Bill George

Executive Pay: Rebuilding Trust in an Era of Rage

Finance reform will bring unintended consequences. Before the new regs arrive, boards need to bulletproof their compensation policies

With 26 million people unable to find full-time jobs, Americans are outraged by disparities in pay between executives and average workers as real incomes continue to decline. Multimillion-dollar bonuses at American International Group and Merrill Lynch certainly didn't help. Two consecutive years of declining CEO pay, on the other hand, haven't either.

As a result, politicians are lining up to give shareholders greater control over executive pay. On the surface these changes sound like shareholder democracy, which would be a good thing. But rather than solving problems with executive compensation, they may result in myriad unintended consequences.

Case in point: The Dodd-Frank Wall Street Reform and Consumer Protection Act grants shareholders advisory votes on compensation, allows activist shareholders with only 3 percent ownership to nominate board members, and prohibits voting by retail brokers representing small shareholders. These changes are likely to empower short-term money movers such as hedge funds at the expense of long-term owners–and pressure management to focus on the short term, which is the exact opposite of what's needed.

In another example of good intentions not adequately thought through, *The New York Times* called on the Securities and Exchange Commission to publish ratios of CEO pay to "typical employees," ignoring variations between industries. What about businesses focused on low-wage emerging markets? What about differences between high-wage software developers and low-wage service companies?

Imposed formulas for executive compensation simply won't work at many companies. And we've seen how powerful the temptation can be for executives to manipulate short-term results to increase their compensation.

The regulations that will spring from Dodd-Frank are still being written. In the meantime, rather than just responding to pressures, boards and CEOs have a shot at restoring the confidence of the public by crafting responsible compensation policies unique to their needs. Doing this now will give U.S. companies an edge in fending off investors who are in it for the quick kill. It will also raise their odds of holding on to the top talent whose pay is the target of all this debate and ire.

Here are six policies that should be rigorously followed, including in bad times when boards are more prone to bend the rules for those in their top ranks:

1. *Provide full transparency for compensation policies and actual practices.* Principles and pay policies should be consistent over time. Novartis has been the forerunner in Europe by making its compensation practices fully transparent.

2. *Create policies that reward long-term performance with long-term pay.* ExxonMobil withholds more than two-thirds of its officers' compensation until they retire or for 10 years, whichever is greater. This focuses executives on long-term results and provides for sound succession.

3. *Reward executives for their performance, not the company's stock price.* Target, for example, compensates its executives based on same-store sales performance relative to its peers.

4. *Lengthen the time horizon for bonuses.* Companies should withhold significant amounts of compensation using restricted stock, with forfeiture for accounting adjustments and leaving the company. In 2009 the top 30 officers of Goldman Sachs received no cash, getting bonuses in restricted stock with three-to-five-year vesting periods instead.

5. *Avoid formulaic approaches.* Compensation tied only to short-term metrics leads to long-term problems. Companies should include qualitative performance measures like strategy implementation, research milestones, and leadership development. To make its shift to "leading by values" relevant, IBM includes bonus opportunities for furthering its values, especially in global collaboration.

6. *Boost equity between workers and executives.* People with greater responsibilities should receive greater compensation, but one way to signal that everyone matters is to drop special plans, benefits, and perks for executives. Medtronic gives employees a "means to share in the company's success" by enabling them to become shareholders through company-funded employee stock ownership plans.

To rebuild trust and negate the impact of restrictive regulations, corporate boards must develop compensation systems that reward all employees fairly and are applied consistently. This will focus leaders on long-term value creation and give boards a solid footing from which to defend their policies. It might even enlighten policymakers as they figure out how to put Dodd-Frank into practice.

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