

November 22, 2004

COMMENTARY**Money, Money, Money**By **ARTHUR LEVITT JR.**
November 22, 2004; Page A14

One hundred and forty million dollars pay for 15 months of work is a wish upon a star that Disney's board of directors granted Michael Ovitz in 1995, and as shareholders are contending in a lawsuit now under consideration, an example of an egregious lack of oversight by Disney's board.

While the Disney case is grabbing attention, it's just one of hundreds of examples of executive compensation gone out of control and corporate boards asleep at the wheel. As we approach the third anniversary of the implosion of Enron, the single greatest impediment to the restoration of confidence in corporate America is continuing instances of extravagant non-performance-based compensation.

These huge paydays bolster a system in which executives have incentives to manage the numbers for short-term gain and personal payout, and not manage their businesses for long-term growth and shareholder value. Exorbitant compensation feeds the worst instincts and egos of powerful CEOs, fueled by their desire to win at all costs and resulting, too often, in the cutting of ethical corners.


Until now, regulatory interventions and the glare of the media have been ineffective in changing corporate America. What is needed is an approach that recognizes that we are dealing with a phenomenon that is more cultural than commercial.

My experience on boards -- large and small, private and public -- leads me to believe that unseemly excessive compensation and separation packages are a consequence of boards falling victim to a seduction by the CEO. They fail to question and too often give management the benefit of the doubt. This is not unexpected. After all, Americans are a friendly people and tend to serve on boards made up of friends and colleagues. The boardroom culture is fraternal, rather than skeptical.

Therein lies the crux of the problem. How likely is it that a board member would challenge the person who invited him to join, and can re-invite him? How likely is it that a board member would stand up to the CEO who directed the company's foundation to support his favorite charity? Or hired his law firm? Or his wife's interior decorating shop? And when it becomes clear that the person whom the board hired to be CEO just isn't working out, the board often resists pulling the plug. If and when they do, too often boards agree to unreasonably high separation packages in order to assuage their conscience.

To bring down this culture of CEO dominance and board pliability and build up a culture of accountability and oversight, we need to use modest regulation to promote independence, accountability and disclosure. But while necessary, these regulatory moves are hardly sufficient. We also must use the pressure of peers, the public, and the media to force more subtle -- yet fundamental -- behavioral change.

DOW JONES REPRINTS

 This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers, use the Order Reprints tool at the bottom of any article or visit:
www.djreprints.com.

- [See a sample reprint in PDF format.](#)
- [Order a reprint of this article now.](#)

Already, there have been both high-profile media exposés and blue-ribbon commissions on the issue of executive compensation, but these come and go. Recently, Calpers announced that, as part of a three-year campaign to reform executive compensation, it would scrutinize the pay plans of top companies in 10 industry sectors and coordinate with other investors to get them to improve their practices. This is a good start: Investors, especially large ones, must be engaged. But we need a more comprehensive effort that will use the leverage of the larger investment community to praise, rebuke and bring about change.

That is why I support the creation by the investment community of a committee of business, legal and community leaders beyond reproach to lay out guidelines as to best practices for compensation committees to follow, such as stock awards earned over time based on the long-term performance of the company. Funded and convened by institutional investors, this group's annual report would not only expose, for some of our nation's largest shareholders, the bad apples. It would also praise the good ones such as Kinder Morgan, where base salaries top out at a relatively modest \$200,000 a year and that compensates its executives with grants of restricted stock that can only be cashed in after at least three years and the meeting of yearly targets. Once up and running, I imagine that most companies would want to have this panel's seal of approval, and most CEO's would not want to be fingered for not being fairly paid.

In addition to naming names, this panel could also be a force for the modest regulatory reforms needed to rein in extraordinary, non-performance-based executive pay.

- First, we need greater board independence and accountability. According to Governance Metrics International, 35% of U.S. companies reported a related-party transaction involving a senior executive, the chairman of the board, or one of their family members. Another study found that one out of every 12 publicly traded companies has a CEO who serves on the board of directors of a company run by a member of his own board. These cozy relationships must end; there should be no interlocking relationships, especially on compensation committees.

To foster greater accountability, the SEC also should pass its current proposal to open up proxy access to shareholders and make directors more accountable for their actions. The SEC proposal is pragmatic with realistic thresholds that would prevent a free-for-all of board nominations and management chaos. At the same time, this new rule would give shareholders a way to force change in a company where boards are unresponsive or irresponsible. Shareholders deserve this right.

- Second, we need to bring more transparency to executive compensation and more accountability to the boardroom. As Lucian Bebchuk and Jesse Fried argue in their new book, "Pay Without Performance," the overuse of stock options as a primary vehicle of compensation has been a way for boards to camouflage how much they are paying their executives as well as a disincentive for managers to manage a business for long-term growth. That is why the Financial Accounting Standards Board must not be hindered in its initiative to issue a rule treating stock options as an expense.

* * *

But accounting for stock options is only a first step. Boards are also able to camouflage compensation through the use of corporate jets and cars as well as loans and huge retirement packages that do not have to be disclosed as compensation. Investors are left in the dark when it comes to understanding the basics of executive compensation: SEC rules do not require disclosure as to whether compensation is performance-based and if so, what the performance triggers are.

What shareholders need is a clear explanation of what portion of compensation is performance-based, how the performance is measured, and what triggers are used. If performance metrics are changed, this should be considered a material event and should be disclosed as such.

Next, companies should be required to include a compensation table that includes all benefits including deferred compensation, retirement benefits, and other perks along with their monetary value plus a column that discloses the grand total of compensation paid.

Finally, shareholders would be well-served with a chart that compares the performance of their company and its compensation for its top executives with those of its peers. If the comparison shows that the company's compensation relative to performance is greater than its peers, than the compensation committee should be required to justify this in its report.

Hopefully, by pushing for these regulatory changes, this committee would help bring about the transparency and accountability so needed when it comes to executive compensation. More than that, I hope that this effort would help to create an environment where huge paydays are seen as shameful and where those who milk companies for every dime are scorned.

Ultimately, we need to create a culture in which a CEO believes that if he or she accepts hundreds of millions of dollars for running a company into the ground, they not only would be pilloried in the press, but also would be shunned by their peers at the country club or on prestigious non-profit boards. That's a tall order, and a job well beyond the power of any regulator.

Mr. Levitt is a former chairman of the SEC.

URL for this article:

<http://online.wsj.com/article/0,,SB110108304413780419,00.html>

Copyright 2004 Dow Jones & Company, Inc. All Rights Reserved

This copy is for your personal, non-commercial use only. Distribution and use of this material are governed by our **Subscriber Agreement** and by copyright law. For non-personal use or to order multiple copies, please contact Dow Jones Reprints at 1-800-843-0008 or visit www.djreprints.com.