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The Crystal Report on Executive Compensation



The SEC Finally Gets It Right

by Graef Crystal

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Over the past 40 or so years, the U.S. Securities and Exchange Commission has attempted to define “total compensation” in a fair and transparent way. Its first attempt would have been fine, but the business community went bananas over it. The second and third attempts were strangled in their cradles by the very same business community. Now we have a fourth attempt – another fine one – that I pray is left alone and becomes the long-term norm.

All of the various fumbblings involved the treatment of stock options.

The Harold Williams Era

Let’s start with the first attempt at reform when Harold Williams, in the mid-1970s, had become the chair of the SEC.

Harold was the quintessential wunderkind. He graduated from Harvard Law School when he was barely 20. He rose rapidly to become chairman of Norton Simon, a large conglomerate. He sat on many boards. After serving as chair of the SEC, he became dean of the UCLA business school and the founding head of Los Angeles’ famed Getty Museum.

I first met him (I think it was in the early 1970s) when he was in his outside director mode. He was a member of one board’s comp committee, and I was the consultant.

Why he ever had anything to do with me after a certain evening mystifies me.

Following Part I of a two-part comp committee meeting, we joined the CEO of the company (we'll call him John Smith) and went to the CEO's club for dinner.

As we settled in our chairs, a waiter appeared and took drink orders. When he got to the host, he asked: "Your usual ginger ale, Mr. Smith?" John nodded his head.

I turned to him and asked: "You don't drink?" "No", he replied, "I don't drink."

Before and during dinner, John downed four large ginger ales.

Following dinner, I made a presentation to the committee, and hardly had I begun but John started throwing at me what I deemed to be hostile questions.

I backed up a bit and as calmly as I could answered each of them. But he became more and more obstreperous. Rather than sit there and take it, I started to shoot back.

The meeting broke up very shortly thereafter.

As Harold and I started walking back to the hotel at which both of us were staying, he said to me: "You weren't very gentle with John".

"Gentle?", I asked. "How was I supposed to be gentle when he was really nasty to me."

"Well", Harold said, "John was drunk", and we have to make some allowances for the fact that he is a heavy drinker.

"You're kidding", I said. "I sat right next to him and watched the waiter serve him ginger ale after ginger ale. And he told me himself that he didn't drink."

"Oh, the ginger ale was code between the waiter and John. Ginger ale means straight gin." And John downed four huge glasses of the stuff.

My naiveté, I guess. At any rate, I kept the client. And I even became more friendly with Harold.

Shortly after he took over the SEC, Harold decided that the pay proxy rules needed to be simplified. At the time, disclosure was all over the map, with large sums buried amid reams of prose or put in footnotes set in tiny type.

He called me and asked me to come to Washington to work with a young lawyer who was deputy director of the SEC's division of corporation finance. That lawyer was Francis T. Vincent, Jr. (AKA Fay Vincent). In due course, he left the SEC to become CEO of Columbia Pictures Industries, then president of baseball's American League, then Commissioner of Baseball. He and I remain friends today.

During the ensuing weekend, Fay and I, aided in the area of benefits by my Towers Perrin colleague, Don Sullivan, rewrote the proxy disclosure rules.

At the time we did this, either the Black-Scholes model had not yet been invented, or if it had been invented, it was a curiosity in business schools and had not risen into the consciousness of compensation consultants. Recall also that at that time, it would have taken a mainframe computer to run the Black-Scholes model.

Still, we had to find a way to take account of stock options and stock awards.

We settled on a “mark to market” approach.

To illustrate, suppose at the end of the preceding year, a CEO was holding 1 million option shares that were above water by \$3 million. Then assume that this year, the above water position increased another \$2 million, to \$5 million. That increase of \$2 million was reported in the new Summary Compensation Table, along with the base salary, the bonus, the profits made from exercising stock options, the change in value of stock awards, perks and the increase in pension present value. At the far right hand of the table was a column for Total Pay.

The business community went ballistic. “How can you show me as having made \$2 million in options last year, when I didn’t cash in my options and when this year, that \$2 million might evaporate and another \$2 million with it?” Our answer: “If that happens, we will show you with minus-\$4 million option pay next year. And if that \$4 million negative figure overwhelms your salary and bonus, then you will be shown as having worked for less than nothing during the year.

It was a simple system and it fairly showed that executive pay didn’t always go up and up.

Unfortunately, that system didn’t last very long. Indeed, as soon as Harold Williams left the SEC, his successor’s first official act was to scuttle it

Chaos Again

Between that time and 1992, chaos again reigned. One of my favorite proxies was that of Coca-Cola covering, I believe, 1991. In its pay table, the company reported only the late CEO Roberto Goizueta’s base salary, though I think it may also have reported his bonus. But you had to read page after page of numbing text until you encountered a paragraph which, in effect, said, “By the way, Mr. Goizueta also received 1,000,000 shares of Coke stock free.” If memory serves, those shares had an initial value of more than \$50 million.

To make it even easier for shareholders to skip over this paragraph, the figure “1,000,000” shares did not appear. Rather, the reader, if he didn’t miss it, saw “one million shares.” Small change, but it could escape the notice of someone like me who had become reasonably adept at looking for Arabic numbers in paragraphs of dense prose.

In 1991, I wrote a bestseller entitled “In Search of Excess: The Overcompensation of American Executives”.

In a chapter on needed reforms, I stressed three points:

- That the proxy disclosure system needed to be overhauled totally.
- That earnings should be charged for the cost of stock options.
- And that comp committees should hire their own consultants, and neither those consultants nor their colleagues should have any contact with the management.

The first two of my wishes became law. As for the third, it would be the rare comp committee that today would not want its own compensation consultant.

My blasting of proxy disclosure brought me an invitation to testify before a Senatorial committee headed by Carl Levin (D-MICH). (I later testified at a second senatorial hearing also conducted by Sen. Levin, in which the subject was charges to earnings for stock options.)

After hearing what I and others had to say, he beat the SEC around the head and shoulders and demanded action.

The Richard Breeden Era

The new SEC chair was Richard Breeden, and he quickly took action to reform the whole rotten system. I served as an informal consultant to him now and again.

But he, too, was rolled by the business community. By now, the names “Black” and “Scholes” were known, and they struck terror in the hearts of CEOs everywhere. In the view of the CEOs, some sort of “dark magic” took place in a “black box”, and voila, you had a present value figure. That was the figure you had to show in your proxy statement and to include in your reported total compensation .

If the actual gain far exceeded the present value figure (more recently known as the Grant Date Fair Value figure), that was just fine. But if the option finished out of the money, CEOs were enraged to learn that they would not receive any relief in the Summary Compensation Table.

Mr. Breeden arranged a compromise:

- A company could determine the grant date fair value of a stock option; or
- It could tell the shareholders the gain the executive would realize if: 1)He held the option until the end of its term; and 2)The stock appreciated 5 percent a year. Under this alternative approach, the company also had to produce a second figure showing the results on the basis of the stock’s having appreciated 10 percent a year.

If companies were given those choices of valuation, then it would have been impossible to produce a total pay figure in the Summary Compensation table. So the total pay figure – a concept Mr. Breeden initially championed – fell by the wayside. And as a result, shareholders and analysts could not agree on just how much someone had earned.

That approach lasted some 13 years – until Christopher Cox became chair of the SEC.

The Christopher Cox Era

Mr. Cox was also a reformer. He promptly tossed out the alternative option valuation methods. And in his initial proposals, he advocated for the very approach that new SEC chair Mary Schapiro and her colleagues finally adopted this Dec. 16.

Under Mr. Cox, the Summary Compensation Table would contain a total pay figure, and it would consist of the grant date present value of all grants made during the year under study.

But once again, the business community played the role of spoiler. It persuaded Mr. Cox to show as compensation the amounts recorded on the company's books for the particular year.

For an illustration, suppose a new CEO comes in from the outside in 2006. When he joins the company, he is handed an option with a grant date present value of \$20 million, an option which becomes exercisable in equal portions over the ensuing four years. The figure shown in the Summary Compensation Table would be, not \$20 million, but \$5 million, because that is the amount the company would be charging to its books in the year of grant. Then in each of the next three years, further charges of \$5 million per year would be taken and shown in the Summary Compensation Table.

What the business community forgot about were option grants made before the new regs were implemented that would themselves create charges to earnings in out years. If those charges occurred after the new regs were emplaced, they had to be put in the Summary Compensation Table, too.

The result: There wasn't as much savings as the business types thought there would be. And to top it off, confusion reigned. How was one supposed to evaluate the total pay of Executive A, our new hire just noted, and compare it to the total pay of Executive B who, for years, had been receiving options with a grant date present value of \$20 million each year? In the first case, total pay would show only \$5 million of option present value; in the second case, the amount would be \$20 million.

The New Era Under Mary Schapiro

Now, SEC chair Mary Schapiro has done a merciful thing. She has restored the Summary Compensation Table to where it would have been under SEC chair Cox before he caved into the demands of the business community.

It is said that Ms. Schapiro is a tough lady. Thanks be to God for that. She needs to hunker down in her foxhole and direct a 50-caliber machine gun at any business types who show up to make yet another attempt to rewrite history.

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Equilar, a leading provider of executive pay information has published a comprehensive report on the SEC's Proxy Reform rules. To request a copy, please use the following link:
<http://info.equilar.com/PreparingforProxySeason.html>.

Graef Crystal's is now in his 51st year 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 still contributes occasional columns to Bloomberg News.) He has written six books and more than 1,600 articles on executive pay.