PROXY SEASON 2000 REFLECTIONS ON COMPENSATION

1999 Executive Compensation Seminar

September 30, 1999
New York Palace Hotel
New York, NY

No constituent of Tyco International begrudges CEO Dennis Kozlowski his hundreds of millions of dollars of company stock; no Mellon person feels other than that Frank Cahouet was worth every share with which he retired; there is no fundamental quarrel in America today with high pay. There are a few protean value creators who deserve to be considered significant owners of the enterprise; there are a very few like Edward C. Johnson, III of Fidelity who deserve the ownership on account of their management, notwithstanding their inherited ownership. The concern is with the perception of the class of CEOs' dominion over all other interests and paying themselves without reference to increasing shareholder value. The arrogance of the successful exercise of power has made of compensation the defining measure of management and owner involvement in the governance of corporations.

Corporate America and its professional advisors have needlessly contributed to an atmosphere of confrontation. We start with the lawyers. Consider the exquisite lengths to which lawmakers have gone to style directors as being "independent". Virtually every regulatory and professional body along with many institutional shareholders has promulgated their own exquisite definitions of independence. All of this is in aid of creating an impression that simply is not true. Some individuals, I have even served with a few, are independent by nature and will act independently whether their brother or their appointer is the object of consideration. I don't think it rude to suggest that the more independent board members are not likely to be on the compensation committee. Most people are reluctant to affront someone who has done them a favor. Directorships in major companies are coveted. It is very difficult for someone on whom membership in a prestigious group is conferred to act in a way that confronts that group's exercise of power.

"Best practice" has decreed an elaborate "ritual" through which the board of directors creates a Compensation Committee consisting entirely of "independent" directors. The independence of the directors on the Compensation Committee is adduced in explanation of the reasonability of executive pay. Likewise, when the

independent members of the compensation committee appoint an independent executive compensation consultant to assist them, one need suspend disbelief as to the appetite of personal service organizations to thrust unwelcome advice on to their clients. I don't pause here to characterize the appropriateness of current levels of pay. I certainly do not impugn the integrity of the individual participants in the process. As will be clear from the balance of this paper, compensation professionals are the victims of the current system and not its cause.

Moving from legalisms to reality, let me take you back to a meeting of the Compensation Committee of a ten billion dollar multi national conglomerate. Its stock is trading at $50, down from a year earlier level of $65 at which price options had been granted to the senior executives. The CEO, who is present by invitation, is heatedly confronting the Committee Chairman: "I know that we are all big boys, that we freely took the risks, that we are complete hypocrites in our professed belief in free competition, but I am just telling you the facts of life. My guys are depressed; they have no practical financial incentive as their options are so far under water for the foreseeable future; they are not moral philosophers - they are simply the best team in the industry and the competition is picking them off." "Does that mean", said the Chairman, "that you are recommending that we reprice their options." "Either that or find some other way of giving these guys incentive right now." I have participated in this conversation. Maybe in today's ever

rising stock market, most people have not heard it. What we hear instead is that options are the best way of aligning managements' interests with those of the shareholders. Where is the simple truth? Options are a free ride for management - no cost, no risk on the down side, only wins - and in those cases where the market goes the wrong way, repricing and a new start. Every responsible board member knows they must act so as to retain and attract the best managers. The problem is not one of pay. It is the insistence that options provide a vehicle for aligning shareholder and manager interests, which they so plainly do not.

And now on to the co-optation by business groups of professionals and ultimately the government in setting the rules under which business operates. This was exemplified by the 88-9 vote of the United States Senate in 1994 expressing its "sense" [sic!] that the current cost of issuing options not be reflected on companies" income statements. The Business Roundtable successfully organized a lobbying effort to pressure the Financial Accounting Standards Board (FASB) to reverse its proposal that account be taken of the "value" of options at the time they were granted. Thanks to the Roundtable's lobbying skills and power - henceforth, options not only are a one way street, but they are "free" - they don't cost anything.

Warren Buffett, whose ability to make money deprived the country of a literary talent, wrote to Senator Chris Dodd, then Chairman of the Securities Subcommittee of the Senate Committee on Banking:

The most egregious example of let's-not-face-up-to-reality behavior by executives and accountants has occurred in the world of stock options. The lack of logic is not accidental: For decades, much of the business world has waged war against accounting rulemakers, trying to keep the costs of stock options from being reflected in the profits of the corporations that issue them. Typically, executives have argued that options are hard to value and therefore their costs should be ignored. At other times managers have said that assigning a cost to options would injure small start up businesses. Some of them have even solemnly declared that "out of the money" options (those with an exercise price equal to or above the current market price) have no value when they are issued. It seems to me that the realities of stock options can be summarized quite simply: If options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And if expenses shouldn't go into the calculation of earnings, where in the world should they go…. Managers thinking about accounting issues should never forget one of Abraham Lincoln's favorite riddles, "How many legs does a dog have if you call his tail a leg?" The answer: "Four, because calling a tail a leg does not make it a leg." It behooves managers to remember that Abe's right even if an auditor is willing to certify the tail is a leg."

Because the CEO community were so successful in overpowering FASB, the supposedly independent accounting rule setting organization and enlisting the support of the United States Senate, the challenge of creating a CEO compensation system with real alignment to owners' interests has been exacerbated. The Business Roundtable has won too big. Not only are the shareholders powerless, but "independent" professionals and the government have been brought to heel. Management's overwhelming victory with compensation called into rude question what had been assumed to be the effective participation of activist shareholders in corporate governance.

The drama of shareholder resistance to management power was acted out in the 1999 proxy season on the compensation stage with formal resolutions and legal action addressed to the repricing of options. Believing that repricing is a "fundamental issue requiring shareholder approval…" the State of Wisconsin Investment Board (SWIB), the most resourceful and principled of the activists, filed binding shareholder proposals, seeking to modify company bylaws in order to prohibit the repricing of option without first obtaining shareholder approval. SWIB won a series of battles with the SEC and the courts and obtained 53.8% of the vote at General DataComm Industries (GDC). This victory was the precursor of success with many other companies that had come to SWIB's attention, including Cambridge Technology Partners, Glenayre Technologies, Cadence Design Systems, Handelman, Idexx Laboratories, Molecular Biosystems and Wall Data.

How the compensation challenges are being met at these companies is unknown. That critical issue has been buried in the more fundamental struggle to define the appropriate limits of shareholder and management power.

Shareholder activism has been accepted as an increasingly important factor in American corporate development in recent years. Hear Secretary of the Treasury Larry Summers: "The priority in Europe, as many people in Europe have recognized, has to be on developing an appropriate domestic growth strategy. That means restructuring companies, allowing empowered shareholders to do the work of restructuring. It was these kinds of changes from the bottom up that I think contributed, along with deficit reduction, to the prosperity that we're enjoying in the United States." (Emphasis added) U.S. Treasury Secretary Lawrence Summers on CNBC, July 7, 1999. With all the credit given to new notions of American governance, it is frequently lost sight of that under the interrelated federal / state legal structure prevailing in the United States shareholders have relatively little real power (certainly in contrast with the situation in the United Kingdom). They have the power to persuade and to enlist support through public relations. They have virtually no legal power to replace directors and, apart from that, no power with respect to compensation. Executive compensation is the category where the absence of shareholder power is most noticeable. If all the high fallutin' talk about corporate governance and meaningful accountability of management is to be believed, how can we explain the utter inability of the owner-principals to control the pay to manager-agents.

Shareholders have been driven by their recent small successes in the option repricing cases to consider further "atrocities" in the field of effective corporate governance. Proposals were passed at Applied Materials, Chubb and Union Carbide requiring that shareholder approval be obtained before "poison pills" could be put in place. In the aggregate 19 poison pill proposals have come to a vote during this proxy season, with 14 receiving majority votes. Of those 14, ten were passed (the other four were not a majority of outstanding shares, only shares cast). Of the six binding pill proposals, five received majority votes, but only two passed. CREF has been particularly focused on "dead hand" poison pills, which allow only continuing directors or their handpicked successors to redeem the pill. Recent CREF proposals asking Bergen Brunswig and Lubrizol to redeem or allow shareholders to vote on dead hand provisions received 74.3% and 68.3% of the shares voted, respectively. On August 19, the board of Lubrizol finally made public its repeal of the dead hand provisions. Shareholders have escalated the level of confrontation in order to deal with the perceived problem of lack of management accountability in critical areas.

"New Labor" is having a particularly difficult time with executive compensation issues in the United Kingdom, even though the levels are well below U.S. standards. There is by no means such a general acceptance of the entitlement of the hugely successful to wealth as there is in the U.S. The bonanza conferred on to the high officials of denationalized utility companies affronts virtually everyone, not just "old labor". New labor is nothing, if it is not conscious of public relations. So Secretary of State for Department of Trade and Industry (DTI) Stephen Byers has recently (August 1999) issued a Consultative Document, entitled Directors' Remuneration. The first clauses of his Forward mouth the popular market place mantra - "It is vital that British companies are able to offer the remuneration packages that are necessary to attract the best executives to run their business…" The Government's view of "best practice" in Directors' (directors in the UK sense includes officers in the U.S. terminology) accountability to shareholders (Chapter 7) is:

The board of a quoted company, acting on the recommendation of the remuneration committee, should determine both the company's general policy on executive remuneration and the remuneration packages for the chairman of the board and each of the executive directors. Boards of directors face a conflict of interest in relation to directors' remuneration; for this reason, and because failure to achieve an effective link between directors' remuneration and company and individual performance may be damaging to the prosperity of the business, the Government believes that director's remuneration is of legitimate interest to shareholders. It may be appropriate for the board to discuss aspects of directors' remuneration with investors, particularly

when investors have concerns about the company's overall remuneration policy or about linkage to performance. A member of the remuneration committee should normally be present at such discussions. Dialogue between the board and investors on remuneration issues is more likely to be effective if it is underpinned by a framework which facilitates voting on resolutions relating to directors' remuneration at company meetings. (emphasis added)

Byers finishes the first sentence of his Forward - "… but it is also essential that high pay at the top is linked effectively to performance. Both must be right if the U.K. is to be rally competitive." to use the vernacular - "There is the rub" - Is there really a competitive market or have the folks who fixed FASB and the United States Senate also managed to rig the executive compensation market?

The tendency of compensation committees, compensation consultants and management to ratchet up compensation in the laudable interest of putting their executives in the top quartile for comparable officers is virtually universal. It is difficult to figure out what to do about it. Who is going to stand up (metaphorically) at a meeting and say that "our executives aren't very good, they should be happy with 2d quartile pay levels." Graef S."Bud" Crystal runs a service analyzing the appropriateness of corporate compensation with the eye, the patience and the data base of a genuine expert. http://www.crystalreport.com. His best seller, In Search of Excess, The Overcompensation of American Executives (Norton 1991) is a vivid tableau of the abuse of power. He recommends "What we need to do , then, is to strengthen the ability of market forces to do their job, rather than abandon the free market altogether,… If the CEO is going to have professional help on his side of the negotiating table, it seems obvious that the compensation committee should also have its own professional help. Hence, our first suggestion is to mandate that the compensation committee have its very own compensation consultant….." (at 242) This rather self-serving recommendation is anticlimax to the stunning insights of the book. It is also echoed in the Byers document. These modest suggestions make clear that nothing less than a fundamental "rebalancing" of the market place will remedy the problem.

The underlying legitimacy of any "market" is the interaction of participants who are informed and motivated. If there is only one party so endowed, no real market can be said to exist. The problem of asymmetry - outlined below - assures that no market presently exists or can exist in the field of executive compensation without the introduction of a new party (or parties) with properties of information, motivation and power comparable to those of management.

Asymmetry

Chief Executive Officers Those Responsible for Setting Pay Motive The specific focus of competent management with a personal interest, control over an organization and access to specialized knowledge A very generalized non-specific concern the business be run by the best possible executives and that pay rates be "competitive" Knowledge Management dominates board membership and agenda - recommendations of the CEO will generally be followed Directors are generally comfortable questioning management decisions only in egregious situations Power - Professionals Management has the continuing power to retain the services of the best professional consultants Neither board members nor professionals envisage their responsibilities to require commercial self destruction Power - Associations Management participates in many organizations permitting collective strategies and action Directors' responsibilities and experience is limited to a single enterprise Power - Corporate Resources Management has the capacity to direct corporate resources into public relations programs and advertising Boards do not have control over corporate operating. Shareholders must spend their own money

The vital elements of a functioning "market" place are absent under present circumstances. The appearance of self-awarded compensation is real. The only constituent in the corporate constellation, who is independent of management and motivated, informed and powerful is the

owner. The challenge is to create a competency for collective action by shareholders that will comprise a counter force to management and, thereby, the prospect of a real "market place".

How can such an "ownership collective" be created ? How can we tell that it is real? There is a simple test. It is self-answering. You will know that shareholder involvement is real the day that you accept professional engagement to work for it.

Endnotes