



JUST REWARDS

LET'S GET
CEO PAY RIGHT
THIS TIME.

BY EDWARD E. LAWLER III

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CEO COMPENSATION IS NEVER NOT A HOT TOPIC—AMONG CEOs, ANYWAY. FOR EVERYONE ELSE, IT'S A SUBJECT THAT FLARES UP PERIODICALLY AND SPARKS A HEATED DEBATE THAT ALWAYS CONCLUDES THE SAME WAY: *THE SYSTEM OF CEO PAY IN U.S. COMPANIES IS BROKEN.*

The criticisms are familiar: The system rewards the wrong things, ignores shareholder objections, relies on arcane financial machinations, focuses on short-term results, and insists on black-box opacity. It's perpetuated by self-serving compensation consultants and crony board committees. It's unconnected to actual company performance.

And, oh yes, CEO pay is too high—absurdly, obscenely high—whether compared to other countries' practices or simply measured against common decency and fairness.

The op-ed essays fly, carrying charges of “class warfare.” Graef Crystal publishes charts of “overpaid” CEOs. Legislators, reluctant to question the free market and miss grandstanding opportunities, tentatively issue warnings of new regulations and threaten to hold hearings. And when the dust settles, next year's executive-compensation plan looks a lot like this year's.

Well, after the notorious AIG bonuses, reports of massive layoffs, and rounds of government bailouts—making U.S. taxpayers surprise part owners of a range of companies—we're all talking about executive compensation again. Only this time, legislators, spurred by widespread economic frustration and resentment, seem to be more willing than ever before to take actions that will limit how and how much executives are paid.

How to avoid the worst-case scenario of legislative oversight—of all companies, not just bailout recipients? Boards and executives must take actions that answer at least some of the criticisms of today's pay practices. And they should begin the process with an acknowledgment that the existing system is indeed seriously flawed—if not totally *broken*—and by examining whether their corporation is spending its compensation dollars wisely.

GETTING WHAT YOU PAY FOR

The issue of executive compensation is never just about an executive's compensation. How a company pays its CEO affects an organization in many areas, including cost savings, corporate culture, reputation, and attracting, retaining, and motivating leaders. The most effective pay system, then, is one that supports an organization's overall strategy.

Expense levels are a part of all strategies. Critics have argued that even in extreme cases, a CEO's earnings are too small to significantly affect the corporation's bottom line—after all, they involve only one person. A decade or two ago, this argument

had some validity, but today, with some chief executives taking home over \$100 million a year, it is important to look at compensation for what it really is: a business expense. Every dollar spent on an organization's top leader is a dollar not spent on vital corporate projects and or added to a firm's profits. As such, an organization must design its pay program at a cost level that is reasonable and competitive.

Except: What is reasonable? What is competitive? The answers may be up for some debate, but there are good reasons to argue that executive compensation in many U.S. corporations is too high. For starters, American CEOs are the world's highest-paid. That U.S. companies spend more on compensation than their offshore competitors doesn't necessarily put them at a significant cost disadvantage, but it does unnecessarily reduce earnings and may reduce shareholder value. A more serious problem exists in U.S. corporations with executive-compensation costs that are too high relative to their international *and* their domestic competitors. They definitely are wasting money.

Still, an effective pay plan's main strength is its ability to attract and retain the right executives. Because they pay out such large amounts of money, most of today's compensation plans already do that quite well—perhaps *too* well. Lavish comp packages don't just attract effective top talent—they reel in and ultimately lock in *all* executives. And since not all CEOs are good CEOs, companies inevitably have to resort to expensive buy-outs in order to remove poorly performing leaders.

For most companies, the challenge is to find the right combination of base pay, bonuses, stock, and deferred compensation that will lure and keep high performers—no simple undertaking. Indeed, packages often need to be complex and carefully designed in order to be effective. It takes a relatively multifaceted mixture of short- and long-term incentives, which requires cash and stock vehicles tied to the CEO's—as well as the company's—performance.

The biggest challenge a company faces when devising a pay package concerns how it will affect CEO motivation. In some respects, the way in which compensation affects motivation is relatively simple and straightforward: Individuals tend to feel motivated when they are rewarded for performing well. However, this largely depends on how clear the connection is between performance and reward and how valued the reward is.

One can argue, as has Federal Reserve chairman Ben Bernanke,

ENOUGH BLAME TO GO AROUND

BY NELL MINOW

Boards of directors, especially their compensation committees, have failed by any possible standard when it comes to risk management, their most important and most challenging task—and the determining factor in designing executive compensation. But they aren't the only ones who should be doing better: Securities analysts must make compensation an essential element of their assessment of a company's strategy and credibility. Director and officer insurers must make pay an integral component of their appraisal of litigation and liability risk. And journalists must include the names of the board members in stories about executive pay. After all, it is not "the company" that decides to pay the CEO a mountain of money for a molehill of performance—it is the members of the board.

Unfortunately, boards have set pay according to highly artificial formulas tied to even more artificial comparables. The result has been a disconnect between pay and performance. Directors should evaluate expenditures on pay like any other asset allocation, in terms of return on investment. Instead, they are basing compensation on what the competition is doing. But just who is the competition? Say you're on the board of shoe company Timberland. Should your CEO's pay be comparable to that of Nike's—even though Nike's revenues are more than eleven times higher? We must not define competition so loosely.

Bonuses, too, have been tied to overly flexible benchmarks. At one financial-

services company, there was a pay plan that had nine different measures of performance. But the plan gave the board discretion to award *all* of the bonuses for meeting *any* of those goals. That was a recipe for disaster. The company was Bear Stearns.

This is not risk management—it is pouring gasoline on the risk fire. If we reward people based on the number of transactions rather than the quality of the transactions, as we did during the subprime era, we have to expect that the results will be a lot of transactions with a lot of risk.

Now, boards of directors may bear the primary responsibility for poorly designed pay, but shareholders have enabled a system of pay without performance by repeatedly reelecting directors who approve it and by voting in favor of excessive stock-option plans. If compensation were evaluated by return on investment, shareholders could have done better with a piggy bank.

It's time for shareholders to make CEO pay an essential element of their evaluation of the compensation committee and the board as a whole and stop routinely endorsing directors who get it wrong. Shareholders should expect to see better justifications for pay, and compensation-committee members should expect to be called on for better communication with investors and must be able to come up with more than the boilerplate "to attract and retain top talent" explanations for pay. The smart committee members will not wait but will reach out to

investors to find out what their concerns are and begin to earn back some of the credibility that they've lost over the past two years. (A good way to begin is by adopting clawbacks for awards based on numbers that are later revised and by tying option grants to specific performance goals and making them indexed to the peer group.)

Some investors believe that the best way to make a difference is with an advisory vote on the entire compensation package. In fact, companies bailed out by the govern-

ment are required to include such "say on pay" as a condition of receiving taxpayer funding. These stipulations have been effective in other countries, and various legislative proposals have periodically included provisions that would impose them on all public companies. But I believe that shareholders will have more of an influence on pay by refusing to vote in favor of compensation committees that agree to outrageous pay. Only then can organizations move toward getting pay right and getting the benefit of stable, committed investors, a lower cost of capital, and executives motivated to deliver sustainable growth.

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that many of today's problems in the financial-services industry are the result of compensation plans motivating what turned out to be poor performance. When organizations pay large bonuses for immediate results, as many financial-service firms have done, excessive risk-taking and short-term focus are particularly likely. The time from action to measurable results for most major business decisions is usually several years, so executive plans that pay out on an annual basis—or even

somewhat longer—run the risk of rewarding the wrong performance.

Often, critics suggest limiting CEO pay primarily to deferred bonuses and stock in order to increase the focus on long-term corporate performance. They figure that combining long-term plans with the absence of large severance packages will produce the right approach to incentive compensation. In some cases, they are correct, but short-term bonus plans may still be

needed in situations where immediate results are needed.

All too often, today's system pays out large amounts of money even when corporate performance is poor—a clearly unacceptable outcome, one that has led to angry calls for the elimination of all bonuses. But the problem is not that executives can earn bonuses—it is that they can earn them even when their performance does not warrant them.

Meanwhile, all of a corporation's stakeholders—customers, investors, employees, the community—judge companies, in part, on the basis of how they pay their executives. Compensation seen as unusually high, especially when combined with poor organizational performance, inevitably leads to bad press coverage, and it damages the credibility of a company, its board, and its chief executive.

Finally, as a result of how much they are paid, many CEOs may be missing a chance to reinforce their credibility as leaders. Given the last decade's large increase in CEO pay, the difference between the earnings of top executives and those of lower-

level employees has increased greatly. In 2007, CEOs of big American companies earned over four hundred times more than their average worker, the world's largest such pay gap. There is little doubt that when chief executives' pay is more in line with that of other employees, it increases their credibility as leaders and bolsters investors' impressions. It also gives them the ability to say they are committed to seeing that the organization is not only cost-efficient but fair.

LAW BUT NO ORDER

Critics have suggested a number of CEO compensation "fixes."

First, an obvious solution that isn't really a solution: voluntary reductions. Some executives have responded to their companies' poor performance by reducing their pay, in some highly publicized cases to as little as \$1 per year. Others have kept their compensation low even though their companies have performed well. Voluntary reductions may ameliorate cost and credibility problems for those who take them, but it is unrealistic

CEOs TODAY DESERVE EXACTLY



There are two ways of interpreting that statement, of course. Do chief executives deserve punishment for being overpaid? Or do they deserve their millions in compensation? Definitely the latter, says Ira Kay, global director for executive compensation at Watson Wyatt Worldwide. That a compensation consultant balks at the notion that CEOs' salaries and bonuses are too high probably comes as no surprise. Still, that doesn't mean that Kay sees no ways to calm the critics. For starters, the grumbling public needs to remove its blinders, because when it comes to examining compensation, there's the wrong way, and then there's the Kay way. —VADIM LIBERMAN

"Images of lavish executive lifestyles are so engraved in the popular consciousness. The result: public support for political responses that include new regulatory measures and a long list of demands for greater shareholder or government control over executive compensation." Those were your words, which you wrote for the Jan/Feb 2006 issue of this magazine.

I was angry then. Claims that CEO pay was out of control were wrong, and they're still wrong.

So are you still angry?

No, but I'm very upset and worried about the populist over-reaction today. People either forget or do not understand that we are in a labor market, with a supply of and a demand for labor. Those who say that CEO pay is out of control or that boards are weak-willed and not standing up to CEOs are misunderstanding the nature of the market.

I think people understand the market. They just believe that it needs regulating.

Why does it need regulating? It's an effective labor market that already rewards the highest performers and punishes the weakest performers.

That doesn't mean it's perfect, though. There are flaws, but they are not in the pay level and in the incentives but in the *real* shareholder irritants, which are mainly perquisites, severance—especially severance—and supplemental pensions. When it comes to such irritants, I can understand why people think it's unfair for executives to get such large payments when they leave the job after they've failed. To recruit CEOs, historically, you did need to offer them substantial severance packages. However, the payments have gotten too large, so companies are going to have to give on some of these shareholder irritants.

In 2006, you claimed that the real threat to economic growth was regulatory overreach. Do you still feel that way?

Yes. Right now, I understand that there's this populist outcry, so the government needed to do something—hence the TARP rules. The problem is that TARP doesn't regulate the pay packages of the core traders and investment bankers who created the risky things at the financial-services companies. So the government scratched the wrong itch. It is not the pay model but the risk model that is broken—and let me point out that our research shows that executive pay packages at the financial-services companies did not appear to motivate excessive risk-taking.

to expect more than a few CEOs to take such a dramatic step. As a result, this will not solve the high-pay problem. In fact, it may make it worse by calling attention to it.

Overall, CEO pay did drop slightly in 2008, as did corporate earnings, but the key issue now is whether it will continue to fall this year—and how much. Given the certain decline in corporate earnings, bonus payments *should* be much lower. If they are, it will reduce compensation costs and increase the credibility of corporations' pay-for-performance plans. It might even quiet some critics. If high compensation levels persist, it will be one more piece of evidence that corporate America's executive pay is dysfunctional and should be regulated.

The door to increased federal regulation has already been opened, by way of the government's executive-pay cap imposed on institutions receiving bailout money. It is impossible to determine just how far open it is, and whether the government's limitations on a few companies are just the first step in a federal effort to control compensation in most publicly traded



WHAT THEY ARE GETTING

I also think that there is real danger that if you overregulate pay packages at the top companies, they won't be able to pay the TARP money back. They'll lose people and underperform. Now, it *is* true that there is very little turnover now, but that will eventually change. It's just that the labor markets are frozen now. Management is quite demoralized.

Who isn't?

It's all horrible, but who wants to have a demoralized CEO running the company? You don't have to triple a CEO's salary, but it's important to keep incentives to help a company get back in the game.

Most people are paid a salary and, if they are lucky or perform well, a bonus. Understandably, many are unfamiliar with the extra complexities of an executive-compensation package.

Perhaps that explains why—

It explains why they can't see compensation from the CEO's perspective. People are complaining because they are looking at the wrong things. People are not looking at the right pay measure. Even sophisticated people who should know better are looking at a CEO's stock grants. Let's say a CEO's pay includes \$10 million in stock grants, but the company's stock price just went down by 30 percent. Somebody now says, "See, he's overpaid! He's not paid for performance. He made \$10 million, but his stock numbers are down by 30 percent." The CEO says, "What are you talking about? I now have \$7 million in stock options, and they're all underwater. They're not worth \$10 million. They're worth maybe \$3 million. I took a huge pay cut last year, and my other stocks that I own went down \$25 million. What are you talking about that I'm not paid for performance?"

We just surveyed eighty large-company CEOs, and they lost \$13 billion of wealth from 2007 to 2008. A huge amount of their net worth in the company stock was wiped out, which is even worse than their shareholders did. As a result of their companies not doing well, they didn't do well, so there is very good alignment. The impact on CEO pay is exactly what you would expect it to be. We don't need clawbacks when their stock ownership has already taken \$13 billion away from them. They suffered horribly from their decisions.

Perhaps not horribly enough. Why are poorly performing CEOs getting any bonuses at all?

Look at it this way: If a CEO owns a lot of stock, which went from \$30 million to \$5 million, and he gets a \$1 million bonus, the public says, "Oh, he made \$1 million for bad performance!" But the CEO says, "No I didn't—I *lost* \$24 million." That is how the executives look at it, and I think that's the correct way of looking at it.

How, then, do you convince an angry public that they're focusing on the wrong aspects of compensation?

I have written four books. I've done the best I can.

Still, your best hasn't been enough to create an entire shift in thinking.

To do that is impossible. It will basically take the Dow to go back to 10,000 for people to move on from this. And if that happens, it will have been because management is highly motivated to make excellent decisions—and that won't happen if we focus on reducing CEO pay.

IT IS HARD TO IMAGINE ANY NEW REGULATIONS OR TAX PLANS THAT WOULD EFFECTIVELY NUDGE CORPORATE COMPENSATION PLANS TOWARD BETTER PRACTICES.



companies. It could be the only measure—or the first of many actions triggered by rising public anger over CEO pay. In any case, it is a good time to ask: Can government regulation increase the effectiveness of executive-compensation plans?

Certainly, laws could effectively limit executives' total compensation, at least as far as cost control is concerned. A hard cap on pay levels could eliminate some of the sky-high stock and bonus payments executives get today, and it could minimize or eliminate golden parachutes and death benefits. But though such efforts might help control expenses, they may damage motivation, attraction and retention, and corporate culture.

In fact, all previous efforts to limit compensation have produced unintended negative consequences and failed to accomplish the objectives they were designed to achieve. Indeed, past regulations have created a large pool of compensation consultants and lawyers who now help companies "deal with" them. For example, in 1993, outrage over high pay led to a tax-code change limiting the deductibility of executive pay as a business expense; it specified that corporations could treat only \$1 million

of salary as a business expense for each of its five top executives. (Not covered by this stipulation: all kinds of incentive pay.) Today, most agree that the provision only served to establish \$1 million as the minimum acceptable level of base salary for top executives. Further, it appears to have stimulated the development of the pay-for-performance bonus and stock plans that contribute to today's high levels of executive compensation—not to mention the results-at-any-cost thinking that led to the accounting scandals earlier this decade.

In 2006, the SEC issued a set of disclosure requirements ordering companies to provide in "plain English" a view of their executive-compensation plans. These rules did little, if anything, to change how and how much executives are paid—2007 was a record year for executive compensation. They did, however, lengthen proxy statements.

It is hard to imagine any new regulations or tax plans that would effectively nudge corporate compensation plans toward

better practices. It is also impossible to develop rules that take into account the strategies and needs of a wide variety of corporations—which raises the question of whether there is a better alternative to federal regulations. I believe there is.

BUILDING A BETTER SYSTEM

Boards can take a leadership role in improving executive pay, but this will happen only if they are willing to institute new governance and compensation practices. Will they actually make the necessary changes? My research shows that 31 percent of board members already feel CEO pay is too high in most cases, which suggests that they may be willing—at long last—to make changes in executive-compensation plans.

But hold on. Eighty-five percent of directors claim that *their own company's* CEO pay program is effective. In other words, it is the other guys that have a problem—not exactly an attitude likely to lead to change. Furthermore, in the United States, many board members are CEOs themselves and are well aware that higher pay for one CEO influences the market to increase compensation for most. So it is hardly surprising that boards have been reluctant to significantly limit executive compensation.

When boards are hesitant to implement compensation changes, shareholders should move to do so. For instance, they can nominate and elect directors who are committed to altering the amount and way executives are paid. But it's unrealistic to expect many shareholder-nominated candidates to win—given the way most companies run their board elections, shareholder-nominated candidates rarely win.

Another shareholder action is to submit resolutions limiting executive compensation, but the problem is the same as the one created by government regulations and taxes: Simply limiting pay often doesn't take into account the complexity of the organization and executive compensation. In any case, such resolutions typically target a single practice (e.g., perquisites or death benefits) rather than a total compensation system.

There are, however, three key governance changes that have a good chance of leading to boards more willing and able to create effective executive-compensation plans. If all of them were to be put into place, it could have a very positive effect—without ending the free-market approach to executive compensation.

First, as many have urged over the past decade: Boards should have a separation of the role of CEO and chairman. They should also have an independent chair. Separation is likely to lead to more boards being willing to make tough calls about executive pay. The CEO/chairman controls board meetings and, in most cases, has a large say in who is on the board. When the CEO chairs the board, board members—understandably—hesitate to make compensation decisions that negatively impact the CEO's paycheck. Thus, it is hardly surprising that CEO compensation has gone up so much in the United States, where despite an increase in the number of companies that separate

the two roles, most still combine them. Separation is common in the United Kingdom, and it may be no accident that executive-compensation levels are lower there. (In Britain, however, the chair is often a former CEO of the company and cannot truly be described as an independent chair.)

Second, boards should develop principles and objectives to guide decisions. These should include, but are not limited to, the following points:

- Pay should match that of competitors. It should reflect performance relative to the competition—higher when a company outperforms others and lower when it underperforms.
- A majority of the compensation package should be based on the company's performance.
- The pay system must be set up so to align the interests of the CEO with those of major stakeholders.
- How compensation is determined should be transparent to all stakeholders.

On an annual basis, the board, after doing its own analysis, should have an independent auditor evaluate whether the organization has adhered to the principles it has established. The evaluation should then be distributed to shareholders.

Biotech firm Amgen has introduced an approach based on principles that is a promising start toward using them to guide its decision-making. The board (rather than a third party) assesses the company's executive-compensation results against its principles each year, and it asks shareholders to complete a short questionnaire appraising the compensation results.

Finally, boards should put executive-compensation plans to a shareholder vote. Because shareholders are “the boss,” they are the logical ones to determine CEO pay. A first step—to date taken by less than a dozen major U.S. companies—is to make the vote advisory. But this is just a first step. Firms should move on to a mandatory shareholder vote on its CEO pay plan. Yes, this approach has risks—shareholders are not experts and may not vote intelligently—but it is much less risky than opening the door to shareholder-submitted resolutions on executive compensation that may or may not be in the company's best interest. It may also be corporate America's most effective way to stave off government intervention.

One way to think about the current situation is that a race is under way. It is between those who would like to greatly reduce executive-compensation levels through regulations and taxes and those who believe, as I do, that reducing compensation should not be the primary objective. At the moment, the regulators are ahead, but they haven't reached the finish line yet. Those of us who advocate for changes that will foster more effective organizations can still get there first, but we must act quickly, and we need help from boards, CEOs, and the public. If we decline to take immediate action, then soon there may be no choice. ■