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EXECUTIVE COMPENSATION

The Need for a Principled Approach to Compensation Reform

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The global economic crisis has aggravated existing concerns about executive compensation practices. Executive and key employee pay practices among large financial sector companies in particular have drawn public scrutiny and condemnation. Lost jobs and lost savings, as well as extensive government support for the financial sector and the automobile industry, means that executive compensation is a concern not just to shareholders, but for everyone affected by the faltering economy. The issues are now seen as so significant and systemic that our elected representatives are taking the matter out of the hands of the private sector. Congressional proposals for sweeping corporate governance and executive compensation reforms and the new Administration's interest in tackling this subject means that there is a very real prospect for significant changes to executive compensation regulation later this year.

We do not advocate a political solution to executive compensation issues, but if a legislative response is inevitable, it is imperative that it take the right form. As we have seen in the past, a piecemeal response to an assortment of perceived, and often isolated, executive compensation abuses will create as many problems as it solves—and is unlikely to take account of the systemic issues that must be addressed. After all, the intricacies of determining the ''right'' executive compensation across the diverse range of businesses and industries comprising corporate America defy a single solution, no matter how well intended and thoughtfully crafted.

Any government regulation of executive compensation should encourage compensation practices that will contribute to the sustainable long-term value of America's business as we emerge from this crisis, rather than simply ''fixing'' specific compensation practices which are seen as having contributed to the crisis. What is needed is a set of principles to guide the design and operation of any responsible executive compensation program. The guidelines announced by the Obama Administration recently do this, focusing in part on pay for performance and, in particular, long-term performance. However, for guidelines of this nature to have real practical application, they must provide guidance to—and reinforce accountability by—the body that makes the decisions about executive compensation—the board of directors. A measured and principled approach overseen by corporate boards is the only way to ensure that the eroding trust between companies and their shareholders is restored, based on a shared commitment to the sustainable long-term value of the enterprise. Under the Administration's plan, responsibility for crafting this approach will fall largely to the Securities and Exchange Commission.

Fortunately, there is no need to create a new set of governing principles out of whole cloth. Legislators should look closely at the work that has already been done in this area. A useful example is the guidance de-

veloped by the Aspen Institute's Corporate Values Strategy Group. The thinking of this group was motivated by a concern with excessive short-term pressures in the capital markets that result from intense focus on quarterly earnings and incentive structures that encourage companies and investors to pursue short-term gain with inadequate regard to long-term effects. The Aspen group recommends that companies and investors do three things to promote sustainable long-term value creation. First, define the metrics of long-term value creation. Second, focus corporate-investor communication around long-term metrics. Third, align compensation policies with those long-term metrics. While the group's guidance describes several features of a compensation structure that supports long-term value creation, it does not purport to prescribe any particular framework.

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The principles-based approach to regulating executive compensation has two significant benefits. First, it places responsibility for executive compensation squarely where it belongs—with directors who are elected by and responsible to shareholders. Companies and their shareholders will be much better served by engaged and accountable directors, appropriately guided, who can tailor compensation plans and awards to the immediate and long-term needs of the organization, respond nimbly to unforeseen corporate, industry, and economic events, as well as evolving trends and developments, and fine-tune a program to address investor priorities and concerns. Second, it gives company boards and compensation committees sufficient flexibility to design executive compensation programs appropriate to and in the best interests of their shareholders. This not only avoids the rigidity that detailed prescriptions would bring but also reduces the need for complex implementing regulations and clarifying interpretive guidance, and the risk of unintended consequences and cynical evasions.

How would legislative reform introduce into the executive compensation system the principles that will allow executive compensation to contribute to long-term sustainable value? One approach is a ''comply or explain'' regime that has been used successfully in other jurisdictions (the United Kingdom, Canada, Australia, and South Africa to name just a few). The principles which should guide executive compensation plans and arrangements could be set out in a formal regulation with a requirement that boards of directors disclose to their shareholders annually how the executive compensation packages they have approved align with those principles—and if they do not, why they do not. This could be seamlessly integrated into the SEC's existing executive compensation disclosure regime and would be a helpful enhancement for investors in connection with the increasingly common requests for advisory votes on executive compensation.

The principles themselves could draw heavily on the Aspen Principles and the related work done by other groups. In our view, the principles that must inform the development of any compensation plan promoting sustainable long-term value would include at least the following components:

- the accountability of the board for executive compensation;
- the independence of the compensation committee, or other directors charged with making executive compensation decisions;
- disclosure that creates and maintains an environment of transparency to shareholders about compensation philosophy, policies, processes, and decisions; and
- a long-term focus and appropriate features for mitigating excessive risk-taking.

We believe that legislation directed at promoting faithful adherence to these principles is preferable to any set of largely reactive and *ad hoc* prescriptive mandates, with their inevitable unforeseeable consequences. Such an approach will be well-received by the diverse constituencies that have an interest in the executive compensation debate and it should spark a much-needed (and informed) dialogue about the purpose and objectives of executive compensation and its relationship to enterprise value. Such a dialogue could go a long way to resolving the current criticisms, anxieties, and misunderstandings about executive pay.

For years, the ongoing executive compensation controversy has dominated the corporate governance landscape, obscuring the larger need for a stronger and more responsive governance system. With the debate over the ''federalization'' of corporate governance and the degree to which shareholders should be further empowered to be more directly involved in corporate affairs now fully engaged, the Administration and Congress should be directing their energies to that discussion on a broad and principled basis, rather than trying to regulate executive compensation in isolation. While compensation needs to be addressed, it should be done within the context of this larger debate. Now is not the time for prescriptive rules. Give directors a framework within which to operate and let them do their job. Ultimately, that's what they are elected to do.

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