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The Crystal Report on Executive Compensation

More On the SEC's Proxy Proposals

by Graef Crystal

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In last week's article, I rejected the idea of mark-to-market reporting for stock options and stock awards. I now think I was wrong to do that.

My error lies in "either-or" reasoning. If it comes to a single choice – the current system using grant date fair values or mark-to-market reporting – I clearly favor the former.

But who says we have an "either-or" situation? How about a "both-and" situation?

There are many critics of grant date fair value for stock options. They make the following arguments:

- The value produced by the Black-Scholes is totally theoretical and may be considerably overstated, given that most option recipients are undiversified.
- It is also subject to assumption manipulation, especially in the areas of volatility and date of exercise.
- In the real world, the option may prove to be worthless. (Critics rarely admit that, in the real world, the option may prove to be worth a lot more than the Black-Scholes value would suggest.

But if you produce an alternative – dump the theoretical value and include the gains from exercising options in the particular year – other critics emerge. If a CEO makes more than $700 million from exercising options in a single year, as Larry Ellison of Oracle Corp. once did, they are quick to point out that you can't say that the entire $700 million was attributable to one year's work. It might have been attributable to much as 10 years work.

The Idea of Having Two Summary Compensation Tables

My revised thinking goes like this:

- Produce a Summary Compensation Table (SCT) as the SEC has now proposed. This approach provides a good picture of what the compensation committee intended to do from a pay policy standpoint.

- Then produce a second Summary Compensation Table to incorporate the "mark-to-market" approach.

For an illustration of how this second table would work, let's look at Time Warner Inc. and pretend that an option covering one million shares was granted on Dec. 31, 1997, when the close price was $12.54 a share. Let's also assume the option had a term of 10 years and was not exercised until Dec. 31, 2007. (I chose an end date of Dec. 31, 2007 to avoid the effects of the recent market crash.)

In preparing the "mark-to-market" SCT, the charge in each year to be shown for this option would be as follows:

YEAR	YEAREND PRICE	SCT CHARGE (millions)	CUMULATIVE CHARGE (millions)
1997	$12.54		
1998	$85.95	$73	$73
1999	$168.16	$82	$156
2000	$77.13	-$91	$65
2001	$71.14	-$6	$59
2002	$29.03	-$42	$16
2003	$39.87	$11	$27
2004	$43.11	$3	$31
2005	$38.65	-$4	$26
2006	$48.27	$10	$36
2007	$36.59	-$12	$24
	TOTAL	$24	

Note that the charge for options shown in the SCT would:

- For any single year, represent the aggregate paper profits in the option between the date of grant and the end of the particular year, less the sum of all charges made in previous years. (If the option was underwater at the end of the particular year, then a negative sum would be recorded equal to all the charges made in previous years.)

- Incorporate the above reasoning for all options that were still outstanding as of the end of the current year

- Include any gains realized during the current year, without identifying the exercise proceeds as such. (If the option were exercised in any given year, the amount charged to the SCT that year would be predicated on the market price at exercise, rather than the yearend price.)

As a quid pro quo for this second table, the table showing option gains would be eliminated.

Note that, as with the option reported above for Time Warner, the figure shown in the SCT in a given year could be negative. Indeed, it could be so negative that the total pay figure in the SCT might also be negative.

Note also that the same reasoning would be applied to all outstanding free share awards.

Finally, note that in the Time Warner example shown above, the total gain at the end of Year 10 is $24.1 million. Yet the figure of $24.1 million would not show up in any of the 10 different SCT tables covering this option.

Although there would now be two SCT tables, instead of one, the aggregate number of tables in the proxy would remain unchanged, because the gains table would no longer be needed.

The two tables, in combination:

- Allow the reader to view the effects of the comp committee's policy decisions.

- Provide at the same time a real-life view of the way most CEOs think about compensation, when they think about compensation (which, for most CEOs is all the time!).

- Not penalize a CEO who exercised for a large gain in a given year, compared to a similarly-situated CEO at another company who decided not to exercise that particular year.

2009 marks Graef Crystal's 50th anniversary in the executive compensation field. He has been a director of compensation for General Dynamics and Pfizer, worked as a consultant for Booz, Allen & Hamilton, served as worldwide practice director at Towers Perrin for 18 years, was a professor at the University of California at Berkeley's Haas School of Business for 10 years and a syndicated columnist for Bloomberg News for almost nine years. He has written six books and more than 1,600 articles on executive pay.

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A Mixed Bag of Reform Proposals From the SEC

by Graef Crystal

July 20, 2009

On July 10, the U.S. Securities and Exchange Commission delivered itself of numerous proposals to improve executive compensation disclosure in proxy statements.

Some of those proposals are quite welcome. Others have questionable value. And still others have the potential to create lasting damage.

Full Value for Options and Stock in the Summary Compensation Table

The SEC referenced its earlier decision to use accrued accounting concepts for the reportage of option and stock awards in the Summary Compensation Table (SCT).

The Commission declared: We believe the current method for presenting this information may have **inadvertently** [emphasis is mine] resulted in investor confusion.

When it reformed proxy disclosure in 2006, the SEC originally wanted the full grant date present value of each option and stock award made during the year to be reported in the SCT.

But almost in the dark of night, on Dec. 22, 2006, it reversed course and adopted accrual accounting, thereby demonstrating, in my opinion, that it was less interested in the letters it was receiving from Harry Markopoulos about Bernard Madoff than it was in basking in the warm approval of fat cat CEOs.

The proposed disclosure in the SCT of the full grant date fair value of all option and stock awards granted in any given year will be quite useful. It will certainly save my time and the time of many others – time spent in tweezing out of the SCT the accrued values shown for option and stock awards and then adding in the grant date present value figures obtained from the Grants of Plan-Based Awards Table.

But I heartily disagree with the SEC's idea of eliminating the disclosure of grant date fair value in that just-mentioned table.

There's a certain logic to what the SEC is proposing. Originally, when the disclosure of the full value of options and stock in the SCT was being proposed, there were no grant date disclosures required in the Grants of Plan-Based Awards Table. Then when the SEC made its midnight switcheroo, it ordered that grant date fair value be included in the grants table. Therefore, in knocking out the grant date fair value requirement, it could be argued that the SEC is merely reverting to its original position.

But in my view, it is vital to retain that requirement under the new rules.

To my jaundiced eye, many companies play games with their option valuations. They shade their volatility assumptions and especially their effective term assumptions. It is important, I think, that there be grant date fair value disclosure for each and every award. Producing the aggregate figure for all grants and then stuffing same into the SCT is not sufficient.

I would also add that some companies are already taking liberties with the current regulations. If on a single day, they grant an executive X free shares, Y performance shares and Z option shares, they show only one line on the Grants table and one aggregate Grant Date Fair Value figure that encompasses all three grants. It is my belief that this practice is not legal. The SEC needs to insist that every grant get a separate line, even if there are multiple grants made on the same day.

Defining Risk

The SEC, as well as other parts of the Federal government, are fixated on the role of risky incentives. Yet no one seems to be able to define with any precision just what a risky incentive is.

So maybe I can help out here, with my favorite list of incentives that might be deemed to be too risky under certain circumstances:

- Granting bonuses more frequently than annually. That's a speciality in a lot of Silicon Valley firms. If you make some risky decision in the first half of the year that seems to turn out well, you get a big bonus. If the second half of the year shows that the decision was a dog, you don't get a bonus for the second half. But you don't lose your bonus for the first half.

- Incentives based on return on equity. Here, there is an implicit temptation to leverage the company, so long as you can earn even a few more dollars in profit than you pay in interest costs.

- Bonuses that disregard the impact of extraordinary events or that are predicated only on profits from continuing operations.

- Bonuses that are based on EBITDA. Now, the executive is utterly indifferent to the effects of overleveraging. He doesn't even bear the burden of interest costs.
- Incentives that reward for increasing sales.
- Bonuses that bulk too large in the total compensation package, especially when combined with artificially-low base salaries. That for years was The Wall Street Way.
- Long-term incentive plans that are not long-term or at least not long-term enough. In this category are stock options, where some of the shares can be exercised as early as one year following grant.
- Stock option plans that allow the executive to choose the timing of exercise, thereby abetting "pump and dump" behavior.
- Enormous severance pay packages that provide for a soft landing if a risky decision fails to pan out.
- Ultra large pensions that again provide for a soft landing.

Targeting Divisional Incentives

The SEC seems to be casting a skeptical eye on incentives that generate bonuses based on the results of business units. I consider this to be dangerous thinking. There is nothing implicitly wrong with a business unit incentive plan.

But there is something implicitly wrong with giving the CEO of the company a piece of the action in one of its subsidiaries or a company in which it has a substantial interest. This happened under Ed Whitacre when he was head of SBC Communications. Perhaps in his new job at General Motors, he will engineer for himself a bonus based on the overall results of GM as well as a second bonus based only the results of Chevrolet.

That practice is rife with conflicts of interests and should never occur.

Timing of Reporting

The SEC is on to something here. Currently, a bonus that is paid in early 2009 but that relates to 2008 is reported in the proxy statement covering 2008. But a stock option or free share award made in early 2009 is reported in the proxy statement covering 2009. We need some harmony here.

I would suggest treating long-term incentive awards in the very same way as bonuses are treated.

Smoothing of Awards

Under the current system, if an executive receives, say, a huge option grant, the full grant date fair value of same does not show up in the SCT in the year of grant. Rather, it is amortized over the option's vesting period.

The SEC's proposed changes will make an option mega grant show up big time in the SCT.

But that's not the SEC's problem. It need not sweep up after a comp committee's horse. If the comp committee is worried about optics, then let it split the mega grant into smaller grants and issue them one year at a time.

Mark-to-Market

The SEC took note of one petitioner's idea that there should be mark-to-market accounting in the SCT. Thus, if a stock option declines in value by the end of the year in which it is granted, that decline would produce a negative compensation figure that year. If it is rises in value, then the figure disclosed would rise.

In the late 1970s, I received a call from Harold Williams, then the chairman of the SEC and a former client of mine. He told me he wanted to reform the proxy disclosure system. And he wanted it done fast.

He asked me to work over a weekend with the Associate Director of the SEC's Division of Corporation Finance. I did, and we have been friends ever since. His name, by the way, is Fay Vincent, and he went on to great fame as, first, the CEO of Columbia Pictures Industries and second, as the commissioner of baseball.

Fay and I decided to recommend mark-to-market accounting for stock options. The result was anger and confusion. CEOs whose stock had risen were incensed that their total pay would be shown to have risen, even though they had not yet exercised anything. And shareholders were confused when being asked to believe that a CEO worked for negative $5 million last year, which was the result of a huge drop in the paper profits in his stock options.

Although there is logic to this proposal, I don't think it's really worth adopting, given the results that occurred the last time.

And that's especially the case, were the SEC to apply the concept to all outstanding stock options, not merely those granted in the particular year.

Eliminating Performance Targets

The SEC asked: "Should we consider proposing to eliminate the instruction that provides that performance targets can be excluded based on the potential adverse competitive effect on the company of their disclosure?"

Reminds me of Mort Sahl's famous line that: "Maybe we should consider giving the Russians all our secrets, and then they'd be five years behind, too!"

When I worked with Richard Breeden, the former chairman of the SEC, in structuring the reforms inaugurated in 1993, he told me that the disclosure of performance targets for various bonus plans should be such that "any shareholder, armed with a simple calculator, ought to be able to figure out to the dollar how much the CEO and other senior executives will earn".

Well, we never got that far. But it's a worthy goal. And more steps to achieve it ought to be taken by the SEC.

Compensation Consultants

Between the proposals made by the SEC and the draft legislation released by the Treasury on July 16, executive compensation consultants look to have a secure future.

To encourage truly independent compensation consultants, the SEC has proposed that if the consultant's colleagues perform other consulting services for the management of the company, those services must be described in the proxy statement, as well as the total fees the consulting firm received, including the fees received for compensation consulting.

The draft Treasury legislation raises the ante even further. A compensation committee is not compelled to hire its own independent compensation consultant, but if it decides not to, it must explain to shareholders why it made that decision.

Consulting firms which offer nothing but executive compensation advisory services would seem to be the big winners here. But consulting firms which offer a smorgasbord of services could find themselves in a bind.

This issue surfaced a few years back when *New York Times* columnist Gretchen Morgenson made a front page example of Hewitt Associates. She implicitly questioned how objective Hewitt's executive compensation consultant could be when the firm had received immense fees for actuarial and benefit services.

Which makes one wonder about the newly-announced merger of Towers Perrin and Watson Wyatt. (I was employed by the former firm for 18 years, ending Dec. 31, 1987.) That merger seems likely to generate even more potential conflicts of interest than either of those immense firms were experiencing prior to the merger.

But the SEC, demonstrating once again the naiveté that permitted Bernie Madoff to keep his scam going, added that if the compensation consultant's colleagues were only consulting on broad-based plans, then all those nasty fee disclosures would not have to be made.

Isn't it a bit artificial, though to give a pass to a firm's actuary who is working only on a pension plan that conforms strictly to IRS rules but not to give a pass to a firm's actuary who is working not only on the broad-based pension plan but also the company's supplemental executive retirement plan?

One can argue that if a compensation consultant is generating, say, $100,000 of fees from a compensation committee, while his firm is generating $2 million of fees from consulting only on broad-based pension, 401(k) and health plans, the potential for mischief is still there, and probably to the same degree as if the non-compensation consulting was for, say, organizational design studies.

I think that if the SEC is going to require fees to be disclosed, then it should require that all fees for all services be disclosed.

Diogenes was endlessly engaged in the search for an honest man. Now, compensation committees will be in search of a certified kosher compensation consultant, one who not only knows what he or she is doing but whose firm has no other ties to that company.

Still, even the most Republican of compensation consultants should be grateful for what the Obama administration has proposed to do in their behalf.

Let the good times roll!

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