FIRESIDE CHAT: EXECUTIVE COMPENSATION
TUESDAY APRIL 19, 2005

THERESA GABALDON: Good afternoon. I'm Theresa Gabaldon, Professor of Law and Carville Dickinson Benson Research Professor of Law, at The George Washington University Law School, as well as this year's host of the Fireside Chats of the Securities and Exchange Commission Historical Society. The Securities and Exchange Commission Historical Society is a non-profit organization, separate from and independent of the SEC. The Society preserves and shares the history and historic records of the SEC and of the securities industry through its virtual museum and archive at www.sechistorical.org. Today's chat will be preserved in the museum so you can listen to the discussion or read the transcript later.

Today's Fireside Chat looks at executive compensation. Our panelists today are Lawrence E. Mitchell, Professor of Law, and John Theodore Fey Research Professor of Law at The George Washington University Law School, and Kerry D. Moynihan, Managing Partner of the McLean, Virginia office of Christian & Timbers, one of the nation's largest executive search firms. The 2005 Fireside Chat series is made possible in part through the support of Pfizer, Inc. The remarks made today are solely those of the speakers and are not representative of the Society. Our speakers cannot give investment or legal advice.

As we begin, I would like to thank our museum visitors, some of whom have sent in questions which I'll include in this chat, starting with our first question which was sent in by Nell Minow, editor of The Corporate Library with an eye toward setting the tone of the discussion. "Viacom's proxy statement revealed this week that an officer who was based in Los Angeles but owns a home in New York received an additional $105,000 in 2004 as reimbursement for staying in his home, rather than a hotel when in New York on business. What's wrong with this picture?"

Kerry, rather than specifically responding, perhaps you could start us off by describing in general terms the prevailing different types of executive compensation.

KERRY D. MOYNIHAN: Thank you. I feel like I'm here in part as the representative of rapacious and mercenary self-interest, and Larry is here as the representative of the aggrieved widows and orphans. That isn't quite the case.

LAWRENCE E. MITCHELL: That's about right.

KERRY D. MOYNIHAN: But you know, base and bonus, cash still goes a long way. Certainly we've seen an increasing trend towards performance-based bonuses over time. The historic long-term incentive compensation has largely been stock options, but we're going to see some changes around that, given the new deduction requirements from companies' income statements as accounting for the cost of options. I think over time we're going to see more restricted stock grants. A lot of big companies are moving toward that. Microsoft is a good example where they've moved away from the options, where they historically had an option culture and have moved to restricted stock grants, and then there's a whole cornucopia of executive perks and compensation. You've seen a lot of the supplemental executive retirement programs after that legislation in the '70's where as is so often the case, Congress' legislation had unintended consequences: separating into two tiers workers' and executives' retirement plans and there's certainly been a lot of controversy around some of the retirement benefits here of late. You're going to see more performance-based options and more longer-tailed options over time as well.

THERESA GABALDON: We've had a related question from another listener, J. Allyn, who wrote in to ask: "Is anyone keeping good comparative statistics on executive compensation in the US versus the EU and the rest of the world? It's not just a question of hard currency, of course, but the manner of compensation – pensions, stock options, company perks, etc."

KERRY D. MOYNIHAN: I don't know how comprehensive the data is, but at least as of a couple of years ago, much cited has the disparity of the multiplier on CEO compensation in the

US versus the average workers pay, and we were just talking about this a moment ago, it's somewhere between 475 times and 900 times in the United States the CEO makes as much as the average worker. In Japan and Germany, that average is more like 11 or 12 times. In France, it's about 15 times. So, historically across the other countries, you have much lower executive pay as a general rule in cash; probably, the biggest difference is that historically there has been much less of an equity-based business culture in those places. So you'll find senior executives at Japanese and German corporations who don't have any equity in the company and the UK is closer to our system, but not quite the same. With the Europeans typically, you're going to have a lot more executive perks. Not to pick on the Germans, but if you work for a German company and you don't get a 7-Class BMW they look and ask what's wrong. I think we're less likely in the United States to do that, and more likely to give people direct compensation than country clubs and all kinds of perks that are borne by the corporation. More cash here and give the executives the right to decide what to do with it.

THERESA GABALDON: You started us down the road by mentioning the multipliers there, but I was wondering if either or both of you might have some additional way of quantifying or generally characterizing the prevailing amounts of executive compensation.

LAWRENCE E. MITCHELL: I guess this was the softball for me, and I suppose the way I would characterize it is as vaguely obscene. The median direct total CEO compensation in 2004 according to last week's *Wall Street Journal* Mercer study was $5.6 million. Now I know Kerry, or I suspect Kerry will later talk about issues and how one quantifies a CEO's worth relative to performance and the like, but it seems to me that there is some abstract number, and I'm not sure it's 5.9 million or whatever it is, there's some abstract number that on its own is just wrong. And certainly compared to my compensation that number qualifies, while a CEO and a really talented CEO is I'm sure a hard thing to find and a very valuable asset to a company, it's not like they're needles in haystacks. It seems to me that relative to what they do which is to say manage other people's money in the course of running a business producing goods and services, and relative to the quality of life they generally have as CEO's, even though, yes, they work really hard, there's a level of compensation that's inconsistent with a decent notion of corporate capitalism.

THERESA GABALDON: I'm going to give Kerry equal time on this in a minute, but I'd like you to expand a little bit, Larry, on what you see as being the danger of excessive executive compensation. You're saying it's too much. Why?

LAWRENCE E. MITCHELL: Well, I suppose there are a number of dangers. The one that comes to mind first, and I think this is a phenomenon that really flourished in the late 1990's, was the developing sense of entitlement that this kind of compensation can create in the minds of an executive. You opened with Nell Minow's rhetorical question – what's wrong with this picture? Well, yes, everything, but the notion that an executive would think that there's any justification for being paid to stay in their own home does reflect to me a sense of entitlement that's inappropriate mindset for somebody who is charged with the kind of responsibility that a chief executive officer is charged with. So in the late '90's, you know the Jack Welch story and the embarrassment at some of the perks that he got. There's a level of unreachability, a level of almost absolute rightness to these people in their entitlement, in their judgment in managing the company that I think is enhanced, if not caused by at least in part this level of compensation. There are other dangers as well. One, it seems to me the legitimacy of managerial capitalism has to be based on some notion of reasonable compensation. When the median income in the United States for a family of four hovers around $42,000 a year and I look at numbers as I look at from the CEO compensation survey and just reading directly down - 3.6 million, 28.9 million, 13.8 million, 1.2 million, 1.7 million, 3.1 million, 4.1 million, 11.5 million - there is a danger that those kinds of numbers destabilize the legitimacy of the system in popular view, and it's a danger I think Kerry should well be concerned with.

THERESA GABALDON: Equal time?

KERRY D. MOYNIHAN: Just to be clear, in our executive search business, we're not the ones who are setting compensation. We are the finger on Adam Smith's invisible hand. We reflect the marketplace; we're not setting the marketplace. I think Larry is getting at issues that are beyond the purview of this forum, issues of social engineering and what is the right level of equality. Cleary there's a danger of excessive compensation when it's not performance-related and to me that's the nub of the issue. Pay has to be related strictly to performance and it has to be related to higher standards of performance and also standards of performance that are over a longer period of time. I think the danger to our American capitalist system is the quarter by quarter thinking and people thinking the entitlement, as you say, of those stock options are mine and it's part of my regular income. No, they're supposed to be granted because you've taken a long-term view and are building for the long-term health of the business and of course for the shareholders. Those, you know, family of four have every opportunity, every right to be shareholders and I don't have a problem with Jack Welch getting rich if he makes all his shareholders rich. I do have a problem and we're probably in violent agreement on this, Larry, with a Henry Silverman whose company has gone down in value by 2% a year compounded 5 years and took home $18 million in cash before he exercised his options last year. Somehow the linkage between pay and performance is broken there and has been severed and that's really the issue because executive pay can't be seen as kind of a social lottery, where you got to the top and therefore you're entitled to ridiculous wealth. It really has to be are you performing for the people, are you acting as guardian of their money. Maybe it's a false analogy, but I'm always struck by what does a second-rate shortstop in the major league make today, versus directing a global enterprise where you are responsible for the well-being of thousands of workers and their families, I would argue that the latter has perhaps a little more societal benefit.

LAWRENCE E. MITCHELL: I wouldn't disagree.

THERESA GABALDON: Larry, do you think that companies are getting what they pay for, or as conveyed in the title of a new book by two Harvard Law School professors *Is There Pay Without Performance?*

LAWRENCE E. MITCHELL: Well again, I think the recent statistics show that they may very well be the case. Last year again, 350 major corporations surveyed, the median shareholder return was 7.4% and the total direct, increase in total direct CEO compensation over 2003 was 40.9%. That strikes me as being somewhat disproportional to performance. Now I realize these are median numbers. These are not specific companies, but overall, and there may be some companies that overbalance some of the others, but overall that does seem to be hard to justify relationship to performance there. I know, Kerry, we don't want to get into social engineering, but it's hard to justify when the average white collar salary is going up 3.4%. Surely the CEO has a great deal of value, but somebody's got to do the day-to-day work, and the relationship between performance and pay there is actually inverse in the opposite direction the CEO pay is. So I think that it's reasonable to say that at least in gross terms, companies are not getting what they pay for.

KERRY D. MOYNIHAN: I think that you're probably right. Certainly I'll leave it to Ms. Minow to point out the horrors of some of these things. You also can look at some of these who've looked at the data and say there are many examples, probably not as many as there should be, but many examples of executives who have, and I only did the ones where they were tripling the average compounded returns of their competitor group, and where if I'm beating the averages for a group. Take the industrial sector and there's David Hoover at Ball Corp, where the average shareholder return has been 36.4%. It's been precisely 4 times the average of the group. He's underpaid. He's doing a terrific job. Whatever he's doing, he's doing a terrific job for his shareholders.

LAWRENCE E. MITCHELL: I just want to say, Kerry, I don't think anybody who gets total direct compensation of $13.5 million can be considered underpaid.

KERRY D. MOYNIHAN: If you look at the wealth creation to the shareholders over that period of time, I would argue that's a pretty small percentage of the overall increase. I think we do agree there has to be more linkage of pay to performance and I think companies should increasingly have options that are tied to beating your cost of capital, weighted average cost of capital, to beating the S&P, or even more specifically to beating a group of your direct competitors. Take Telecom a couple of years ago. You didn't have to be a genius to have a Telecom stock in 1999 that was up hugely and people cashed in enormously. I would argue that a more appropriate measure would be take your competitor group, at that time AT&T, SBC, Nextel, etc. and say are we beating the competitive group, not just did we rise with the tide, for the rising tide lifts all the boats. Are we beating our competitive group? And those would be more appropriate measures as well as having longer tail options so the executives do take more of a long-term, strategic vision on the business.

THERESA GABALDON: You're making an argument clearly justifying some fairly substantial amounts. Do you think that paying what some of us would characterize as whopping payments is really necessary to recruit the best and brightest for the jobs? Would they simply refuse to work if they were paid a measly $2 million a year?

KERRY D. MOYNIHAN: Well, it certainly depends. If you're giving somebody a step-up opportunity where they haven't sat in the seat, let's call it for the sake of this discussion a Fortune 500 CEO where they haven't done that before, you probably could get away with paying $2 million. Gee, it's my chance to get ahead. If however, you were trying to recruit somebody who has already punched that card, has already been successful as the chief executive of a large company, the question isn't, does the company's compensation committee just want to shower them with riches, it's that they have to attract them from gainful employment elsewhere. Take the example, much publicized recently, of the Disney Company, which theoretically conducted a search for an outside CEO. I'm not sure that we'd characterize it as such, as fully so, but Meg Whitman's name of eBay was bruited about. Now you could argue whether you want to take the job at Disney to begin with. The tenure of CEO's tends to be pretty short. If you don't perform, you're out, sort of like NFL running backs. You have shorter tenure than you used to. But a Meg Whitman, who has had a terrific run, has enormous vested interest in staying where she is and companies construct these golden handcuffs and long-term pay packages so she could be walking away from literally hundreds of millions of dollars and to attract her, to take that one example to Walt Disney, you've got to make good on that somehow.

THERESA GABALDON: This is very much related to a question submitted by Stephen Bachelder. "Starting off, how do you value a CEO if the best person for a vacancy has increased the stock price at her current company by 12% in each of the last 5 years and is making $6 million per year in cash, $15 million per year pursuant to her annual option grants and has a handsome severance package? Is there any question about whether you should meet that price?" Larry? And then Kerry.

LAWRENCE E. MITCHELL: Well one question I would ask is how they increased the stock price. Kerry was talking about Telecom in the late '90's before, and in that comparison group with AT&T of course was WorldCom. There was a fascinating article shortly after the WorldCom scandals broke. I think it was in the Sunday *Times* that heads had been rolling at AT&T for some time because they weren't meeting the same kind of targets that WorldCom was meeting, but WorldCom was doing it with fraud. So if the way you get your stock price up is fraud, then clearly not. But there's a lot between fraud and good, honest long-term growing of a business. There's lots of ways to manipulate earnings at least in the short-term and now that CEO terms are increasingly short especially for non-performance, you might as well make your money in the short-term and get out because there'll always be another job for you or so it appears, but there are lots of different ways of managing your stock price. Laying off workers is a method of manipulating stock price. Playing with accounting rules, even within the bounds of the law, are ways of playing with stock price, and running a short-term shop. Short-term doesn't have to be quarter-by-quarter though I completely agree with Kerry that that phenomenon has been a real problem, but running a short-term shop over a year, two years, five years and letting the next guy worry about the consequences while you take home huge amounts of money because you've gotten the stock price up by certain targeted amounts is a potentially dangerous game. I'm not suggesting it's always a dangerous game. I'm not suggesting that manipulation per se is something that's commonly engaged in, but asking whether the compensation is deserved because the stock price has met targets without asking how they got there seems to me to be a real question. If I were sitting on a Board of Directors or compensation committee, I'd want to know what a long-term horizon for the company looked like a couple of years into a CEO's tenure.

THERESA GABALDON: Kerry?

KERRY D. MOYNIHAN: Well, there are a couple of things that I can't let lie. I think historically, it was the part of the mission of senior management to manage earnings, to make them consistent, to grow them, so we can leave that aside, I suppose for the moment. But I think that you have to ask the question: what yardstick do you substitute if compensation committees and people on boards are not to pay attention to the stock price? Should they rely on ratings of societal good? Should they rely on the ISS scorecards? I think at some point you have to agree that capitalism is a game. It is not a zero sum game, however, I would argue as some seem to think, but it is a game and you need numbers to keep score.

LAWRENCE E. MITCHELL: Have I been provoked? I don't disagree with you, Kerry. Of course you need numbers to keep score, and there's no question that stock price is a number, although one has to have a great deal of faith in the efficiency of the market to believe that that's a direct translation into the success with which the business is being managed. I would argue that the market is an extraordinarily short-term gauge of success and in fact if you look at changes in stock turnover rates over the past decade and a half, that would suggest that that's probably true. What other metrics would you use? Well, that's a good question. I confess to being a good critic and perhaps less of a good engineer, but it seems clear to me that there has to be some way of gauging the long-term impact of a CEO's performance year to year that's more effective than simply looking at stock prices. You could triangulate with earnings, cash flow, whatever, and you could balance the compensation package that really defers a substantial portion of it. There are ways that you could do this that wouldn't rely on quarterly or even annual stock price. One of Warren Buffet's greatest aphorisms in my view is nothing important happens in a quarter. Nothing important even happens in a year if you're talking about managing a business unless obviously there are catastrophic things that can happen, but surely in terms of the long-term health of the corporation, it's rare that events of a quarter or a year make a huge difference.

KERRY D. MOYNIHAN: Well, I don't know about that, but I don't disagree with you that there are other measures. I remember several years ago going back to the Telecom boom, there was a company much ballyhooed and it was called Teligent. The CEO, recruited from AT&T with a $20 million sign-on bonus, was the poster child for excessive compensation at the time. I would characterize the business as the Marx brothers model. Chico Marx describes it in the movies: we buy at retail, we sell it at wholesale. We make the difference up in volume." That was sort of what they were doing and so the stock price was fabulous. They had a market cap of $6 billion and they had no earnings. And they weren't meeting the cost of capital and at the time I remember thinking, gee, if I were on the comp committee, I'd make sure we put in return on invested capital and that we actually have earnings. At the end of the day, when you pay for a share of a public company, you are buying a share of their future earnings. And I remember thinking also, they have a market cap at $6 billion and I believe in capitalism, there must be something about this I don't get. I must be dumb. It must be me. The market is always right. Well the market wasn't right and did correct, despite the short-term emphasis and even the institutional investors are now much more short-term than they used to be.

LAWRENCE E. MITCHELL: I agree.

KERRY D. MOYNIHAN: But it corrects over time. It's just a question of what is the time frame. And that company is no longer in business, by the way. It's a question in part of what is the time frame you're looking at. I think we're coming by different routes potentially to the same destination, which is you have to look at the long-term health of the business and you cannot short circuit these things. You have to beat your weighted average cost of capital. You have to have earnings. You have to have a sustainable value proposition that isn't just gamesmanship in managing the expectations of Wall Street's analysts. There has to be a there, there.

THERESA GABALDON: Thus far, we've been talking almost exclusively about CEOs and the particular amounts that they make and how you can justify paying a particular amount to a particular person. Larry, how important do you feel a strong CEO really is? Can one person really make a difference?

LAWRENCE E. MITCHELL: Well, this is a question which I think Kerry and I would respond similarly, and the answer is yes. I think that anything one reads about leadership, anything one sees about leadership, lets you understand that the quality of leadership makes a big difference in an organization, even for some of the things that I may care about in my social engineering phase. A leader who's got integrity, a leader who has a long-term vision, a leader who believes a corporation should be run ethically and should satisfy its consumers properly and the like, and conveys those values through the corporation can and does make a significant difference. Conversely, in corporations where the atmosphere is more laissez-faire or even worse at the top, one does see a greater incidence of misbehavior and internal corruption that is not healthy for the shareholders, never mind anybody else. So the symbolism of the CEO's values and the CEO's management I think is extremely important. I think the CEO's competence really matters a lot too. People can tell, workers can tell, if you're working for somebody who's competent or somebody who's not and that gives you some strong feeling about your own performance and the way the company values real talent as well.

KERRY D. MOYNIHAN: I think we certainly agree and the tone does come from the top, not just the CEO, you find that with boards as well. The tone has to come from the top. The Sicilians have a saying that a fish rots from the head, and so that holds true for the bad companies, the bad people at the top it tends to go bad all the way down. Likewise, if the tone is good, when there's real overt leadership and clear communication, then the people who are out in the trenches working have the faith that is often not even strategy. It's often just force of personality in many businesses. We've seen it. You think about what's happened in business, so many businesses. The commoditization of capital, the access, ready access to the capital markets, the ubiquity of information that we have with the Internet – a lot of the things that were traditionally competitive advantages for companies have disappeared or have been equalized. I think we fall if you look at studies that McKinsey and Company did last fall, for example. They did a piece a couple of years ago on human capital and it comes down to people. I mean we all know that intrinsically, but there's a lot of data now that says it really is about the people. It's about the quality of the people. It's about attracting and retaining the best people so that you're out on that skinny end of the bell curve where you want the 99% people. You're going to get 99% performance if you have the 99th percentile people.

THERESA GABALDON: Kerry, do these issues arise for officers other than CEO's? The lists that are printed in the newspapers, those are CEO's.

KERRY D. MOYNIHAN: They tend not to get quite as much publicity and scrutiny. You don't see as much of a spotlight on the other senior members of the leadership team, but certainly with SEC disclosure requirements, the top executives, their pay is disclosed. It's just that the spotlight has largely fallen on the CEO's and I think the gap is not as great at the senior functional levels if I'm a divisional president running a sizable business, or I'm a senior functional officer like a Chief Financial Officer or a Chief Information Officer, but certainly executive pay and particularly with the prevalence of our American capitalist style equity culture has dramatically risen.

THERESA GABALDON: Nell Minow wrote in with what I think is the perfect follow-up question to that. "Currently SEC rules require disclosure of the pay of the top five officers of the company, but not the five highest paid executives, so investors have no way of knowing what division heads, traders, etc. who often make more than the officers are actually being paid. Is that legitimate, or is the undisclosed information material?" Kerry?

KERRY D. MOYNIHAN: Well it certainly can be material. The classic examples of this would be Wall Street firms, not to pick on them, but Wall Street firms where, or banks, where the guy heading the government bond trading desk can be making a multiple of what the CEO is making. Typically they're paid more on a cash basis. You could certainly make the case that it is material if you're paying people $20 and $30 million a year and that it requires disclosure and that maybe a better rule would be an amalgam of the two, i.e. the five highest ranking officers, but also add the five highest paid people. It would be interesting to see how those two columns link up or not.

THERESA GABALDON: And as another follow-up, Larry, how would you respond to those who say that in absolute numbers, executive compensation is never material and shouldn't have to be disclosed at all? As the flipside, are there aspects of executive compensation that really should be disclosed or disclosed more clearly?

LAWRENCE E. MITCHELL: Well, if you use an absolute numerical metric that to me is a very narrow understanding of the concept of materiality, certainly a legal standard is what a reasonable investor considered important. It would seem to me that anybody who invests money in a corporation would like to know what they're paying their top people, so the idea that compensation is never material is just nonsense. Compensation is always material. While for the most part, technically, legally not direct agents of the shareholders, the CEO is in some sense an agent for the corporation and the shareholders, certainly for the corporation and then indirectly for the shareholders, and you always want to know what you're paying your agents. I don't even understand the idea that it wouldn't be material.

KERRY D. MOYNIHAN: I'm not sure I follow the logic on that either. I certainly want to know as a shareholder. It certainly is material. Perhaps the philosophical construct behind that is back to the earlier point that people always make the difference and if you have leadership that is going to increase the value of the enterprise significantly, whatever you pay them is worth that, that is highly debatable nonetheless.

THERESA GABALDON: Looking at perhaps another way in which disclosure might be material, Kerry, do you think that disclosure requirements do shape or in any way effect the actual board decisions about how much to pay particular people?

KERRY D. MOYNIHAN: I think they probably do. On the one hand, to use the example raised by Mr. Bachelder's question, the market is what the market is. If you say we want to attract a star proven leader who's done a great job of increasing shareholder wealth before, we're going to have to pay what the market will bear. On the other hand, I think the general rule, all the more so today given the scrutiny and scandals of the last several years, the general rule that's probably a good one and many people have repeated it, is you want to always make decisions that you would be comfortable having people read on the front page of the *New York Times* or the *Wall Street Journal* and I don't think directors are immune from that.

THERESA GABALDON: My mother told me that once.

KERRY D. MOYNIHAN: It's not a bad rule to live by.

THERESA GABALDON: Again from Nell Minow, Kerry and Larry both, do you think changes in anything other than SEC disclosure requirements can either enable or embarrass the compensation committee into doing a better job? Larry?

LAWRENCE E. MITCHELL: Well, since Nell's leading question about that $105,000 or whatever it was for living in your own house reflects a distinct lack of shame, I think, look, disclosure, while it may be imperfect, is the basis for the way we regulate our businesses, and what could do better than disclosure. Well the whole idea of disclosure is exactly as Kerry put it, not only do you not want it on the front page of the *New York Times*, you don't want an SEC filing either, if it's something that you can't really feel comfortable about or feel is defensible. The problem isn't so much disclosure it seems to me, but again a more societal trend that, and I think it's not just, it's got to be much broader than CEO compensation but it certainly plays a role here and frankly I think the business press is partly responsible for this too, it's a lack of shame. In order for disclosure to work, in order to follow the rule that you've got to feel comfortable on the front page of the *Times*, you have to be capable of being uncomfortable and I think that increasingly, and maybe the trend's reversed a bit, but certainly in the late '90's and through the beginning of this century, it seemed to me that it was increasingly hard to make, the level of discomfort was attained at a much higher level of excess than was necessarily appropriate.

KERRY D. MOYNIHAN: I think that maybe my experience is unusual, but in the boards that I've worked with, I have almost universally found that the directors, rather than being the willing stooges of the CEO, compliant and supple, are pretty active advocates and genuinely so for the shareholders interests. I've seen change in the boardroom and, not withstanding the whole discussion today, I think over the next several years, you're going to see much more linkage of pay for performance because the boardrooms of America's large corporations are changing. They're skewing younger. They're skewing toward people with fewer board seats, and they're skewing toward people who are much more activist and involved, so you're seeing more people who serve as corporate directors who are on two or three boards, not six or seven and it's hard to pay attention when you've got seven big companies that are pretty complex in operation. If you've got two or three, you can pay more attention. I'll share an anecdote. There was a company we did some work for, helped them recruit directors and they had a bit of a flap over the CEO's compensation. He had actually done a good job of building the long-term shareholder value, but the company had a couple hundred million dollar operating loss and he rather inopportunely choose to exercise many millions of shareholder options in a year in which they had this huge loss. I was with another fellow who knew some of the board members who had been investors in this, and he said, "Boy, I can't, I just don't get it. They were always tough SOB's when it came to my compensation, so I think they must have changed!" I don't think they changed. I think that it's just that the directors I think are by and large really much more activist and much more eagle-eyed toward getting value for the dollars. Again because there's more of a distance from other relationships to CEO's and boards are acting and being formulated in a much more independent fashion.

THERESA GABALDON: Let's turn briefly to the question of pay for the directors themselves. We have a question from J. Allyn. "There's been a lot written about tying executive compensation to productivity levels or share price, some peg of corporate performance. What about Board of Directors compensation? Has anyone put out a good idea on tying directors pay to performance, or tying that pay to some other measure of corporate health, such as management stability, measured by how long top executive stay with the company?"

KERRY D. MOYNIHAN: Certainly, director pay is undergoing an equalization and I think it's going up, and probably appropriately so. I think the general rule is you want to pay the directors enough so that they're paying attention, but not so much that they feel beholden to you or are going to make a significant lifestyle change for them as a result of the cash you're giving them. You had a range not too long ago of directors of companies being paid roughly $125,000. Sort of the poster boy for bad boy behavior, the Health South, was a $4 billion nominally revenue corporation, and they were paying their directors $14,000 a year. Now that is not going to happen any longer and you're seeing more pay that is in line with people's duties. So many more companies now are giving extra compensation, usually nominal, $10,000 or something like that if you're chairing the audit committee, or you're taking on significant roles. Some firms, particularly early stage in technology firms, have often paid their directors strictly in stock options, and tied those option plans similar to the executive option plans. Theoretically, that will encourage directors again to take a long-term view. I don't think we've seen yet a significant trend of having directors pay linked quite as closely to earnings targets and so on. As you do executive pay, because again, you have to think of the dual roles here. Directors you want, the old saying is: noses in, fingers out. You don't want them managing the company and if their pay is tied to hitting this quarters earnings targets, I think you're creating some mis-incentives, misaligning incentives pretty significantly.

LAWRENCE E. MITCHELL: My response is more in the form of a question for Kerry, and it's something I really don't know the answer to and that is when the practice of compensating directors with anything resembling real money because certainly the figures we're talking about in CEO compensation, knowing where directors come from, it's not real money in terms of their lives, but when the practice of compensating directors in any serious way developed, it was historically the case and through most of the last century as I understand that directors served pretty much without compensation, that the role of director was itself its own reward. It was a distinguished thing to do, not just to sit in, although obviously there is some, more than a few historical examples of do-nothing directors, but it was a trust and it was a responsibility and if you assumed that you did the job not because you were getting paid enough as you put it to pay attention, but you paid attention because you assumed the role itself and some sense of public trust. I don't mean to sound old-fashioned about it, but that was the reality and I was asleep at the switch because all of a sudden at some point, directors started making real money. When did that happen?

KERRY D. MOYNIHAN: The idea that you're talking about, sort of, it's not a bad one. There is something to noblesse oblige, from whom much is given, much is expected, and I think that's appropriate. It's akin to the way we used to think about public service in government. You had a responsibility to serve. We didn't have quite as many career politicians and people didn't spend millions of dollars to get elected to office, but that's another topic for another day. You know about the historical antecedents of that, but I think as companies have become much larger and much more complex in the post-war capitalist society, there has been more of a trend towards compensating people. Again, you'll look and even large companies that pay directors $35,000 a year, typically your directors have been senior executives of other companies who are earning many times a multiple of that, so I don't think it's inappropriate. It's not an inappropriate level of compensation as I said. You want enough so people take it seriously, but I don't think, very few directors take on those roles for reasons of money. We conducted studies, surveys, and money is about 8th on the list [of reasons to serve]. Most of it is that they feel some measure of community or intellectual excitement with what the core enterprise of the business is.

LAWRENCE E. MITCHELL: So with that, and I appreciate the answer very much, it strikes me that as it does, thinking about this question generally, that you start, you suggested, Kerry, that director compensation would be going up. You start down a road that's probably not a good one when you're compensating directors really at all in any way that resembles real money, anything that is enough to make them pay attention. It may be, and who knows the future, but when you start down that road of course you open the possibility that directors, like CEO's over time, will demand more and more compensation. Now maybe that turns out to be a good thing, maybe we wind up with a professional class of directors.

KERRY D. MOYNIHAN: Increasingly you are because of the time demands on a major company. You must meet more giving and selfless people than I do, Larry, because to suggest no compensation whatsoever, when I think the NACD, the National Association of Corporate Directors recently did a survey and they figured that for I think a Fortune 500 or Fortune 1000 company, an average director is going to spend 140 hours a year. That's a lot of time from doing whatever, your legal studies or playing with your grandchildren or sailing your boat or doing anything for goodness sake. It's a significant commitment and that time commitment is not going down. It's going up.

THERESA GABALDON: Speaking of boats, I'm going to change tack for just a minute and raise some issues related to stock options. Part of this is addressing in general terms just how important stock options are, but to shape the conversation, I'd like to read a question sent in by Michael T. McConnell. "In December 2004, the Financial Accounting Standards Board issued statement of Financial Accounting Standards #123. This statement will significantly change the way stock options and other forms of equity awards are accounted for in public company financial statements. In the past, no expense was recorded for most types of stock options. In the future, virtually all stock options, including those to employees and other equity awards will result in recording an expense. In your opinion, did the failure to recognize compensation cost for most employee share options in the past obscure important aspects of reported performance and impaired the transparency of financial statements? Will the accounting change be an improvement and what do you anticipate will be the long term effect on executive compensation?" Larry, first.

LAWRENCE E. MITCHELL: Well, not being a professor of accounting, I'm not going to give a very precise answer to this question, and I have to admit that I'm very agnostic on this point. It's not as if stock options aren't reported. It's not as if the market isn't aware of stock options granted. I've been puzzled by this whole debate I guess because it's really not clear to me that expensing stock options is a bad idea. It's not harmful by any means, but whether it's an issue that really had material consequences or not is something that I simply am not sure about.

KERRY D. MOYNIHAN: I think it's going to encourage companies to essentially keep two sets of books, one on the real operating results and one if they continue to grant significant options, one reflecting that. What FASB is suggesting is indeed a hit to earnings, so it has an impact, and major companies have certainly complied with this, GE, Microsoft, you can go down the list. I guess I'm with Larry to a certain extent and agnostic. I mean on the one hand, Warren Buffet says they are a cost of doing business, and who knows more about investment than the Sage of Omaha?   But on the other hand I think that it's a critical component to our American style capitalism that if you want people to think and act like owners, make them owners. They do think and act differently if they have an ownership stake in the business, and if we saw that with the LBO phenomenon of the 1980's where huge value is unlocked because management was empowered and they really changed their thinking. It was as if they were spending their own money, and people do act differently when they think they're spending their own money.

THERESA GABALDON: Speaking of owners and their own money, what elements of executive compensation should be subject to shareholder approval, if any? Larry?

LAWRENCE E. MITCHELL: I don't really think executive compensation should be subject to shareholder approval at the moment. Yes, Kerry, it's okay. I really said that.

KERRY D. MOYNIHAN: I'm picking myself up from the floor.

LAWRENCE E. MITCHELL: And I really hate to be this deferential, but there is an expertise that's involved in setting these things. I would say the concerns that I would have, notwithstanding my earlier remarks about some absolute number that's just too high is, I suppose if executive compensation or particularly CEO compensation or even executive compensation of a defined package of executives, exceed a certain percentage of the corporations earnings or net worth, you might have some serious reason for concern, and ask that stockholders approve that. So there might be some ceiling amount, a trigger that would allow shareholder approval, and that, I think, would be a way of ensuring that compensation didn't get unduly out of hand, and it would be appropriate to ask the shareholders to approve that. I don't want to go off the question too much, but Kerry's been talking about this equity culture that we have, and that too is an historical phenomenon, at least from a managerial perspective is a relatively recent development in American corporate capitalism. It wasn't always so, and if fact it wasn't so until the 1980's really or the late 1970's, so that this is a relatively new phenomenon, but following that idea that there is some equity culture, then one has to look at compensation as a percentage of equity or a percentage of earnings because the way you've translated this makes the CEO, makes the top executives in a way that they never have historically been, really as you think is a good thing and I have some real questions about, co-owners with the shareholders. So it stands to reason that, and they're getting their shares for work, not for money invested, it stands to reason that at some level, the shareholders have a right to approve that. I also have questions about things like retirement compensation and the like that might be subject to shareholder approval because I really do believe there's some expertise in this.

KERRY D. MOYNIHAN: Really, with your, if you had sort of an open discussion on executive compensation, you can imagine that a lot of people would be spending their time doing nothing but, and I think you have to rely on the analog that we have to our representative government and democracy. The shareholders do have a vote in electing the board. They don't necessarily decide who will be on the compensation committee of that board, but the compensation committee should be acting as the representatives of the shareholders just as our Congress acts as our representatives. Except in California, we don't vote on every issue of substance in this country, and I think you have to defer to people who have expertise in that respect.

THERESA GABALDON: That raises, perhaps, and this one's for Larry, an issue about the role of court review and appropriate deference to expertise. Do you think that there is an appropriate role for judicial oversight of executive compensation?

LAWRENCE E. MITCHELL: There certainly is. The condition on which, and it sounds like you threw me a lob on that one, but I really hadn't planned it, the condition under which I would say that expertise gets to be exercised is a condition because we're dealing with the situation where conflicts of interest can readily occur, where courts really do exercise some meaningful oversight over the boards' compensation decisions. As you well know, Theresa, the current state of the law, particularly in Delaware, is to exercise virtually no oversight at all. The general standard of review of board decisions on compensation is a standard of waste. The standard of waste used to have a reasonableness component to something resembling it, at least with respect to compensation. The standard of waste now has been gutted to virtual meaninglessness and so it is a dangerous situation when you rely on experts in a conflict situation with no other means of review. The courts have always been a coordinate system of our corporate governance, and it would seem to me that it would be appropriate to see a greater judicial attention paid, not necessarily to the substantive decisions, although I tend to be skeptical of when a court allows procedure to substitute for substance, but something more than bare procedure, something more than an absolute 'are you out of your freaking mind' test, which actually is probably too high to describe the standard of waste now.

KERRY D. MOYNIHAN: I guess I'm a strict Jeffersonian and subscribing to that tenet that government is best which governs least, and I don't think that you need to insert judicial review into this. The shareholders have the right, and your idea of compensation beyond a certain portion of earnings is actually a very good idea, but to get the courts involved to me sounds like more full employment for lawyers act, rather than improvement on the situation.

LAWRENCE E. MITCHELL: But, Kerry, we're talking about regulation. We're talking about a back check in the event that shareholders sue.

THERESA GABALDON: Well, I think it's time to wrap up now because we're just about out of time. I was hoping I'd be able to ask where you each thought this was all leading and whether we'd be having the same conversation in five years, but it looks as though our time is up. Thank you a very enlightening discussion of executive compensation. Just a reminder, today's chat is now archived in the Society's virtual museum and archive, so you can listen again to the discussion or read the transcript later on. Our next fireside chat will look at Regulation FD and real-time disclosure. Our panelists will be Professor Jeffrey Bauman of

Georgetown University Law Center, and Dixie L. Johnson, partner with Fried, Frank, Harris, Shriver and Jacobson, LLP in Washington, DC. Please join us on Tuesday, June 14th at 3 PM, Eastern Daylight Savings Time. Thank you for you joining us today.

KERRY D. MOYNIHAN: Thank you.

LAWRENCE E. MITCHELL: Thank you, Theresa.