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Executive Compensation – A New Framework for Rebuilding Trust in Business

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I appreciate being here and having the opportunity to share my thoughts with you on executive compensation. I am going to take some liberties with the topic and offer a framework for thinking about executive compensation that, I believe, can help us get back on the road of rebuilding trust in business. Rather than tackle the topic head-on, I am going to take more of an 'outside-in' approach because I believe we must revisit the context in which we consider executive compensation.

<u>Tragedy of the Commons</u>

Let me start with a couple of stories. First, I share with you a few sentences from Rachel Carson's 1962 book, '*The Silent Spring*'. In many ways, Carson's book launched the modern environmental movement that led to fundamental changes in how we are allowed to treat the earth. She began this way:

> *There was once a town in the heart of America where all life seemed to live in harmony with its surroundings. The town lay in the midst of a checkerboard of prosperous farms, with fields of grain and hillsides of orchards where, in spring, white clouds of bloom drifted above the green fields. In autumn, oak and maple and birch set up a blaze of color that flamed and flickered across a backdrop of pines. Then foxes barked in the hills and deer silently crossed the fields, half hidden in the mists of the fall mornings.*
>
> *Then a strange blight crept over the area and everything began to change…. There was a strange stillness. The birds, for example—where had they gone? Many people spoke of them, puzzled and disturbed. The feeding stations in the backyards were deserted. The few birds seen anywhere were moribund; they trembled violently and could not fly. It was a spring without voices… No witchcraft, no enemy action had silenced the rebirth of new life in this stricken world. The people had done it themselves.*

Second, let me turn to the 'Tragedy of the Commons'. The term refers to the overgrazing of common lands that took place in England in the late 18th and early 19th centuries. It works this way: for each additional sheep a shepherd added to his flock and allowed to graze on the common lands, the shepherd would gain the benefits, while the group, or community, shared the damage to the commons. If all shepherds made this individually rational economic decision, the commons would be depleted or even destroyed, to the detriment of all. In economic terms, therefore, the 'Tragedy of the Commons' is the depletion of a shared resource by individuals, acting independently and rationally according to each one's self-interest, despite their understanding that depleting the common resource is contrary to the group's long-term best interests.

Why do I share these stories?

Rachel Carson's story is a playing out of the 'Tragedy of the Commons' on an environmental stage. What followed her 'wake-up' call was legislation to establish new rules, and other initiatives to begin to change our behavior with regard to how we treat the environment. While many in business may bemoan the cost and inconvenience of environmental regulation, we can't deny that we live in a world of relatively cleaner air, cleaner water and higher standards for the use and disposal of toxic chemicals. If you think you prefer the alternative, just visit Beijing or Mexico City.

I submit to you now that in business today, we are facing a new version of the 'Tragedy of the Commons.' Business and particularly financial leaders today rank near the bottom of the public trust scale for the fact that we are seen to take a myopic view of the world through the lens of our self-interest alone; for the fact that business is seen to favor short-term profit maximization over long-term value creation and the broader interests of society; for the fact that the constructive voices of business leaders are largely absent from the necessary discussions as to how we address the problems of society – other than to protest when our self-interest appears threatened. Capitalism is a system based on trust, and today, we – the business leaders – have lost that trust.

The way society reacts should not surprise us. Following the collapse of Enron, Worldcom, and Arthur Andersen we saw the Sarbanes Oxley legislation. Following the banking meltdown of just a few years ago, we see the Dodd Frank legislation. The pattern should be clear: if business is going to continue to act in ways that society deems inappropriate, society will pass laws to 'contain' business that, in the end, will add cost and make it harder for business to contribute the good that business can contribute.

Now, I am sure there are some of you who will dismiss all of this as nonsense; but, many thoughtful people and highly regarded institutions are giving it renewed attention. In addition to The Conference Board, there is the work of The Aspen Institute Business and Society Program – the advisory board of which I chair; and The Brookings Institution, which is re-examining corporate purpose. The Business Roundtable, in its 2012 Principles of Corporate Governance, notes that '*Corporations are often said to have obligations to shareholders and other constituencies, including employees, the communities in which they do business and government, but these obligations are best viewed as part of the paramount duty to optimize long-term shareholder value. Business Roundtable believes that shareholder value is enhanced when a corporation engages effectively with its long-term shareholders, treats its employees well, serves its customers well, fosters good relationships with and appropriately oversees its major suppliers, maintains an effective compliance program and strong corporate governance practices, and has a reputation for civic responsibility.*' More recently, the Committee for Economic Development, of which I am a trustee, has announced it will undertake a new four-year initiative examining sustainable capitalism.

Why do we need the adjective 'sustainable?' The answer is because there is a growing recognition that the practice of capitalism in the United States today is not sustainable.

Here today, we are a group of business leaders – executives of companies, directors of public and private corporations, compensation experts and others with an interest and involvement in executive compensation. We must face the disturbing fact that we are part of the problem. And by 'we', I mean all of us. I am a CEO, have served on the boards of private and public companies, and have served on and chaired compensation committees. We must change and begin the process of rebuilding the trust on which our capitalist system relies.

Purpose

We need to start with basic principles: the purpose of the firm. I believe that the lack of attention to this topic is one of the fundamental reasons why business finds itself near the bottom of the 'trust' scale in society today. We don't agree. How we address a corporation's purpose, and define to whom it is responsible, has far-reaching implications. It is essential to the kind of political and economic system on which our society is based, and the values we choose to bind us together.

Today, corporate purpose is being held hostage by the myth of shareholder primacy. Society is debating between a *property*, or solely economic view of the corporation, and a *citizenship* view. The 'property' view holds that the purpose of the corporation is for its shareholders; the 'citizenship' view believes that the purpose of the corporation is for a number of players, or citizens, including shareholders, employees, customers and society at large.

We are having the wrong debate! The problem should not be framed as property (i.e., shareholder) v. citizenship (i.e., multiple constituents) because in the long-term, there is no conflict. A vibrant, healthy corporation that delivers sustainable value for its shareholders can only do so by paying attention to the needs of its employees, customers and other constituents. Further, we run a huge risk if we frame the citizenship theory as anti-shareholder. This construct will not serve anyone well and will distract us from the real issues we must address.

The real issue is time. In the long-term, the interests of all constituents align. It is in the short-term that they conflict. We must focus on the timeframe in which one measures success, the priorities driving near-term decision-making, and a more careful consideration of the rights of shareholders.

If, in the short-term, we choose and act solely on the property view, we are on a path to replay the 'Tragedy of the Commons' and we all will lose. Even more tragic, in the long run we will destroy our own motivations, beliefs and trust in each other and in our institutions. We sacrifice our societal 'soul' for the short-term, yet unsustainable gratification of the few. If we embrace the citizenship view, we can regain the path where business is a trusted and responsible member of society delivering for all its constituents, including its shareholders.

Why do companies exist? We must be careful not to fall into the false trap of believing that the legal requirement of a corporation is to maximize wealth, or profit, in the short-term for its shareholders. It was Milton Friedman – not corporate law – who wrote more than 40 years ago in an article entitled '*The Social Responsibility of Business is to Increase its Profits*' that the sole purpose of the corporation is to maximize profit for its shareholders.

Lynn Stout, Distinguished Professor of Corporate and Business Law at Cornell University has written that:

"United States corporate law does not, and never has, required directors of public corporations to maximize shareholder wealth. To the contrary, as long as boards do not use their powers to enrich themselves, the law gives them a wide range of discretion to run public corporations with other goals in mind, including growing the firm, creating quality products, protecting employees, and serving the public interest. Chasing shareholder value is a managerial choice – not a legal requirement."

The corporate charter is granted by society and provides, among other benefits, limited liability protection to the managers and owners of the corporation. The expectation is that in return for liability protection and other rights, the corporation will make a positive contribution to society. Edwin Gay, the founding Dean of the Harvard Business School, stated that the role of the company is to do well for itself by doing well for society… to do '*both well and good'*, and for business leaders to *'make a decent profit, decently'*.

The traditional view of management was that they were stewards of the corporation, with a career aim of improving the enterprise during their tenure, and then to leave it to their successors in better shape than when they began. This view has been replaced by the view that the goal of management is to maximize share price during their tenure, and to benefit accordingly. The goal of maximizing shareholder value in the short-term is inconsistent with the goal of building sustainable performance that will enhance company value over a longer term.

I want to be clear and avoid being misunderstood on one point: a corporation should make a profit. But, in so doing, the courts recognize and respect the business judgment of directors to balance a multiplicity of factors. Often-cited cases such as the 90-year-old *Dodge v. Ford*, and the more recent *eBay v. craigslist* actually don't make the point shareholder primacists want. This 'business judgment' standard allows for more balanced and reasoned considerations and actions. Practically speaking, in our litigious society today it may be your safest of safe harbors to act to maximize profit for shareholders, but it is not your legal obligation.

Pursuing a multi-stakeholder approach to running a business will, in fact, deliver the best returns to shareholders…. *over time.*

The timeframe over which positive results are to be delivered merits far more attention than it has received. The faceless 'market' demands results now or it will punish a company's stock price. At the same time, society wants to ensure that delivering results now for shareholders does not come at a far greater cost to society in the future, long after the investor beneficiaries have exited the stock. The lack of agreement on the appropriate timeframe over which to measure performance is a major cause of the 'disconnect' we face today around the role of business in society and is at the root of the problems, both real and perceived, that businesses face.

Time is also at the center of the debate over shareholder rights. If the desired role of business is to build sustainable long-term value, contribute to society by delivering quality products and services to its customers, motivate its employees, and provide a fair return to its shareholders, then why do the short-term activist shareholders – the ones that bought the stock yesterday and will sell it next week or next month -- have the same voting rights as the long-term investor who has a strong interest in sustaining the long-term health of the company? I will be the first to note that delivering the best results to shareholders over time means that it is not likely to deliver the <u>maximum</u> return to <u>current</u> shareholders <u>next</u> quarter. Frankly, I am surprised that we don't hear more of the voices of the index funds on this point… those investors who can't sell and churn in the short-term.

It may be helpful here to distinguish between the *purpose* of the firm and the *nature* of the firm. Those who think the purpose of the firm is to maximize shareholder value also typically think the nature of the firm is as an economic entity in which people are rational, economically self-interested actors. The purpose-driven, multi-stakeholder perspective that I embrace recognizes people as social actors, and views the firm as fundamentally a *social* institution as well as an *economic* institution. In these firms, the foundation of the firm is meaning, identity and trust, rather than simply economic self-interest. By creating a meaningful purpose, engaging employees, and attending in a reliable and responsible way to the relationships with all stakeholders, corporate leaders can unleash higher levels of personal energy and establish relationships of trust, which in turn can enable their enterprises to outperform other firms over time. As work becomes more knowledge-based, and as corporations build the capacity to collaborate across more complex boundaries, understanding the firm as a social institution becomes ever more important.

This point should be obvious to all by just looking at what the millennial generation values. These young people are the employees we need now and for the future. They have become disillusioned with the demands and values of traditional corporate America, which they regard as short-term, self-serving and in conflict with the broader interests of our national and global stewardship responsibilities. Partly as a result, we are seeing the emergence of a new segment of business committed to social entrepreneurship, and 'triple-bottom-line' values.

So, we must ask ourselves – with a huge dose of humility – what, in fact, is our goal? What does a productive, just society look like? What is 'good', and therefore, what constitutes a 'responsible' business?

If you pick up any newspaper, or check any current-event web-site, you can only conclude that we don't like what we have today. Switzerland has proposed curbs on executive pay, and the UK and European Union are discussing caps on bonuses. In the United States, we must face the reality of statistics that show that the top 1% received more than 100% of the economic gains of the last few years. What do these factors reflect about our society, today, and where are we trending?

We have a system that is out of synch. While there are many contributing factors to our current situation – excessive short-termism being just one – we must face the reality that many people believe that executive compensation is one of the root causes contributing to the public's loss of trust in business.   This fact shines a spotlight on the role of Boards of Directors.

<u>Boards of Directors</u>

I believe that the boards of directors of our public companies are a major part of the problem; at the same time, they can be the most significant point of leverage for changing what is wrong. Corporate boards of directors establish incentives to ensure performance and accountability at the level of individual corporations. To do so effectively, boards need to become more engaged in strategy, not just compliance, and must serve as more effective buffers and bridges between management and shareholders.

If business is to regain the trust of society, be given the benefit of the doubt and thereby have as open a playing field as possible, then it cannot just meet a legal standard but must act, and be seen to act, to meet a responsible, ethical, and more fundamentally, a moral standard. The underlying issue, therefore, is how companies make decisions, and how they reward performance. Are decisions made with the long-term interests of the company in mind, or are they made in a way that sub-optimizes the creation of long-term value due to short-term market pressures, demands of short-term stockholders, or desires of management to reach an unsustainable stock price in order to time their exit and cash out?

The role of the board is to ensure that a company's purpose, vision and core values are in place, and then to give the CEO and executive team the time and space to act responsibly. The board must understand and support the company strategy, confirm the metrics that will indicate both success and progress, and hold the CEO accountable for performance. The board also must help the CEO counter the short-term pressures of the market, and ensure that the company does not make decisions to accommodate the interests of short-term stockholders that are not in its long-term interest as a responsible contributor to society. The focus of companies must shift to the sustainable economic development expectations of long-term investors.   The fact that the average tenure of public company CEOs is as short as it is may be a reflection of poor CEOs, but it is certainly an indictment of boards of directors. To date, boards have become too compliance-oriented, are insufficiently grounded in company purpose, vision and strategy, and are too quick to buckle to short-term market pressures. In doing so, boards deny CEOs and executive teams the time and space necessary to run the company in a responsible fashion.

If our aim is to find a better balance among short-, medium- and long-term goals, and if we are committed to addressing more of the needs and expectations of multiple constituents, then boards of directors have an obligation to re-examine executive compensation from this perspective. I think we will find that the levels of executive compensation at many companies can no longer be justified by what shareholders might approve under the property theory of the corporation. Executive compensation is no longer a solely economic arrangement between an executive and the board but now takes on a moral dimension as we consider the broader needs and expectations of society.

Executive Compensation

In turning now to executive compensation, let me make three observations and then propose a number of specific initiatives.

First – it's ok for Board Compensation Committees, occasionally, to say no… In fact, it is time to say no. Not everyone can be paid as one of the top five quarterbacks in the league. If we keep looking to what others are being paid, we are on a run-away train with no end in sight. It is time for boards to have the courage to step up and say no. You may lose a CEO or two; but guess what – the next one may be better, or at least as good! Many of you are undoubtedly aware of the story that Jack Bogle, the founder of The Vanguard Group of investment funds, tells in his book, 'Enough.' He recounts the poem by Kurt Vonnegut where Vonnegut, in turn, recalls a conversation with his friend, the author Joseph Heller. Both men were guests at a lavish party thrown by a hedge fund manager. Vonnegut commented to Heller that the hedge fund manager made more money in one day than Heller's bestseller 'Catch-22' had made since it was published. 'Yes,' said Heller, 'but I have something he will never have…. Enough.' It is time for us to say 'enough.'

Second – Compensation advisors need to recognize that they are feeding the status quo and therefore, are part of the problem. They are protecting and perpetuating a system that is not working. Boards of directors rely on compensation experts, even though they are not the ultimate decision makers. These experts have a responsibility to change the conversation, and give boards the cover they may need.

Third, and most importantly – we all need to recognize that executive compensation is more than just an economic contract between a willing board and a company's executives. Under a citizenship view of the corporation – which I argue is the only view we can have of the corporation if we are committed to sustainable capitalism – there are other parties to the contract. There is, therefore, a moral dimension to the issue.

So where does this discussion take us? Against the backdrop I have provided, let me suggest four specific areas of focus for compensation experts, compensation committees and board of directors which I believe can put us back on the track to rebuild trust.

First, we must re-examine the purpose and focus of business. As long as business sees its primary mission as maximizing share price in the short-term, and acts accordingly, we simply will not rebuild trust in business as engines of prosperity for society at large. Purpose is important because it anchors a vision which, by definition, cannot be achieved in a quarter.

Second, we need even more transparency. We should start by disclosing how and why directors are chosen to serve on compensation committees. We should increase transparency in advance about potential payouts to executives under different scenarios. We need to take the first step to demystify the interplay and impact of the different components of executive compensation.

Third, we must examine the structure of incentive metrics. Let's revisit the basics: base compensation needs to be sufficient to attract necessary talent. Annual incentive compensation should reward employees for performance based on meeting annual operating goals. Long-term incentives should be tied to delivering sustainable value over time. Incentive compensation metrics must reflect the particulars of a company, its competitive situation and market environment, and therefore its strategy and goals. For one company, it might be to increase market share or top line growth; for another, it might be to improve margins, or increase cash flow. Annual and long-term incentives, therefore, must be tied to the financial and operational measures that best reflect management's success in executing the strategic objectives of the business. They should not pay out based on simply riding an industry or market wave that lifts all players, but should be tied to a company's relative performance against specific and relevant metrics.

And fourth, we must look, with sharpened pencils, at the issue of alignment. If we are truly seeking sustainable performance and value creation, we must stop tying payouts to short-term stock price movements. I believe some of the most effective steps we can take would be to require executives to hold stock beyond exercise or vesting periods, and beyond retirement – not just six months, but two or three years. We must eliminate the temptation of orchestrating and then cashing out at the time of a short-term stock price spike. If we want executive 'skin in the game', then let's require 'skin in the game' via minimum stock holdings based on real investment – not just sharing in upside gains. We should apply Bogle's 'Enough' rule, and not have uncapped incentive payouts because they tend to focus management on maximizing short-term performance at the potential expense of long-term value creation. Finally, we should revisit introducing cash payouts based on delivering sustainable long-term performance as an alternative to equity holdings. This change would open the door to broader employee participation in incentive plans, and broader focus on longer term goals.

In the end, we need stronger leadership. I am reminded of Al Pacino's speech from the 1999 film, 'Any Given Sunday', in which he says 'Life is a game of inches,… and the inches we need are everywhere around us.' We can say the same about leadership… the leadership we need is everywhere around us – in board rooms, in executive offices, in compensation experts' reports and advice. We are seeing it in some quarters. Take a look at the structure of the GE or FedEx compensation plans, and Pfizer, with its five and seven year shareholder return incentives; and take a look at how family-owned companies compensate. They tend to have a longer-term, multi-generational focus, but also must compete in today's market for professional management. Recently conducted research in Europe looked at over 2,400 companies listed on various European stock markets during the 2001-2010 period and concluded that family businesses dramatically outperformed their local stock market indices. I believe we can learn from this research.

Summary

We think of our challenges as business issues. In doing so, I think we miss a crucially important point that the rest of society gets: what we really are talking about, and what is at stake, is something as fundamental as the kind of society in which we want to live. Topics such as executive compensation are more than economic issues; they serve as windows into a discussion of what is just and fair for the society in which we want to live.

In 1962, Rachel Carson asked the question:

Have we fallen into a mesmerized state that makes us accept as inevitable that which is inferior or detrimental, as though having lost the will or the vision to demand that which is good?

150 years ago we went to war over a commitment to end slavery; in the last century we pushed for woman's suffrage and basic civil rights for all Americans; we fought wars to protect democracy and freedom around the world. Now, with the knowledge we have at the start of the 21st century, we once again need to recalibrate. We need to revisit such basic issues as wealth inequality, the collapse of our K-12 public education system, the hardening of strata in society that is leading to less economic opportunity and social mobility; and the degree to which we care and therefore will provide a soft landing – or not - for those who have less. Today, people across the United States and around the world are saying that things aren't right… they aren't fair. There are too many undeserved winners, and undeserving losers.

The government, therefore, from time to time must adjust the rules to deal with the changing values, needs and desires of society, to balance short- and long-term goals and costs, and to make sure that unintended negative consequences are avoided or mitigated so that society operates within the boundaries of what is considered fair and just.

In business today, we hide behind the notion that market forces act on their own, should be left alone, and make us behave as we do. Market forces, however, are amoral. It is we, the humans, who must bring a sense of morality to our society. We must be the ones to say where the market can play, and where it must stop so that life is governed by other values.

In short, if we, the business leaders, don't act on our own initiative and take some responsibility for the Commons, society will push back, and insist on new, well-intentioned laws and regulations that, if history is to be our guide, will be poorly thought through yet passed into law in an effort to protect society against us! The business environment will only become more difficult.

Business has a choice: we have a powerful long-term self-interest to act before new restrictive rules are imposed, and win back the confidence of society. Or, we can simply wait and see what will be imposed. If we take the latter approach, I think we run a high risk of witnessing our modern day version of the 'Tragedy of the Commons' play out: each party acting in accordance with its own short-term self-interest, with no one taking responsibility for the Commons. As the Honorable Leo Strine, Chancellor of the Delaware Courts has noted, *"we don't have time to relearn the lessons of the 19th Century!"*

I don't offer you a prescription, but I have tried to propose a better framework in which to think about executive compensation, and a few areas that need more attention and innovative thinking. We must engage this topic of executive compensation not by constantly looking sideways at what the 'other guy' is making, but instead by engaging in a constructive and responsible dialogue that recognizes our obligations to multiple stakeholders and our commitment to sustainable capitalism by building long-term value, responsibly. When we open these doors – or perhaps more accurately when we realize that these doors already are wide open – the issue of executive compensation takes on a moral dimension.

As individuals, we need to know what is enough. As corporate executives and board members, we must do so as fiduciaries. In the end, responsible, sustainable capitalism cannot avoid addressing the irresponsible elements of executive compensation.

Rachel Carson – one last time – observed as follows:

> *We stand now where two roads diverge. But unlike the roads in Robert Frost's familiar poem, they are not equally fair. The road we have long been traveling is deceptively easy, a smooth superhighway on which we progress with great speed, but at its end lies disaster.*

As to the other road – the one 'less traveled' – we all have work to do.

Thank you.