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STATEMENT OF THE HON. PETER G. PETERSON
CO-CHAIRMAN, THE CONFERENCE BOARD COMMISSION ON PUBLIC TRUST AND PRIVATE ENTERPRISE
CHAIRMAN, THE BLACKSTONE GROUP
BEFORE THE SENATE BANKING COMMITTEE
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Mr. Chairman:

We come to you today as individual members of The Conference Board Commission on Public Trust and Private Enterprise. Please understand that our views are our own, and we do not speak to you today on behalf or as representatives of The Conference Board. Attached to my testimony are copies of our reports including some seventy-five recommendations covering virtually every area of corporate governance.

Fellow commissioners Paul Volcker, former chairman of the Federal Reserve Board and Charles Bowsher, former head of the GAO will discuss certain of our auditing and accounting recommendations. Mr. Ralph Larsen, former Chairman and CEO of Johnson and Johnson and former Chairman of The Business Council will discuss the critical importance of how building an ethical culture can prevent the extraordinarily destructive scandals that our country has witnessed in the last few years from happening in the first place.

Public trust in American business corporations is at the lowest level in my fifty years of experience in American business life. And public trust matters a lot, particularly in an economy like ours that depends so heavily on outside or foreign capital sources.

I will focus my remarks on the Commission's recommendations about executive compensation, which we consider the most fundamental and toxic cause of the serious breakdown of public trust in American business. The highly publicized case in recent days of Richard Grasso and The New York Stock Exchange has only punctuated the need for reform in the way executives are compensated and in the process at the board of directors level that determines this compensation.

But before getting into our recommendations, I'd like to make a few comments about the Sarbanes- Oxley Act and the possible role of the Congress in the near future in any further legislation.

First, as to Sarbanes-Oxley, it is by and large a very constructive and much needed piece of legislation. Already, I sense a sea change in attitudes toward corporate governance practices to implement better governance. I have never seen boards of directors and CEOs as diligent and as proactively involved as they are today on achieving governance improvements.

I believe that the private sector needs some time not only to fully digest Sarbanes-Oxley, but also to make constructive changes in other areas of corporate governance. Furthermore, history seems to teach us that, in the particular area of executive compensation, Congressional action has had serious unintended negative and sometimes ironic consequences and rigidities. We observed these negative consequences when Congress placed a cap of $1 million on cash compensation deductibility, inadvertently setting off an explosion in awards of fixed-price stock options and inflating senior compensation dramatically in the process - hardly the intent of that legislation. This kind of well-intentioned, but unfortunate Congressional involvement is the political equivalent of what the medical profession, borrowing from the Greeks, calls the iatrogenic effect, in other words a side effect or disease caused by the "iatro," the doctor.

When we started our work in this area, I assumed that the widely reported, generic increases in executive compensation would present the major problem to the public. All of us on the Commission had read the *BusinessWeek* report that showed that CEO compensation had risen about 9.5 times faster than the compensation of rank and file employees over a 10-year period. We also knew that *BusinessWeek* had reported that in 1980 CEO compensation was 42 times that of the average worker, whereas in recent times, it was roughly 500 times that average—far higher than in Japan and Europe.

We were also aware of critics who questioned management claims that executives' compensation reflected their productivity. These critics asked: Has management's productivity grown that much faster than the average worker's productivity? William McDonough, former President of the Federal Reserve Bank of New York, gave his direct and widely publicized answer to this question in his speech to the Trinity Church of New York, discussing the morality of the excesses of executive compensation: "I'm old enough to have known both the CEOs of 20 years ago and those of today. I can assure you that the CEOs of today are not 10 times better than those of 20 years ago."

Clearly, this huge imbalance in pay between senior executives and other management and workers has contributed to plummeting public trust. But, as we delved further into this issue, I came to believe that the more dominant contributor to the loss of the public's trust was the highly publicized reports of excessive and, indeed, egregious compensation of CEOs in <u>failing</u> or <u>failed</u> <u>companies</u>. A *Financial Times'* headline read, "A Stunning Payoff For Corporate Failure." A cover of *Fortune* magazine featured the following story, "YOU BOUGHT, THEY SOLD." The *Fortune* story reported that executives at certain companies whose stock prices had declined 75% or more from their peak in a relatively short period had, nevertheless, reaped billions of dollars of gains from stock sales. The headline of this story shouted, "Since 1999, hundreds of Greedy Executives in America's Worst Performing Companies Have Sold $66 Billion Worth of Stock." In effect, the *Fortune* article seemed to be asking the corporate version of the "Watergate question": What did they know about their companies' declining prospects? And, when did they know it?

These kinds of public suspicions led to our recommendation of full, conspicuous, and readily understandable – "plain English" "plain sight" – disclosures of executive compensation arrangements. In addition, to reassure the public that senior management is not involved in stock transactions involving the company in advance of material information being available to the public, we recommended that executive officers give advance notice of their intention to dispose of the corporation's equity securities.

Now, why do I believe that excessive compensation at these failed or failing companies – rather than simply the overall increase in executive compensation – is the more dominant explanation of the precipitous decline in the public's trust? Many Americans believe that the American dream is a real possibility for them: witness the interesting statistical anomaly that 20% of Americans believe that they are in the upper 1% in terms of income, and another 20% believe that they will be. Moreover, $20 million salaries for sports stars do not seem to engender anything comparable to the criticism or anger engendered by executive compensation. Perhaps their success is seen more as something to be admired, along with the hope that they or their kin can someday achieve that success.

In many of the recent scandals, the public witnessed certain executives reap unprecedented gains just prior to a time when their shareholders suffered huge losses, and many of their employees lost their jobs and at the same time saw their retirement savings suffer irreparable damage. This was most visibly demonstrated and most highly publicized in the case of Enron. Dan Yankelovitch, the well-known public opinion expert, reported that Americans were particularly outraged and frightened by widely publicized reports that the restrictions placed on Enron employees selling their company stock held in retirement accounts during periods of rapidly falling stock prices were far greater than those placed on Enron's executives. Employees and the public alike saw this phenomenon as still another example of a rigged system that favored executive over non-executive employees.

After the Commission's extensive study and analysis, we came to believe in the following triad of principles for establishing effective compensation systems:

a) A renewed focus on <u>long–term</u> success of a corporation;

b) A renewed focus on <u>corporate operating performance</u> - not simply on stock price performance, which can obviously be capricious. With this in mind, the Commission recommended that independent compensation committees should be unconstrained by industry median compensation statistics or by the company's own past compensation practices and levels when awarding senior executive compensation. Instead, we recommended that the compensation committee, with the concurrence of the Board, should establish performance-based incentives that reinforce the corporate performance goals approved by the board (for example, return on equity, revenue and profit growth, cost containment, cash management, and other non-financial objectives, such as quality goals); and

c) A renewed focus on substantial long–term stock ownership, which, in turn, can validate operating performance, help serve as a driver of long–term corporate performance, and more truly align the long–term interests of shareholders and management. History teaches us that stock prices do tend to reflect operating performance over the long-term. But it also teaches us that stock prices and operating performance often deviate over the short term. Therefore, we believe that, whereas managing for stock price gains too often means managing for the short term, managing with an eye towards long-term operating performance is in the best long-term interests of the corporation and its shareholders, as well as the corporation's other constituencies, such as employees, communities and customers—all of whom have a decided interest in the long-term success of the corporation. That is why we believe it is critical to focus executive incentives on the long term.

Our recommendations for longer holding periods for equity-based compensation and for substantial stock ownership requirements by senior management and independent directors fit directly into this context. Indeed, had just these two best practices been in place, we may have avoided a number of the recent corporate collapses that were accompanied by egregious short–term gains by executives of those failing companies.

Fixed price options, which were the dominant form of stock options, were not expensed and did not reduce reported earnings. Nonetheless, they conferred substantial tax deductions on employers at the time that employees exercised the options. As a result, there became a perception in some circles that these particular options were either "free" or low cost. This, along with the 1993 tax legislation that considered these options as "performance based" and therefore not subject to the $1 million deductibility cap, led to an explosion in the number of stock options that were granted. In the period following the 1993 legislation, stock options roughly doubled as a percentage of total equity and came to dominate - and, at the same time, to inflate, the compensation of many executives. The combination of a huge number of options granted; a bull market; and short holding periods proved; in some cases, to be highly seductive and led, in some instances, to the practice of "managing" short–term earnings. This phenomenon also led to unprecedented short–term gains by some executives - gains unrelated to corporate operating performance – or, if you prefer, too de-linked from operating performance.

We also came to believe that the elimination of the accounting bias towards fixed price options, which we felt led to an inadequate focus on corporate operating performance, is one of the most powerful reasons to favor the uniform expensing of all forms of equity-based compensation. In the best of worlds, the Financial Accounting Standards Board and the International Accounting Standards Board would adopt a uniform standard, thereby increasing transparency and comparability among companies on an <u>international</u> basis. The uniform expensing of equity based compensation would also, we believe, improve the comparability of earnings <u>among companies operating across different industries</u> (I was surprised to learn that, whereas expensing of options in S&P companies would decrease reported earnings by an average of about 10%, in the information technology industry the expensing of options would reduce earnings by approximately 70%).

We believe that a more level accounting playing field would result in a far greater use of long–term compensation incentive programs that are more closely tied to the corporation's <u>actual operating performance</u> and that would not distort financial results for investors. If all forms of compensation – cash and equity-based awards – were treated similarly in terms of their impact on profitability, then it seems to me that companies will be more likely to choose programs that offer real, balanced incentives to help create long–term value.

It pleases me to report that 175 of the nation's largest 500 companies have announced their intent to expense stock options. Even greater progress has been made in the important area of achieving better balance of power and checks and balances by either appointing a non-Chairman CEO, a presiding director or a lead director.

Mr. Chairman, please be assured that we will not stand by and simply hope that the private sector will substantially improve their executive compensation practices. We are now actively involved in getting a large number of corporate directors, CEOs, large investors and others to participate in advertisements and other public statements that pledge to implement the executive compensation principles I have just outlined.

To sum up, we thank you warmly for your constructive efforts in formulating and passing the Sarbanes-Oxley legislation.

At the same time, before developing further legislation, particularly in the area of executive compensation, we ask that you give those of us in the private sector some time to make the changes that are so obviously needed.