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Has Pay for Performance Gone Awry? Views from a Corporate Governance Forum

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In order to maximize investment performance, some institutional investment managers, such as TIAA-CREF, continually monitor the performance and policies of the companies in which they invest. A key governance issue at many public companies is compensation policy: the system of incentives and rewards that corporations use to encourage employees to act in shareholders' interests. This issue of *Research Dialogue* summarizes the discussions at a recent TIAA-CREF Institute forum on compensation policies at public corporations. The article provides important background information on compensation issues, demonstrates the need for a judicious and informed approach in the design and implementation of compensation programs, and highlights the consensus on several issues that arose at the forum.

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» » » INTRODUCTION

An important way in which many large institutional investors, including TIAA-CREF, attempt to serve the interests of their constituents is by promoting good corporate governance practices in the public corporations in which they invest. While there are several ways in which TIAA-CREF and other entities pursue this goal, an important first step in evaluating the appropriateness of any governance practice is thoughtful research and open discussion of the issues.

Some of the most controversial governance-related issues that have arisen in recent years involve executive and employee compensation. Investors, the press, and the public have expressed concern over (1) escalating executive pay packages and (2) the growing use of stock options. These two trends raise several complex governance issues that have significant implications for all investors.

Indeed, compensation issues have become an increasingly important component of corporate governance for a number of reasons. First, well-designed compensation programs should serve to align the interests of executives and employees with those of shareholders. It is also clear that an effective compensation policy is critical in attracting, motivating, and retaining employees. However, the costs and benefits of large pay packages and option grants—to executives in particular—are not always obvious. Second, in many companies, particularly knowledge-based companies, the role of workers or “human capital” has become critical in generating returns to shareholders. Many employees recognize this, and justifiably desire a “piece of the action,” that is, to be compensated with equity for their contributions to value creation. Third, an explosion in the use of option-based compensation during the past decade has led to concerns about how much this is costing shareholders. Finally, there is a concern that misuse of stock-based compensation, particularly in the context of a booming economy and rising stock market, has led to a fundamental disconnect in the relationship between pay and performance.

Motivated by these concerns and others, on April 5, 2001, the TIAA-CREF Institute, in cooperation with the TIAA-CREF corporate governance staff, sponsored a Corporate Governance Forum, *Executive Compensation, Stock*

Options, and the Role of the Board of Directors, at which the issues of executive compensation and the use of stock options were examined and discussed in detail. By bringing together a diverse audience, including corporate officers and directors, academic and other researchers, compensation consultants, corporate human resources personnel, institutional investors, regulators, and other practitioners, the Forum provided an opportunity for an open exchange of views among groups that do not often meet together. Participants discussed current trends in compensation practice, the accounting for stock-based compensation, the appropriate use of stock options and alternatives to standard at-the-money options. They also reviewed and debated the role of shareholders in approving compensation plans, and the importance of the board of directors and board compensation committee in determining compensation policy.

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This article discusses the important issues raised by conference participants and attempts to provide an overview of the comments and observations of both panel members and the audience. The article first provides a primer on stock options and related compensation issues, then generally follows the order of the conference sessions: (1) Executive Compensation and Executive Stock Options, (2) the General Use of Stock Options and Dilution Issues, and (3) the Role of the Board of Directors and the Compensation Committee. Necessarily, there is some overlap within each of the three broad topics. This article is not a transcript of the Forum, a comprehensive background on compensation

programs, or a statement of best practices as it relates to compensation policies. Rather, the goal is simply to share some of the insights and information presented at the conference with a broader audience.

A Primer on Stock Options

A basic understanding of what options are and how they work is a prerequisite for thinking about the governance issues related to their use; thus, a brief outline of stock options is presented here. When a stock option is granted to an employee, a company gives the employee the right to purchase a share of her company's stock at a future date, at a prespecified price—the so-called exercise price. (Typically, the exercise price is set at the market price of the stock as of the date of grant.) Although the difference between the exercise price and the market price on the grant date is zero, the possibility that the stock price will increase gives the option an economic value. After the grant date, if the price of the underlying stock increases above the exercise price of the option, the value of the employee's option increases—so she can effectively buy the stock at a discount.

Thus, owning an option gives an employee the incentive to act in such a way as to increase the company's stock price, and hence the value of her stock options. Shareholders also benefit from any increases in the stock price. While this seems to be a remarkable win-win situation for shareholders and employees alike, there is an important secondary effect of rising stock option values: As the value of the options held by employees rises, the obligation of the company to honor these options also increases. Thus, it is vital to recognize that the use of stock options benefits shareholders only so long as the gains from compensating employees with options exceed the costs of doing so.

By the early 1990s, stock options were viewed by many investors as an effective means of aligning the interests of executives and shareholders. Consequently, options have been increasingly used to compensate senior executives. For example, in 1992 the median value of options granted to CEOs at S&P 1,500 firms was approximately 16% of their total compensation. By 1998, this had increased to 35% of total compensation.¹ Similarly, the use of options to compensate employees beyond the

executive suite also expanded rapidly during the nineties. In her presentation at the Forum, Ms. Pearl Meyer noted that "option overhang" (defined as shares reserved for outstanding option grants, plus shares available for future grant, divided by the weighted average shares outstanding) for the top 200 industrial and service companies increased from 6.5% in 1989 to approximately 15% by 2000. Moreover, average annual grants increased from just over 1% to approximately 2.3% of shares outstanding during the same time period. At 100 "dot-com" companies surveyed in 2000, grants averaged 10.7% of shares outstanding, and option overhang averaged approximately 37% of shares outstanding.

An Outline of Compensation Issues

Increased use of stock options has led to greater scrutiny of option-based compensation. A key concern, sparked by large gains for executives and employees in the face of a bull market, is that the cost of stock options to shareholders may exceed the benefits from their use. This reflects, in part, the idea that stock prices may be poor measures of employee performance, because stock price changes are beyond the control of most employees. A clear question is whether option-based compensation rewards employees for their own performance, for their company's performance, or for the performance of the economy (or stock market) as a whole. Put another way, the issue is whether option plans reward employees for superior individual performance—or for luck.

Two other issues have led to questions about the appropriateness of using options to compensate employees. First, academic research suggests that employees place a lower value on stock options than the potential cost of those options to shareholders.² If true, then the rationale for using a form of compensation that costs shareholders more than its perceived value to employees is unclear. Second, it has been argued that option-based compensation may not be appropriate for employees at lower levels in the corporation because of the risk involved.

Another important aspect of the current compensation environment is the way in which companies account for

option-based compensation. Granting employees stock options “at-the-money” (with an exercise price equal to the market price of the company’s stock as of the date of grant) generally does not result in a compensation expense in corporate financial statements—in contrast to other types of options and forms of compensation. (See the box below.) Thus, the reported income of many companies (i.e., their profits or losses) does not reflect the full cost of their option-based compensation programs. Similarly, measures of diluted earnings per share, calculated in accordance with current accounting rules, do not reflect the economic cost or full dilution resulting from option grants. These accounting practices raise at least two issues for consideration. First, do finan-

cial statements reflect the economic reality of the cost of stock options? Many would argue that they do not. Second, and perhaps more important, does the current accounting treatment encourage the use of at-the-money options in preference to potentially superior alternatives, simply because at-the-money options receive favorable accounting treatment?

Another significant issue deserves mention as part of a general introduction. Recently, option repricing has served to focus attention on many of the issues pertaining to option-based compensation. Stock market declines have left many employees holding “out-of-the-money” or “underwater” options (i.e., options that give the employee the right to purchase shares at a price above the current market price of the stock). Although these options continue to have value, because stock prices may rise again in the future, they could not be profitably exercised at the current share price. As of January 2001, option grants made during 1999 were underwater for approximately 40% of S&P 1,500 companies.³ To address this issue, many companies have moved to restore all or part of the option value by means of a “repricing.” A repricing often takes the form of granting employees new options with a new exercise price equal to the current market price, effectively reducing the price that employees must pay to exercise their options.

Investors are concerned that repricing rewards employees for poor stock price performance and undermines the rationale for using options as incentive compensation. This asymmetry, where employees are rewarded in a rising market and made whole in the face of a market decline, has been viewed as a “heads I win, tails you lose” arrangement. Moreover, repricing stock options is perceived as providing employees with a benefit that is not available to shareholders, who have also suffered a decline in the value of their investment but cannot recover their losses.

In contrast, many companies argue that in a tight labor market, failure to reprice options may result in poorly motivated employees and/or undesirable employee turnover. For example, employees can effectively “reprice” their underwater options by leaving their current jobs and getting new options from a new employer. Thus, failure to reprice may result in additional costs to the company and shareholders in the long run.

Accounting for Stock Options

Under SFAS 123, Accounting for Stock-based Compensation, companies are required to estimate the fair value of options at the grant date and typically do so using an option-pricing model, usually Black-Scholes. Companies must then either take a charge to income or else (as almost all do) include a note to the financial statements that shows net income and earnings per share as if that cost had been charged to income. The estimated cost of each year’s grant is allocated equally over the vesting period.

Under SFAS 128, Earnings per Share, diluted earnings per share (EPS) is reported for both continuing operations and the “bottom line” corporate earnings number. In each case, shares underlying in-the-money options are considered to be shares outstanding, and are added to current shares outstanding in the denominator of the earnings per share calculation. However, that denominator is reduced by the number of shares that could be purchased in the open market with option exercise proceeds. Options “at-the-money” or “out-of-the-money” do not result in EPS dilution. Researchers argue that existing shareholders experience dilution from all options, not just those in-the-money. Any increase in firm value as a result of an increase in future earnings accrues in part to all optionholders, and this takes place at the expense of current shareholders.

Finally, the current regulatory environment allows companies to adopt some stock option plans without shareholder approval. Thus, a central governance concern relates to the right of shareholders to approve stock option plans that have the potential to dilute their voting power and their wealth.⁴

>>> EXECUTIVE COMPENSATION AND STOCK OPTIONS

The first session of the day addressed *Executive Compensation and Executive Stock Options*. (For the full list of session speakers and panelists, see the conference agenda that appears on page 9 of this article.)

In focusing on executive compensation, the discussion related not only to the use of options per se, but also to the overall levels of compensation and the mechanisms that govern the pay-setting process at corporations. This session focused primarily on the state of CEO pay in general and features of the compensation environment that may tend to undermine the potential incentive effects of option-based compensation.

Presenting a view of compensation practices and trends from the perspective of an experienced compensation consultant, Mr. Frederic W. Cook highlighted several factors considered influential in driving CEO pay to high levels. Among these is the public company board model. The public company board places an emphasis on independent outside directors, with no affiliations to the company other than stock ownership. Mr. Cook argued that this is a useful governance model that ensures general accountability to shareholders, but it can result in an imbalance in the pay-setting process. High-powered executives may end up negotiating for pay with part-time directors who have difficulty valuing the job of the CEO, which can create a dynamic favoring CEOs, if not creating a systematic bias toward management.

Mr. Cook contended that a reliance on surveys in setting pay may also lead to higher compensation. Surveys lead to asymmetry in compensation practices, emphasizing pay for performance when companies are performing well, and offering peer group pay norms when companies are not performing well. Moreover, Mr. Cook suggested that companies relying more heavily on surveys tend to be poor performers. This leads to

performance-related differences in compensation practices: strong-performing companies tend to link pay to performance, while weaker performing companies rely on surveys. The result is that the pay-to-performance link is weakened, and pay levels ratchet ever upward.

Mr. Cook suggested there has been a cultural shift toward pay aggressiveness, and that “the cult of the CEO as a star” impacts compensation practices. He observed that in the past, CEOs were embarrassed to have their pay packages publicized, but now some CEOs

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enjoy being mentioned in the listings of top-paid executives, such as the annual review by *Business Week*.

The “total pay model” also seems to influence the level of compensation and the link between pay and performance. The idea of the total pay model is that companies grant stock options annually based on competitive guidelines irrespective of recent corporate performance. The value of option grants has come to dominate changes in annual pay. This, in turn, may result in total pay rising in the face of poor performance and an apparent disconnect between pay and performance.

Professor David Yermack’s comments focused on the growing evidence of a disconnect between pay and performance. As noted earlier, it seems clear that the aim

of incentive-based compensation is to align the interests of executives and shareholders. That is, shareholders should want to see the executive's personal fortunes tied to the stock price of the company that he or she manages. However, the aspects of executive behavior that Professor Yermack highlighted suggest that option-based compensation may not be achieving this objective. For example, one of the often-stated reasons companies award stock options is to encourage ownership by management. There is evidence, however, that executives rarely continue to hold the stock acquired from exercising options. Indeed, by encouraging cashless exercise of stock options, companies may even encourage executives not to hold stock acquired from option exercise. Professor Yermack also noted that option recipients tend to sell stock when they receive new grants of stock options. Although taxes and/or incentives for executives to diversify their personal holdings may partly explain this behavior, he noted that the selling of company stock does not appear to be in the interests of their firms. Moreover, it contradicts one of the stated reasons why equity compensation plans exist.

In contrast, Professor Brian Hall highlighted evidence on managerial stock holdings, suggesting that executive stock ownership has grown by a factor of 10 during the last two decades. During the flat stock market of 1994, 25% of executives "lost money," given pay and the net change in the value of their equity. This demonstrates that changes in executives' wealth constitute "pay for performance."

Professor Yermack raised a related point regarding the "shadowy hedging market." Basically, this market enables executives to trade out of their personal equity positions using strategies such as equity swaps, put options, "collars," and secured borrowing using the stock as collateral. These practices provide executives with an opportunity to undo the incentives that firms impose on them when stock options are awarded. To the extent that executives can undo the incentive structures, the rationale of using incentive-based compensation is undermined.

The appropriateness of "reload options," a variation on standard options, was also discussed. An executive with reload options triggers the "reload" feature by exercising the option and paying the exercise price

with shares of company stock he already owns. For every share surrendered, the executive receives one new option with an exercise price equal to the current market price of the stock. Professor Yermack argued, essentially, that by exercising and reloading, executives can insure themselves against stock price declines. Furthermore, the use of an incentive contract that makes executives better off in the face of falling stock prices than they otherwise would have been does not appear to be in shareholders' interests.⁵

Another compensation puzzle discussed by Professor Yermack is evidence suggesting that executives tend to exercise standard stock options earlier than might be expected under financial theory. When executives exercise options early, they receive the difference between the current stock price and the option exercise price, while essentially donating back to their employers the further upside potential of the option.

Professor Hall offered several explanations for observed early exercise. First, risk-averse executives rationally seek to diversify their personal portfolios, so they have an incentive to exercise early. Second, in part because of a desire for diversification, risk-averse executives may place a lower value on stock options than the potential cost to shareholders. Finally, because of executive incentives to diversify, short vesting periods (as opposed to longer vesting periods) may contribute to early exercise.

Professor Yermack also noted that some research shows stock option awards tend to occur at times favorable to the executives involved. For example, evidence suggests a close association between option award dates and the release of news, such as earnings announcements, that push company stock prices higher. Other research reports similar patterns of "fortuitous timing" for option repricing: Options tend to be repriced when the stock price hits a low point relative to the recent past. This pattern has striking similarities to what would otherwise be considered illegal insider trading, and raises a question as to why such practices are not curtailed through better corporate governance, improved disclosure, or enforcement actions by the SEC.

>>> THE GENERAL USE OF STOCK OPTIONS, DILUTION, AND RELATED ISSUES

The second session of the Forum emphasized the use of stock options beyond the executive suite. Moreover, other general issues related to stock option use were also discussed, including measuring the cost of stock options, option repricing, shareholder concerns, and shareholder voting.⁶

In many industries, stock options have become standard compensation practice. Thus, given competitive labor markets, the use of options to attract talent, particularly in the context of high-tech or knowledge-worker reliant companies, has become something of a necessity. Furthermore, there is a strong perception that options are a source of competitive advantage in the U.S., and are linked to value-building performance. Indeed, Mr. Larry G. Stambaugh argued that the boom in U.S. productivity and innovation has been enhanced by the use of stock options.

However, the appropriateness of using options at all levels of the organization has been subject to question. For example, Mr. Michael Mauboussin argued that, at best, most employees can have only a small impact on overall corporate performance. In addition, even if individual employees can directly contribute to corporate performance, there is a question as to what extent their contributions are reflected in the stock price. There is also a potential “free-rider” problem, in that an employee incurs all the costs of working hard to increase the stock price, but any consequent increase in corporate value will be divided among all stockholders and all optionholders. Thus, option-based compensation may provide weak incentives for employees to increase stock price.

Mr. Eric D. Roiter highlighted this issue by questioning whether option-based compensation serves to reward performance or, rather, encourages a “lottery ticket” mentality on the part of employees. He also noted shareholders’ concerns about the potential reallocation of ownership rights as a result of option-based compensation and the associated value transfers from shareholders to employees. To the extent that the costs of option-based compensation exceed the perceived benefits, it implies the destruction of shareholder value as opposed to the creation of shareholder value.

Ultimately, the panel concluded that companies with perceived high levels of dilution and poor compensation practices will face financial constraints as they return to the capital markets for additional funding.

Mr. Stuart L. Gillan’s presentation focused on the implications of option repricing. Given recent stock market declines, option repricing has become a highly contentious compensation issue. Even when the option

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exercise price is below the current market price (options are underwater), the options still have economic value (share prices may rise again in the future). However, underwater options are typically considered to be “worthless” by employees. When employees hold underwater options, companies have a number of concerns, such as how to deal with demoralized employees and how to approach a repricing given shareholder apprehension over dilution in general and repricing in particular.

As highlighted by Mr. Cook earlier in the day, there are numerous approaches companies can use to deal with underwater options. These alternatives range from doing nothing to making employees entirely whole for the value decline they have experienced by means of a repricing.

Recent FASB rulings, however, require that companies repricing options must adopt “mark-to-market accounting” for the repriced options and have those adjustments flow through the income statement. In other words, the cost of the repricing would have to be

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reflected in reported income. A key element of the FASB's ruling is that any stock option issuance within six months of a cancellation constitutes a repricing for accounting purposes. To avoid this definition, and the associated charge to earnings, some companies have adopted a "synthetic repricing" strategy in which they leave six months *and one day* between option cancellation and reissuance.⁷

Another approach to dealing with underwater options is "on-top" grants. On-top grants simply award employees additional options at a lower exercise price, while allowing them to keep their underwater options. Mr. Gillan noted that although this may alleviate the employee morale issue, underwater options do have value and, in fact, they represent a significant potential value transfer from shareholders to optionholders. Most option grants have a 7-to-10-year life; and if stock prices increase dramatically, it could prove very costly to shareholders at these companies to double-up option grants.

On a related issue, an audience member made the observation that repricing relates to the extent to which employee compensation is at risk, and one could argue that lower-level workers should not have a significant element of pay at risk.⁸ High-level employees, on the other hand, should have risk—but real risk, both upside and downside. These arguments have a great deal of merit; indeed, it would seem that they provide the rationale for the current wave of repricing, as many companies apparently face pressure to readjust employees' "at-risk" compensation now that the "risk" has been realized. This need for companies to reprice options

provides evidence that the standard practice of granting at-the-money options to a broad range of employees does not always work well.

The gaming of the accounting rules to effectively reprice options and avoid an accounting charge raises questions as to whether a focus on earnings numbers results in the choice of compensation strategies that may be inferior relative to alternatives. For example, Mr. Mauboussin proposed the use of indexed options, which would adjust the option exercise price to reflect changes in some benchmark, say the return on the S&P 500. As the return on the index increases, the exercise price would also rise. Similarly, if the market declines, the exercise price is adjusted downward by the change in the index. Only when a company's stock return outperforms the index (in either up or down markets) do employees get a payoff. That is, indexed options reward superior performance in all markets, whether the market trend is up or down. However, current accounting requires that a cost for indexed options be charged to earnings, again highlighting the notion that disparate accounting treatments may disadvantage some compensation plans relative to others.

Given shareholder concerns about compensation practices in general and the use of options in particular, shareholders want the ability to approve option plans. Many companies actively seek shareholder approval for all stock option plans, and still others have adopted plan restrictions prohibiting future repricing without shareholder approval. However, past repricing activity can serve as a trigger for institutions to vote against new option plans. Similarly, high dilution levels have surpassed "vote no" thresholds for many institutional investors. Indeed, increased dilution levels have heightened shareholder concerns relating to the potential costs of option-based compensation. Evidence of shareholder concern is apparent when one focuses on shareholder voting on stock option plans. Average shareholder votes cast against proposed stock option plans have reached more than 20%—which is very high relative to other management issues put to a shareholder vote.⁹

Mr. Gillan noted that by assuming all grants will be exercised, standard dilution measures effectively provide an upper estimate of the potential cost of option grants to shareholders. When one considers other factors, the

AGENDA

TIAA-CREF Institute Corporate Governance Forum: Executive Compensation, Stock Options, and the Role of the Board of Directors

April 5, 2001

OPENING REMARKS

Madeleine d'Ambrosio, *Executive Director, TIAA-CREF Institute*

WELCOME

John H. Biggs, *Chairman, President, and CEO, TIAA-CREF*

I. EXECUTIVE COMPENSATION AND EXECUTIVE STOCK OPTIONS

Moderator: B. Kenneth West, *Senior Consultant on Corporate Governance, TIAA-CREF*

Presentation: Executive Compensation: Puzzles, Problems, and Mysteries

David Yermack, *Associate Professor of Finance, New York University*

Presentation: Equity Trends and Aberrations

Frederic W. Cook, *Chairman, Frederic W. Cook & Co.*

Panel Discussion

B. Kenneth West
Brian J. Hall, *Associate Professor, Harvard Business School*
Samuel C. Scott, *Chairman, President, and CEO, Corn Products International, Inc.*
Abbie Smith, *Professor, University of Chicago Graduate School of Business*
David Yermack
Frederic W. Cook

II. THE GENERAL USE OF STOCK OPTIONS AND DILUTION

Moderator: Peter C. Clapman, *Senior Vice President and Chief Counsel, Corporate Governance, TIAA-CREF*

Presentation: Option-based Compensation: Panacea or Pandora's Box?

Stuart L. Gillan, *Research Economist, TIAA-CREF Institute*

Presentation: Employee Stock Options: Incentives and Value
Michael Mauboussin, *Managing Director, Credit Suisse First Boston*

Panel Discussion

Peter C. Clapman
Peter N. Larson, *Former Chairman and CEO, Brunswick Corporation*
Pearl Meyer, *President, Pearl Meyer and Partners*
Eric D. Roiter, *Senior Vice President and General Counsel, Fidelity Management and Research Company*
Larry G. Stambaugh, *Chairman, President, and CEO, Maxim Pharmaceuticals, Inc.; Chairman, Corporate Directors Forum*
Stuart L. Gillan
Michael Mauboussin

III. THE ROLE OF THE BOARD AND THE COMPENSATION COMMITTEE

Moderator: B.A. (Dolph) Bridgewater, *Senior Consultant on Corporate Governance, TIAA-CREF*

Panel Discussion

B.A. (Dolph) Bridgewater
Joseph L. Bower, *Professor of Business Administration, Harvard Business School*
Sanford R. Robertson, *Partner, Francisco Partners*
Clayton Yeutter, *Of Counsel, Hogan and Hartson*

CLOSING REMARKS

Peter C. Clapman

expected cost of the grant as a proportion of market value may be markedly lower than standard dilution measures would suggest. For example, when employees exercise their options, companies are generally able to deduct the difference between the market price and the exercise price from taxable income. This can represent a significant reduction in the estimated economic cost of the options to shareholders. Similarly, to the extent that companies have large numbers of stock options outstanding, the cost of future grants will be shared by both current shareholders and current option holders. Finally, (1) adjusting the estimated cost for possible cancellations as employees leave prior to exercising their options and (2) using option-valuation approaches based on financial theory, will lead to lower estimates of the cost of stock options relative to the company's market value.

The conference discussion earlier in the day also focused on the use of share repurchases to offset dilution from stock options. Many companies explicitly state that they repurchase shares to accomplish one of two goals: (1) limit the dilution of existing shareholders and (2) influence the accounting measure of earnings per share.

As noted by an audience member, boards who repurchase think they can give more options because they believe they are countering dilution effects.

Conference participants were generally dismissive of the notion that repurchases offset dilution in a value sense. It is true that repurchases offset the dilution of current shareholders' voting power. It is also true that repurchases can be used to maintain the number of shares outstanding, and thus prevent lowering earnings per share. However, repurchases cannot "undo" the value transfer from shareholders to employees that occurs from granting options to employees. Thus, limiting dilution and preserving earnings per share do not seem relevant in a financial sense.

Although repurchases may have potential benefits—for example, investing in the company's undervalued stock, curbing wasteful investment programs, achieving tax savings relative to dividend payments, or maintaining a target capital structure—it is not clear how these benefits interact with the presence of stock options, if at all. As noted by Professor Yermack, repurchasing stock creates value only if the company acquires shares below their true worth. In general, if a stock trades at \$50 per

Despite the friction between corporate America and investors over stock option use, there remains a commonality of interests between investors and employees. In the evolving economy, both financial capital (from shareholders) and human capital (from employees) have the opportunity to benefit from each other.

share and the firm pays the \$50 market price to repurchase it, no one is any better or worse off. Likewise, "dilution" from option grants does not harm existing shareholders if the services contributed by employees equal the value of the option compensation awarded. Simply managing earnings per share numbers cannot increase the value of the firm. It was further suggested by Mr. Samuel C. Scott that the decision to use options and the decision to repurchase shares are fundamentally separate issues. One (the use of options) is a compensation issue, whereas the other (share repurchases) is an issue of capital budgeting and corporate capital structure.

>>> THE ROLE OF THE BOARD OF DIRECTORS AND THE COMPENSATION COMMITTEE

The capstone session of the day addressed the role of the board of directors, the compensation committee, and its chairperson. As with the earlier sessions, several common themes arose in relation to the corporate governance environment and the role of corporate boards. Many conference speakers and participants viewed compensation policy, particularly executive compensation policy, as a window through which the effectiveness of the board may be viewed.

Professor Joseph L. Bower presented evidence suggesting that, despite substantial destruction of shareholder value at some U.S. corporations, CEOs at those companies have received very large salary and bonus increases. This appears inconsistent with the concepts of pay for performance and aligning management incentives with those of shareholders—which in turn suggests that pay for performance is something of a myth. Other aspects of current compensation policy are also troubling, particularly “megagrants” (very large option grants) and retirement awards, where the relationship to shareholder interests is obscure.

As the last speaker in the conference session on dilution, Mr. Peter N. Larson stressed that despite the friction between corporate America and investors over stock option use, there remains a commonality of interests between investors and employees. In the evolving economy, both financial capital (from shareholders) and human capital (from employees) have the opportunity to benefit from each other. Nevertheless, the board of directors and its compensation committee play crucial roles in addressing the governance of compensation.

Both Mr. Sanford R. Robertson and Mr. Clayton Yeutter echoed these sentiments. Mr. Robertson noted that many questions about the use of stock options center on high-tech companies that use stock options broadly and deeply down the corporate hierarchy. The nature of the company, as interpreted by the board, may significantly impact compensation policies in these types of companies. Thus, the board of directors is critical in not only determining the company’s strategic direction, but also the compensation policies to achieve that direction. Mr. Yeutter stressed that corporate boards need flexibility to assess the nature of compensation for a particular

company, in a particular set of economic and company-specific circumstances. There is not a “one-size-fits-all” compensation policy, particularly for companies heavily reliant on knowledge workers for innovation, growth, and returns to shareholders.

Professor Bower also highlighted aspects of compensation policy that boards need to address including: the underlying philosophy of compensating employees, retaining employees, designing severance packages, and ensuring that compensation packages are equitable internally and relative to the external labor market. This encompasses not only the use of equity-based compensation, but also aligning expectations as to employee performance and sharing in the firm’s success.

While the inclusion of performance-based measures in compensation programs may be desirable, Mr. Yeutter suggested that care must be taken to avoid unintended consequences. For example, if a performance award pays off only in a period where earnings reach a certain level, there may be an incentive for employees to game the system, for example, by managing earnings numbers to achieve the goal.

Several speakers throughout the day, including Professor Bower, considered the role of the compensation committee chair to be critical. The chair must lead the compensation committee, work with the CEO to oversee management development and performance appraisal, and approve and oversee compensation policy. The task of the compensation committee also extends beyond that of just compensation to evaluating the CEO and succession planning.

Input is also needed from consultants, including good, detailed information on true comparables. However, as was discussed throughout the day, care must be taken to avoid the so-called “Lake Woebegone” effect, in which many firms attempt to have an “above average” compensation policy.¹⁰ Other inputs may also be of use to compensation committees. For example, there was an overall sense that industry guidelines on appropriate levels of dilution would provide a signal to management and boards as to the appropriate levels of option use without foreclosing the possibility of exceeding a guideline when the board judges it to be appropriate and can explain why.

In his observations regarding the development of prescriptive compensation policies, Mr. Yeutter

suggested that care must be taken to ensure that boards are not hamstrung by excessive oversight. He also suggested, however, that concerned shareholders can seek to address compensation practices. Shareholders can discuss compensation practice and philosophy with boards, critiquing performance (including the performance of the compensation committee) and the pay-to-performance relationship, and communicating with directors and managers. Moreover, shareholders can withhold votes for directors where circumstances warrant a strong signal.

▶▶▶ **SUMMARY AND CONCLUDING REMARKS**

The Forum provided the opportunity for an exchange of views on compensation-related issues. Clearly, stock- and option-based compensation can be powerful motivators. However, at least two features of the compensation environment lead one to question the overall efficacy of option-based compensation. First, the Forum discussion highlighted an apparent disconnect between pay and performance, a disconnect that is exacerbated in the context of option repricing. Second, there is evidence suggesting that employees undervalue options relative to the potential cost to shareholders. This is not a condemnation of all option-based compensation. Rather, it is a prelude to the idea that a judicious and informed approach is needed in the design and implementation of compensation programs.

Two observations suggest that financial accounting considerations may unduly influence compensation policy: first, the continued use of standard at-the-money options relative to potentially superior alternatives such as performance-based options; and second, the gaming of the accounting system, particularly in the case of synthetic six-month-plus-one-day repricings. The proclivity of companies to adopt compensation policies to avoid a charge to earnings is somewhat disturbing. Indeed, it leads one to question whether a myopic focus on measured earnings and earnings per share distorts economic decisions and results in the adoption of suboptimal compensation programs.

A related concern is that if standard options are viewed as “free” from an accounting perspective, it may well lead to their overuse. Moreover, if firms compete for talent on the basis of “free” stock options, it may inflate

the potential costs to shareholders. An understanding of the costs, benefits, advantages, and disadvantages of standard at-the-money options relative to alternatives is essential. In addition, an understanding of the incentive effects of option-based compensation and the actions that employees can take to undo or limit those incentive effects is critical. It is particularly important that boards of directors and compensation committees understand these issues. This is especially true in the context of governing the pay setting process for senior executives.

The Forum itself produced a general consensus that there is an ongoing need to address compensation issues. Several important themes emerged throughout the course of the day, and comments at the Forum appeared to reflect the beginnings of a broad, if somewhat general, consensus on a number of issues:

- 1) Legitimate shareholder concerns exist regarding the potential costs of option-based compensation; option plans should be submitted to shareholders for approval.
- 2) In an increasingly knowledge-based economy, employees will continue to demand a “piece of the action.”
- 3) Conventional measures of dilution may not be the best way to determine the “cost” of stock options; however, such measures may be useful in identifying companies at which compensation practices may be worthy of increased scrutiny.
- 4) The repricing of employee stock options has focused attention on some of the more controversial aspects of option-based compensation.
- 5) Common guidelines and general education regarding the use and operation of stock options would serve the interests of all parties involved.
- 6) The development of “best practices” from accounting, board, investor, and company perspectives is essential.
- 7) Compensation policies are not a matter of “one size fits all,” but there are common problems with many current compensation practices.
- 8) Board and committee governance is critical.
- 9) Leveling the accounting “playing field” so that alternate forms of performance-based compensation are

not disadvantaged relative to standard at-the-money options is desirable.

- 10) There may be a role for a task force of qualified representatives to focus on the elements of compensation policy and the pay-setting process.

While certainly not the last word on the issues discussed, these observations, and the insights of the Forum participants, may provide a basis for progress toward the development and implementation of compensation practices that can benefit employees and shareholders alike.

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ENDNOTES

- ¹ See Table 2 in Perry and Zenner (2000).
- ² Hall and Murphy (2000).
- ³ See Gillan (2001).
- ⁴ Gillan (2001).
- ⁵ Although reload options were not debated at the Forum, Mr. Cook has subsequently argued that while reload options allow executives to “dampen” their losses relative to standard optionholders who did not exercise, the reload mechanism does encourage stock ownership.
- ⁶ Although the discussion at the Forum regarding share repurchases actually took place during the morning session, it is incorporated here for ease of exposition.
- ⁷ See “Options Overdose,” *Wall Street Journal*, page C1, June 3, 2001.
- ⁸ It could also be argued that individuals receiving option-based compensation have chosen to accept a risky compensation package.
- ⁹ See Bethel and Gillan (2001).
- ¹⁰ A number of observers noted that a significant proportion of companies target pay levels above the 50th percentile, and few target below that level. The effect over time is to cause pay levels to “ratchet” upward. See Bizjak, Lemmon, and Naveen (2001).

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