

Executive and Professional Compensation Issues and Potential Directions

Today there is an unprecedented focus on executive and professional compensation, fueled by the bursting of the technology bubble, various scandals, continuing unease around stock option accounting, executive and advisor greed, and long-standing flaws in program design and implementation. The list of issues and concerns is long, but unfortunately not surprising to those who have closely followed events over the past decade. Importantly, U.S. politicians, regulators, and media played a significant part in creating the current situation.

Our objective in this note is to review both current issues and potential directions without bowing too heavily towards political correctness. We believe the present compensation environment is the most interesting/infuriating in the last two decades, and presents real opportunities for positive change.

Issues

Enron – Contrary to many commentators we do not believe there are great lessons to be learned from Enron. This fraud was similar to prior scandals in that a complicated financial structure hid losses and obligations within a wrapping of arrogance and incompetence. On the accounting issues, it is unrealistic to have expected independent directors on an audit committee to have uncovered such a complicated fraud. From an incentive perspective, many financial service firms have successfully utilized carried interest plans, where senior professionals and executives share in investment gains outside their core business. However, Enron directors did little to monitor value creation across the various incentive plans and partnerships, and for this they should be held accountable.

Arthur Andersen and Other Advisors – The compromised roles of Arthur Anderson and other advisors at Enron, and other reported and unreported situations, are both important and unsettling. Arthur Anderson developed a business model which over emphasized current profits and productivity, but also clearly fell short on ethics and integrity. From a management perspective, it is truly remarkable that local business leaders were able to override national accounting experts on matters of accounting theory and implementation. There are profound lessons here on how a professional services firm should behave if it really wants to flourish for the long-term rather than selling the firm's reputation and value in the sole pursuit of today's partner profits.

One lesson from Arthur Anderson is the risks many professional service organizations are taking with their real and perceived independence. We believe on governance and compensation issues, firms will increasingly be held accountable for exhibiting independence and backbone. Many accounting, law, and consulting firms, will be shocked at the change in mindset and practices needed to prosper under heightened scrutiny and expectations.

"Managed Earnings" – For decades, public companies have managed themselves with at least one eye on the accounting impact of various decisions. There is clearly a wide-spread belief that stock markets, including those for well capitalized stocks, cannot see past accounting figures to uncover economic realities even when fully disclosed. For example, at their heart, discussions involving stock option accounting hinge on whether markets utilize publicly available information to incorporate option awards in evaluating corporate earnings and prospects.

- However, there is generally a significant difference between "managed earnings" and fraud. In well-known situations, the justifiable frustration with accounting irregularities deals with the misapplication of existing and understood rules. Many executives and employees have benefited from inappropriate accounting through bonus payouts and stock option gains. It is unlikely that even more elaborate rules will help create the transparency so important to investor confidence without harsher penalties for criminal acts.

Stock Option Accounting – There has never been much logic to the current accounting approach for stock options. Moreover, coupled with the belief the market does not fully incorporate the impact of stock option dilution, the lack of an accounting charge has clearly led to larger individual and aggregate awards and much broader participation. In addition to increasing awards, current accounting has suppressed incentive design innovation since, as an example, options based on relative returns require an accounting charge.

For many years, we, like many others, could rationalize stock option accounting since it helped lead to broader participation and stock ownership, which are generally positive. However, aggregate award magnitudes and abuses have reached the point where it is difficult to justify the existing accounting treatment and we vote for realistic accounting charges for all options.

Employee Ownership In Retirement Plans – It is clearly a problem when rank-and-file employees have the bulk of their retirement invested in their company's stock. It has been surprising and disappointing the lack of sensitivity exhibited by many major corporations on this issue.

"Treatment Of Bad Guys" – In today's business community, there are clearly executives and advisors who lack ethics and may exhibit a pattern of criminal conduct. Historically, white-collar criminals were treated quite leniently, particularly where it involved securities or accounting fraud. Once the current "witch hunt" environment subsides, there is no clear reason not to impose realistic penalties consistent with real damages.

SEC/FASB Oversight – Until recently, both the SEC and FASB had not been mentioned in discussions about corporate advisors. The expectation should be these entities will more aggressively act in the interests of shareholders, rather than the interest groups that appeared to have dominated both their agendas and decision making for the past decade.

Potential Solutions and Actions

Stock Option Accounting Charge – There should be a realistic accounting charge for stock options. The damage from excessive awards and manipulation now exceeds the benefits of broader awards. It would provide an opportunity to utilize better option designs (i.e., incorporate relative performance) that could provide much closer links to real long-term value creation. Moreover, a stock option accounting charge could help bring balance to award sizes and grants, by making shareholder costs explicit.

Stock Ownership Levels and Expectations – Senior executives and outside directors should own 5 to 10 times their annual compensation in company stock. Modest guidelines for window dressing should be avoided. Significant ownership continues to be the single best remedy for a host of executive compensation issues.

Stock Option Vesting – Longer vesting periods (i.e., 5+ years) would help link stockholder and executive interests across volatile markets and business cycles. Modest vesting periods make little sense given the size of today's awards and volatile markets.

Diversify Retirement Funds – No more than one-third of a rank-and-file employee's retirement savings should be invested in company stock. It is difficult to justify placing an inordinate burden on lower-level employees if the company does not succeed. However, company stock can/should be used aggressively in funding the retirement benefits of senior management.

Adopt More Long-Term Performance Plans Linked to Business Strategy – There is a role for cash based long-term incentive plans, particularly in diversified companies. Goal driven plans can focus on key objectives and create a line-of-sight that may not always exist with conventional stock options. If implemented correctly they provide an opportunity to examine future expectations, measures, and objectives.

Formal Behavioral Guidelines and Enforcements – Compensation programs should provide specific "claw back" provisions for bonuses and long-term gains when firm financials are ultimately determined to be inaccurate (i.e., publicly restated earnings). There needs to be both tangible incentives and penalties for all professionals so "keep quiet" cultures become more uncomfortable and less sustainable.

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