Written Statement of
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Introduction

Chairman Grassley, Senator Baucus, and distinguished Members of the Committee, thank you very much for inviting me to testify today regarding executive compensation.[1]

The first part of my remarks will focus on the executive retirement plans that I was asked to discuss, and I will then comment on some other issues. My discussion of executive retirement benefits is based on the analysis in a book on executive pay I co-authored with Jesse Fried,[2] as well as on a subsequent empirical study with Robert Jackson.[3]

As explained below, executive retirement plans have provided top executives with large amounts of non-performance compensation that were neither salient to investors nor subject to the limitations on tax deductibility established by Section 162(m). The SEC's recent disclosure reform, which I strongly support, would in the future place these types of compensation on investors' radar screen. However, it will still be possible to use executive retirement plans to provide large amounts of non-performance pay without falling within the scope of Section 162(m).

[1] The views expressed herein are solely my own and should not be attributed to Harvard Law School, the National Bureau of Economic Research or any other institutions with which I am affiliated.
[2] Lucian A. Bebchuk and Jesse M. Fried, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press, 2004). This book's analysis of executive retirement benefits also appears as Lucian A. Bebchuk and Jesse M. Fried, “Stealth Compensation via Retirement Benefits,” 1 *Berkeley Business Law Journal* 291 (2004), available at http://papers.ssrn.com/abstract_id=583861.
[3] Lucian A. Bebchuk and Robert J. Jackson, Jr., "Executive Pensions," 30 *Journal of Corporation Law* 823 (2005), available at http://papers.ssrn.com/abstract=694766.

Executive Pensions

Because companies have not been reporting a monetary value for executives' pension plans (as the SEC rules have allowed until recently), standard datasets have not included pension values. My empirical study with Robert Jackson demonstrates that this omission has led public officials, investors, and the media to have an inaccurate picture of executive pay.

The study analyzes the pension arrangements of CEOs of S&P 500 companies who were near the retirement age or left their positions during the period under examination. With respect to the two-thirds of the CEOs who had a pension plan, we found that:
(1) The executives' pension plans had a median actuarial value of $15 million;
(2) The pension plan of the median CEO was worth twice as much as the aggregate salary paid during his or her service as CEO; and
(3) The value of the median CEO's pension comprised 35% of the total compensation (including both equity-based and non-equity-based pay) during that executive's service as CEO.

Explaining the Heavy Use of Executive Pensions

The use of executive pensions might seem natural given that firms offer pension plans to many non-executive employees. However, the plans offered to executives and non-executives differ in two important ways that raise questions about why firms use executive pensions so often.

First, the pension plans used for non-executive employees are designed to capture the benefits from the favorable tax treatment of "qualified" pension plans. However, because of the limits on the amount that can be placed in an employee's qualified pension plan, firms cannot use qualified plans to provide executives with pensions that approach the magnitude of their annual compensation. Instead, firms have been providing pensions to executives mainly through nonqualified Supplemental Executive Retirement Plans (SERPs) that do not enjoy a tax subsidy. Firms that provide SERPs to executives generally do not offer such plans to other employees.

Second, while firms have been moving away from defined-benefit plans for non-executive employees, they continue to offer defined-benefit pension plans to most top executives. Unlike defined-contribution plans, defined-benefit plans shift the risk of investment performance to the firm and its shareholders. However, one would expect the defined-benefit structure to be more valuable to regular employees who – relative to executives – are probably less able to bear the investment risks associated with defined-contribution plans.

What then could explain why firms have been making a massive use of defined-benefit pension plans for their top executives while moving away from defined-benefit plans for other employees? One possible explanation is based on the fact that firms have not been required to place a monetary value on SERPs and include this value in the summary compensation tables that are publicly disclosed. As a result, SERPs have provided large amounts of non-performance pay without making them transparent to investors.

Because the SEC's new disclosure requirement will obligate firms to make the value of pensions transparent, another possible explanation for the use of pensions is worth stressing. Because Section 162(m) does not apply to payments made *after* an executive retires, executive pensions have enabled the payment of large amounts of non-performance compensation that is not subject to the $1 million limitation established by section 162(m). For the median CEO in our empirical study of executive pensions, adding the pension value on top of aggregate salary during the CEO's service roughly tripled the amount of the CEO's non-performance pay.

Deferred Compensation Plan

Deferred compensation is another form of compensation that has provided large amounts of performance-insensitive compensation to executives without attracting much shareholder attention or falling within the scope of Section 162(m). The lion's share of firms offer their top executives deferred-compensation programs that permit executives, or sometimes even require them, to defer receipt of compensation until some future date.[4] The deferred compensation "builds" according to a formula devised by the firm, and executives do not pay taxes on the original compensation or on the accumulated increase until they receive payment, which often occurs after they leave the company.

Some deferred compensation plans provide executives with above-market returns. Even when the plan offers only market returns, however, executives can make substantial gains from accumulating investment income tax-free. Depending on the company's tax rate and investment returns, the executive's tax savings come at the expense of the company, the taxpayer, or both.

Because there are limits on how much money can be contributed annually to a 401(k)

4. See, e.g., Clark Consulting, Executive Benefits – A Survey of Current Trends – 2005 Results (reporting that about 90% of public firms surveyed have deferred-compensation plans for executives).

account, firms provide executives with deferred-compensation plans outside the framework of 401(k) plans. Again, as in the case of SERPs, the question arises: Why do firms commonly offer nonqualified deferred-compensation plans to executives but usually not to other employees? If nonqualified deferred compensation is an efficient form of compensation for the executives of certain firms, it should also be an efficient form of compensation for their nonexecutive employees. But firms rarely, if ever, provide nonexecutive employees with the option of participating in nonqualified deferred-compensation plans in addition to their 401(k) plans.

What can explain the massive use of deferred-compensation plans for executives? One possible explanation is that such plans have enabled getting around the limitations on non-performance pay established by Section 162(m). First of all, a firm may give an executive any amount of non-performance compensation, however large, and still not fall within the reach of Section 162(m) – as long as the payment of this amount is deferred until the executive's departure. On top of the original amount deferred, a deferred-compensation plan can provide the executive with additional performance-insensitive gains from a tax-free accumulation of investment returns.

In addition, as in the case of SERPs, deferred-compensation plans have provided large amounts of non-performance compensation that fall below investors' radar screens. Past disclosure requirements have allowed firms to provide little information about executives' deferred compensation plans. Indeed, the information disclosed has been insufficient f r outsiders to be able to quantify — as our empirical study did for executive pension benefits — the gains that executives have been making from deferred compensation plans. We do not have even ballpark estimates of these gains.

In the next proxy season, however, the SEC's disclosure reform will require firms to disclose the amounts credited to executives in deferred-compensation plans. These figures will enable outsiders to estimate for the first time the magnitude of executives' gains. Public officials and investors should pay close attention to the figures that come out.

Non-performance Pay through Bonus Plans

Firms can also use bonus plans to make payments that are barely tied to performance yet do not fall within the scope of Section 162(m). Section 162(m) does not apply to bonus payments as long as the bonus plan satisfies certain formal requirements. In particular, as long as the payment of a bonus amount was not certain, Section 162(m) may not apply even if the threshold for getting a bonus amount is sufficiently low as to make the likelihood of receiving one quite high.

Neither stockholders nor public officials are in a position to assess the magnitude of this problem. Firms often do not disclose the specific numerical thresholds used to determine bonus payments. A firm may disclose that bonuses were paid on the basis of earning targets set in advance by the compensation committee but not disclose the precise numerical targets used.

In my view, firms should be required to provide full and detailed disclosure of the numerical thresholds used to determine bonus payments. Opponents of such disclosure argue that it could help the firm's competitors. Even if this consideration were valid, however, it would at most justify delaying such disclosure to a later proxy statement. This information is necessary for outsiders to be able to assess the extent to which a firm's bonus payments have been meaningfully tied to performance.

Strengthening Shareholder Rights

I would like to conclude with a remark on shareholder rights. Although reform in this area is not the focus of this committee, the weakness of existing shareholder rights should be noted in any examination of executive compensation.

The SEC's recent disclosure reform, as well as the earlier passage of Section 162(m), might have been partly motivated by recognition that, without some push from the outside, corporate boards cannot be expected to adopt pay arrangement that are sufficiently linked to performance. However, as long as shareholder rights are not strengthened as well, neither disclosure requirements nor tax penalties can by themselves address the problem.

Disclosure by itself is insufficient when investors do not have the power to act on the information they obtain. And tax penalties by themselves can have little influence on compensation arrangements; when shareholders' rights are weak, designers of pay arrangements may not feel sufficient pressure to change these arrangements because any tax penalties will be borne largely by shareholders, not executives.

Indeed, the very need to expand disclosure requirements indicates the limits of shareholders' existing rights. Despite the dissatisfaction of investors, companies have continued to avoid making pay arrangements transparent, something they could have done on their own. Their failure to do so made SEC intervention necessary.

What else needs to be done? To ensure that directors focus on shareholder interests, they must be made not only independent of insiders but also dependent on shareholders. Shareholders' power to remove directors must be turned from a fiction into a reality.[5] Shareholders should be able to place director candidates on the corporate ballot, as well as to vote by secret ballot. All directors should stand for re-election annually, and should not serve if they fail to get a majority of the votes cast.

Furthermore, shareholders should have more power to influence the setting of companies' governance arrangements.[6] Shareholders' involvement has been limited to the passing of advisory resolutions that boards may (and often do) choose not to follow. We should remove all legal impediments to shareholders' ability to adopt bylaws or even charter amendments. And shareholders should also get to vote on the compensation committee's report, or least get the power to opt into having such a vote.

In the end, executive compensation arrangements reflect the quality of the corporate governance processes that produce them. Problems of executive compensation can thus be fully addressed only by improving these processes. Strengthening shareholder rights would make boards more accountable and attentive to shareholders – and thereby improve corporate performance and enhance shareholder value.

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[5] I put forward a detailed proposal for reforming corporate elections in "The Myth of the Shareholder Franchise," available at http://ssrn.com/abstract=829804.

[6] For a detailed explanation why shareholders need the power to adopt governance arrangements and not only the power to replace directors, see Bebchuk, The Case for Increasing Shareholder Power,118 *Harvard Law Review* 833-914 (2005), available at http://ssrn.com/abstract=387940; and Bebchuk, "Letting Shareholders Set the Rules, "Harvard Law Review (2006), available at http://papers.ssrn.com/abstract=891823