SUMMARY

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FAIR PAY, FAIR PLAY

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Summary of Fair Pay, Fair Play by Robin A. Ferracone

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Learn why excessive executive compensation is problematic.

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Introduction

If you pay attention to the news-- or even to many popular sitcoms!-- you've probably noticed that "fair pay" is a pretty big hot-button issue right now. Even the popular NBC sitcom *Superstore* regularly addresses the issue of fair pay and workers' rights throughout the course of its six seasons.

In the context of *Superstore,* a group of employees at a fictional big-box store (which is clearly modelled after Wal-Mart) contend with long hours, low pay, and increasing disrespect from corporate. Over the course of this summary, we'll see how this analogy is applicable in real life-- and what can be done about it.

Why Fair Pay Matters

Outside the context of *Superstore,* most real-life employees have probably experienced the same thing-- especially when it comes to the gender-pay gap faced by female employees. As an executive compensation consultant, the author is intimately familiar with the widespread issue of fair compensation. In fact, it was his long professional history with this problem that motivated him to write this very book!

Because, after 30 years of advising companies about fair compensation, he felt that it would make a lot of sense to distill his professional knowledge and "bottle" it in the form of this book, so that his advice could be accessible for everyone! In his own words, the author describes his experience and philosophy by writing:

"When I walked into the boardroom, I saw four compensation committee members staring at me, eager to hear my presentation on how to retain the CEO of this publicly traded, high-flying company. The CEO had enjoyed meteoric performance, but he was threatening to quit if he didn't receive a generous helping of restricted stock as part of his new employment agreement. Weeks earlier, I had been called by the chairman of the compensation committee to provide advice to the committee regarding this matter.

And while the members of the committee said they wanted my opinion concerning what they should do, my hunch was that they really wanted me to bless the CEO's requested grant. Like most board and compensation committees, this one wanted to be supportive. It would be easier to say "yes" than "no." Further, the compensation committee thought that the CEO was doing a splendid job. The stock price had risen more than 50% since the CEO had taken charge three years prior. They figured that the company would be at considerable risk if they lost their "rock star" leader. After all, there was no successor in sight.

On the other hand, the committee realized that what the CEO wanted was "over the top" and that they could be subject to undue criticism if they approved the requested package, particularly without an outside, objective opinion. My report was not a surprise. I had telegraphed my preliminary findings well in advance of the meeting. My analysis showed that the requested grant would put the CEO 's compensation well above the market, even considering the company's high performance.

As a result, I recommended a more modest grant, contingent on performance. I delivered my report to the compensation committee in the executive session, with the CEO absent from the meeting. The compensation committee heard my report and asked a few questions, and then the committee chairman excused me from the room. A few days later, I called the chairman to see what had happened. He said, "The compensation committee was extremely pleased with your work, but decided to give the CEO what he wanted."

In fact, the board had penned a lucrative new employment agreement, complete with generous severance, change-in-control, tax gross-ups, and other bells and whistles. Of course, the news media had a heyday when the agreement was disclosed, and shortly thereafter, one member of the compensation committee even resigned from the board, although I suspect that it wasn't only about CEO pay.

Fast forward to a year later, when the demand bubble for the company's services burst and the financial performance collapsed. The CEO was asked to resign in return for the large severance deal that had been provided by his employment agreement. As the consultant who had given the compensation committee advice to pare back the sought-after restricted stock grant and apply performance hurdles, I felt vindicated that my advice had been sound, but not satisfied that it had been dismissed.

Is this a story out of today's news? It sounds like it is, but it's not. It actually took place a decade ago. But in a fundamental way it doesn't really matter. Getting the pay-for-performance equation right is a long -running issue that remains an issue today. But why should we care? Does pay for performance really matter? Do incentives really motivate good performance?

The Issue of Executive Compensation

In the previous chapter, the author laid some groundwork by introducing us to a problematic real-life case study that explores the issue of executive compensation. From this example, we saw that the question of fair pay is universal. Average workers like the characters in *Superstore* absolutely deserve fair pay and their labor should be valued and respected.

But if we look beyond the floor workers and into the board room, we can see that this issue goes all the way to the top. We should fight to ensure that everyone receives fair compensation for their labor-- but we should also take a critical look at the compensation given to employees at the executive level. That's because executive compensation is often exorbitantly high-- so much so that it far outweighs that employee's performance and thus, the level of compensation that they actually deserve.

To explain this, the author considers the issue of incentives as a performance-based motivator. Many people think that incentivizing employees with bonuses and perks is the way to go because they believe that this will encourage employees to perform well. However, the author's research disagrees. He observes:

"Among academics there is a great deal of debate regarding the motivational power of incentives. Some, such as Dan Ariely, James B. Duke Professor of Behavioral Economics, Duke University, think incentives are not good motivators.

"In experiments, we've seen that in some cases, people's performance actually was lower the larger the bonus they got," Ariely said. As a result, stock bonuses, stock grants, and other incentives are "probably better for creating loyalty than performance," he said. Among other academics, some agree with Ariely; some disagree. My own view from working on matters of compensation over the years is that good people, and top executives in general, are intrinsically motivated, but incentives provide a powerful messaging and focusing device.

In addition, the market for executive labor is generally willing to pay more for an executive who produces great performance versus one who does not. For these reasons, incentives matter. As for the question "Why should we care?" investors have said that they care. In a study conducted by the Center on Executive Compensation in 2008, twenty of the top twenty-five institutional U.S. equity investors were interviewed regarding their views on executive compensation. Investors resoundingly reported that the most important issue of concern was the alignment between executive performance and pay.

Correspondingly, their second most important concern was having a compensation committee that they could trust and rely on to represent their interests. For this reason, we should care. Nearly every board in America states that its philosophy for executive compensation is to align pay with performance (or words to this effect). This is not without reason. Not only is paying more for better performance intuitively appealing, it also has motivational value to executives and seems fair to investors. And although I have not proven causality, companies whose pay is more sensitive to performance also have better performance.

Further, corporate leaders are not living up to their pact with investors and employees if they don't put real meaning behind the mantra "our objective is to align our executive pay with performance." Finally, pay for performance has become a biting social issue. The populist view is that executive compensation is the root of all evil. In fact, some blame the largest financial collapse since the Great Depression on egregious executive pay. While I have not met anyone sophisticated in business and finance who agrees with this view, the fact of the matter is that it has built up a head of steam and is implicitly shaping public policy.

According to a study conducted by Farient Advisors, the executive compensation and performance advisory firm I founded, the vast majority of board directors and executives feel as though greater government intervention will not only not solve the pay-for-performance issue, but could make matters worse. Except for requiring clearer disclosure, there are almost always unintended and negative consequences to government intervention in matters of executive pay, the most famous of which was the decision made to cap the deductibility of non-performance-based pay at $1 million for certain executives in public companies.

As a result of this governmental decision made in 1993, early in the first Clinton Administration, CEOs began receiving less in the way of cash, but more in the way of stock options and restricted stock. Ultimately, rather than pushing down CEO compensation, the result of this action was to raise CEO pay levels. But if we come back to our question, "Should we care about linking pay to performance?" the answer is a resounding "yes."

Short of inviting the government to do our work for us, it is incumbent upon boards, their advisors, and management to crack this code. Charles M. Elson, director at the John L. Weinberg Center for Corporate Governance at the University of Delaware, sums it up nicely: "Government will only make it worse. If you didn't like what they did in 1993, then you 're really not going to like what they' re doing now." It is something that we all need to get right.

For nearly thirty years I have worked on solving vexing issues around performance and pay. I certainly am not the first or only one to tackle these issues. Many have gone before me and acknowledged the difficulty. As far back as the 1980s, Robert A. G. Monks, founder of Institutional Shareholder Services, Inc. and cofounder of The Corporate Library, was practically inventing the shareholder rights movement when he took on Sears, Roebuck for the way it generously compensated its top team, made poor investments, and developed an ill -fated strategy.

From Monks's point of view, the compensation system is far too arcane. In fact, he calls it "complex, difficult, remote, and virtually inaccessible to anyone without a lot of experience." At about the same time, Graef "Bud" S. Crystal left the world of compensation consulting to become the b ête noire of American CEOs by widely publishing articles with extended tables showing how CEOs compared to each other with regard to pay and performance. Crystal's analysis led to a great deal of finger pointing.

What he did was to tally CEO salaries, bonuses, stock options, restricted stock, and other types of compensation. He then compared what CEOs received relative to the performance of their companies and created tables comparing who got what, when, and what for. Crystal's 1992 book In Search of Excess: The Overcompensation of American Executives became a best-seller and for many people a reason for outrage, since so much of the information Crystal uncovered was hidden in proxy statements that were difficult to decipher.

Crystal is still at it and publishes a weekly newsletter not surprisingly called The Crystal Report, but let's pick up where Crystal's book left off. What Exactly Are the Problems? What exactly are the problems? Is it that executive compensation is simply too high? Or are there executive pay outliers that attract undue attention and create a media feeding frenzy? Is the problem that there are too many instances when executive pay is high but performance is low (including cases in which executives take lucrative stock option gains off the table right before the bottom falls out of company performance)?

The short answer is "all of the above," although my view is that the most significant issues are outliers, which I am defining as companies paying at the 95th percentile or higher, and high pay coupled with low performance. Median executive compensation is not really the issue. On the surface, performance-adjusted CEO pay has increased threefold since 1995. This seems like a lot. But if we take into account (1) inflation (as measured by the Consumer Price Index) and (2) the increase in median company size (larger size begets higher CEO pay) over this same time period, then real size- and performance-adjusted CEO pay has increased approximately 1.6 times the 1995 level.

This implies a compound annual increase in real performance -adjusted CEO pay of 3.6%. Because Gross Domestic Product rose by 2.6%, productivity gains account for all but $400,000 of the total compensation increase. As a result, I conclude that the absolute level of executive compensation is not the issue on which to focus. The real issues are about outliers and performance and pay alignment. Investors agree with me. About 75% of the investors surveyed by the Center On Executive Compensation in 2008 said that they had no real concerns about the levels of executive compensation in the United States.

According to Patrick S. McGurn, vice president and special counsel to RiskMetrics Group, Inc. “There are some investors and obviously other interested parties for whom the numbers are very important, and I think there are some people who simply would like to see pay go down. However, I can’t remember having too many conversations with our clients with that as the ultimate goal. The conversation is generally not about how much you pay them but how you pay them.”

What Does Fair Pay Look Like?

"How much you pay them does come into play, particularly when boards do an absolutely terrible job of calibrating those pay programs and get these huge outsized payouts that I think, even from a board perspective, were never intended when they designed the programs. They simply didn't take adequate care in either setting maximums or multiples or whatever it is they're going to use to stop those payouts from going into uncharted waters."

So, let's consider outliers. They shock the senses. They're the stuff that headlines are made of, and for good reason. There are always a few outliers—companies that generate performance-adjusted compensation that looks "off the charts"-- regardless of how high performance might be. For CEOs, these outliers can range anywhere from 15 to over 250 times median performance-adjusted pay in any given three-year rolling period. Moreover, outliers are powerful contributors to public perception.

The outlier issue is not new. It's been going on at least as far back as the database will take us. Outliers often are the result of runaway pay programs that weren't intended to pay out that way in the first place. For example, take Cisco Systems, Inc. in the mid-1990s. The company was on a roll, generating an annualized average total annual shareholder return of 96% in the last half of the decade. I'm sure that the compensation committee thought it was doing the right thing when it bestowed upon John Chambers, chairman and CEO, five to six million stock options per year during this period, along with a modest annual salary of $300,000 and an average bonus of $400,000 per year.

However, this equity-laden package resulted in three-year average Performance Adjusted Compensation of approximately $300,000,000—that's right, $300 million.3 Other employees' compensation rose too because of stock options. As one Silicon Valley observer said, "What I saw was entitlement. It was worse with options than with an annual bonus because people started living on their options. They could do this because options vested monthly. These people would say to the CEO, ‘You have to give options now. The price is only going to go up. ’ They were living it up. ”

Today, Cisco has moderated its CEO pay package to be more in line with the market. Total cash compensation (both salary and bonus) is targeted to be below the 50th percentile of peer companies, including a continued modest salary level of $375,000, combined with a target bonus of $2.5 million, such that a greater percentage of Chambers’s total cash compensation is directly tied to Cisco’s operating performance. Long-term incentives are targeted at the 75th percentile of Cisco’s peers, and equity grant sizes are considerably more modest than those of ten years ago. In addition, the company has shifted away from relying solely on stock options as a long-term incentive vehicle, to a combination of stock options, performance -based restricted stock units, and time-based restricted stock.

According to Jay W. Lorsch, Louis E. Kirstein Professor of Human Relations, Harvard School of Business, and chairman, Harvard Business School Global Corporate Governance Initiative “The people who are complaining in many respects are the people who have a political or some kind of moral reason for being upset, and I’m even talking about the shareholders. Why did the people at the AFL-CIO get so upset? They’re not getting upset because the investment is in some way damaging their return. They’re getting upset because the union guys don’t like it. Or the media gets upset because it sells newspapers.”

According to Stephen W. Sanger, retired chairman and CEO, General Mills, Inc., and director of Wells Fargo & Company, Target Corporation, and Pfizer, Inc. “I would say with the general public and the politicians that you could make a case that executive pay level is the main issue—’Nobody needs to be paid that much’ kind of mentality. I don’t think the big shareholders look at it that way. The big shareholders want to talk about other things.”

Now, let’s consider the issue of high pay despite low performance. This question is one of misalignment, that is, the extent to which pay is high when performance is low, or vice versa. In mining our database, we found plenty of examples in which executive pay was too high for the level of performance delivered. In fact, approximately one-third of the cases in our database fell outside of what we consider to be an acceptable range for the relationship between performance and pay.

In my work with boards, I have developed a simple definition of fair pay, which I am also calling alignment. Fair pay, or aligned pay, is when total compensation, after performance has been factored in, is:

● Sensitive to company performance over time

● Reasonable relative to the relevant market for executive talent and for the performance delivered

In my explanation of fair pay, or alignment, I've deliberately kept it simple. I've excluded caveats, footnotes, measurement information, and definitions. But while my definition may be succinct, I believe it is powerful because it makes an important philosophical point: executives ought to earn compensation on the basis of the performance they generate over time relative to others in the marketplace.

I believe my definition of fair, aligned pay is simple enough that an outside observer would be able to discern when a CEO's pay is fair and when it is not. As such, it is the kind of definition that can be written on the back of an envelope or committed to memory, and by being kept in mind, can keep boards and executives from getting unwanted calls from the press."

Final Summary

The issue of fair pay is common in every job and every walk of life. Most people are very well aware of the concerns raised by unions and other organizations who support workers' rights. That's because fair pay for workers who are paid a low minimum wage is one of the primary concerns of every workers' rights group.

So, in this context, we are very familiar with the concept that "corporate fat cats" make more than their share while taking all the pay from the proverbial little guy. But the author uses his 30 years of experience to take this concept beyond the abstract and put into cold, hard facts.

Drawing on real-life case studies, figures, and statistics, the author documents the unfair advantage of executive compensation. As we can see from these examples, the financial incentives and bonuses that are given to employees in executive positions often outweigh their performance, creating a cycle of financial inequality in the workplace. That's why the author hopes that his advice can be implemented to reduce unnecessary overspending and create a fair pay scale.