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Stay Tuned . . . to Executive Compensation Practices in 2006

by Hank Boerner

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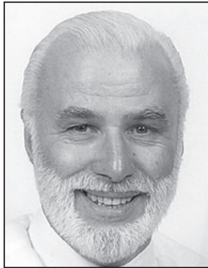
Stay Tuned ... to Executive Compensation Practices in 2006

By Hank Boerner

Each year we traditionally set out critical issues for IROs and finance executives to "stay tuned to," some of which were on target and some off the mark. In January 2001, we advised readers to be on the watch for "exogenous events" that could derail corporate plans. Who could have imagined the horrible terror attacks nine months later and their effect on corporate America's financial fortunes?

Some past issues may not have reached the tipping point yet — remember when we warned about the antics of Venezuelan leader Hugo Chavez a few years back? Timing can get derailed, or we may be way off base. Tricky business, this predicting of the year's trends.



Hank Boerner

For 2006, we humbly suggest that a major issue facing IROs, especially during proxy season, will be executive compensation. (For an overview of the 2006 proxy season, including a discussion of executive compensation, see "2006 Proxy Season Arrives" on page 1.) This one issue could exert considerable influence in the dynamics of the relationships among corporations, shareholders and other stakeholders such as corporate employees, journalists, governance and social responsibility advocates, financial analysts, investment bankers, credit risk agencies, legislators and regulators.

Here are some recent developments centered on this issue that are now shaping your environment for 2006:

Stay Tuned . . . to Congress. In December 2005, the National Association of Corporate Directors (NACD) alerted its members that new government rules for executive compensation could be coming in 2006, citing Massachusetts Democrat Rep. Barney Frank's proposed bill — "The Protection Against Executive Compensation Abuse Act" (which would amend the 1934 Securities Exchange Act). NACD expects Congress to take up the issue when members return in January.

Congressman Frank's bill will likely stimulate more analysis and debate on at least three topics addressed in the latest draft:

- More complete corporate compensation disclosure, with comprehensive public statements required for all types of compensation (including present, deferred or contingent).
- Mandating a plan approval process (if the bill were to become law) requiring shareholder approval for a company's exec comp plan, a provision that could require shareholder approval for golden parachutes.
- Disclosure of a "gains disgorgement" policy — if it exists — explaining how a company will recapture incentive compensation that is "unjustified" or plans for recovery when the numbers on which performance bonuses were paid are found to be inaccurate or in need of restatement.

Even if the bill doesn't become law, consider the headline risk and public debate that could result from

congressional examination of these topics. Could your company's name be in the headlines?

Stay Tuned . . . to the Boardroom. Possible comfort zone: NACD points out that many boards of directors have already cranked performance criteria in their executive comp plans, and these companies may do well in comparisons with the standards being proposed in the legislation before Congress. In 2003, the NACD issued "Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee." This report continues to shape the issue in boardrooms.

Said the report's authors, "Trust in the free enterprise system of our country is at the lowest level in many decades, and perceptions regarding inappropriate executive compensation are at the root of this discontent." Many boards "got the message."

Stay Tuned . . . to New SEC Chairman Chris Cox. Weighing in on governance reforms and future directions of his agency, Chairman Cox recently told the Economic Club of New York: "The Commission does not intend to, and never will while I am chairman, dictate what any employee of any company makes — whether it's the CEO or the mail clerk. Those are marketplace decisions. It [the debate] is not about wage controls. It's about wage clarity — information that is clear, complete and comprehensible. We don't want to judge, comment, editorialize, pontificate, meddle or otherwise interfere in salary decisions. And we most certainly don't want to cap salaries — this is not the 1970s."

However, the chairman said the SEC would soon propose a rule initiative aimed at expanding corporate disclosure. The SEC intention is to provide investors with a more complete and accurate understanding of a company's compensation package; then judgments, decisions and actions taken will be up to boards and investors, not federal regulators. Expanded disclosure on CEO pay could help directors have access to more market information (including the pay practices of other companies).

Stay Tuned . . . to CFA Institute Recommendations. And where are the analysts on this issue? The CFA Centre for Financial Market Integrity recently issued a package of observations and recommendations for analysts and the investors they serve titled "The Corporate Governance of Listed Companies: A Manual for Investors." The leading financial analyst society recommends that investors determine whether a company has a committee of independent board members charged with setting executive compensation. This is important, says the CFA, because such a committee could "encourage" executive management to act in ways that enhance long-term profitability and value.

Two important considerations from this report:

- Only independent board members should be on the remuneration or compensation committee.
- Executive comp should be linked to the long-term profitability of the company and long-term increases in share value relative to competitors and other comparably situated companies.

Investors might also want to consider, advised the CFA, whether the composition of comp packages is appropriate and whether management has pressured the board to award excessive compensation, or provide incentives for actions that boost short-term share prices at the expense of long-term profitability and value. IROs should assume that analysts would be paying much closer attention to executive pay programs in 2006 as they develop their own analysis.

Stay Tuned . . . to the Media Condemnations of Greed. Business and consumer print media have been among the most powerful influences on the decade-long public debate about executive compensation. *Fortune* magazine in November, for example, asked, "Did you

get a 30 percent raise last year?" and then suggested, "If not, you may be among the millions of Americans who are understandably furious that the average CEO did get that big a pay hike. …"

The Economist in November, in a story headlined "Too Many Turkeys," said that executive pay is "on the rise again" and "so are complaints that ordinary performance is attracting extraordinary rewards. …"

BusinessWeek weighed in with its "Fat Merger Payouts for CEOs" (Dec. 12, 2005): "Top execs at companies being acquired are reaping windfalls. Whose interest is being served?" The magazine reported that "as mergers roared back in 2005, so did CEO payouts triggered by the deals."

Stay Tuned . . . to Credit Rating Agency Opinions. When the credit agencies speak, IROs and corporate finance executives need to pay close attention. Credit risk profiles translate into higher or lower costs of borrowing. On Nov. 18, 2005, the influential Standard & Poor's staff issued a short report titled "U.S. Executive Pay Levels Not Likely to Moderate." S&P said recent trends in executive compensation practices actually point to an *acceleration* in pay levels for executives and an erosion of efforts to link executive pay with company performance. Will increased visibility on these issues lead to moderation in 2006? Not likely, says the credit risk rating agency.

"CEO pay continues to escalate at a torrid pace," noted S&P credit analyst Dan Konigsburg, and at some point this could impact the cost of capital through the linkage with the credit risk rating profile of the corporation. "A company's CEO and executive compensation policy is often the clearest window into how the board provides oversight of management," he wrote, "which itself is an important factor in credit analysis. Moderation in CEO pay would be welcome by creditors, as it would soften the incentives for excessive risk taking that high or nearly unlimited payoffs can encourage. Based on the evidence, however, investors may be waiting a long time before moderation is realized." IRU

Hank Boerner is managing director-NY for Rowan & Blewitt, a management consultancy. The views presented here are his own. He can be reached at hank@hankboerner.com.