

Boston Business Journal

JULY 24-30, 2009

Executive pay under scrutiny: Will the backlash stick?

The questions have been swirling around financial and regulatory circles for some time now: How much should top executive officers get paid? What's the best way to tie pay to performance? And should investors have any say in the matter?



INSIDER VIEW

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Executive pay is firmly in the spotlight again as the Obama administration, Congress and the Securities and Exchange Commission renew a debate that has taken on added urgency following the financial crisis that roiled markets and decimated portfolios.

President Obama has long supported "say-on-pay" legislation, and his administration recently called on Congress to authorize the SEC to require nonbinding, annual say-on-pay votes for all public companies. Members of Congress have already proposed several bills seeking to reform compensation and other governance practices and give shareholders more influence. Supporters believe such laws would enhance corporate accountability and rein in executive pay — or, at the very least, better align executive pay with a company's value.

Treasury Secretary Tim Geithner has set out a series of principles designed to tie compensation to performance. Some of the principles will stick; some will not. Either way, it's clear that boards of directors and compensation committees need to focus even more acutely on how they allocate pay.

Risk management is one of the biggest themes of the executive compensation debate. Many compensation packages

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encouraged — or were perceived to encourage — top officers to take excessive risks to meet financial goals outlined in their incentive plans. Some believe that executives had pay incentives that pushed them to make decisions serving their own short-term financial interests, rather than the long-term interests of shareholders.

Some degree of risk is appropriate for any company. After all, if you don't take risks, you won't grow your business. Companies now need to adjust the way they disclose risks, and how they structure their incentive plans so they don't promote excessive gambles.

CEOs must think about their own pay packages, as well as those who report to them. And boards and compensation committees must do a whole lot more than rubber-stamp pay plans. They must dig deeper to fully understand all aspects of pay packages and evaluate whether incentives can be manipulated for an executive's gain.

Companies should consider checks and balances that ensure that executives' and shareholders' interests are aligned, such as:

- Clawback provisions, which allow companies to recover cash and stock incentives if financials have been misstated.
- Stock retention guidelines, which require executives to hold their company

shares for a certain number of years, or until or even after retirement.

- Truly independent compensation consultants retained by, and reporting directly to, boards or compensation committees rather than management.

Companies should also reconsider the necessity of extensive, multi-year severance packages for chief executives. Severance packages have been defended for giving an incoming executive a degree of security. But does an executive making significant amounts from salary, bonus and equity incentives really need such protection?

The Obama administration says its goal is to make companies' practices more transparent. A few new disclosure requirements won't necessarily eliminate inappropriately risky behavior. But they might result in sounder management practices and more intense and thoughtful analysis of compensation structures.

Some of the changes, like say-on-pay votes, may make sense for large, widely held companies, but are probably more burdensome (and expensive) than helpful for small- or mid-size firms. Most of the executive compensation proposals are geared toward very large companies as a result of some bad "poster children" with abusive, risky practices. Unfortunately, smaller firms get caught up in the hysteria.

No matter what rules get adopted, boards and compensation committees need to be vigilant in their oversight of compensation and risk. Executives meanwhile, need to recognize the realities of the changing times.

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