What Price Talent? Why US investors are now less content to hail the chief:

Executive pay is the new front in the battle for better governance

Financial Times
Jeremy Grant, Francesco Guerrera, and Andrew Ward
June 16, 2006

When Bob Nardelli was appointed chief executive of Home Depot in December 2000, it seemed like a consolation prize. He had just lost out to Jeffrey Immelt in the battle to succeed Jack Welch as chief executive of General Electric.

Six years later, the setback is starting to look like a stroke of luck. Since taking charge of Home Depot, the world's largest do-it-yourself retailer, Mr Nardelli has received nearly Dollars 250m (Pounds 135m, Euros 198m) in compensation including stock options - more than double what Mr Immelt has been paid at GE.

The package triggered an investor revolt that stunned Home Depot and has put Mr Nardelli at the centre of a spreading controversy about soaring executive compensation in the US.

After decades of meekly accepting gigantic executive pay packages in North Korea-style annual votes, investors are challenging executives to prove that their performance warrants huge pay cheques. "Executive compensation has absolutely skyrocketed to the number one issue shareholders are concerned about," says Carolyn Brancato, director of the Global Corporate Governance Center at the Conference Board, a research organization.

With regulators and politicians also threatening to act unless companies rein back, executive compensation has become the new front in the battle for better corporate governance in the US.

The current season of shareholder meetings has seen several blue-chip companies - such as Pfizer, AT&T, Merrill Lynch and Wal-Mart - suffer the wrath of shareholders over executive compensation. On Wednesday, Country-wide Financial, a California mortgage group, came under pressure at its annual meeting from shareholders led by the American Federation of State, County and Municipal Employees (AFSCME) pension plan, which called for a say in the level of executive pay at the company.

Across the country, investors' concerns have been deepened by a scandal over the backdating of stock options - once considered the fairest way to provide incentives for executives - that has ensnared some 40 companies in a tangle of investigations, earnings restatements and lawsuits. Last month it emerged that dozens of companies had made retroactive options grants to executives just before rises in the companies' share prices

The suspicion among angry shareholders is that such moves were not properly disclosed and accounted for. The result has been a battery of lawsuits against companies and executives from public pension funds, which claim that something has gone seriously awry with executive compensation.

The Securities and Exchange Commission has moved quickly to address the allegations. It may incorporate further stock options disclosure into an existing executive compensation overhaul being conducted by Christopher Cox, the agency's chairman.

Some executives warn that the US corporate psyche still bears the scars of the regulatory backlash that followed the Enron and WorldCom scandals and can ill afford another raft of onerous corporate governance regulations. "If they keep hitting us with rules, we will never be able to focus on getting our companies to do better and make more money for shareholders," complains one chief executive.

But if the climate of unease intensifies, the focus on executive pay, just like the corporate scandals that preceded it, could change the way US companies are run and held accountable. "We are in the midst of a paradigm shift in the US. There is a chance for boards to take companies' driving seats away from senior management," says Patrick McGurn at Institutional Shareholder Services, which advises more than 1,600 fund managers.

Part of the reason for rising anger over executive pay is that, in absolute terms, America's corporate chieftains have never had it so good.

The typical chief executive of one of America's top 350 companies received Dollars 6.8m in salary, bonus, options and other benefits last year - more than double what they would have earned 10 years ago, according to Mercer Human Resource Consulting. The biggest-earning 25 per cent of executives, who tend to run the larger groups, earned more than Dollars 12m on average.

These pay levels are about twice what the head of a company of similar size makes in Europe. They are also 431 times the average wage for a production worker, according to another survey (see chart) - a hugely sensitive issue at a time when many Americans live in fear of losing their jobs to cheaper foreign labour.

It is this growing disparity that leads many experts to believe the current furore over executive compensation will not abate soon. The confluence of corporate scandals, volatile stock markets and tougher economic conditions for average Americans means the issue is reverberating far beyond the financial world, affecting public opinion throughout the US.

Yet the pay rises of today pale in comparison to the eye-watering awards handed out during the internet bubble, when total compensation for chief executives rose more than 24 per cent. By contrast, their total pay between 2002 and last year increased by 5 per cent and the base salary of chief executives only rose 3.6 per cent - in line with workers'

wages.

But the numbers tell only part of the story. Unlike their British counterparts, for example, US shareholders and public opinion have rarely been outraged by the large amounts earned by chief executives.

The US entrepreneurial culture, admiration for winners and belief that wealth breeds wealth, spared corporate America from popular outcries such as the "fat cats" controversy that engulfed the people who ran Britain's privatised utilities in the early 1990s.

Shareholders' fury has been stoked by the realisation that executive pay has not been accompanied by improvements in share price and performance. "Shareholders are not opposed to generous compensation when merited," says Paul Hodgson, analyst at the Corporate Library, which monitors corporate governance in the US. "The complaint against Home Depot is that compensation has been so far out of step with performance."

This divergence has called into question the traditional rationale for large pay awards - that huge monetary incentives reward executives for making money for shareholders. Shares in six of the 10 companies whose chief executives received the highest rises in total compensation in 2005 under-performed their peers over the previous five years, according to the Corporate Library.

At a bellwether such as AT&T, Ed Whitacre, chairman and chief executive, has received more than Dollars 34m over the past two years despite the fact that total shareholder value fell by more than 40 per cent in the 2000-05 period.

Much of the blame for the failure to give shareholders bang for their buck has been pinned on stock options. Once regarded as a spur to chief executives' performance, options' limitations have been cruelly exposed by recent events.

By linking future compensation to share price increases, options have the glaring drawback of rewarding executives for stock market gains that have got nothing to do with them. If, according to an old traders' saying, a rising tide lifts all boats, then America's corporate captains have been riding high on the crest of the long bull market.

In theory, executives should be exposed to the risk of a fall in the value of the shares, but in practice many companies have repriced options after a market setback. The backdating scandal has additionally raised the spectre of executives blithely awarding themselves options knowing these were profitable almost from the grant date.

If, as one chief executive puts it, the scandal has confounded the long-held perception that excessive pay is a "victimless crime", who is the perpetrator?

Some observers blame a culture of "superstar chief executives" for spurring a remuneration "arms race". But although the fictional Gordon Gekko's "greed is good" creed still resonates in corporate America's corner offices, most observers agree that the

onus to contain boardroom excesses rests with the independent directors on boards' compensation committees.

According to Norman Veasey, a former chief justice in the Supreme Court of Delaware, the state where most US big companies are incorporated, "directors who are supposed to be independent should have the guts to be a pain in the neck".

But academic and empirical evidence suggests that this ideal can be difficult to realize, given the ties between independent directors and management. Professors Lucian Bebchuk and Jesse Fried, who analyzed the issue in their book Pay Without Performance, concluded: "Compensation arrangements have often deviated from arm's length contracting because directors have been influenced by management, sympathetic to executives, insufficiently motivated to bargain over compensation or simply ineffective."

With human factors making it difficult for directors to challenge management - and no prospect of America embracing a UK-style division of roles between chairman and chief executive - the answer may lie in the details of executive compensation.

Some experts argue that traditional stock options should be adjusted to "filter" the effects of stock market movements unrelated to company's performance. Others suggest companies should issue options at a premium, rather than at the market price, so executives have to sweat for their millions.

Corporate governance experts also bemoan the use of the same targets for both annual and long-term bonuses, arguing that executives get paid twice for the same achievement.

Several large fund managers privately advocate replacing crude measures such as revenue and earnings with yardsticks closely linked to shareholder value. The SEC's Mr Cox, meanwhile, is focusing forthcoming reforms on disclosure. He proposes telling compensation committees to release all material information regarding their decisions - "and we mean all", he says.

A company would provide one number that includes all compensation to top executives in a given year. The different elements that make up that number would be presented "not in an impenetrable thicket of details", but in clearly presented tables. "The principle here is simple," Mr Cox says. "No shareholder should need a machete and a pith helmet to go hunting for what the CEO makes."

Whatever the structure of executive compensation, the leaders of corporate America are unlikely to be able to enjoy the fruits of their labour in quite the same way in future.

Recent events suggest that more and more investors agree with Warren Buffett, who is paid just Dollars 100,000 a year. Nearly three years ago he wrote: "In judging whether corporate America is serious about reforming itself, CEO pay remains the acid test. To date, the results aren't encouraging."