THE SHAREHOLDER'S PERSPECTIVE ON TOP PAY AND PERFORMANCE
Cranfield University - June 14, 2000

Shareholders have two interests with respect to top executive compensation:

> To secure the services of the best people to do the needed job and
> To incentivize top management to direct the enterprise congruent with the interests of the owners.

As Secretary of State for Department of Trade and Industry ("DTI") Stephen Byers has recently put it: "It is vital that British companies are able to offer the remuneration packages that are necessary to attract the best executives to run their businesses, 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 really competitive." [i] The theory of paying whatever kind and level of compensation required by the market is easily stated. What is more difficult is to understand whether any true market exists or whether it has been manipulated by the powerful in their own interest. Let me give a view from America.

Top managers (hereinafter referred to collectively as CEOs) in the United States can no longer be viewed as a category of salaried employee. They have become substantial corporate owners – largely as the beneficiaries of option grants. Option holdings represent more than ten percent of the total publicly outstanding stock. Institutional Shareholder Services reported as early as 1992 that the top 15 individuals in each company received 97% of the stock options issued to all employees. Business Week reported: "[T]he 200 largest corporations set aside early 10% of their stock for top executives… In almost all cases, moreover, it's the superstar CEO who takes the lion's share of these stock rewards." The very best like the late Roberto C. Goizueta of Coca Cola acquire more than a billion dollars, even the mediocre like Occidental Petroleum's Ray Irani are "bought out" with the best part of $100 million. The compensation of top corporate officials in the United States today exceeds by orders of magnitude every comparative measure of pay irrespective of time and place. "In 1999, the average CEO earned an astonishing 475 times the average wage of a blue collar worker."[ii]

The preponderant source of this new wealth is options, so we need pause and reflect on the co-optation by The Business Roundtable of the U.S. governmental and professional processes to change the way in which options are charged on company financial statements. 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 (a trade association made up exclusively of CEOs [no surrogates]) successfully organized a lobbying effort to pressure the Financial Accounting Standards Board ("FASB") - the principal self regulatory agency for professional standards for accountancy - 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 don't cost anything.

Warren Buffett, whose ability to make money deprived the country of a great 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 was so successful in overpowering FASB, the supposedly independent accounting rule setting organization, the challenge of creating a CEO compensation system with real alignment to owners’ interests has been exacerbated.

Not only are options “free”, but they are not aligned to shareholder values because – in reality – they are a “one way street”. 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. And yet, everybody assures everybody else that a world in which managements have awarded themselves over ten percent of the outstanding capital of America’s publicly traded companies represents a desirable solution. Desirable for whom?

We have arrived at this unsatisfactory state out of disastrous deference to fine sounding corporate procedures. 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 have 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. Most people, however, 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 ("Remuneration") 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 bring unwelcome advice to their clients. The reality is that very intelligent people have deliberately misused language and structure in describing the process by which the pay for principal executives of American corporations is decided.

The National Bureau of Economic Research (U.S.) has recently made clear that the abuse of power by CEOs that has led to the grotesque compensation profile of today is attributable to poor governance, specifically, to an absence of any effective involvement of ownership. “In practice, executive compensation seems to be better characterized by either the skimming or the contracting model depending on the extent to which there is an active “principal” (or principals) present to actually design pay contracts. Better governance means that there is more of an active principal and optimal contracting fits better. Worse governance means that there is less of an active principal and the CEO is more likely to set his own pay.”[iii]
Maybe, this is what Stephen Byers had in mind: “It may be appropriate for the board to discuss aspects of directors’ remuneration with investors…”[iv] This responsibility must be laid at the door of the trustees, themselves it is utterly unrealistic to expect money managers, hardly ill compensated and dependent on the good will of corporate management, to discharge the function of “principal.” It is time to “Get Real”.

Real Corporate Direction: CEOs do what they are paid to do. Boards of Directors are responsible for creating compensation arrangements for key officers that align their interests with those of the owners of the corporation.

Many corporations have made efforts to create a public image that is more sympathetic than that of the mechanical profit seeker. We will consider at some length a variety of performance codes over the last three decades and their relationship to corporate functioning. Elsewhere I have suggested that it would be inappropriate, and possibly illegal, for a corporate management to pursue objectives beyond long-term value maximization.[v] What we will first try to understand is how the adoption of values that cannot be numerically related to profit maximization and their inculcation throughout the corporate system can be expected to influence results.

Certain companies have taken up the challenge of demonstrating consciousness of their need to co-exist with others in the universe. Sir John Browne, CEO of BP Amoco, broke ranks with the rest of the oil industry in a speech at Stanford in May 1997 by conceding that global warming may be real. Browne pledged that BP would achieve real reductions in the level of carbon dioxide emissions. He has been the industry leader in adopting pro environmental policies towards developing cleaner fuels and disposal of wastewater. In response to the question - What is the ultimate goal of your environmental policies? Browne answered: “In the end, it’s just good business. We know that people are concerned about the environment, that they want to buy products that don’t pollute, that governments want to deal with companies that are sensitive to environmental issues, and that people are motivated to work for companies that respect the environment. The big thing is to get the timing right. Our ambition is always to be ahead of the curve, although of course you can get too far ahead of it.”[vi]; More recently Sir John delivered the Reith lecture (April 24, 2000) and refined the dialogue: "Performance is now measured on many dimensions and success is defined in a holistic way."

British Petroleum, having acquired Amoco, has wrestled with the compensation sophistications of two continents. Although his leadership portends great value for society, the long term performance targets on which Sir John’s compensation is based remain rooted in market place measurements.

“Reward Philosophy The remuneration of executive directors in ERP Amoco will be based on the following guiding principles:…total potential rewards will be earned by the achievement of demanding performance targets based on measures which represent the best interests of the shareholder in the short, medium and long tem…. Levels of reward for meeting business targets will be fully competitive within the appropriate market while outstanding rewards will be given for delivering world class results…

Long Term Performance Plan (LTPP) – LTTP focuses on performance within the oil sector and looks at performance against demanding three year shareholder return, profitability and growth targets [in relation to other oil companies]…

Share Options - Option grants will be related to performance comparisons with a wide selection of global companies. The Remuneration Committee will take into account the ranking of the company's total shareholder return (TSR) against the TSR of the FTSE Global 100…". [vii]
BP has gone to great lengths to be sure that executive incentive is virtually congruent with shareholder enrichment. There is protection in the program against the more usual opportunities for manipulation by corporate executives. For example the use of share repurchase programs being choreographed with option grants so as to lock in profits would not be availing to BP Amoco executives.

The quest for incentive compensation can be counted on to elicit ingenuity and persistence. The question remains as to the effective impact of the company's commitments in the environmental area. Is anyone's pay materially dependent on achieving these objectives? Even if there is no linear connection, will company culture justify a higher market price. Will the market accord higher value to BPAmoco than to a company with less ambitious announced environment ambitions? The auditors of BPAmoco's 1998 Environmental and Social Report consider that management processes could be strengthened through "objectives relating to the implementation of the ethics and relationship policies within performance contracts for business units and key managers."[viii] What about for the executive directors and Sir John Browne?*
Pearl Meyer is one of the foremost authorities in the United States on executive compensation. She advises that many of the largest corporations use non-financial based measures of compensation for executives (not for the top one, however!). These range from the Customer Value Added and People Value Added tests used by AT&T to the "4-Es" of General Electric Company – the personal energy to welcome and deal with the speed of change the ability to create an atmosphere that energizes others the edge to make difficult decisions and the ability to consistently execute. Philip Morris might reward for leadership in achieving a nationwide settlement of healthcare cost recovery while Merck focuses on fostering a productive work environment so as to attract and retain employees with the skills, abilities and attitude to meet present and future business requirements.

There is considerable interest in tying managerial compensation to employee and customer satisfaction. Even in such companies, like Eastman Kodak, the CEOs pay is based almost exclusively on traditional performance measurements.[ix]; "Employee satisfaction, though, remains difficult to measure, and that has been a big impediment to the survey's use in setting executive pay… What's surprising about Nortel's reluctance to link employee satisfaction with executive pay is that the company has found that satisfied employees add significantly to the bottom line. By analyzing the employee surveys the company has taken for some time, Nortel found that on its scale of 1 to 5, a 0.2 increase in the mean score for specific questions related to productivity conditions can increase profitability by 6.8%. And a 0.2 increase in the mean score of items relating to "employee engagement" – how satisfied the employee is and whether he or she feels valued – can translate to an increase of 4.5% in profitability. Still Mr. Kozyn concludes, unless shareholders 'start getting vocal about how companies deliver results in respect to how they relate to their people, you won't see a huge movement' toward tying executive pay to employee satisfaction."[x] The question lingers – does the market place higher value on a company with earnings of "x" and a good record with respect to employee satisfaction than another also with earnings of "x" with mediocre employee relationships.

The Compensation and Option Committee of Ford Motor Company – Michael D. Dingman, Chairman, Carl E. Reichardt and Robert E. Rubin – explicitly included normative values in determining the 1999 compensation of top executives. "The grant of Restricted Stock Units depends on the achievement of several major Ford goals based on progress in becoming the world's leading consumer company for automotive products and services with superior shareholder returns: strong global brands, superior customer satisfaction and loyalty, best total value to the consumer, nimble organization with leaders at all levels, and corporate citizenship." It is to be noted that Ford Motor Company has a "principal" in the ownership of the Ford family and the presence of a family member as Chairman of the Board of Directors. The stature and experience of the committee members are without peer in the commercial world. William Ford set

a new standard of industrial leadership in raising questions about the company's continued production of its most profitable automobile - the sports utility vehicle (SUV").
In a question-and-answer section of today's report, Mr. Ford said that it might be difficult to persuade Wall Street that it was worthwhile for Ford Motor to take big steps to be perceived as a progressive, environmentally friendly company. "Analysts are focused on the next quarter's report, and at most, your next year's report," he said. "And the kinds of issues we've been discussing today have payoffs 5, 10, 20, 50 years down the line. I do believe that I'm building a stronger Ford Motor Company for my children and grandchildren. But that's not a theme that resonates very well with most analysts."[xi]

The Ford Motor Company is providing leadership in directing CEO energy along lines that are congenial to the interests of society as a whole. This is the right road. We can hope that industry as a whole will follow.

In summary:

There can be no substitute for a qualified and independent Remuneration committee willing to set and monitor subjective criteria to assure that CEOs direct enterprises towards the desired goals.

Endnotes

* The Remuneration Committee "incorporates an assessment of the performance of the CEO on environmental matters in the CEO's reward decision…in the table headed "Performance measures and targets for 2000" under annual performance bonus." The pattern of compensation packages for comparable companies suggests that the annual performance bonus is not a major component of the total ultimate compensation package.

[i] Consultative Document, Directors’ Remuneration, August 1999 - Forward[ii] Special Report – Executive Pay, Business Week, April 17, 2000, pp. 100, 110.[iii] Marianne Bertrand and Sendhil Mullainathan, Do CEOs Set Their Own Pay? The Ones without Principals Do, Working Paper 7604 (March 2000), National Bureau of Economic Research, p. 6.
[iv] Consultative Document, Chapter 7.
[v] Robert A.G. Monks, The Emperor’s Nightingale, (Capstone,1998)[vi] Fortune, p. F-89, March 6, 2000
[vii] BPAmoco, Annual Report and Accounts, 1999 – Remuneration Committee Report – February 2000[viii] BPAmoco, Environmental and Social Report 1998 – Ernst & Young Attestation Statement March 31, 1999.[ix] Timothy D. Schellhardt, "Bottom Up Pay – Companies regularly survey how employees feel about their bosses, But they rarely use the ratings to set compensation", Wall Street Journal, April 6, 2000 p. R5.[x] Ibid.
[xi] Keith Bradsher, "Ford is conceding S.U.V.' Drawbacks", New York Times, May 12, 2000, p. 1.