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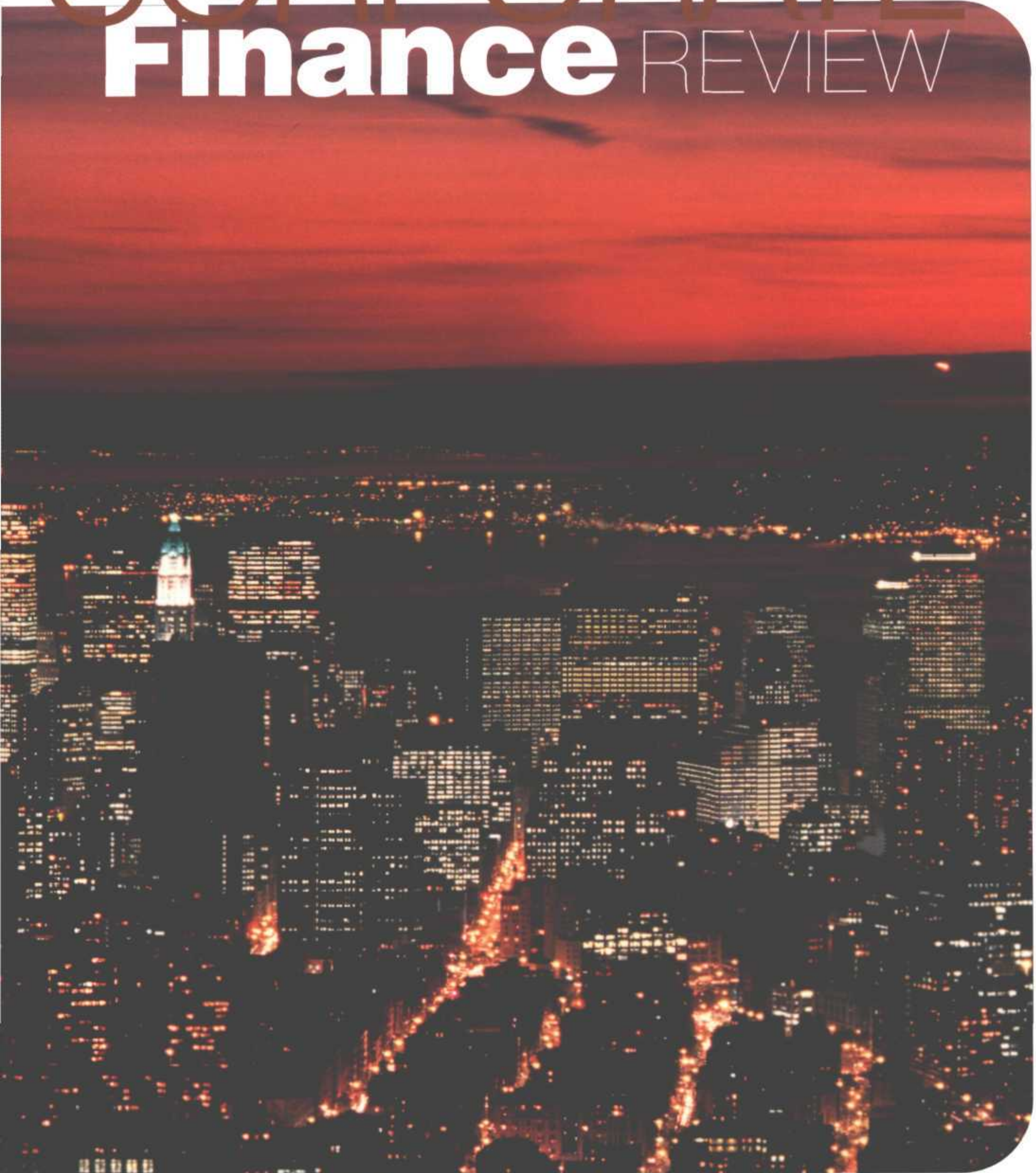

CEO Compensation

Stock Options: What Happened Here?

The Four Horsemen of the (Accounting) Apocalypse

Stock Repurchase Programs Among *Fortune* 1000 Companies

HANK BOERNER

DRAMATIC EVENTS MAY FOLLOW EXPANDED PROXY DISCLOSURE ORDERED BY THE SEC FOR CEOS' "TOTAL" COMPENSATION PACKAGES

Executive compensation has become the major lightning-rod issue in the changing relationships among institutional shareholders, corporate boards, and senior executives. CEO pay emerged as a more public and social issue in the mid-1980s to the early 1990s. It faded a bit in the heady days of the 1995-2000 bull market but then came roaring back into the headlines in the aftermath of dramatic corporate scandals, congressional inquiries, Securities and Exchange Commission (SEC) penalties, an epidemic of financial restatements, and continued inquiry by observers and journalists.

The issue surrounding the pay packages of public company leaders is now a robust civic and social debate: How much is "fair pay" for company CEOs? What is an appropriate ratio between the average employee's pay and the compensation for the special few in the corner offices? Who is watching out for shareholders? What can be done about runaway executive compensation short of dramatic public-sector intervention? What about board oversight? Why are a relatively few corporate oligarchs, shareholder activists ask, able to live in the splendor once reserved for royalty and robber barons while their companies downsize, outsource, and cut pensions and benefits?

These social-justice and fairness questions are raised now not just by a handful of advocates and socially responsible investors but, increasingly, by more mainstream institutional shareholders — including managers in the hedge fund world who are joining in the chorus against "runaway corporate pay."

On the other side of the issue, supporters of current CEO pay practices point out that one person in the corner office absolutely can make a difference in the success of an enterprise, and that as these leaders create wealth for shareholders, they should be suitably rewarded.

The issues surrounding executive compensation go well beyond traditional corporate financial reporting, disclosure and accounting practices and policies, enterprise human resources policymaking, board-management and company-shareholder relations. The positions taken on 2006 CEO and C-suite compensation is forming the dividing line between key stakeholders in the democratic capitalist system of the United States — and it is spreading to other continents and nations.

The dividing line—on this side or that

The stakeholders lining up on this cultural, political, economic, and corporate-governance divide include these interests:

- Senior executives of large publicly traded companies.
- The CEO's major lobbying arm, the Business Roundtable (representing 160 of the largest cap company CEOs).
- The corporate community's broad-based lobbying arm, the US Chamber of Commerce.
- Individual board members bravely defending prerogatives of the board and sanctity of boardroom deliberations (and the pay packages devised behind those closed doors).

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CONGRESS MAY END UP IMPOSING NEW STATUTORY REQUIREMENTS ON PUBLIC COMPANIES TO FORCE GREATER DISCLOSURE OF EXECUTIVE-COMPENSATION PROGRAMS.

- Compensation consultants (hired very often by the CEOs whose packages they help develop).
- Political and ideological defenders of the free-market system, including elected officials and Right-leaning think-tank scholars.
- Capital market players with an interest in maintaining goodwill with corporate management (such as major mutual-fund advisory companies that vote billions of proxies each year but traditionally have sided with management, especially in companies whose 401(k) plans they manage).

And more often now on the opposite side of the line, demanding reforms, are the following:

- Institutional shareholders, including those advocating better corporate governance and more responsible corporate social practices; CalPERS, the giant California public-employee pension fund, and TIAA-CREF, the largest pension fund in the US, are prime examples of advocates for better corporate governance.
- Trade associations of the institutions, such as the influential Council of Institutional Investors (CII) and the Interfaith Center on Corporate Responsibility (ICCR).
- Consulting and advising organizations retained by institutional shareholders to advise on proxy votes and assist in executing the votes for millions of shares held in portfolios.
- A rapidly growing number of independent board members who are constantly reminded of their fiduciary—and other—responsibilities to the shareholders (who elected them), and whose duties include setting C-suite compensation.
- Academics, many of whom are now churning out thought-provoking studies of the impact of excessive CEO compensation on the corporation and society.
- Journalists, including a growing corps of reporters, editors, and editorial writers.

The SEC has just come down on the side of the latter group of stakeholders: In July it issued final rules on sweeping changes in the reporting of executive compensation to shareholders.

Congress debates CEO compensation measures

The US Congress may end up imposing new statutory requirements on public companies to force greater disclosure of executive-compensation programs. As the average wage earner reads headlines of "runaway CEO pay" and worries about his or her own paycheck week to week, a lot depends on voter sentiment. In June 2002 the *New York Times* reported in a page-one story that Sarbanes-Oxley was dead in the water. Then came an outpouring of angry communications from constituents and within a month the measure sailed through both houses.

Congressman Barney Frank, Massachusetts Democrat and Ranking Minority Member of the House Committee on Financial Services introduced the "Protection Against Executive Compensation Abuse Act" late in 2005 and the draft measure has continued to draw attention throughout 2006. The draft bill may die in the 109th Congress, but Mr. Frank and his allies promise to reintroduce the measure in the new Congress that takes office January 1, 2007.

Congressman Frank's bill would not set an artificial limit on individual executive compensation; rather the legislation would provide shareholders with more information— much greater transparency—about executive pay packages and would empower owners to take action against management abuse and self-dealing. "We have witnessed a number of high profile executive pay packages that are hidden to the owners of the company . . . " Mr. Frank explained, "and I want to make sure we have full disclosure. We are not taking anyone's pay or even setting any limits, we just believe these owners should know how their employees (management) are being paid and have some ability to do something about it if they so desire."

The legislation as drafted would require public companies to include in the annual report and proxy solicitations a comprehensive "Executive Compensation Plan" to be approved by shareholders and cover the following items:

- Full disclosure of top executives'[1] compensation including any and all types of compensation paid, such as pensions, golden parachute agreements, and personal use of private jets, company apartments, and other perquisites.
- Full disclosure regarding short- and long-term performance measures or targets used to determine top executives' compensation and an explanation of whether or not targets were met in the year covered by reporting.
- Company policy for recapturing all forms of incentive compensation that subsequent financial results may show were unjustified—such as when bonuses are paid or stock options granted for meeting targets "only to learn later that numbers were inaccurate and must be restated."
- Shareholder approval of executive-compensation packages.

Congressman Frank cited data from the Corporate Library's 2004 CEO Pay Survey, which revealed that median "total" compensation received by CEOs increased 30% in fiscal year 2004, with the average increasing almost 100%. Twenty-seven CEOs received compensation over 1,000% greater than the prior year.

The Frank bill received the support of the AFL-CIO, the Corporate Library, the California State Teachers Board, and the Council of Institutional Investors. The Business Roundtable opposes the bill.

In May 2006, as the tempo of debate on the measure increased, the Business Roundtable's Thomas Lehner told the Associated Press, "If we adopted a system where small groups of activist shareholders used the process to politicize corporate decision making, the consequences could very well be destabilizing .... We should not ruin our free-market system because of a few rogues."

The Business Roundtable counters "Runaway CEO Pay" headlines

In July 2006 the Business Roundtable countered the negative headlines and responded to agitated shareholders regarding executive compensation. It published an analysis covering eleven years of pay programs at 350 large companies and claimed executive pay had only increased by 9.6%—about the same as shareholder returns in the same period.

The analysis was conduced by Frederick Cook & Co. based on data on the 350 largest companies contained in the Mercer Human Resources Consulting database. Said the Business Roundtable's Mr. Lehner, "We wanted to try to promulgate a consistent set of facts because a lot of what we have seen in the media on executive pay [we felt] was misleading." The nation's business media and shareholder interests responded in a nano-second to the data findings.

Asked corporate governance writer Gretchen Morgenson in the *New York Times:* "Is 'Total Pay' That Tough to Grasp?" At issue: The Business Roundtable data excluded (she wrote) dividends paid to executives on their restricted stockholdings and the value of stock options they cashed in (the study counted the value of the option grants and value of restricted stock on dates of awards). "Hide and seek" analysis, she quipped in the July *Times* column.

Defending the analysis, Frederick W. Cook, the well-known compensation consultant who produced the study claimed that the cash generated by exercising stock options could have been accumulated over many years and that the SEC did not require disclosure of much of the data that critics found were inappropriately "missing" from the Business Roundtable analysis.

Ms. Morgenson summed up the situation nicely with this observation: "Despite its claims of setting the record straight on executive compensation, the roundtable's analysis does exactly what it has accused pay critics of doing: picking and choosing numbers to bolster their views. That's fine, even expected. But will it be the last word? Not a chance."

Corporate directors vs. institutional investors

Another study, this one released in June 2006 by compensation consultants Watson Wyatt Worldwide, surveyed fifty company directors and fifty-five institutional investors."Despite major reforms [of recent years]," Watson Wyatt's Ira Kay told the Associated Press, "executive pay and cor-

THE BUSINESS ROUNDTABLE COUNTERED THE NEGATIVE HEADLINES AND RESPONDED TO AGITATED SHAREHOLDERS REGARDING EXECUTIVE COMPENSATION.

CYNICS POUNCED ON THE FACT THAT THE BUSINESS ROUNDTABLE'S STUDY OF CEO COMPENSATION WAS RELEASED JUST AS PUBLIC CRITICISM OF ITS CURRENT CEO, HANK MCKINNEL, BROKE INTO THE HEADLINES.

porate governance continue to be a source of controversy. While the views of directors and institutional investors on executive pay issues are closely aligned in many areas, we found several differences... demonstrating that more work is needed . . . ."

The differences? Two-thirds of the directors said that executive pay and generous incentives spurred strong corporate performance and contributed to growth; not surprisingly, now less than a quarter of institutional investors surveyed felt the same way.

What could directors and investment managers agree on? Almost all (90%) of the institutional money managers surveyed said that executives at most US companies were now overpaid; 61% of directors agreed, and just under half of the directors felt that management still had too much influence over setting compensation for top officers. In addition, 80% of directors surveyed felt that today's executive pay model had hurt the image of companies; 85% of the institutional managers agreed. More than three-quarters of the directors and investors agreed that better disclosure of executive pay information in annual proxy statements would help.

The SEC acts on disclosure

On July 26,2006—just a few days shy of the fourth anniversary of the signing into law of the Sarbanes-Oxley Act—the SEC adopted a sweeping set of new rules to make it easier for shareholders, analysts, advocates, and others to see just how much a company's top executives were being paid.

Beginning with next year's filings, public companies must describe how their senior managers are being compensated—in "total," the SEC ordered, including such benefits as the lump-sum cost of retirement benefit and the "why" of the boards' approved stock option grants. (The rules will be in effect for the 2007 proxy-voting season.)

The rules were spelled out in January 2006 in a 372-page proposal, and in response the SEC received more than 20,000 comment letters. "No issue in the history of the Commission has generated so much interest," observed SEC Chairman Christopher Cox.

Companies will have to state in simple charts the details of total executive compensation (for the top five executives), with total amounts for the latest three years of salary, bonuses, and other perks. The action was the SEC's response to rising criticism of CEO pay packages — faulty or partial disclosure of the same—and was intended to empower shareholders with information on which they could base their own actions.

The board of directors' compensation committee will be required to disclose (in the proxy statement) its adopted operating rules, objectives, policies, and decisions: the "Compensation Discussion and Analysis," also to be certified by the firm's CEO and CFO.

As the new rules were adopted, the SEC was investigating more than eighty companies concerning allegations of the manipulation of grant dates for executive stock options. The first criminal case was brought as this column was being prepared. SEC insiders were telling journalists more such actions were sure to follow.

Watch for canaries on CEO pay

As the pages of the calendar fall away and all of the key stakeholders move toward showdown dates in 2007 proxy voting contests, consider some of the recent (mid-year 2006) events as"canaries-in-the-coal-mine" harbingers of events to come.

In June, shareholders of Countrywide Financial Corp. (CFC), one of the US's largest home mortgage outfits, rejected a shareholder-sponsored proxy proposal calling for a yearly "up/down" vote by shareholders on the company's executive compensation plans. But note that 43% of the shares cast supported this resolution. The American Federation of State, County and Municipal Employees (AFSCME), representing public sector employees, sponsored the resolution.

Individuals targeted—including high-profile CEOs — in these types of resolutions may be directors at other companies. Shareholders were outraged over the lack of appearance by most of the Home Depot (HD) directors at the company's annual meeting (one showed up). Included among the missing was CEO Angelo Mozilo of

Countrywide, whose company then received the AFSCME resolution.

The union claimed that CEO Mozilo stayed away from the HD meeting because company management decided that board members would not attend the annual meeting. Who is in charge here? asked AFSCME officials.

Earlier in the proxy season, UnitedHealth Group CEO William McGuire recommended that the company's board immediately "suspend" option grants and other means of executive compensation against the background of an SEC inquiry concerning whether options at UnitedHealth and other companies were in violation of securities laws. Also, Minnesota Attorney General Michael Hatch had just joined a federal civil suit brought against the company's management team and board members for alleged backdating of option grants.

All this followed a front-page story in the *Wall Street Journal* (March 2006) that raised many questions about "timing" of a series of options grants (back to 1994) for CEO McGuire and other managers. The *Journal's* investigative team reported the odds of grants occurring on certain dates (favorable to the CEO) were about one-in-two million.

Finally, *Fortune* magazine trumpeted in a June 30, 2006 cover story—"The real CEO pay problem"—that" [v] oters are outraged. Big investors are demanding change. Even CEOs admit there's a crisis. But rewards that defy all economic logic don't simply spring from greed. Corporate America's executive-compensation system is broken."

The magazine pointed to UnitedHealth CEO McGuire's $1 billion in compensation; departing ExxonMobil CEO Lee Raymond's $405 million; Home Depot CEO Bob Nardelli's $250 million "total package"; departed Fannie Mae CEO Franklin Raines's $90 million package; and Pfizer CEO Hank McKinnell's $99 million pay package, including $83 million in built-up pension value. (Cynics pounced on the fact that the Business Roundtable's study of CEO compensation was released just as public criticism of its current CEO, Hank McKinnel, broke into the headlines.)

The importance of these early indicators: These events and others are setting a tone and shaping perceptions in a very public debate that is moving toward showdowns in a growing number of companies (primarily through proxy contests). While management and boards usually feel safe ignoring these nonbinding votes, influential mainstream institutions are joining in the campaigns—and quite often, on the opposite side of corporate management.

As a financial officer, you can surely count on this: There will be many more words expressed and actions demanded by shareholders in the months ahead related to your company's executive compensation programs. •

NOTE

[1] Small companies have some relief: "top executives" means only the CEO for companies with less than $250 million in total assets; for companies with $250 million to $500 million, the CEO and the next two highest executives; for companies with over $500 million in total assets, the CEO and the next four highest executives.

REFERENCES

The Securities & Exchange Commission's new rule on executive compensation disclosure can be researched at http://www.sec.gov/news/press/2006/2006-123.htm.

Congressman Barney Frank's pending bill is H.R. 4291, introduced in First Session of the 109th Congress, November 10, 2005, as an amendment to the Securities & Exchange Act of 1934 to require additional disclosure to shareholders of corporate executive compensation. The short title is "Protection Against Executive Compensation Abuse Act." A press release from Congressman Frank concerning the bill is available at http://www.house.gov/banking_democrats/pr11102005.html.

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