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# Directorship

IN ITS THIRTY-FIRST YEAR AS THE AUTHORITATIVE BOARD RESOURCE

**How Well Is SOX Actually Working?**

More than 30 months have passed since the enactment of the most far-reaching legislation to have affected governance in three generations. Total estimated costs for compliance with Section 404 alone according to Financial Executives International for companies with revenues over $5 billion almost doubled from $4.6 million to $8 million. *Directorship*'s survey of 270 board members revealed the total compliance cost of SOX to be $16 million. Calls for scaling SOX back are matched by complaints that it did not go far enough. Former Ernst & Young partner Mary Locatelli, who has taught corporate finance at USC, examines the unintended consequences of the law's impact on internal controls. P. 10

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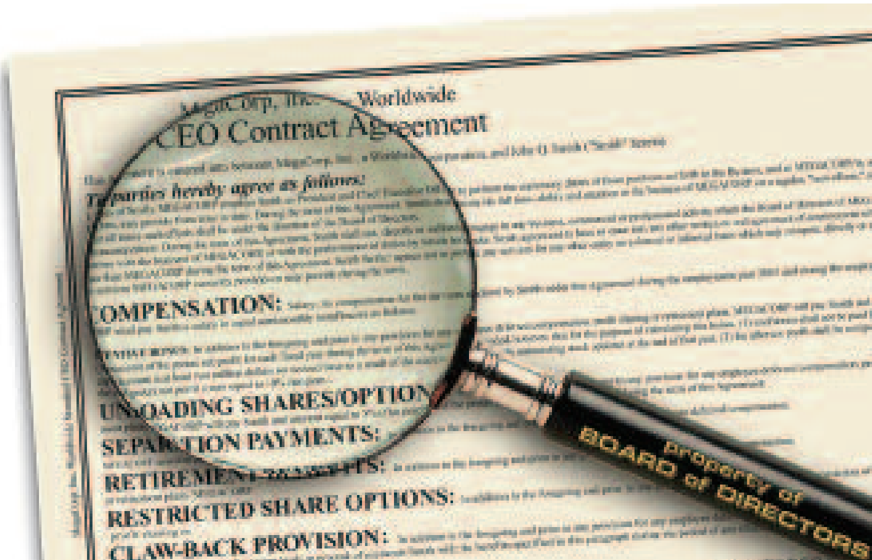
# What Boards Should Do About CEO Pay

*Despite a host of reforms, the executive pay process remains fundamentally flawed, says Harvard Law School's Lucian Bebchuk. Board directors' independence isn't the answer, he argues. Making directors less insulated from shareholders is.*




*Boards aren't the guardians of shareholder interests that they could be, argues Lucian Bebchuk, the William J. Friedman and Alicia Townsend Friedman Professor of Law, Economics, and Finance and director of Harvard Law School's program on corporate governance. Together with Jesse Fried, a professor of law at the University of California at Berkeley, Bebchuk has studied pay arrangements over the better part of the last decade and finds a number of structural defects in which boards consistently fail to negotiate at arm's length with the executives they are meant to oversee.*

*In their recent book* Pay Without Performance *(Harvard University Press, 2004), Bebchuk and Fried conclude that most executive pay practices are decoupled from performance in a systemic way and that camouflaged compensation, in the form of indirect compensation, retirement benefits and perks, actually dilutes and distorts executives' incentives. Many board members will take issue with the authors' conclusions, but other academic studies reach similar outcomes. A study conducted by David Yermack finds that*

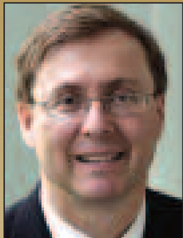
*continued on page 4*

*What Boards Should Do About CEO Pay*
*continued from front cover*

*that pay – performance sensitivity decreases as the size of the board increases. The presence of directors on multiple boards is said to increase the relative power of the CEO, leading to a greater likelihood of more generous compensation of that CEO. Also, a CEO who also serves as board chairman is less likely to be fired from the board and can expect to obtain more favorable pay arrangements.*

*Contrary to received wisdom, Bebchuk argues in the following interview with* Directorship*'s J.P. Donlon that director independence is not the solution. Rather, board members should be made more dependent on shareholders by eliminating the arrangements that entrench board members and insulate executives. Born in Wroclaw, Poland, in 1955, Bebchuk studied mathematics and economics and earned a law degree from Tel Aviv School of Law in Israel before emigrating to the US, where he studied and later taught at Harvard. Over the last 15 years he has written extensively on corporate control and executive compensation. In the following interview and book excerpt nearby, (p. 7) Bebchuk advances a number of proposals to remedy the situation, among which include: Indexing to filter out industry-wide windfalls, eliminating camouflage comp and gratuitous golden goodbyes, allowing greater shareholder access to the ballot, eliminating staggered boards, and when necessary, putting pay schemes to a shareholder vote.*

**You argue in your book that "directors tend to have financial and nonfinancial incentives to please or at least not displease the CEO, [and] even absent such incentives, there's a host of social and psychological factors that are likely to lead directors to favor managers." Where's the evidence?**


Lucian Bebchuk

*"Indexing of the option's exercise price is one way of filtering out windfalls."*

There are several pieces of evidence. If pay was set in an arm's-length fashion, we wouldn't expect to find this systematic correlation between managers' power vis-avis the board and shareholders and how favorable managers' pay arrangements are. Furthermore, examining directors' incentives, one does not find significant incentive to focus on advancing shareholder interests. For example, because company slates generally run opposed, the likelihood of directors being reappointed depends primarily on whether the director will be renominated by the board, not on how content shareholders will be with the company performance.

**So you think it's primarily social pressure, wanting to be likeable, that drives directors to be generous with CEO pay, since it's not their money?**

It's a combination of both kinds of "economic rational" considerations and various social-psychological forces to go along with colleagues and leaders. It's difficult for directors to switch hats from treating their CEO in a collegial and sometimes deferential way as their company's leader, to treating him or her in an arm's length way.

**Many directors would counter-argue that they are personally not beholden to the CEO or as beholden as they were before the scandals. Is there any evidence of this?**

There has definitely been some improvement. Directors are more willing to fire CEOs. But if you look at the firing cases that have received attention, most of them are cases of CEOs that are suspected of legal or ethical misbehavior or have failed in a very big way. But it is far from clear that a CEO who is merely mediocre faces any significant liklehood of being fired. A good corporate governance system must also address the large universe of cases in which performance is merely mediocre.

**You argue that many compensation incentives don't really work. So what incentives really do work, and how are they best implemented?**

Let's start with equity-based compensation. The devil is in the details. A large fraction of the gains that executives now obtain from equity-based compensation come from industry-wide or market-wide movements. We need to filter out "windfalls" that result from such movements. Secondly, managers continue to have broad freedom to unload options and shares and thus to be able to benefit-from short-term spikes in the stock price even when long-term performance is flat. Firms should separate the point in time in which equity-based instruments vest from the point in time in which executives are free to unload them.

**So you're in favor of longer holding periods?**

Yes, for both options and shares. Such limitations should be applied not only to restricted stock grants but also to option grants. In addition to making equity-based compensation more linked to long-term, firm-specific stock returns, firms should not provide executives with "soft landing" arrangements that guarantee generous payment in the event the executive is pushed out due to failure. In addition, standard executive pay contracts should have claw-back provisions under which restatement of earnings should lead to a reversal of payments that were made on the basis of earnings that have been restated. This seems like a no-brainer.

**Why do you suppose there is a reluctance to have claw-back provisions in executive contracts?**

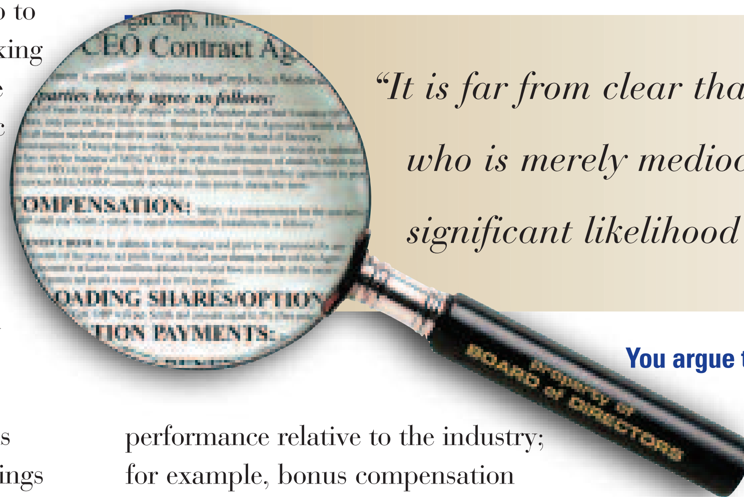
Some might object to such provisions on the grounds that executives should not be automatically faulted for restatements. But claw-back provisions are appropriate even for cases in which the executives can be safely assumed not to be in any way responsible for the restatement. The simple principle should be: If it wasn't earned, it must be returned. Others might claim that firms have not been adopting claw-back provisions yet due to inertia. But this explanation isn't convincing. We find that innovations that favor executives have spread much more quickly, even when they are more complicated than claw-back provisions.

**How should boards try to reduce windfalls?**

Companies should attempt to reduce rewards for aspects of the company's performance that have little or nothing to do with a manager's own performance. With respect to bonus compensation, it should be based on performance relative to the industry; for example, bonus compensation should not be based on earnings growth but rather earning growth relative to the industry. With respect to options, indexing of the option's exercise price is one way of filtering out windfalls, but we discuss in the book more moderate ways of doing so. For example, the exercise price of options could be linked to the stock price of the bottom 20 percent of the firm's industry. This would provide the executive with gains as long as the firm is not in the bottom 20 percent, but will eliminate the possibility of rewards for sector-wide movements that even the worst-performing firms enjoy.

**Are there companies that use performance condition vesting, or some variation of the indexing that you favor?**

Indexing has not taken hold. There has been a movement in the direction of performance conditioning. But it's still a minority practice. In any event, performance conditioning is not a good way of addressing the windfalls problem. Any compensation arrangement that is discontinuous—that is, that provides a substantial amount of compensation for a passage of a threshold—is problematic; it might produce perverse incentives when performance is close to but falls short of the threshold.




*"It is far from clear that a CEO who is merely mediocre faces any significant likelihood of being fired."*

**You argue that expensing options really doesn't solve the problem that options represent. Can you elaborate?**

Expensing options would make the cost of option arrangements more transparent to investors. Transparancy is beneficial, but it does not by itself ensure that option arrangements will be set optimally. For example, expensing in no way ensures that firms will redesign conventional options to reduce windfalls from sector-wide movements or to place limitations on executives' freedom to unload vested options.

**Why do you say that restricted stock, which is now a larger component of executive pay than it has been historically, is just simply an option in another form — and perhaps not the best way to go about incentivizing the executives?**

Conventional options can provide windfalls when stock prices increase due to market-wide movements. Restricted stock awards do not address this problem but rather exacerbate it. Shares are options with an exercise price of zero. With restricted stock, executives make gains not only when the firm's stock price goes up nominally due to market-wide movements but also when the stock price declines.

*"Standard executive pay contracts should have claw-back provisions under which restatement of earnings should lead to reversal of payments."*

Some view restricted stock grants as attractive because they involve long holding periods. But long holding periods can be required without increasing windfalls by reducing by the exercise price to zero. Instead of restricted stock awards, firms should provide executives with "restricted" reduced-windfall options that executives are required to hold for a certain period after vesting.

**Many of the conditions that gave rise to the very high levels of chief executive compensation that have drawn media and public fire existed before the sudden upward surge in executive pay. So what accounts for the sudden surge?**

A couple of factors have contributed to making larger pay more legitimate. The bull market of the nineties made investors more forgiving and more willing to accept large compensation. Furthermore, and perhaps more importantly investors have accepted the idea, put forward by financial economists and others, that shareholders might be best served by providing managers with high powered incentives. Shareholders have accepted higher levels of pay as the necessary cost of providing such incentives. The problem, however, is that firms have not adopted arrangements that generate incentives in a cost-effective way. Firms could have provided the same or better level of incentives at a lower cost.

**To what degree are camouflage arrangements a problem, and how should directors deal with this?**

One main way in which firms provide "stealth compensation" to executives is through retirement benefits. As you know, firms' disclosures do not have to include a dollar figure for these benefits. In a recent empirical study, a colleague and I examined the value of the pension plans of CEOs of S&P 500 companies. Roughly two-thirds of the CEOs had a defined benfit pension plan, and the median value at retirement of such plans is $15 million. Moreover, the ratio of the executives' pension value to their total compensation during their service had a median value exceeding 30 percent. Increasing pension values increased the median percentage of the executives' total compensation composed of salary-like payments during and after their service from 15 percent to 39 percent.

Our findings indicate that the standard omission of pension plan values by researchers and by the media leads to significant underestimation of the magnitude of total pay. Furthermore, this omission leads to severe distortions in comparisons among executives' pay packages, as well as significant over-estimation of the extent to which pay is linked to performance. Firms could and should make retirement benefits more transparent by disclosing in their annual filing the increase in the value of an executive's retirement benefits during the year and the current monetary value of these benefits.

**How much of poorly aligned pay for performance is an accounting problem? That is, boards needing better metrics such as economic value added or market value added in order to differentiate true economic profit from accounting profit?**

We should keep an open mind to developing alternative metrtics for measuring performance. But there are some important general principles to follow. We should seek to filter out at least some of the industry- and market-wide effects. Second, whatever metric is chosen, we should link payoffs to long-term changes. Finally, to the extent possible, we should avoid frequent changes in the metrics used.

**What are the most perverse incentives? Cite the one that you find the most egregious.**

Practices, in both equity-based compensation and bonus compensation, that reward managers for short-term results. There is empirical evidence that such practices have had perverse effects, encouraging executives to seek short-term improvements that do not serve, and sometimes even undermine, long-term value.

**What practical steps should directors take to improve executive compensation arrangements, as you see them?**

Directors should make pay more transparent. They should not follow a "lawyerly" approach of not going beyond what the SEC requires. Second, as we discussed, directors should seek to tighten the link between pay and performance. Firms should filter out gains due to market-

wide and industry-wide changes from both their equity-based compensation and their bonus compensation. These should be linked only to long-term values. Firms should reconsider "soft landing" termination arrangements and consider making severance payments depend on the performance during the executive's service. Firms should reexamine whether it is desireable to provide a large fraction of total career compensation via retirement benefits that are largely decoupled from performance. In our book we discuss in detail these and other ways in which firms could provide improved incentives to executives in a cost-effective way.

**You say that shareholder proxy access, because it would put the director's seat at risk, is a partial solution. But since most companies fight that fiercely, is this really practical?**

This is a reform that is practical but might not be, at least in the short run, politically feasible. It might not be politically feasible in that supporters of the status quo have thus far been able to stop the SEC from adopting a shareholder access rule. If such a reform is adopted, however, it will provide a mild but positive step toward better governance arrangements.

**You also advocate putting compensation arrangements to a shareholder vote. Do you see that happening at all?**

This is a possibility. It is something the UK, whose governance arrangements are overall better than [those in] the US, has. We would not prefer this to be done by a one-size-fits-all form of imposed regulation. Shareholders should be able to vote on such arrangements when necessary.

And second, there is really no substitute for directors having the right incentives, because sometimes shareholder voting is just too crude and rough an instrument to handle a case involving complex choices.

**Are you optimistic or pessimistic that the issues we've discussed will be resolved in the direction you think would be most favorable to linking pay with performance? If we have this conversation three years from now, will we be talking about the same problems?**

By inclination I'm an optimist, and I would like to think we'll see progress. But I do recognize that there are strong vested interests that make progress in this area difficult. For reform to be possible, it's very important for investors, public officials and directors to recognize that we have not yet solved some basic problems with our corporate governance system, and that much remains to be done. Helping bring about such a recognition was one of our main aims in writing our book. ■

# 10 Steps to Improve Executive Compensation

*In their book,* Pay Without Performance *from which the following is excerpted, authors Lucian Bebchuk and Jesse Fried devote a chapter to what investors and boards should do to repair the link between pay and performance as well as improve disclosure and ensure transparency.*

We have identified various ways in which current schemes fail to perform well and could be improved. To illustrate, let us note some important changes that investors should support to improve executives' incentives.

**Reducing Windfalls in Equity Based Plans.**

Investors should encourage equity-based plans that filter out at least some of the gains in the stock price that are due to general market or industry movements. With such filtering, the same amount of incentives can be provided at lower cost, or more incentives can be provided at the same cost. Investors must recognize that a move to restricted-stock grants, which provide an even larger windfall than conventional options, is not necessarily in the interests of shareholders. To reduce windfalls, investors should press boards to consider schemes under which the exercise price is adjusted to filter out general market or ndustry movements. At the minimum, option exercise prices should be

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*Reprinted by permission of the publisher from* Pay Without Performance: The Unfilled Promise of Executive Compensation, *by Lucian Bebchuk and Jesse Fried, pp. 190 – 194, Cambridge, Mass.: Harvard University Press, © 2004, by Lucian Bebchuk and Jesse Fried.*

adjusted so that managers are rewarded for stock price gains only to the extent that they exceed those gains (if any) enjoyed by the most poorly performing firms.

### Improving the Link between Bonus Plans and Performance.

In assessing whether executive pay is adequately tied to performance, investors should scrutinize whether firms' bonus plans actually reward good performance or do so in name only. They should be wary of boards that give bonuses to managers for accomplishments, such as acquiring other companies, for which no special incentive is needed. As part of the effort to strengthen the link between bonus plans and performance, investors should resist bonus plans that include discretionary elements. While such discretion in bonus plans could be desirable if exercised by boards solely guided by shareholder interests, it might be counterproductive if given to boards as they currently operate.

### Limiting and Regulating the Unwinding of Equity Incentives.

Investors should also seek to limit executives' broad freedom to unwind the equity-based incentives created by their compensation plans. It may well be desirable to separate the vesting and unwinding of options. With such separation, options that have already vested and become the executive's property (or the shares received upon exercising these options) will remain in their hands for some time, continuing to provide incentives to increase shareholder value. To prevent executives from circumventing such limits on unwinding, executives should be prohibited from engaging in any hedging or derivative transactions that reduce their exposure to fluctuations in the company's stock price.

In addition, whenever executives are allowed to sell shares, they should be required to disclose in advance of their intention to sell shares. When making such pre-trading disclosure, executives should provide detailed information about the intended trade, including the number of shares to be sold. Limiting and regulating the unwinding of equity incentives will reduce the ability of managers to profit from short-term gains that do not reflect the company's long-term prospects.

### Avoiding Soft Landing in the Case of Failure.

Investors should also be wary of practices and arrangements that reward failing managers. They dilute incentives to enhance shareholder value — and thus undermine some of the incentives to increase value that other elements of the compensation package attempt to provide. Investors should scrutinize generous severance provisions to ensure that they do not provide large payments to executives when they depart with a record of poor performance. Investors should also oppose golden goodbyes to departing executives, including gratuitous payments beyond those required by their contracts.

### Scrutinizing the Magnitude of Nonperformance Pay.

Investors should attempt to assess the overall magnitude of nonperformance pay given to executives. In doing so, investors should take into account the various hidden forms of nonperformance pay such as retirement benefits. Once the total amount spent on pay unrelated to performance is identified, investors should assess whether it is possible to enhance shareholder value by making total compensation more sensitive to performance.

In scrutinizing the compensation arrangements approved by the board, investors should be well aware of both directors' limitations and their own. Given the many factors that currently induce directors to favor executives, investors should not presume that directors' compensation choices are those optimal for shareholders. At the same time, although shareholders can and should try to influence the general contours of compensation plans, they should recognize that they lack company-specific information and are hardly in a position to fine-tune the details of their arrangements. These competing considerations should shape the extent to which investors second-guess (and if need be, criticize) the choices made by directors.

### Improving Transparency

We argue for reforms that would increase shareholder power. But shareholders do already have some power. This is in part why the outrage constraint matters. *The greater outsiders' understanding of compensation arrangements, the tighter the outrage constraint.* Improving the transparency of compensation arrangements is therefore desirable.

Financial economists have paid insufficient attention to transparency because they often focus on the role of disclosure in getting information incorporated into market pricing. It is widely believed that information can be reflected in stock prices as long as it is known and fully understood by even a limited number of market professionals.

In the case of executive compensation, there is already significant disclosure. SEC regulations require detailed disclosure of the compensa-

tion of a company's CEO and of the four most highly compensated executives other than the CEO… . The main aim of requiring disclosure of executive compensation is not to enable accurate pricing of the firm's securities. Rather this disclosure is primarily intended to provide some check on arrangements that are too favorable to executives. This goal is not well-served by disseminating information in a way that makes the information understandable to a small number of market professionals but opaque to others.

Public officials and governance reformers therefore should work to ensure that compensation arrangements are and remain transparent. Several transparency-boosting measures are worth considering.

**Accounting Treatment of Options.**
Employee options should be expensed… . Rationalizing the accounting treatment of option plans would also level the playing field among different types of options. It would eliminate a major excuse used to avoid reduced-windfall options. The fact that reduced-windfall options must be expensed while conventional options need not has long been a convenient excuse for using the latter and failing to filter out gains due to general market or sector rises.

**Placing a Monetary Value on All Forms of Compensation.**
Companies should be required to place a dollar value on all forms of compensation and to include these amounts in the compensation tables contained in company disclosures. Companies have been able to provide executives with substantial "stealth compensation" by using pensions, deferred compensation and postretirement perks and consulting contracts. Although some details of these arrangements have appeared elsewhere in companies' SEC filings, firms have not been required to place a dollar value on these benefits and to include this value in the tables. These benefits have not even been included in the standard database used by financial economists to study executive compensation.

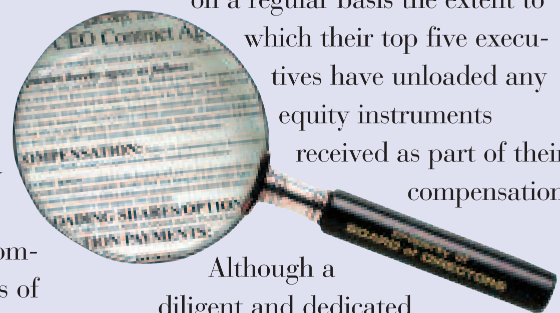
In our view, companies should be required to place a monetary value on each benefit provided or promised to an executive and to include this value in the compensation table in the year in which the executive becomes entitled to it. Thus, for example, the compensation table should include the amount by which the expected value of the executive's promised pension payments increased during the year. In addition, it might be desirable to require companies to place a monetary value on any tax benefit that accrues to the executive at the company's expense (for example, under deferred compensation)—and to report this value.

These measures would provide shareholders with a more accurate picture of total executive compensation. They would also eliminate distortions that might arise when companies choose particular forms of compensation for their camouflage value rather than for their efficiency.

**Placing a Monetary Value on Total Compensation From all Sources.**
By paying executives in many different forms, with some of them not even given a monetary value, companies make the total amount of compensation less salient than it should be. Companies should be required to indicate in the executive compensation section of their filings the total amount of compensation that each of its top executives earned in that year as well as since coming into office.

**Pay and Performance.**
It might be worthwhile to require companies to disclose to shareholders in a transparent way how much of the gain that managers make on their options is due to general market and industry movements. This could be achieved by requiring firms to calculate and report the gains made by managers from the exercise of options (or the vesting of restricted shares, in the case of restricted-share grants) and to report what fraction, if any, resulted from the company's superior returns over its industry peers. Such disclosure would make much more transparent the extent to which the company's equity-based plans reward the managers' own performance.

**Unloading of Options and Shares.**
Companies should be required to make transparent to shareholders on a regular basis the extent to which their top five executives have unloaded any equity instruments received as part of their compensation.



Although a diligent and dedicated researcher can obtain this information by sifting through stacks of executive trading reports filed with the SEC, requiring the firm to compile and report such information would highlight for all investors the extent to which managers have used their freedom to unwind incentives.

Of course, designers of compensation plans may find new ways to make compensation, or its insensitivity to performance, more opaque. As new practices (and new means of camouflage) develop, disclosure arrangements should be updated to ensure transparency. ◻