HOW TO FIX EXECUTIVE PAY

Executive Pay: It's About "How," Not "How Much"

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It seems we are moving from an era when "greed was good" to one in which "jealousy is justified"--the executive-compensation regulations being considered now by the government and advocated by shareholder activists aren't very thoughtful, and I believe they're born out of jealousy and misinformation.

But "How much should CEOs be paid?" is the wrong question to be asking right now. The right questions are: "How should they be paid?" and, just as important: "Should changes in the way CEOs are paid be mandatory or voluntary?"

Pay must be structured to attract the right executives and give executives effective incentives to lead their companies to great performance. The poor showing of too many firms, despite ample CEO salaries and equity packages, and excessive compensation at times of poor performance shows that pay typically isn't structured correctly and that executive compensation practices need serious reform.

All too often, executive incentives are based mostly on short-term financial metrics and shareholder returns. Financial results are the consequence of a firm's strategy formulation and implementation. Effective incentive systems should focus on effective organizational learning and growth, process improvements, and customer-related metrics and milestones. In addition, companies should design compensation packages to attract the right people for implementing the company's strategy. For instance, below market salaries coupled with aggressive incentive pay linked to individual performance is likely to attract self-motivated entrepreneurial individuals.

Companies also need to assure their executives longer tenure and horizons. A CEO who is afraid of being fired for not making short-term financials will not focus on the long term. A board that is actively engaged in strategy formulation and implementation and compensates a CEO for strategy implementation milestones and monitoring long-term performance is more likely to understand, appreciate, and encourage a CEO's efforts even if they yield short-term financial results that are below expectations. Thus there is an urgent need for boards to evaluate their executives' performance annually to determine their progress on long-term goals. Simultaneously, boards should engage in active succession planning so that they do not find themselves looking for a superstar CEO to rescue them from their financial problems. It is precisely in those situations that CEOs are able to negotiate outrageous compensation packages.

Simultaneously, companies should get rid of egregious practices such as over the top severance packages (more than two times annual compensation), grossing up taxes, defined-benefits plans, guaranteed returns on deferred compensation, accelerated vesting in the event of change in control, and time-based vesting of restricted stock. On the stock question, companies should require that equity pay vest on the basis of company performance relative to their peer group over five to ten years.

It would be highly unfortunate if, as now seems possible, massive amounts of regulation and active government intervention were to be the dominant forces determining how American executives are compensated. Caps on pay, shareholder "say on pay," ceilings on ratios of CEO pay to worker pay, appointment of a federal compensation czar, and labeling of incentive pay as pay that causes excessive risk--all these would reduce innovation in American companies and hurt shareholders without necessarily reducing excessive executive compensation.

Governmental and shareholder second-guessing on pay would create an environment of fear in which no board would dare try an approach that's different from the herd's or that is tailored to the company's particular strategy. And one size definitely does not fit all when it comes to compensation - when business strategies differ between companies, their compensation practices ought to differ as well. Worse, governmental regulation will probably have unintended consequences without curbing excessive pay. For instance, if the maximum ratio of CEO pay to worker pay were mandated, companies might respond by outsourcing the work of the lowest paid workers rather than curbing CEO pay.

While compensation reform is needed, it must come from within--from executives and boards, acting in the company's best interests.

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I have argued in this debate that the CEO and top leadership roles should be redefined to put at their core a balance of risk-taking and risk management and the fusion of high performance and high integrity. I have also argued that redefined measurements for performance, risk management, and high integrity can and must be developed to assess that foundational role.

These key economic performance, risk management, and integrity measurements must then be the lodestone for variable cash and variable equity compensation that is paid out or held back over time as objectives (performance, risk, integrity) are met, exceeded, or missed. Similarly, compensation plans must risk-assess jobs below the top business leaders (e.g. traders), and apply new compensation design for individuals, not just top officers, with the ability to commit resources with long-term results. And, below the top officers, compensation must be built on company, division, and individual results, not on solo contributions alone

The “accounting period” for compensation should be a year for fixed compensation and for a portion of variable cash---but practices must be shifted to reward sustained performance, not the risky spike. A strong consensus is emerging on this point of spreading variable cash out over time and, depending on performance, holding back or delivering the original nominal amount in actual increments in outyears, such as Year 3 and Year 5 (the “bonus-malus” concept). A performance, risk, or integrity miss means that significant cash compensation awarded in one year but held back by the company will not be paid out in subsequent years. Such a structure should end the huge annual cash bonus which ignores risks created by (potentially unsound) revenue or profits generated in Year 1.

Variable equity should, of course, vest in the years after the grant. The amount awarded in Year 1 should be increased, stay the same, or be reduced at vesting in Year 3 or Year 4--or whenever--depending on comparisons with peers both for total shareholder return but also for economic performance metrics such as cash, return on capital, and product development that relate to creation of real economic value. So, too, it can be held back for significant performance, risk, or integrity misses. This redesign should sharply reduce the role of the naked stock option or RSU based only on share price as a dominant form of compensation (although pure share price instruments should be an element of exec comp). One salient reason: The growing criticism of “efficient market” theory, which assumes share price over time reflects efficient and rational markets (Lord Turner, chairman of the UK’s Financial Services Authority, offers a trenchant critique in a widely noticed recent report).

It should be obvious even from this brief discussion that redefining the CEO role, changing management development, redesigning executive compensation, and recalibrating priority board oversight, even if undertaken according to new principles, will require substantial, granular effort because each business and

each industry will have its own particulars. It should also be obvious that this necessary granularity is why public regulation of core governance and of executive compensation is so prone to over-simplification and unintended consequences, not just at the outset when emotions run high but subsequently when hard decisions are no longer on the front pages but are delegated to individuals trained in public institutions, not businesses, and when bureaucratic politics, not balanced policy, gains influence. So real reform inside companies must navigate around the extraordinary public pressure to regulate governance and pay practices at the federal level (Congress, the Treasury Department, the SEC, etc).

But such “real reform” must then depend on boards of directors whose performance has been questionable at best (and abysmal in the financial sector).

At least four hard issues must be candidly addressed:

• Given past, stark failures, can boards of directors, as an institution, engage in such a sophisticated, fine-grained assessment of a corporations and sectors? One answer is that they need a new kind of compensation expert reporting only to them (although obviously working with the CEO and the company). Such individuals’ expertise would be less on pay trends and pay packages and more on how companies operate. They would be capable of addressing the fundamental questions of redefining CEO role, choosing CEO that meet spec, altering management development, redesigning compensation, and focusing oversight on priority issues relating to executive pay in ways to minimizing “gaming” the system.

• Can shareholders have a constructive advisory role based on the merits of their ideas--and genuine public debate on company pay through corporate solicitation of ideas and considered responses--rather than on a plebiscite? “Say on pay” is one advisory mechanism, but a very crude one, and it raises issues because there are so many different kinds of shareholders with so many conflicting goals.

• Can individual corporations that redefine the business leader role and redirect and stretch out executive compensation compete in the labor market for leadership talent with those that just want to throw cash and options at top leaders and performers? This may not be an issue for TARP companies today, but it will emerge, as the economy and financial institutions resume growth, in the future. (Look at the hasty exodus from TARP of financial companies that could buy out.) One approach, beyond individual firm initiative and well short of comprehensive public regulation, is for firms in the financial sector to develop a code of compensation principles (without raising any antitrust concerns) to which they would commit themselves and which would be reported in proxy statements or other reports. In such an approach, public officials might have a “convening” and “dialogue” role, given the legitimate interest in the safety and soundness of the financial sector, rather than a “rule-making” role.

• Most difficult of these difficult issues is the fundamental cause of so many problems: How do directors resist the short-termism of the stock market, which creates pressures for behaviors that are not in the interest of a sustainable, durable institution focused on creation of real economic value--and indeed can injure the company (corruption, ill-considered risk-taking, hyperactive decision-making). Certainly, making the changes described above is a start. And nothing that I have said takes away from a corporation’s primary mission: To have strong, sustained growth based on superior, high quality goods and services which provides durable benefits to shareholders and other stakeholders. Securing buy-in for real creation of shareholder value from institutional investors is one approach to this recurring, vexing problem.

In the end, we are back at the critical role of directors on defining the role of the CEO and setting executive pay to reward desired behaviors---and the ultimate question of whether they will be weak reeds or pillars of strength. The record of the recent past does not engender optimism, but the only way to direct legislation and regulation in “least harmful” ways is for companies and directors to step up to the task--and speak out.

- Posted by Ben Heineman
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