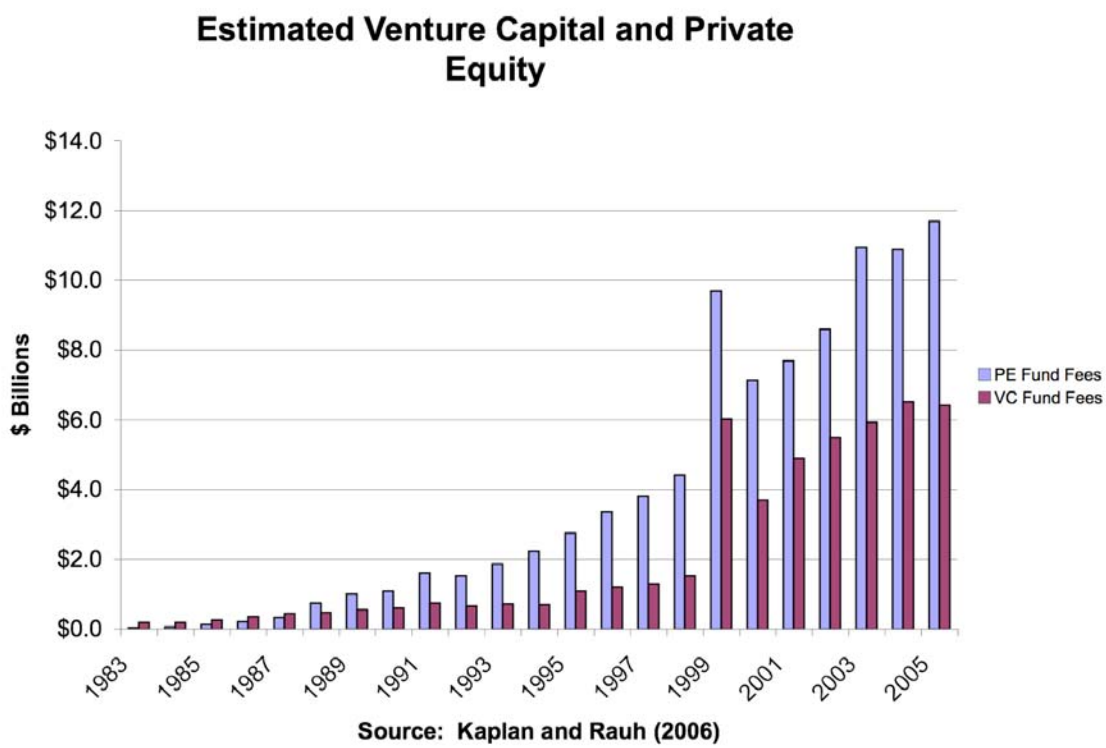


Exhibit 9

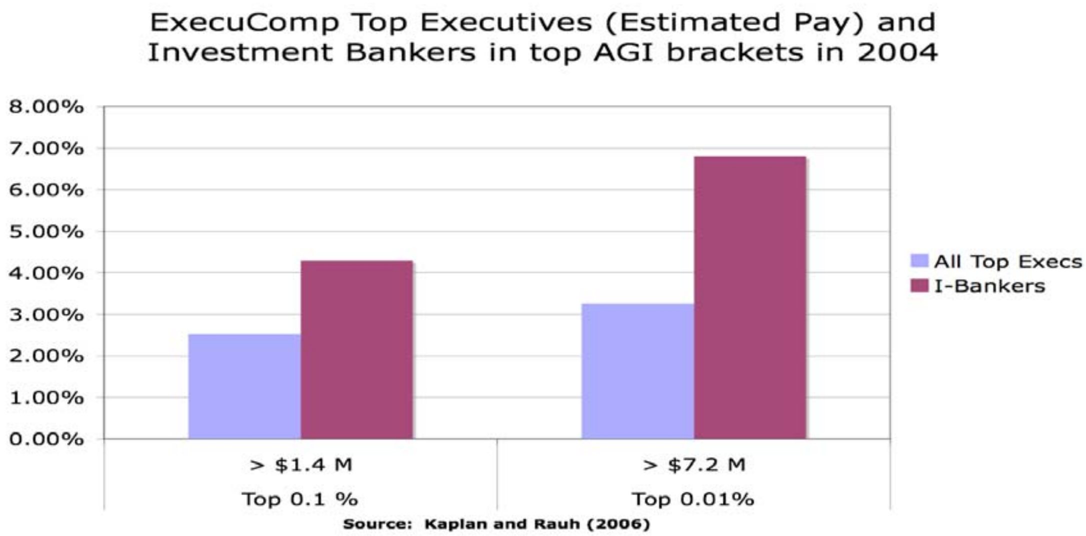


Exhibit 10

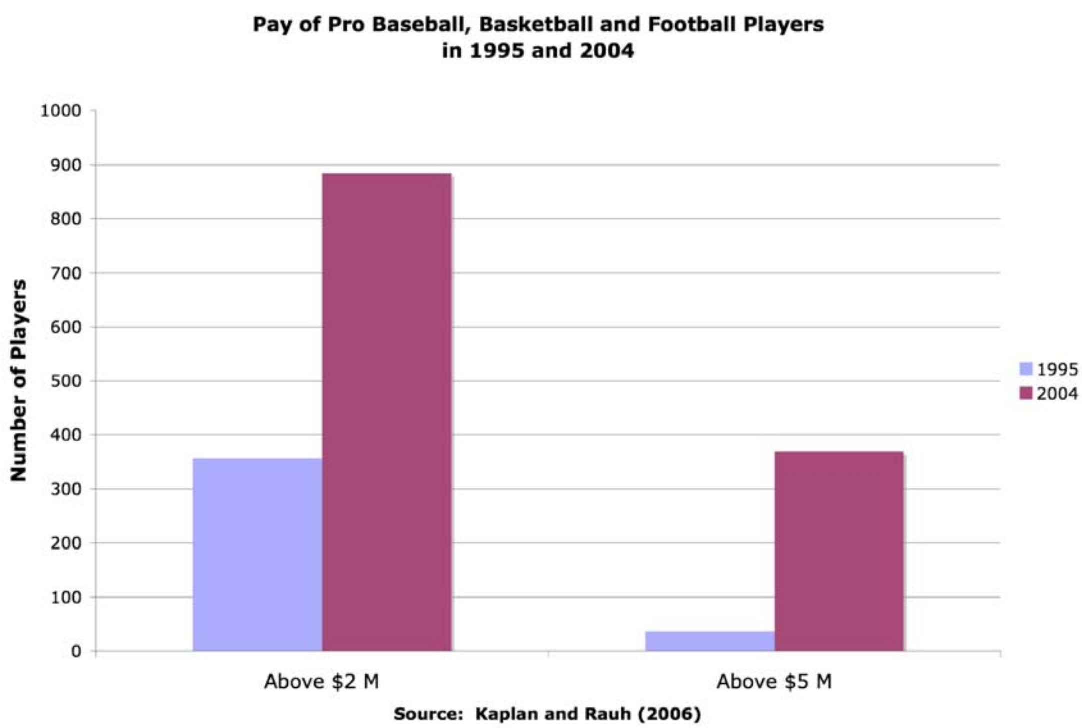


Exhibit 11

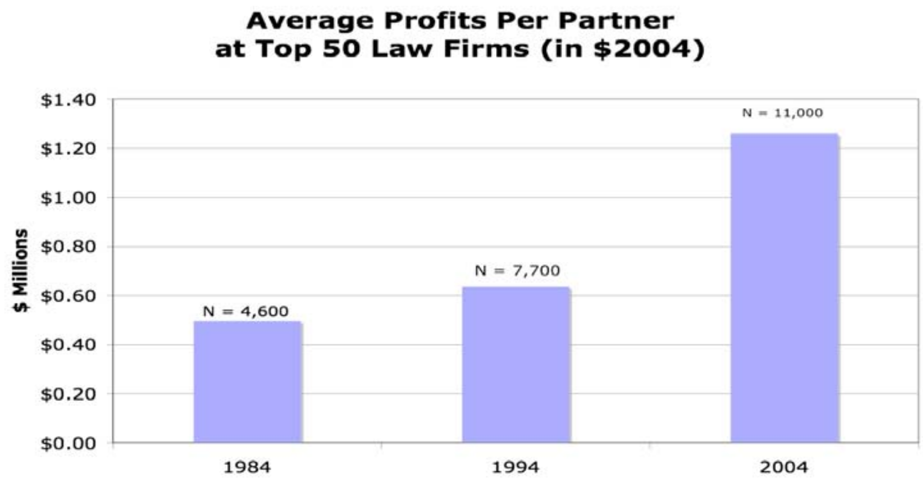


Exhibit 12

Exhibit 13

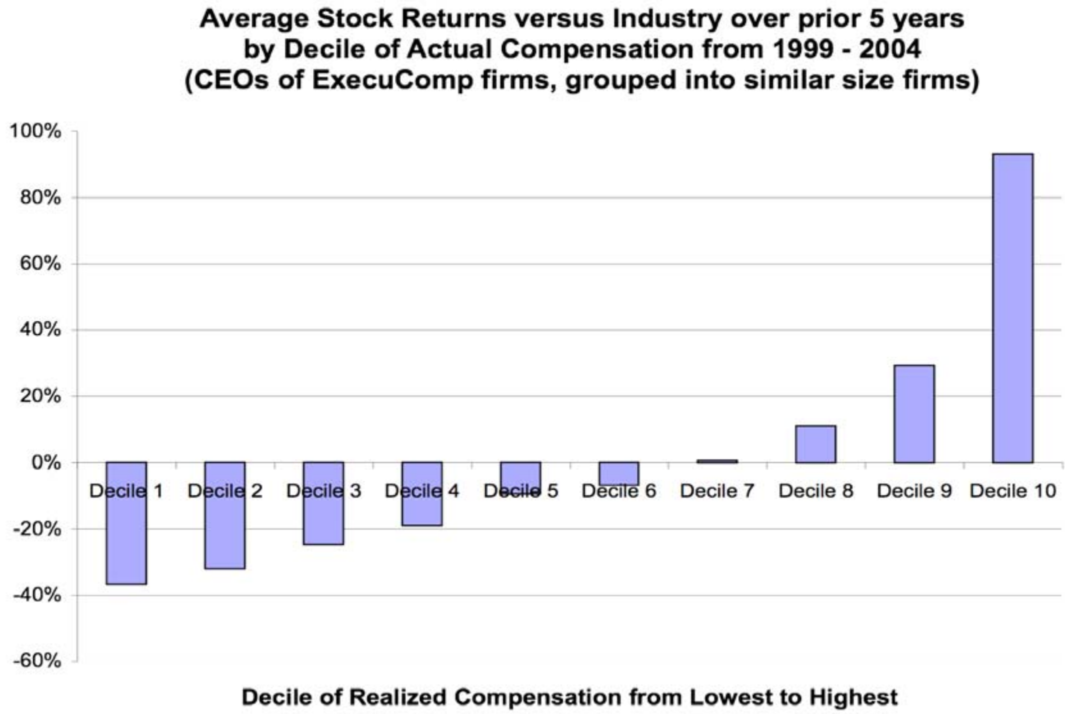


Exhibit 14

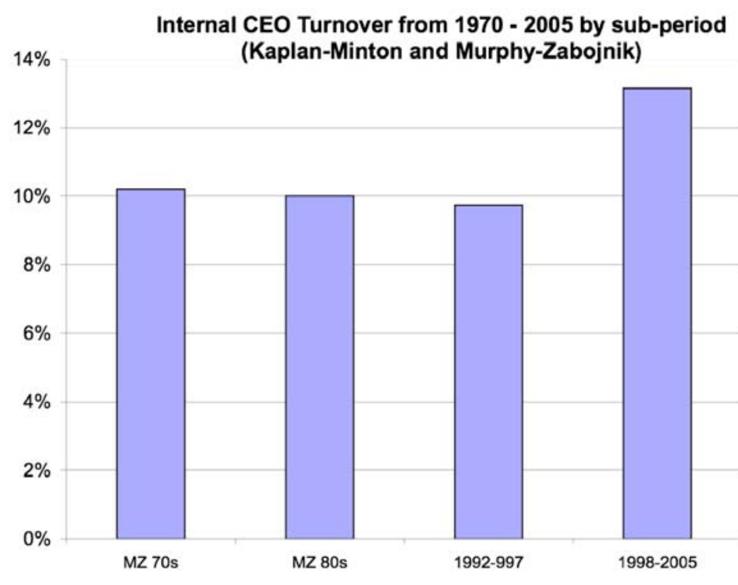
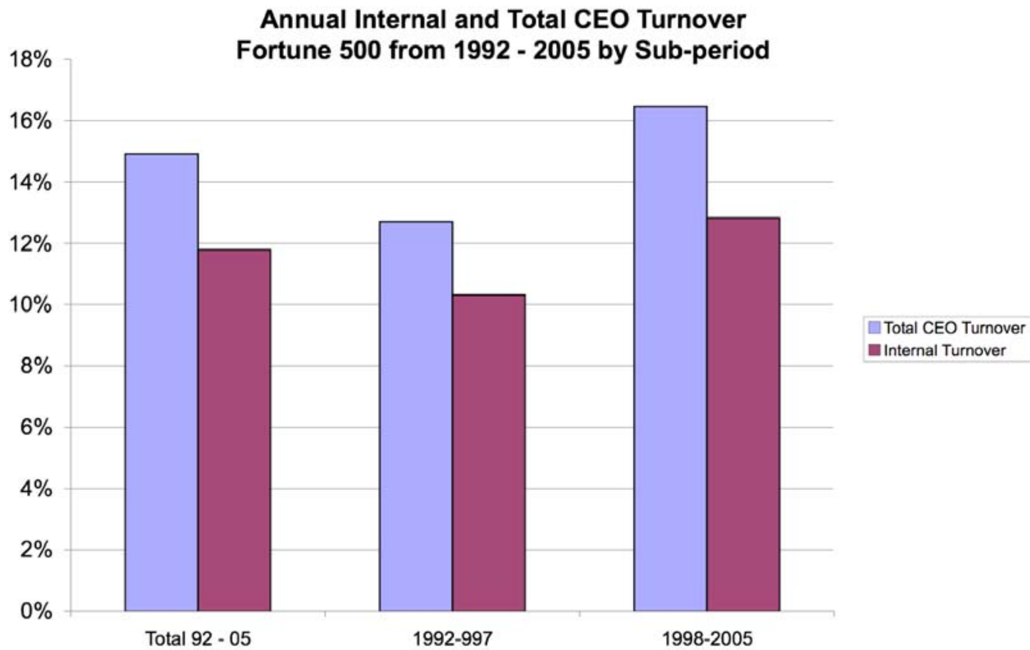


Exhibit 15


Annual Internal and Total CEO Turnover
Fortune 500 from 1992 - 2005 by Sub-period
18%
16%
14%
12%
10%
8%
6%
4%
2%
0%
Total 92 - 05
1992-997
1998-2005
Total CEO Turnover
Internal Turnover