Corporate Culture and the Problem of Executive Compensation

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Let me begin by saying that I was struck by an observation made by Ken West in his contribution to this symposium. He posed the question: “Is corporate America bending the social contract business has with the American public?” I wholeheartedly agree with him that the answer is yes. I also was struck by an observation made by Ira Kay, the thrust of which was that companies are actually not paying executives excessive amounts as compared to the contribution that they make. Frankly, I think Kay’s argument misses the point. That argument may well have been made at various points in time in our country’s history, but not today. If there is anything that engages the public today about the business community, it is the issue of compensation. Having built and run a variety of businesses, I know that public confidence is a strong motivating factor and that public perceptions matter a great deal.

I believe that Lucian Bebchuk and Jesse Fried have brought to light one of the most important issues facing our society today.† I agree enthusiastically and almost completely with their analysis of the problem. I am not so sure that I totally agree with their solutions, or whether I believe their solutions are practical. I tend to be pragmatic about things of this kind, and I would rather move toward what can be done than what might be done. Their findings confirm what many have seen firsthand: a breakdown in corporate governance and a buildup in greed. I know that you can argue the greed question, but there is a difference between personal greed and the profit motive. As the former head of Goldman Sachs, Gus Levy, used to say: “Yes, we’re greedy, but long-term greedy,” and that makes a lot of sense.‡

When it comes to the issue of executive compensation, I have found that when you point out the various distortions in certain circles, people look at you funny. They think that you are some sort of radical calling for a redistribution of wealth, and that you do not believe in markets. However, I believe in markets passionately.

While these huge discrepancies in compensation call into question our notion of fairness and equality, I do have problems with exorbitant executive pay precisely because I care about the market and private enterprise. These huge paydays, I believe, undermine corporate governance and send a signal that boards are willing to spend shareholders’ money lavishly and too often with too little oversight. Moreover, these compensation

* The Carlyle Group; former Chairman, Securities and Exchange Commission. This paper builds on comments delivered at the Symposium on Bebchuk & Fried’s Pay without Performance, held on October 15, 2004 at Columbia University.
packages set up a system in which executives have, I believe, the wrong incentives. Too
often they are managing the numbers for short-term gain and personal payout, and not
managing the business for long-term growth and shareholder value. I believe this
behavior has to stop, and the time to reform this issue of executive compensation has
come. I would like to lay out some of the reforms that I would like to see, but let me first
say a word about the limits of such rules.

They may not have intended it, but Bebchuk and Fried’s book makes clear that there
is a larger cultural issue that must be addressed. I think that issue relates essentially to
how boards are structured and the personality of Americans. We are a friendly people; we
tend to go on boards when invited by people we know. One of the first questions we
invariably ask is, “Who else serves on this board?” Once we are on that board, how likely
are we to challenge the person who invited us and to go against the persons who will re-
invite us if we enjoy that service? The culture is almost fraternal. I have been on and have
structured small boards and large boards, nonprofit boards, and other kinds of boards, and
I see that situation played out over and over and over again. This fraternal culture is the
background music that is simply not going to change, and I think we have to understand
that.

Now, the proposals that I would put forward are focused on accountability and
disclosure. First of all, I think we have to make sure that the expensing of stock options
really occurs. At the end of March, the Financial Accounting Standards Board (FASB)
proposed, as expected, to change the rule so that options will be treated as an expense.
Yet, there has been resistance. At the beginning of his administration, President Bush
weighed in on this issue. Well, I don’t care whether you’re a Republican or a Democrat—
and if it was Clinton I would have felt precisely the same way—for the President of the
United States to weigh in on an accounting standard and to oppose the independence of
the independent standard setter, the FASB, is bad public policy. There are some issues
that defy the political process: closing military bases and establishing accounting
standards are two that come most readily to mind. I cannot help but fault our President
for getting involved in that situation. Fortunately, he has not repeated that since the first
months of his administration. Unfortunately, there are business groups who continue their
opposition.

I remember ten years ago when Silicon Valley companies led an unprecedented
effort against the FASB and the SEC for trying to expense options. The effort in the past
six months has exceeded even that time period. But the climate is different today, the
International Accounting Standards Board in London has already enacted rules to
expense options. Nearly five hundred U.S.-listed companies, including such companies as
Amazon, ExxonMobil, and General Motors, have begun to expense options or intend to
start. After the scandals of the past three years, the mood is definitely one of reform. The
litmus test for companies that place the interests of shareholders first is the issue, and
those that do not continue to resist the expensing of stock options. Yes, the opponents
have mobilized and the lobbyists are out there in force. In my judgment, however, the
issue is not whether, but when expensing will begin. I am disappointed that the FASB
chose to defer the implementation of this matter for six months. I think it gives an
opportunity for those who oppose it to continue to undermine that effort.

Second, I think we need better disclosure of executive compensation. There are far
too many ways for boards to, as the book puts it, “camouflage” executive compensation
from the eyes of shareholders. This can be done in the form of huge retirement packages, perks like corporate jets and cars, loans, and consulting contracts. This compensation is not only not linked to performance in any way, but it also does not have to be disclosed as executive compensation. I know that this site is a law school—and I honor the profession, my father having been a lawyer—but I have found during my years in Washington that the lawyers often led the effort toward corporate obfuscation, which is at the heart of this issue. There are all kinds of ways of not telling it as it actually is, and compensation committees have been pathetic in telling it like it is. Disclosures have been pure boilerplate. We need to be very bold about this, particularly with respect to actions that take place after the end of the year. I think that a great deal more can be done by the compensation committee in terms of establishing what its policy is. Current SEC rules do not require disclosure about whether compensation is performance-based and, if so, what the triggers are. They do not require a compensation table in which a total column is included. I think that this should happen. Yet, the answer is not just piling on more rules and more regulations or demanding the disclosure of so much material that it becomes so voluminous that it distorts and clouds the issue. I think we have to be very precise in terms of what the disclosure will be.

The notion of peer group comparison is a down-and-dirty, plain-English kind of disclosure that we should seriously consider. The SEC should disclose precisely the portion of compensation that is performance-based, how it is measured, what performance triggers are used, and details about if and how they were changed during the year. Greater disclosure of actions taken before the proxy would be worthwhile, as would a chart that compares the performance of the company and its compensation with top executives in peer groups.

Third, I think we must increase the independence of independent directors. Last month, Governance Metrics International (GMI) released its ratings of more than 2500 global companies. The data show that Sarbanes-Oxley has had a measurable positive effect on the governance of U.S. companies: 95% of companies have a qualified financial expert on their audit committee, versus 65% in 2002; 51% have auditor personnel rotation policies, versus 8% two years ago; 80% now provide director training, versus 14% two years ago. Yet there is still work to be done. According to the GMI survey, 46 out of the top 1000 companies have adopted the more stringent independence requirements for their directors that either the NASDAQ or the New York Stock Exchange has proposed. Yet Bebchuk and Fried detailed the problems with the current rules, from the allowance of significant compensation in business dealings to charitable contributions to directors’ favorite causes.

Before I leave the notion of self-regulating agencies, such as the New York Stock Exchange and NASDAQ providing the template in terms of their listing standards for good corporate governance, we have to carefully consider whether those institutions

3. BEBCHUK & FRIED, supra note 1, at 67-70 (defining camouflage pay).
4. Id. at 95-111.
6. Id.
themselves manifest the kind of governance that they would impose upon their constituents. I would suggest that in the past they have been very disappointing in that regard. And with respect to compensation, if you carefully examine their compensation practices, I think they have a long way to go themselves.

Getting back to the issue of independent directors, the GMI report found that 35% of U.S. companies reported a related party transaction involving a senior executive, the chairman, or a relative thereof. These related party transactions must stop, and the stock market’s definition of who is independent must be tightened. We also need to untangle interlocking relationships between CEOs and boards. A CEO should not be permitted to have directors on his or her compensation committee if the CEO also serves on boards that establish compensation levels for the fellow directors. This is a much too cozy relationship.

Fourth, we need to empower shareholders. Now, I do not think that this empowerment is right around the corner. We have gone through a cultural change in the United States, and I am asked almost every day whether today is the end of post-Enron reforms. After all, we have Sarbanes-Oxley, and we have a battery of new reform proposals by the self-regulators and the SEC. Are these reforms an end? My answer to that is “no.” This is like steering a car. Our markets are so resilient, so resourceful, so innovative, that we cannot possibly right a pattern that must be static. We have a very dynamic environment, and regulation, oversight, behavior, and culture must similarly be dynamic. The culture of America’s boardrooms has changed less because of Sarbanes-Oxley and more because of humiliation and embarrassment. Whether that change will endure depends upon the attention and commitment of the media, academia, the kinds of people who serve on boards, and most importantly, the people who chair those boards.

Of course, I believe that the basic principle that the owners of a company, the shareholders, should be allowed to put forth a board nominee is a good one. I do support the SEC proposal about proxy access; I think it is a modest proposal. I do not quite understand the fervor of the Business Roundtable’s and the Chamber of Commerce’s opposition to this proposal. I imagine they feel this proposal is the first step in the total empowerment of shareholders, which they think would distort the system. I do not believe that to be the case. This proposal is reasonable and modest. We need to give shareholders a greater say in those extraordinary circumstances where the will of the shareholder is being frustrated.

Finally, there are limits to what rules and regulations can really do. Serving on a board, as I have said before, is akin to belonging to a club, and that is not likely to change. But what is likely to change, if history is any guide, is the kind of individual who sits in the chair heading the board. In the 1990s, the typical CEO was the muscular individual, the Al Dunlaps of this world, who could acquire a company with the stroke of a pen, fire 20,000 employees six months later, sell the company as a misguided adventure a few years down the road, and receive a huge pay package as a sop to the conscience of the directors who had to acknowledge their original decision to hire him. The kind of CEO needed today, and the kind that generally follows a period of public disenchantment

7. Id.
8. Cf. BEBCHUK & FRIED, supra note 1, at 201-16 (putting forward proposals for increasing shareholder power).
with the business community, is a CEO who is much more concerned with the public interest. An example is the kind of CEO who is willing to give up his or her high-paying job to run the New York City school system, that is, a CEO who takes a greater interest in society at large. I think we are already seeing that: CEOs more in the mode of some of the people sitting on this platform with me.

In conclusion, market forces are at work and can work in terms of changing the perception of what is good in our markets. Look at the number of companies in existence today that measure corporate behavior. It is a small industry, and directors and CEOs are beginning to care about the Glass Lewises, the Audit Integrities, and the dozens of others that have sprouted up to evaluate corporations. Pretty soon, the analysts of this country will pay more attention to governance issues. Believe me, when the analysts begin to think about these issues, the market will reflect these issues. So while I do believe that market forces do work and are working, I do not believe that market forces are going to do it alone. Dialogues such as this one are terribly important as we try to establish a new ethos of propriety. It is a complicated issue, I do not mean to sound preachy about it, but I think the restoration of public confidence in our markets is fundamental to ensuring that we retain the primacy of America as the foremost capital market in the world. The debates and the arguments that are being put forth today provide me with great hope that we are in a period of change, and we will be moving forward. By and large, I believe our boardroom culture is moving in the right direction and needs a subtle but important nudge from people such as those who sit in this room.