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EXECUTIVE COMPENSATION

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED SECOND CONGRESS

SECOND SESSION

ON

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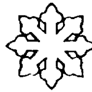

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EXECUTIVE COMPENSATION

THURSDAY, JUNE 4, 1992

U.S. SENATE,
SUBCOMMITTEE ON TAXATION,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:15 a.m., in room SD–215, Dirksen Senate Office Building, Hon. David L. Boren (chairman of the subcommittee) presiding.

Also present: Senators Baucus, Daschle, and Danforth.

[The press release announcing the hearing follows:]

[Press Release No. H–31, May 27, 1992]

TAX SUBCOMMITTEE HEARING PLANNED ON EXECUTIVE COMPENSATION; EXCESSIVE COMPENSATION A "REAL PROBLEM," BOREN SAYS

WASHINGTON, DC—Senator David Boren, Chairman of the Finance Subcommittee on Taxation, Tuesday announced a hearing on executive compensation.

The hearing will be at *10 a.m. Thursday, June 4, 1992* in Room SD–215 of the Dirksen Senate Office Building.

"I am looking forward to this opportunity to hear from shareholders, the business community and government officials on the topic of executive compensation. Excessive executive compensation is a real problem in our country, and it is my hope that this hearing will provide a good discussion of possible solutions, from increased disclosure to changes in the tax code," said Boren (D., Oklahoma).

Legislation limiting the tax deduction for executive compensation to $1 million a year was included in the tax bill passed by Congress and vetoed by the President in March. The House Ways and Means Committee has reported a bill using an identical executive compensation provision to help finance additional emergency unemployment compensation benefits.

OPENING STATEMENT OF HON. DAVID L. BOREN, A U.S. SENATOR FROM OKLAHOMA, CHAIRMAN OF THE SUBCOMMITTEE

Senator BOREN. Good morning. We will commence the hearing at this time. Today we are considering an issue that has received considerable attention over the last several months, the issue of the amount and structure of executive compensation.

CEO compensation in this country rose 75 percent in real terms during the 1980's. In 1990, the median total compensation for chief executive officers, including cash, benefits, and long-term compensation, was $1.397 million per year.

Perhaps more disturbing than the actual amount of compensation is the disparity between what an executive is paid and what an average worker in the company is paid.

Ten years ago, the CEO made 35 times more than the average worker did. Today that ratio has jumped to approximately 100 times.

The chasm between average salaries and executive compensation is alarming for two reasons. First, the ratio is dramatically out of line with ratios in other countries that are our most effective competitors in the global marketplace.

For example, CEO's in Japan make about 17 times what their average workers earn. The ratio in Germany is 23 to 25 times. As I have indicated in the United States, it is 100 times.

More importantly, it illustrates the increasing divide between the most highly-compensated in our economy and the average American.

As incomes and lifestyles become increasingly divergent, the sense of community—the feeling that all Americans are working together as one team in a common effort to improve the economy and our society for ourselves and for future generations—is lost.

Instead, the average worker feels alienated, permanently excluded from the American dream that is a reality for fewer and fewer of our citizens.

In fact, while executive compensation has been skyrocketing, the average real wage for American workers has been dropping during the last decade.

The jobs that we lost in this country during the decade of the 1980's averaged $440 per week, while the new jobs that we added in our economy during the 1980's averaged only $280 per week.

So we have been moving in the wrong direction, dropping from $440 per week to $280 per week for new jobs for average Americans in our economy, a time when executive compensation has been skyrocketing out of sight.

We saw the most extreme result of this sense of division and alienation in our society last month, tragically in Los Angeles.

And while certainly no one would argue that executive compensation was the immediate cause of that disorder, such excess is a symptom of a society comprised of citizens who share fewer and fewer common experiences and goals than we shared even a decade ago.

Of course, this is an economy founded on free enterprise principles, principles that include the basic tenet that a job well done should be rewarded by appropriate compensation.

So we would be less concerned about the amount of compensation paid to executives if we believed that pay tracked performance. The statistics suggest otherwise.

While CEO pay rose 7 percent in 1990, for example, profits fell 7 percent—not exactly a correlation between performance and pay.

And during those years that CEO pay was increasing 75 percent in real terms, the decade of the 1980's and early 1990's, corporate profits before taxes fell by 17 percent. Real compensation up 75 percent; performance and profits down 17 percent.

Currently, it is a matter for discussion whether corporate profits are the only, or necessarily the best, proxy for firm performance, but these statistics are sufficient to raise questions in our minds.

The focus of the hearing is on the proper governmental response to this problem. Most of the discussion of solutions has centered on ways to increase disclosure to the shareholders of the amount and the structure of executive compensation.

These discussions have prompted responses by both the Legislative and Executive Branches. And we will hear updates on those initiatives today.

Senator Levin will discuss with the Subcommittee his legislation that is designed to assist shareholders by increasing the information available to them about executive compensation and by allowing them ways to influence compensation decisions.

Chairman Breeden is here today to discuss with us the SEC's actions in this area and the developments since it announced its proxy proposals in February.

Another type of solution is of particular interest to this Subcommittee because it involves changes in the tax code. The comprehensive tax bill passed in March and the House version of the unemployment insurance bill include a revenue-raising provision that would limit the deduction for compensation paid to corporate executives to $1 million.

In other words, not more than $1 million a year would be allowed in terms of deductions by the company as a business expense for executive compensation.

This is a change from current tax law which allows a deduction for a "reasonable"—I put that in quotes—amount of salaries or other compensation. In fact, the current system imposes no limit on the amount that a corporation can deduct for executive compensation.

The law does not currently define what is reasonable compensation. This proposal—which has been in the tax bill, which is again in the unemployment extension—would consider all compensation over $1 million to be per se unreasonable.

The Joint Committee on Taxation has estimated that this provision would raise a little over $2 billion between 1992 and 1997.

When the Finance Committee considered the comprehensive tax bill, we did not analyze this tax provision in depth. Now that the provision may soon be before us again, we should use this opportunity to discuss the consequences of adopting such a tax change.

I encourage all of our witnesses and my colleagues to comment on this tax provision in the course of our discussion today.

The information that we gather today and the perspectives of our witnesses will be of great help to this Subcommittee and the Finance Committee as a whole as we consider over the next few weeks various tax proposals that may affect executive compensation and that raise money to allow us to pass important tax legislation: the extension of unemployment benefits, and the expiring tax provisions.

According to the rules under which we operate, we must find a way to pay for those important extensions in the current tax code, extensions that are crucial to our economy. And this is one of the options that we have under serious consideration.

I am very pleased that several of my colleagues have joined us this morning on the Committee. And I know that others are on their way.

I would like to turn at this time and ask if Senator Baucus has any opening comments that he would like to make.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you, Mr. Chairman. First, I thank you very much for holding this hearing.

I think it is one of the more constructive steps that we are taking to help turn our country away from the excesses of the 1980's, a period that I believe was marked by not only conspicuous consumption, but also by conspicuous compensation.

I think it is important to remember the words of an English clergyman, Charles Colten who in 1822 said, I will quote him, Our incomes are like our shoes, if too small they gall and pinch us, but if too large, they cause us to stumble and to trip.

Well, I think frankly, it is time for corporate America to wear shoes that fit, not too small and not too large.

Executive pay has become in too many instances an excessive free-for-all divorced from reality of corporate results. And unfortunately, this comes at a time when rank and file workers have lost jobs at the rate of 2,600 a day.

The growing gap between executive compensation and the salary that an average worker receives, if allowed to continue, will breed more cynicism and more indifference in our country. And I think that detracts from the shared sense of commitment which is vital to successful, competitive business and to a strong country.

The real question is less whether executives are paid too much, rather it is whether shareholders and employees are getting their money's worth from their executives.

Mr. Chairman, you have stated that the statistics are very alarming. I think they are worth hearing again because repetition sometimes does help to get a point across.

CEO's pay in America far exceeds that of CEO's in any other country. And in Germany as you stated, Mr. Chairman, the CEO's make about 23 times what average workers do. In Japan, the figure is 17 times, whereas in the United States, CEO's enjoy a disparity that exceeds 100 times.

This exorbitance in executive compensation is increasingly unrelated to increased profitably at American firms. At one American corporation, profits have declined by 71 percent. At that time, the compensation received by that corporation's CEO totalled nearly $18 million.

Another American corporation had its profits decline by 27 percent. It filed for bankruptcy the same year. And the reward for the CEO was a 38 percent pay raise.

Corporate America should be willing to set examples. After all, CEO's are leaders. All leaders must set examples. They should not take bonuses while their employees lose their jobs.

What happens to American competitiveness, for example, when workers get the message that performance does not affect compensation?

What happens to the quality of American products when American workers get that message, that performance does not affect compensation or quality of product?

It is demoralizing. It actually condones slip-shod performance and unnecessary cost. It can also result in a flight of capital away

from those corporations in which executive compensation is divorced from performance.

While I generally believe that wages should be left to fair and free competition in the market, I also believe that government should not subsidize this excess.

Corporations need to inject performance, scrutiny, and disclosure into the executive compensation equation. And if they refuse, we have an obligation to ensure that tax policy or other public policy provides no comfort.

I am very interested in the proposals of Senator Levin. I think they have merit. I am very interested in your proposals, Mr. Chairman, and others that I am aware of. I am also particularly interested to hear from Chairman Breeden.

I was once an employee at the SEC. I worked then in a division called Corporation Finance. I examined proxy statements of shareholders. And it is my very strong belief when I worked at the SEC that shareholders really had no control over executive compensation.

I would scrutinize footnotes very closely, trying to determine what, in fact, the executive compensation was. It is very hard to determine. We didn't really know what it was.

And even when we did know, because of the powers of inside directors and the powers of management in portraying what they do in the proxy statements, as a practical matter, the shareholders had no control over it.

I think there is no doubt that something is wrong here. Something is glaringly wrong. There is excessive greed too often among too many American CEO's which does have these deleterious and unfortunate consequences that we have all mentioned and will continue to mention until there is a solution.

And I believe, Mr. Chairman, we in the Congress have not only the right, but more importantly as public servants, we have the duty to do something about it. That is, we have a duty to do all we can to encourage more cooperation in our country, more of a sense of team work in our country.

We have a duty to address excessive executive compensation because I think in doing so ironically, we will be not only helping American employees, the American workers, we also are going to be helping those CEO's, encouraging them to spend more time on performance, more time on team work, more time in cooperation with their employees, and less time on their perks and on excessive compensation.

Senator BOREN. Thank you very much, Senator Baucus. I think you have pointed out very well the importance of developing a sense of teamwork in this country.

We are not going to solve our economic problems, we are not going to get back our share of the world marketplace, we are not going to stop replacing $440 jobs per week with $280 jobs, if we do not have a sense of teamwork. Everyone is a part of it.

And how in the world can we have our leaders in the business community effectively obtain cooperation from those in the work force to tie compensation to productivity when we have had a decade where real executive compensation goes up 75 percent, while

profits have gone down 17 percent? There is simply no way, as you pointed out.

Also, we have been joined by our colleague, Senator Daschle. We are glad you are with us this morning and welcome any opening comments that you want to make.

OPENING STATEMENT OF HON. TOM DASCHLE, A U.S. SENATOR FROM SOUTH DAKOTA

Senator DASCHLE. Thank you very much, Mr. Chairman. I, too, want to commend you for your leadership in holding this hearing this morning and welcome our colleague, Senator Levin, who has really taken an active role in providing leadership in the Senate itself. We are delighted he is here.

We spend nearly $500 billion a year on tax expenditures. I am amazed that this Committee or the Senate itself does not have a better appreciation of the magnitude of those expenditures from a budgetary point of view and the ramifications that those expenditures have each and every year.

We are told that, over the next 5 years, we will be spending close to $2.5 trillion through tax expenditures of all kinds. Tax expenditures are a subsidy. There is no other way to look at them. They are a subsidy. And we rightfully subsidize many business-related activities.

Yesterday, we held a hearing in here all day long on whether or not businesses ought to be subsidized if they locate in economically depressed areas. I happen to believe that they should be. And that is a proper form of subsidization.

Subsidization really takes two forms, direct government payments and indirect tax expenditures. The question is should we provide unlimited subsidization to those companies that pay their executives many millions of dollars in salary and benefits?

Already we have laws which are intended to limit all business deductions to that which is reasonable.

Well, my belief, Mr. Chairman, is that we really cannot afford unlimited subsidization of this practice, not with a $400 billion deficit, not with a debate looming about whether or not we ought to have a Constitutional amendment to balance the Federal budget.

If we were to examine tax expenditures annually like we examine all the other forms of governmental involvement in our budget, I would believe that this subsidization of excessive executive compensation should be one of the first tax expenditures we should question.

With a $400 billion deficit, can we afford a $2 billion subsidy to businesses that pay their executives unlimited compensation?

I do not think compensation ought to be regulated, but at the same time I do not think excessive compensation should be subsidized. Businesses should have a right to pay their executives whatever they choose, but not at taxpayers' expense.

I think we are making a real contribution to the debate on tax expenditures today. There are different approaches with which to address this issue, and I think it is important to have them on the table. We must consider which is most meritorious and come to some conclusions about the availability of Federal revenues for tax expenditures such as this.

So again let me commend you for your chairmanship in holding this hearing this morning. I am delighted that we have the array of witnesses that we do. I think we are going to learn a lot. Thank you.

Senator BOREN. Thank you very much, Senator Daschle. And again, you are right in focusing on the fact that we are using the tax code to subsidize excessive executive compensation.

And that certainly is the focus of the Finance Committee where we have a direct responsibility to examine how the use of the tax code.

Our first witness this morning is Senator Carl Levin from Michigan. He has been a leader in addressing the issue of excessive executive compensation. In fact, I would say the leader in the Congress on this subject.

One of the first voices to be raised in concern about this issue was his. He suggested legislative solutions to the problem. He has introduced legislation that would simplify the disclosure of compensation information to shareholders.

One of the problems in the past has been that very little information was available. And the information that was available was presented in a way that the average shareholder simply could not grasp what it meant.

And he has also proposed that shareholders be given an ability to vote on compensation plans through the proxy process.

He has held hearings on the issue in the Subcommittee on Oversight of Government Management. He has been very effective in terms of his involvement with this issue.

Senator Levin, we welcome you this morning and would appreciate any comments that you might make.

STATEMENT OF HON. CARL LEVIN, A U.S. SENATOR FROM MICHIGAN

Senator LEVIN. Thank you, Mr. Chairman and Senators Baucus and Daschle. Thanks for the invitation to join you this morning to talk about a very, very critical issue. And that is the issue of executive pay.

First, I want to use some illustrations to illustrate some of the facts which are so compelling here.

The first chart that I have up there shows what has happened during the 1980's through 1987, with executive pay and with profits. You can see that the top line, which is executive pay, went up dramatically during the 1980's. At the same time, corporate profitability, which is the bottom line, stagnated during the 1980's and, as a matter of fact, fell somewhat.

That shows the disconnect between corporate performance and corporate pay. The problems that result from that are immense, including big morale problems in the factories and plants, and also a lack of competitiveness between ourselves and our competitors abroad.

The first chart also shows that while corporate pay was going up dramatically during the 1980's, the rest of us got nowhere. Those two middle lines show that the inflation rate, which is the top of the two middle lines, was actually slightly higher than the wage increases for the rest of us, for the rest of society.

That is why the chairman rightfully said that real wages actually went down during that period while corporate pay skyrocketed and corporate profitability stagnated.

Now, this pattern of skyrocketing executive pay at the time that corporate profits are falling continued into the 1990's. Here are the statistics on that. In 1990 while corporate profits fell 7 percent, CEO pay went up 7 percent. And in 1991, while corporate profits fell twice as fast, by 15 percent, CEO pay rose another 4 percent. So that the pattern of the 1980's continued into 1990 and 1991.

The next chart—the Chairman and I believe Senator Baucus also mentioned—CEO pay in America is 100 times that of average workers. That is tripled the pay gap of 15 years ago.

So the gap between the CEO's and their workers is not only 100 times, the CEO getting 100 times more than their average, but that gap has gone up, has tripled in the last 15 years.

Even J.P. Morgan, who was one of America's leading capitalists, advocated limiting CEO pay to no more than 20 times the pay of average workers. It is now 100 times in the United States, that pay differential.

In Japan, it is 17 times in the pay differential. In Germany, it is 23 times.

Now, what this chart also shows is that CEO pay almost doubled in the last 5 years while workers' pay has not kept up with inflation.

So this chart brings up to date the lines of the first chart and shows that again from 1986 to 1991, worker pay has not kept up with inflation. At the same time, you have this runaway executive pay on the top line.

Finally, CEO pay in America far exceeds CEO pay in the rest of the world. At mid-size companies with $250 million in assets, this chart shows that U.S. CEO's typically receive twice as much pay as CEO's in Germany and Japan, even though, again, many of their companies are beating our socks off.

As you mentioned, Mr. Chairman, the disconnect between CEO pay and corporate performance, the disconnect between CEO pay and worker pay and the disconnect between our CEO's and CEO's abroad were the subject of hearings before my Subcommittee a year ago, May, and in January of this year.

What these hearings dramatized is that the Federal Government is part of the problem. And that is the point that I would like to emphasize here this morning.

The Federal Government is part of the executive runaway-pay problem in America. At least its policies have contributed to executive pay excesses. And that is why my legislation was introduced a year ago, S. 1198.

First, until the bill was introduced, until about February of this year, the Securities and Exchange Commission acted as a roadblock to stockholders who were trying to put the brakes on runaway executive pay in their companies.

That may be hard for people to believe, but it was the rule for decades in the SEC that if a corporation objected, which they routinely did, that a stockholder had no right to circulate even an advisory opinion relative to how pay was set for a vote at the annual

meeting. This was referred to I believe by Senator Baucus in his opening statement.

What my bill did was to direct the SEC to reverse that policy and to allow these advisory stockholder proposals. I emphasize that they are advisory. This is a very modest proposal, just to allow stockholders, the owners of a corporation, to advise their directors and executives as to how pay should be set at their own corporation.

Eight months later, the SEC did that, in response to my legislation, in February of this year. In fact, the SEC has now reversed that policy, and as a result, about 10 corporations' proposals urging pay reforms have been presented for votes.

The second reform involves improving SEC regulations on pay disclosure. Right now, even experts frequently cannot figure out from these proxy statements what executives are paid at the corporations.

And again, Senator Baucus was referring I believe to the complexity, the murkiness, as you did, Mr. Chairman, in your opening statement when you pointed out how difficult it is for the public, for shareholders, and for investors to even figure out what executives are paid from looking at these proxy statements.

Here is a 20-page proxy statement. There are references to pay on 11 pages. You can spend hours reading that statement and at the end I will guarantee you, you still cannot figure out the total that the executives at this company are being paid. That has got to be changed.

We have got to make it simple for owners, stockholders, potential investors to know what it is the CEO's are being paid. The only way they are going to have a chance to change it is if they can understand it. And that is going to require a change in the rules.

Up until now, the Federal Government has been on the wrong side on this issue. We have allowed this murkiness, this nondisclosure to occur.

I am happy to say that in February, Mr. Breeden announced that there was going to be a new regulation on this subject. It has not yet been promulgated. We are awaiting it. We are hopeful that it will be just as strong as he outlined.

I congratulate him for what he did in February, but we do not yet have the details of this regulation on pay disclosure.

By the way just to summarize this one point, my bill would require proxy statements to provide a clear disclosure—a chart which would list all types of pay and a bottom-line total for each executive.

The third and final reform in my bill involves accounting for stock options. Stock options give executives the right to buy company stock at a set price for a period of time, usually 10 years.

While companies in other countries like Japan rarely use stock options, over 90 percent of our companies do grant stock options to executives. And they provide a significant portion of CEO pay, not 5 percent of the total usually, but typically 30 percent and often 50 percent of executive pay comes in the form of stock options.

One business publication recently ran a story entitled, "If CEO Pay Makes You Sick, Don't Look at Stock Options." It featured a CEO who had received a 1991 stock option grant valued at $120

million on top of previous grants valued at $225 million for a 4-year total of $345 million.

The reason that companies can afford to provide this level of stock option compensation is that stock options are the only type of executive pay which a company can deduct as an expense on its tax return, but does not have to list as an expense in the company books.

Keeping stock options off the books as an expense means that even huge option grants have left corporate earnings untouched.

Charles Munger, who is the vice chairman of a leading investment firm, Berkshire Hathaway, has called this accounting system "contemptible." A Barron's commentator has criticized stock option rules for creating a "tax subsidy."

Because these options never appear on the company books as an expense, I call them stealth compensation.

Mr. Chairman and members of the Committee, everybody agrees that stock options have value. And yet they do not show as an expense on the company's books. It simply does not make sense. In fact, I think most people agree on that.

Now, the SEC, which has been considering this issue for a long time, has still not acted, except that they have directed their staff to make a recommendation on how to bring stock options under the rules of ordinary compensation.

Mr. Chairman and members of the committee, if the SEC does not act on this and if the Financial Accounting Standards Board does not act promptly on this, Congress should. This has been going on too long, where options have not been shown as an expense on the company books.

In closing, executive pay unrelated to corporate performance is a threat to our competitiveness. It rewards poor results, causes work place resentment, and it raises red flags in international trade negotiations.

Constantly, our trading partners negotiating with us are pointing to our compensation as an answer to why they should not do something. They say, "Look how excessive your compensation is. You should do something about that rather than demand that we do something overseas."

So one of the reasons to address this issue is to remove that red flag, to remove that argument from the possession of our competitors.

So I congratulate this Committee for holding this hearing, for considering what you are. I feel that we must continue to move forward in this area.

The SEC is doing that, but we do not know the details yet in two of the three areas that I described. And until we have some advances locked in in this area, I believe we've got to keep the pressure on.

I thank you, Mr. Chairman, for your invitation.

[The prepared statement of Senator Carl Levin appears in the appendix.]

Senator BOREN. Senator Levin, we appreciate the comments you have made. Just to make sure I understand the areas in which you think we still have the most serious, unfinished business remain-

ing, one would be the evaluation of stock options so that they are clearly spelled out.

Would you also advocate that stock options show as an expense of doing business for the company?

Senator LEVIN. That is correct. That is the major one.

Senator BOREN. I gather that you are not necessarily opposed to the use of stock options as a form of compensation as long as that is disclosed and as long as that is fully considered as part of the entire compensation package?

Senator LEVIN. I think that there is a legitimate function for stock options, particularly when they relate to performance, but that legitimacy does not exist when they are hidden from the eyes of the owners of the corporation, the stockholders, and potential investors.

Senator BOREN. Now, the other area that you are most concerned about is to make sure that we do simplify the way in which information is given in the proxy statement about compensation?

Senator LEVIN. Yes. We should require that compensation of all forms be disclosed in one simple, straightforward chart.

The SEC is hopefully about to do that. They have announced that they are about to do that, but the rules setting forth the details have not been promulgated. Until it is done, we should keep the pressure on.

Senator BOREN. Would you also favor the proposal of this Committee, one that it may soon have under consideration again, to limit the deductibility of executive compensation as a business expense for corporations?

Senator LEVIN. I think from the perspective of tax fairness that there is some merit to that. It is somewhat of a blunt instrument because it treats large companies, small companies, old companies, new companies all in the same way.

So perhaps you can make it less blunt in some way to address the differences that exist between companies.

But I think from a tax-fairness perspective, there is some merit in that proposal. It does not really address the excessive compensation issue in the ways that my proposal does, because what I do is use the capitalist system, the inherent kernel of the capitalist system, which is the stockholders and the owners and the potential owners, and say, "You should have some rights to at least advise your own board on how a pay is set. You should at least be able to understand what your executives are paid."

That is the disclosure part which to me is the preferable way and the real way to get at the problem of runaway executive pay.

But from a fairness perspective in terms of the rest of society, in terms of our deficit and what we have to do in order to bring our tax code into some fair balance, I think there is some merit to a deductibility cap, but again, I would seek ways to make it more applicable to different situations in different ways.

Senator BOREN. So you see it as really a separate issue. It is an issue of tax fairness, but it is not as effective as your proposal in terms of really involving the owners of companies in policy decisions, for example, to tie compensation to performance.

Senator LEVIN. Exactly.

Senator BOREN. As we explained, the provision would prohibit the ability of corporations to deduct compensation above $1 million as a business expense. That really does not at all get into the question of whether or not that $1 million was based upon fantastic performance by the CEO that caused profits to go up or whether that $1 million or an amount in excess of $1 million was compensation that reflected a raise in pay when the company was losing millions of dollars.

Senator LEVIN. That is basically correct, Mr. Chairman. There may be some impact of the cap on CEO pay, but I do not think it is nearly as a desirable or an appropriate approach for that purpose. It does have again a very strong tax-fairness compelling element to it.

Senator BOREN. I notice in your proposal, you call for only vote by the shareholders that would be an advisory to the board of directors, not mandatory.

Why do you feel that it should be advisory only?

Senator LEVIN. First, I think it will work. I believe the directors will listen to advice when the majority of the stockholders render that advice. So I think it will have an effect, but it avoids directly putting the stockholders in the director's seat.

It leaves some discretion to run the company for the directors and the executives. So it is a balance between letting the executives and the directors run the company at the same time allowing shareholders a greater role.

If history shows that shareholders are regularly giving advice which is ignored, then I think we will have to consider the next step which is to make it binding. But I believe it would not be ignored.

Senator BOREN. On the terms of compensation, do you include clear descriptions of compensation pay to members of the boards of directors as well as to the top executive officers?

Senator LEVIN. Yes, we do.

Senator BOREN. Senator Baucus.

Senator BAUCUS. I just have one quick question, Carl. We all cited these international comparisons on executive compensation. Do you know the extent to which they reflect expense accounts, housing allowances and similar payments?

I raise that because I once raised the issue with a CEO of a very major American corporation. And right away he said, "Well, I'll shift." He was very upset that the issue was raised, saying that Marita at Sony gets paid less, but gets all his housing free and has a gigantic expense account, and so on.

So whenever we Americans say that U.S. compensation is so dramatically high compared with the compensation of CEO's of foreign companies, is this an accurate comparison? Are we comparing apples with apples, not apples with oranges?

Senator LEVIN. It is my understanding that the comparisons which are made on my charts include perks. I think that is the direct answer to your question, that this chart includes the perks.

Senator BAUCUS. So it is your understanding that it does include all the expense accounts and so forth?

Senator LEVIN. That is correct. But we can double check that for the record.

Senator BAUCUS. Thank you.

Senator LEVIN. This is not my chart by the way. All these charts are other folks' charts. We can just ask the people who put these figures together to double check that, but it is my understanding from my staff that perks are included in these numbers.

Senator BAUCUS. I think there is an unfortunate ethic among too many American CEO's to be too concerned about their own compensation. It often comes at the expense of the compensation and the well-being of too many other employees who work within the corporation, which in my view has a very deleterious effect on morale.

I know it is true because I recently travelled to several areas of the country. My sole quest was to determine how American business sees American competitiveness. And I also spent some time with employees and labor unions.

I will say I was not surprised when I learned the depth of their disgust with their companys' CEO's compensation compared to theirs. And it very definitely seemed to have a very adverse effect on morale and therefore, it must have an adverse effect on quality and on performance.

Senator LEVIN. There are just too many cases where companies have asked their employees to take pay cuts and are laying off workers at the same time the CEO's are getting big pay increases.

Senator BAUCUS. Thank you.

Senator BOREN. Thank you very much. Senator Daschle.

Senator DASCHLE. Carl, you made reference to the question of performance and the function that compensation has in recognizing performance. That seems to me to be the novelty argument of those who say there ought not be any constraints, that it really is the tool by which a board can encourage its CEO's to maximize their performance and give them whatever compensation may be required to get the job done.

Have you been able to analyze that argument? To what extent is there a relationship between pay and performance?

Senator LEVIN. The first chart shows clearly that during the 1980's, there was a tremendous gap between pay and performance and that continues right through 1991. The pay line, which is the top line, goes up dramatically.

The performance line, which by the way most CEO's view as the key measure of performance, is company profitability. That one went down during the 1980's.

The figures are that during 1991 that continued. First, during 1990, again corporate profits fell 7 percent in 1990. CEO pay went up 7 percent in 1990.

So that gap between pay and performance, it was dramatic from 1979 to 1987 and continues to be dramatic.

Senator DASCHLE. You mentioned that limiting deductibility is a blunt instrument. I guess I would note that, with respect to meals and entertainment, the business use of automobiles, the practice of paying so-called "golden parachutes," and pension plans, we have applied the argument that deductibility should be limited with some success. I am not aware of any proposals which would call upon the Congress to liberalize deductibility in those areas.

So, in light of the fact that we have limited deductibility with respect to these other business practices, do you have any further comments on the advisability or the applicability of reasonable limits on the deductibility of compensation?

Senator LEVIN. The only comment I would add—and I think this supports your position on this issue when you are looking at the pros and cons. One of the reasons that I think you can fairly use to limit the deductibility is that the corporate share of the tax burden in this country has fallen 25 percent since 1980.

So that putting a cap on companies paying over $1 million to one person is probably a burden which they would be able to bear, given the shift in the burden in terms, of again, the corporate share of the tax burden having gone down in the last 10 years.

That would be the only additional comment. I am not sure that is directly responsive to your question, but it perhaps bears on your questions somewhat.

Senator DASCHLE. The real concern I guess one would have in this deductibility argument is how one quantifies the value of stock options?

This form of compensation presents some practical questions that we would have to resolve. That is a legitimate concern.

It is easy to quantify annual forms of pay, but once one adds stock options into the mix, it becomes a little more complicated, and that would have to be addressed.

Senator LEVIN. It is a very important point. Given the significance of stock options, it is such a big part of pay in America for CEO's that you do have to figure out how to deal with that in your deductibility approach.

But the SEC again has directed their staff to give them a recommendation in this area. And in due time, I am sure that you will be asking Mr. Breeden about this and that may clarify this issue because there is a commitment that he has made publicly and to me that the staff of the SEC will make a recommendation shortly on the issue of valuing stock options.

It is not a simple question, but it is a question which has to be answered. It has been unanswered for over 10 years now. Everybody agrees they have value to the recipient and a cost to the company, and yet no one has decided, well, how do we figure out when to value those options and how?

Sure, it is complicated. There is a lot of complicated issues in the world. The Accounting Standards Board has decided more complicated issues than this one. This one has taken 10 years and they still have not decided it.

So, yes, it is a critical question in terms of determining the deductibility issue, but it should be determined in the next few months hopefully by the SEC and if not by them, by Congress.

And then that, in turn, can fill in that plug in that hole or that uncertainty that exists in the deductibility approach.

Senator DASCHLE. Well, let me again commend you for an excellent proposal and for your presentation this morning. I think you have made a major contribution to the debate and I, for one, appreciate it a great deal.

Senator LEVIN. Thank you, Senator.

Senator BOREN. Thank you very much, Senator Daschle. And again, Senator Levin, thank you for testifying this morning. And thank you for your leadership on this issue.

Senator LEVIN. Thank you so much.

Senator BOREN. We now welcome as our next witness Richard Breeden, the Chairman of the Securities and Exchange Commission.

The SEC has been very receptive to the concerns of shareholders about executive compensation, as Senator Levin has indicated.

And in February, Chairman Breeden announced a new proposal which was designed to give shareholders relevant information about compensation and to permit shareholders to make their views known to members of boards of directors.

I am looking forward to hearing about the initial results of the implementation of this proposal and the chairman's views on this topic, and on the pending tax legislation as well.

And also I hope that he will be able to give us an update on the matter that Senator Levin has just discussed in terms of setting some standards for evaluating stock options, and for additional simplification of the way in which information is presented to shareholders in proxy statements.

So, Chairman Breeden, we welcome you this morning and look forward to hearing your comments.

STATEMENT OF HON. RICHARD C. BREEDEN, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, DC

Mr. BREEDEN. Thank you very much, Mr. Chairman and Senator Daschle. This is my first opportunity to testify before the Finance Committee. And I appreciate this opportunity to discuss an issue that is obviously timely and of great importance to shareholders and citizens across America.

I might add at the outset a word of warning. And that is that certainly the SEC is not the repository of the nation's expertise on tax policy. That is not normally our bailiwick, protecting shareholders is.

As the committee requested, my remarks address the tax issue. However, they focus on some of the shareholder considerations involved in the SEC's work.

Certainly, the subject of executive compensation has aroused considerable public concern. Rightly or wrongly, there is a perception of abuse when a company whose financial results have deteriorated goes ahead and rewards its senior executives with substantial compensation increases.

The same perception may arise when a company has seriously underperformed the market for a sustained period if the CEO continues to receive multimillion dollar compensation.

Stock options or restricted stock worth tens of millions of dollars have also raised questions of proportion and perspective, even when the issuer itself has had positive earnings and increases in its stock price.

In some cases, to be frank, it is difficult for an outside person to understand what factors a board of directors could possibly have relied on in reaching some of the compensation decisions we have seen.

Some practices, such as resetting the price of management's stock options where a company's shares have plummeted in value, are difficult to justify as consistent with shareholder interest.

Similarly, interlocking compensation committees, where one CEO serves on the compensation committee of another company, whose CEO, in turn, serves on the compensation committee of the first company, creates certainly the appearance, and possibly worse than that, of conflicts of interest.

Stock options are the source of some of the largest amounts of compensation for managers of large, publicly-traded companies, and are very much at the center of this debate about compensation.

However, it is important to understand at the outset that stock options are absolutely vital to the small and high-tech businesses in this country that produce most of the new technology in our economy, and certainly by far the largest proportion of jobs in the United States.

Small companies, especially the high-tech, startup companies, use options quite widely in recruiting and retaining executive and scientific talent. Indeed, many small companies use options widely within the company, providing for participation by all employees in stock option plans as a very important means of motivating employees to work for long-term corporate growth.

Increasingly, this use of stock options to motivate employees and to give them entrepreneurial incentives is spreading to larger companies. General Electric, Pepsico, Merck, General Mills, and many others are examples of companies that are now using stock options as a means of providing entrepreneurial incentives to a large number of employees within the company.

Once thought of as largely compensation for executives, stock options have become a common and widely used means of instilling the pride and economic incentives of ownership in literally thousands of employees.

This conversion of employees into owner-employees seems a very positive trend. Indeed, Mr. Chairman, it is consistent with efforts of this Committee and the Congress in the past to foster employee stock option plans, TRASOP's, and other devices.

So this trend is one that I think Congress has consistently tried to encourage, and it is one that we see occurring in the marketplace.

Of course, many companies go to great efforts to seek to align the incentives for executives with the long-term interests of shareholders.

Here, the stock option is a tool for creating management incentives to improve shareholder value.

Unlike the payment of straight cash salary or cash bonus, with stock options, except in the reset case that I mentioned earlier, the executive does not profit unless the shareholders also profit.

That is an important difference from a shareholder-interest perspective. It helps align the financial interest of the executive with the financial interest of the shareholders.

I think there are far fewer problems when executives make their shareholders rich if they also make themselves rich. The problem is really when those two factors are not connected.

One factor that we have observed in the current market that detracts from this normal trend of aligning manager and shareholder interests is the way some of the huge option grants have been priced.

During the decade from 1981 to 1991, a time of rising stock market price levels, the S&P 500 rose 240 percent. During this period, if you granted a 10-year executive stock option and the market price of the underlying stock rose by those levels, if all the executive had to do was to get the price of the stock up 5 percent or 10 percent in order to begin to profit, the executive could have profited notwithstanding the company's serious under-performance in the market.

In fact, for the decade of the 1980's, that certainly was the case. A 10-year option granted in 1981 at the then—market price certainly did not require good corporate performance in order for the executive to profit handsomely upon exercise.

Recently, some major companies have begun to issue options whose conditions of exercise include what we call a hurdle rate. This requires the company's stock price not just to increase, but to increase more than a certain amount.

Certainly, incentives moving in the direction of requiring companies to perform, not just positively, but to outperform the market or to outperform their competitors, are increasingly being utilized in the market today. That seems to me to be a healthy trend.

Although abuses have undeniably occurred in some companies, it is important to keep these cases in perspective. America's economy includes several million corporations ranging from the tiniest start-up companies to some of the world's largest corporations.

The appropriate level of compensation of corporate officers depends on the specific circumstances of each particular company in a particular time period.

Executive compensation that might seem excessive in one company could be inadequate in another. What is deemed appropriate must be constantly adjusted to reflect the evolving circumstances of the company.

For example, a company that lost money, but that managed to move from tenth to second place in market share or earnings in a particular industry could very justifiably be deemed to have had an extremely successful year.

If the average in that particular industry was to lose 30 percent, and you managed to only lose 5 percent, that was a very successful record in that year.

So the question of evaluating corporate performance is not so simple that we can establish bright-line tests without trying to evaluate the particular facts and circumstances of the company on a case-by-case basis.

Who can say what the appropriate level of compensation would have been for Sam Walton, Walt Disney, or Henry Ford? Each of these entrepreneurs created businesses from nothing that went on to employ hundreds of thousands of Americans.

Even with mature corporations, who can say for sure what is the correct amount of pay for running GE or AT&T? Those two companies have 284,000 and 317,000 employees, respectively, and 490,000 and 2.4 million shareholders.

Obviously, the same could be said for trying to specify exactly what network newscasters, fashion models, sports stars, or others who typically earn enormous salaries are really worth.

Determining how much compensation is appropriate is fundamentally a market decision. Since there is not any universal measure of what is appropriate under our traditional system of corporate governance, the board of directors is charged with deciding the issues of executive tenure and compensation in the best interest of the corporation and its shareholders.

To play this role successfully, a director should have both the knowledge and the independence necessary to serve as an informed and active representative of the shareholders.

Limiting compensation to a formula, such as 25 times the salary of entry level workers or an arbitrary amount, such as $1 million, would certainly damage incentives for risk-taking and cause a general loss of valuable flexibility in the economy.

A company that consisted of Albert Einstein and three clerks might justifiably want to pay its CEO more than 25 times the lowest salary.

Furthermore, creating the equivalent of an excise tax on CEO pay would not penalize executives, but would penalize the shareholders because their cost of providing market levels of compensation would rise.

One need only look at the quality of certain economies around the world, such as that in Russia and some of the other former communist states, to see the ultimate results of governmental rather than private control of pricing in an economy.

Indeed, this question of deductibility has very wide implications beyond simply CEO's. If any corporation cannot deduct salaries in excess of a certain amount, if the Baltimore Orioles cannot deduct Cal Ripken's salary or the Bulls cannot deduct Michael Jordan's salary, then it is not likely that those salaries are going to go down. They are set by the market.

What is likely is that the ticket prices for the Orioles and the Bulls are going to go up. I am not sure that this is the best way of contributing to fairness or a strong economy in America.

These examples are not meant to ignore the reality of excess and abuse that has occurred in specific companies, and that frankly causes many Americans to react adversely to practices that are occurring in the corporate community.

Certainly, some of those practices need to be corrected. They need to be addressed by the corporate community as a high priority.

But, I think we need to recognize that use of the tax code or any absolute set of rules to govern every company irrespective of its particular situation will involve enormous cost and unintended negative results.

Thus, if ever there were a decision that would appear best left to the flexibility of the market, this is it.

In many respects, the most serious problem is not the amount of pay, but whether our current system provides adequate accountability for producing good corporate performance.

Where senior executives have not been able to produce superior earnings and increased value for shareholders for many, many

years, the issue should not be how much they get paid, but whether or not they should be fired.

Too many shareholders, employees, and others depend on the performance of the large corporation for the board of directors to allow it to deteriorate indefinitely without forcing a change in management.

When executives do not perform, board action to replace them is a far better way to promote economic growth than imposing new taxes.

The recent action of the board of directors of General Motors in forcing senior executive personnel changes after a period of adverse financial results is an example of the kind of forceful action by a board of directors that we need more of to create a greater sense of accountability for corporate performance.

Greater director independence and involvement in the affairs of the companies on whose boards they sit may well be more necessary in the future, than was true in the past, to assure good corporate performance.

As I mentioned, Mr. Chairman, in dealing with these issues, we believe it is best to focus on removing impediments to the working of market forces.

To this end, the SEC is trying to focus on improving sharply public disclosure concerning corporate performance and compensation awards, and creating broader opportunities for shareholder input to the boards of directors on the appropriateness of executive compensation policies and practices.

We are currently working on, and I expect to announce later this month, a proposal seeking public comment on amendments to the disclosure requirements concerning executive compensation.

Since the shareholders ultimately pay these compensation packages, we believe that shareholders have every right to know what decisions the board has made and to know exactly what and how the company is paying its executive officers.

Today, proxy disclosure is all too often a very lengthy, abstruse narrative that obscures the relevant facts. In its place, we plan to require summary charts and graphs that will set forth clearly and in detail the components of compensation awards to senior officers.

In addition to enhancing disclosure, the SEC will also propose to require that the members of the compensation committee of the board of directors state publicly in the proxy statement, signing it to indicate their support, the factors that they relied on in granting specific compensation packages.

It should not be enough just to announce the total. If you have awarded multimillion-dollar incentive compensation, it ought to be the responsibility of the directors to say why and what were the underlying factors. If they were not profits, were they improvements in quality? Were they improvements in other aspects of how the company is run?

And if the directors cannot explain the awards, then the shareholders ought to know that also. So we believe that this requirement for public disclosure for what the reasons for compensation decisions were will have a very great and a positive impact.

Where companies do not have a compensation committee that is exclusively composed of outside directors and exclusively composed

of directors who do not serve on an interlocking compensation committee, then we will propose even more detailed disclosure.

I might add, we will propose extremely detailed disclosure concerning the facts that went into decisionmaking and all the financial interrelationships among these decisionmakers.

Because we believe that where there are these types of "interlocks," or directors serving on each other's compensation committees, then the shareholders have even more reason to be concerned about the motivation for compensation decisions. We are going to require very detailed disclosure for those situations.

Effective earlier this year, the SEC took what I believe to be a very important step. That was to begin to require all public companies to include in corporate proxy statements resolutions setting forth shareholder views concerning compensation for senior executives.

Traditionally, shareholders were not allowed to express a view or to vote on the appropriateness of board compensation decisions. But we now believe—and I certainly credit Senator Levin for helping to bring attention to this issue—that shareholders who are paying these compensation awards ought to be able to express quite directly and quite openly their views on whether the compensation programs are appropriate.

While shareholder resolutions are only advisory in nature, they allow shareholders to provide direct input concerning decisions on compensation without having to mount an expensive and disruptive proxy election contest to remove the board.

Pursuant to this new voting policy and interpretation, 10 companies were required this year to include resolutions regarding senior executive and director compensation in their 1992 proxy statements.

An additional 33 shareholder proposals were submitted to shareholders regarding executive compensation disclosure and golden parachutes.

The SEC program in this area is simple. Our goal is to assure that shareholders are well informed and that all the facts regarding compensation that the shareholders are being asked to pay are out in the open, on the table for everybody to see.

At the same time, we seek to foster better accountability of the board of directors to the shareholders for the decisions that they reach because the board is legally responsible for protecting the interests of shareholders.

Through these steps, we hope to allow shareholders, directors, and management to work out for themselves in a totally open process what is the best decision for each particular company. Thank you.

[The prepared statement of Mr. Richard C. Breeden appears in the appendix.]

Senator BOREN. Thank you very much, Chairman Breeden. We appreciate your comments. And I want to commend you for the actions which you and your colleagues at the SEC have taken in terms of providing greater disclosure and accountability so that shareholders really can have a greater say in determining what levels of compensation should be.

And I think you are absolutely right that disclosure and accountability are really the two most important factors here because there can be unique circumstances that apply to one company, reasons for setting compensations at a level given the circumstances at one company that might not apply to another.

I especially like the idea of requiring the compensation committees of corporations to provide a clear rationale for these decisions, setting forth the factors, and signing these statements, thereby assuming responsibility. Again, these actions strengthen the whole area of accountability.

And I understand what you said about stock options and that stock options can be a very important device to compensation to performance in the way of uniting the interest of the managers and the owners, the shareholders of companies.

What progress are you making in terms of finding a way to provide evaluation of stock options and to communicate that information about the evaluation of stock options to the shareholders?

And perhaps you could also—I know it is a very complex subject—explain to us some of the technical problems that are confronting you and confronting the accounting profession in trying to make these evaluations and set these standards.

Mr. BREEDEN. Mr. Chairman, I will try, although I should indicate at the outset that I am not an accountant, and these get to be very complex questions.

The fundamental difficulty or the first thing to understand about options is that they are awards of something that is contingent, because exercise is not a certainty.

Options are contingent in two major respects. First, options typically have a period between when they are granted and when they vest—that is, when they become a legal entitlement that the executive may exercise. There may be a period of 4 or 5 years that the executive has to remain with the company before he actually has a right to exercise the option.

If the executive retires or leaves the company for any reason in the interim, then the option is worthless. It may not be exercised. So that is contingency number 1.

Contingency number 2 is a price contingency, unlike restricted stock where you have only the vesting contingency. In the case of restricted stock, you at least know that you have stock of XYZ corporation when it vests. So that stock, unless its price falls to zero and the company is in bankruptcy, will be worth something.

With an option, there is a "strike price." The option is either what we call "in-the-money" or "out-of-the-money." If the company's stock has stayed level or fallen, as might occur in the case of a company that might not be performing well, then the option may vest, but it is "out-of-the-money."

The legal requirement is there, the opportunity to exercise it, but it is not worth anything. You would have to pay $20 to get a $10 stock. So, options may expire worthless.

Now, when an option is granted for, let's say, 100,000 shares of stock at market price of 10 for a period of 10 years, that contract right now certainly has value.

Any investment banker would say that a 10-year call on the company's stock at a fixed price has value, in the same way that a 10-

year call on 1 million barrels of oil at a fixed price would have value. But, it is value that may not be related to what the option will actually ultimately be worth to the executive at exercise.

We can do no more than come up with a rough estimate of what that value is. There are a number of different formulas that people use. The answers you get are only as good as the assumptions you plug into those formulas.

If we use one of those formulas for disclosure, it has the benefit of making clear that a contract right was received that had value. And, that value may be estimated at, say, $5 million, $10 million or whatever it might have been.

The disadvantage arises down the road, when the option is exercised, and the amount that the executive gets may be dramatically different. The number that we put in for value in the year of grant might prove to be either too high or much too low.

I would be a little concerned if a company disclosed to shareholders that an option was worth $1 million, and 5 years later it was exercised for a $100 million gain. People would turn around and say, "Well, why was the SEC allowing people to suggest that this option was worth so little?".

Unfortunately, at the time the option is granted, all we can do is guess at what it will finally be worth. So, the two alternatives for how an option grant ought to be disclosed are: (1) to value it using a formula under which we know the result will not be accurate, or (2) to give a range of possibilities—to say, "Here is how many options were given out at this price. If the company's stock goes up 50 percent, this is what it will be worth. If it goes up 200 percent, this is what it will be worth. If it goes up the same amount it went up in the last 10 years, this is what it will be worth."

Then investors can make their own judgment as to what they think the company's stock price will do.

Senator BOREN. Is that where you think you will probably end up perhaps giving a range using a formula under different sets of assumptions?

Mr. BREEDEN. Well, that decision has not finally been made, and I would not want to foreclose my colleagues. So obviously, that is a decision that will be made by a majority vote.

I personally have come down on the side of a range of possibilities rather than a single number after looking at it very carefully.

That is a bit of change for me. Earlier on, since today we do not assign any grant-date value, I thought we ought to at least have one number. After considering the matter, I think providing the range of possibilities is probably better disclosure.

Senator BOREN. Well, I think it is important that something be put in the reports, because, as you say, it certainly is not accurate to say that it has no value. All understand that it does.

Mr. BREEDEN. That is the one thing we know for absolute certainty.

Senator BOREN. We certainly do know that. At least you can give some general idea about the ranges because, for example, stockholders might think if the value of an option was potentially $500,000—if the stock continued to appreciate at the rate it has ap-

preciated, say, in the last 10 years—that compensation might be appropriate.

However, on the other hand, if the potential is $200 million, they might think that is excessive.

One last question: you talked about using the tax code and your concern about that. And you certainly have spoken very effectively about the need for disclosure, and for the involvement of shareholders, the owners of the company, in setting the appropriate compensation levels.

The other issue that has been raised is this differential, the gap between the salaries of average workers in the United States and the executive compensation versus the size of that gap in other countries.

You heard from Senator Levin's testimony and Senator Baucus' comments that it has been estimated that the average CEO compensation today is maybe 100 times that of the average worker in the United States; whereas, in Japan, it is 16 or 17 times, and in Germany, somewhere between 20 and 25 times.

Do you see any problem with this disparity in our country versus the disparity in other countries?

And I might also ask the question that was posed to Senator Levin. Do you think that these are accurate comparisons from your own study of it?

They take into account fringe benefits often paid to CEO's in other countries that tend to reduce the amount of cash paid and increase the noncash compensation, such as housing, cars, and other kinds of benefits?

What is your position about that? Is that something that should concern us in terms of the size of the gap and especially the size of that gap compared to other societies? Or is this something that simply ought to be left to the marketplace if the shareholders are fully made aware of it?

Mr. BREEDEN. Mr. Chairman, it is a very, very good question. I think that data in comparing other countries' experiences with our own raise some troubling questions.

I personally am not convinced that the data are accurate. People come up with estimates. I do not know how many and what type of companies are in the samples used for comparison purposes.

We have 13,500 public companies in the United States, whose compensation practices vary widely. If all you did was sample the behavior of the Fortune 500 and you left out 13,000 other companies, you will get a rather distorted picture than perhaps what is the average of the entire sample of public companies.

The United States has far, far more emerging-growth companies than those in other economies that tend to get sampled.

As you point out, the fringe benefit practices are totally different, as I know from my own work in just comparing registration statements of companies from around the world.

We have a huge number, approaching 500, of foreign companies whose securities are traded in U.S. markets. From reviewing those financial statements, I know that there are enormous differences in the way accounting rules work, and in the way compensation practices work.

So you get into an element of comparing apples and oranges. Thus, I am a little leery of making decisions of this significance regarding how we are going to run our economy based on some statistical analyses that may or may not be really accurate.

In the long run, I do not want to suggest that there is not a problem out there. I think there are cases in which the abuse is clear and manifest and the shareholders' interest has not been well served.

There are cases in which the directors certainly must have been asleep. That is the best you can say for what some of them are doing in terms of looking out for shareholder interest.

I prefer a market solution to such problems. I prefer making those directors individually sign on the bottom line. There is a refreshing bit of self-examination that goes on when you have to sign a document that is going to give you personal liability for stating, "Yes, I made that decision. I am willing to say it is appropriate."

People need to think a little harder about some of the decisions they have been making. Let's let the shareholders and the directors and the management of these companies work it out among themselves—they are the interested parties—rather than trying here in Washington to come up with a rule for every company in the United States. The only thing we know for sure is that whatever rule we come up with will not be adequate and will not be flexible enough.

Senator BOREN. Would it be appropriate to include in the statement or the summary of what the compensation is, the figure compares the total executive compensation package is in comparison with the salary of the average worker and then let the shareholders have that information?

If it is 25 to 1, if it is 100 to 1, if it is 300 to 1, let the shareholders know what the CEO compensation is in terms of the comparison to the wages of the average employee of that company. And again, leave it up to the flexibility of the company to work out whether it is appropriate or not.

Mr. BREEDEN. I personally do not think that is the most relevant information. I think the relevant information—this is a personal view—is to compare the profitability level of the company, or how it is doing at creating shareholder wealth, with how the company is doing creating managerial wealth.

I accept that there are considerations involved in comparing executive pay versus other pay for other people in the company, but industry by industry, those multiples may vary dramatically.

In the entertainment industry, to include the multimillion dollar salaries of the anchor persons reading the news may askew the numbers rather to the high end. The same would hold true of stars in movie productions as opposed to an industrial company.

I am not sure whether those multiples are as good a disclosure as forcing the company to disclose how its profitability in the marketplace compared with that of other companies in the marketplace.

Is it outperforming its competitors or is it under-performing them? That is where I think we need to focus attention, where executives ought to be held accountable. They are not there just to be ceremonial figureheads. They are there to produce wealth for

the shareholders and security along the way for their employees. If they do not do that, then we should not be debating pay. We ought to be debating when it is time to find somebody who can do better.

Senator BOREN. Well, I understand what you are saying. I will just leave you with the thought that I think it is worth considering whether or not information should be available to the shareholders in terms of the disparity between compensation of the average employee and the leadership of the corporation. There are important social questions involved here.

One of the most disturbing things to me in terms of social developments in this country over the last decade or so is the shrinkage of the middle-income group in this country. The middle class which has been the glue which has held the country together.

I think we only need to go to countries like Brazil, for example, where the middle has begun to disappear, where there is extreme polarization of a society divided between the "haves," and the "have nots," to see the kind of impact this phenomenon has on a society and the social fabric of a society. Moreover there is an impact on the corporate culture of people inside a business who may no longer feel they are a part of a team, that we are all striving for something, rather than some taking more advantage than they should.

Even perhaps, what is the appropriate level of disparity even in a company where there is good performance? Obviously the manager deserves some credit, but the employees obviously would deserve some credit, too, if a company is doing well and has high levels of productivity.

When employees see a gap widening, there is a morale factor that at least the shareholder should be aware of it in the proxy information that is given out.

Mr. BREEDEN. Mr. Chairman, we certainly will think about that as a disclosure item. If we can do it without a 500 page set of regulations, just defining what is in and out of the formula, we will certainly look at it.

It might be interesting to note here that at least one of the resolutions that we required to be voted on this year in the proxy season was a shareholder resolution to cap salary at a multiple of worker wages.

Senator BOREN. Right.

Mr. BREEDEN. So from this point on, it is the law of the United States of America that companies must include resolutions of that kind for shareholder votes.

There is nothing, as of last February and going forward, that would prevent shareholders, motivated exactly by the concerns that you expressed much better than I could, from putting forth such a proposal. Let the management, if it opposes, say why, and let's see what all the shareholders think about it.

So we have forced those questions into the domain in which the shareholders get to have a say about how the company is doing it.

Senator BOREN. Very good. Senator Daschle.

Senator DASCHLE. Thank you, Mr. Chairman. I could not agree more. I think that, in the interest of full disclosure, an approach of that kind would do wonders at stockholder meetings and would

create an opportunity for stockholders to be far more aware of the dealings and operations of the business themselves.

We have talked a lot about the marketplace and its role in making these determinations. And I think, to the largest degree, that really is the issue. But I think we would be foolish to ignore completely that the taxpayers also have much at stake here. Taxpayers are also a part of this decision.

As the chairman indicated, this is a $2 billion commitment. The failure to limit the executive compensation deduction alone is a $2 billion commitment on the part of the taxpayers.

So it becomes more than just a marketplace question. It is also a tax subsidization question. It represents, in my view and I would be interested in your thoughts, Mr. Breeden, a cost shifting away from the stockholders onto the taxpayers in the form of a tax subsidy when compensation questions are determined.

Mr. BREEDEN. Senator, I do not believe so. Again, as I indicated in my statement, I think it is very likely that we will cause enormous economic damage to the country—there will be lower profits to be taxed, less revenue to the taxpayers and, therefore, larger budget deficits if we start getting in the business of micro-managing how corporations conduct their business.

If American business were run with the same quality with which, in the aggregate, the American government is run, we might have considerably higher bills for the taxpayers because companies would be performing less well. We would have more unemployment. We would be paying more unemployment benefits.

You take a company like Wal-Mart, which began with one store in Bentonville, AR. The investors who paid $16.50 a share in the original IPO now have stock worth $27,000 per original share. That company employs over 370,000 people coast to coast now.

If we had in the early stage made it tougher for that company to finance its business through arbitrary rules on what could be deducted and what could not, maybe we would not have 370,000 people working for Wal-Mart today.

So, I accept the point that we should not be encouraging, as a matter of public policy, what some would perceive as an excess, but I do not know where you stop when you start picking out ordinary business expenses and saying, "Well, you cannot deduct this one and you cannot deduct that one."

The result of that kind of an approach is not that the executive pays more tax, but that the shareholders pay a higher cost and have a lower return. That provides less incentive for them to invest unless they receive a higher rate of return.

So, the cost of capital will go up. That will raise the cost of doing business for every company in the country, even those that are not paying excessive compensation. So I just do not agree.

Senator DASCHLE. I guess I have heard you answer the question twice now. The first answer was that it did not represent cost shifting.

And now I think I just heard you say, if we limit deductibility, it is going to mean a greater shift of the burden onto the stockholders, which could have a detrimental effect on overall profitability. Did I misunderstand what you said?

Mr. BREEDEN. Well, if you start disallowing selectively, various deductions. We can disallow deductions for the salaries of corporate employees above a certain level. We can disallow payment of advertising bills above a certain level that we deem not to be socially worthwhile. We can disallow payment of legal bills to lawyers who charge more than a certain amount per hour.

I mean, we can go through every type of expense that businesses have and announce from Washington our policy on how much companies ought to be paying. But what a company pays for salary or legal services or advertising in New York City may be different than what it would spend in Bend, Oregon. How do you set a single, inflexible tax formula that will try to answer all those questions?

The result when you disallow deductions is that you are, through subterfuge, raising the effective tax rate.

Senator DASCHLE. But do we not now limit the deductibility on a whole range of business activities?

Mr. BREEDEN. You cited some of the limits that exist today. Again, I want to repeat that I am not here as an expert in tax policy, and I do not represent the administration in that capacity. So I can only give you my personal view——

Senator DASCHLE. But you have used the tax argument as a reason why we should not do it and then cite your lack of experience in the tax area as a reason why we ought to keep the practice as it is.

Mr. BREEDEN. Oh, no. I am only saying that, if you ask me to describe all the deductions in the current tax code, others can do that better.

Senator DASCHLE. So you would acknowledge that we do limit tax deductibility in many areas of business practices today.

Mr. BREEDEN. I do not know if it is many. I know we do for cars. And there are some——

Senator DASCHLE. Do you support the concept of reasonableness in our approach to tax deductibility?

Mr. BREEDEN. I think the tax code has certain general standards about reasonableness of deductions that do not attempt to apply specific micro-managed limits of "X" dollars per salary, for example, and a general limit that can be applied by the courts or the IRS in an across-the-board fashion. It may be more appropriate in certain very specific circumstances.

But I think the idea of trying to put an express cap on salaries, whether you pick $100,000 or $500,000 or $1 million, is something that would lead to a higher cost of capital for every business in America.

That will make it much harder for the small businesses that are trying to grow and create jobs and opportunity in this country to do so. I think that will be counterproductive.

Senator DASCHLE. Let me make sure we all understand what it is we are talking about here. No one is capping salaries. I do not know of anyone who has come forward to say there ought to be a complete cap on salaries.

The question is whether or not there should be some limit on the deductibility of compensation from a taxpayer's point of view when we face a $400 billion deficit?

Isn't it in the taxpayer's interest to consider limiting the deductibility of compensation at some point, some level of compensation, whether it is $10 million, $20 million, $30 million, whatever it is, if indeed we are as concerned as we profess to be about the deficit?

Isn't there some level beyond which it is detrimental to the taxpayer to be subsidizing compensation, not capping compensation, but subsidizing compensation through the tax code?

Mr. BREEDEN. I disagree respectfully that it is a subsidy of compensation. If we are looking at what is important in taxation, it is to look at the net. Did the company make a profit or did it not? At what rate do we want to tax the profit or loss that they had?

By picking out individual components of that, but not others, I think you run the unfortunate risk of effectively raising the tax rate on equity holders.

Instead, if we have a problem in our tax code today as it applies to the capital markets—and I am on a little stronger ground there—it is that we tax people who make equity investments at too high a rate.

We are the only country in the world that provides no relief for the double tax on dividends. We have not in my judgment made wise decisions about capital gains in this country.

So we tax the holders of equity securities as opposed to people who invest in debt securities. Yet, equity securities provide the greatest flexibility, the greatest ability for investing in long-term R&D, long-term plant and equipment or other productivity-enhancing investments.

We hit equity investors over the head with a two-by-four through the tax code. The proposal you are discussing would make it worse, and I do not think that is the direction we ought to be going.

Senator DASCHLE. Well, that is a completely different issue. And I share some of your concern about double taxation.

I guess we are going to have Graef Crystal here later on. As I understand it, one of his points—which is the same as Senator Levin's point—is that there really is very little correlation between compensation and performance.

We saw it with Senator Levin's chart, and we have seen a substantial degree of evidence in other contexts. Studies have been done time and again. So I do not think that argument is as meritorious as some would believe.

But again, thank you for your comments. And thank you, Mr. Chairman.

Senator BOREN. Thank you very much, Senator Daschle. We have also been joined by Senator Danforth, a very active member of this Committee.

And Senator Danforth, I will turn to you now for questions. And since you were not here when we began our opening comments, if you have any additional comments you would like to make as you proceed with the questions, I will certainly allow you to do so.

Senator DANFORTH. Mr. Chairman, thank you very much. Mr. Chairman, first of all, following directly on the colloquy between Mr. Breeden and Senator Daschle, Senator Daschle did ask important questions about tax policy. And I want to say that I agree entirely with Mr. Breeden's testimony.

But I think that because the issues of tax policy are so important here, we really should hear from the Assistant Secretary of the Treasury for tax policy.

He is the expert on what constitutes an ordinary and necessary business deduction. And he is also an expert on those instances where Congress has attempted to create its own definitions beyond the general definition of ordinary and necessary business deductions.

And I know that we hope to take this up before the Committee next week, but it would seem to me to find an hour sometime when Mr. Goldberg could come before us and talk to us about the tax policy implications.

This does have major consequences with respect to tax policy. It might sound like it is a reasonable thing to do. It is kind of good, popular stuff. Let's cap what an ordinary and necessary business deduction is.

We have been through this time and time again. And I can remember a former and great Chairman of this Committee, Russell Long, on the floor of the Senate.

At one time, I was for one of these schemes to cap business deductions. And he said, "This is just big brotherism. It is an over manipulation of private decisions through an attempt to fine tune the tax code."

And because of the tax policy implications, we really should have the tax policy person of the administration at least giving us the benefit of his wisdom.

I agree with Mr. Breeden. I think that—and I am sure it would be politically popular to say I did not agree with Mr. Breeden.

But just sitting here thinking about the great lesson to me of the 1986 Tax Act, the great lesson of that Act to me is the danger of doing dumb things to the tax code that seem like smart things when we are doing them.

I wanted to serve notice to the Committee about what I would consider to be a matter of common fairness which will turn up as an amendment that I will offer if we persist on this course.

I think if we are going to do this, we should provide that there is going to be a limit to deductibility for payments made to all employees, not just some employees.

The way this proposal, this legislation is written, only those called covered employees, meaning officers of businesses have this limit to the deductibility applied with respect to their salaries. Therefore, Mr. Breeden raised the question of athletes.

Athletes are not covered employees. How do we in Congress say, well, we are going to cap deductibility for corporate officers, but not for athletes?

Why do we say, okay, the St. Louis Cardinals can pay Ozzie Smith whatever they want to pay him? We won't have any limitation on that deductibility, but we will have a limit on the deductibility of what is paid to the chief executive officer of Anheuser-Busch.

I mean, why not do it to everybody? And why have only covered employees? Why only officers? Why only officers of companies? And why employees only? How about partnerships?

I mean, what if a partner is drawing $2 million? Why should we have what amounts to an exception for lawyers? Are lawyers of greater value to this country than corporate executives? [Laughter.]

Do we make the decision here in Washington handed down from on-high that we really think that American business is spending too much money on people who know how to run a business, but it is quite all right to pay whatever they want to to their lawyers?

And then, of course, there is——

Senator BOREN. I am glad, Senator Danforth, you are refraining from populist appeals. [Laughter.]

Senator DANFORTH. I know when to make them. [Laughter.]

How about movie stars? I do not think they are covered by this. Do you know, Mr. Breeden? I mean, you are not the tax authority, but I will just assert that what is paid to movie stars is not covered.

Now, on of the matter of public policy, do you understand why we should limit the deduction for payments to corporate executives and have no limits for the deduction of payments to movie stars?

Mr. BREEDEN. Senator, you are demonstrating rather effectively that this kind of approach gets us out on a slippery slope of trying to engineer the economy through the tax code, which I think would be disastrous.

I do not believe that the people who produce the jobs in America are less important than the people who produce touchdowns in America. In fact, I happen to think both are important, but if we start picking and choosing which ones we think are more important to the economy, the only thing that is certain is that we will do a bad job of that. We will end up having slower economic growth than we would otherwise have.

Senator DANFORTH. We should at least treat them the same way, don't you think? I mean, if we are raising all this money, why not raise money from Michael Jordan's salary?

I mean, why not say to the Chicago Bulls, "Look, if you want to pay all this money to Michael Jordan or to the Chicago Cubs' Ryan Sandburg, if you want to pay whatever it is, $7 million to him, we are going to cap your deductibility?" It would make just as much sense, wouldn't it? And it would produce a lot of dough for Uncle Sam. That is what we need, more money here so we can spend it.

Mr. BREEDEN. Well, it may well produce more income, but it will do so by raising the ticket price of movies and raising the ticket price of going to a baseball game or a basketball game.

In effect, you are—through the back door—taxing the general public rather than taxing the people that are involved. That to me sounds like bad tax policy. I know it is bad economic policy.

Senator DANFORTH. Let me just ask you this. This is something that I think you do clearly know. There are corporate headquarters located all over the country, aren't there?

I mean, there are—we have corporate headquarters in Missouri, St. Louis, and Kansas City in particular and elsewhere as well. And there are corporate headquarters in Oklahoma. There are corporate headquarters all over the place, aren't there?

I mean, there are corporate executives, CEO's of corporations who live in Nebraska and who live in Minnesota and Colorado and

all over the country. And there are also some corporate executives who live in New York City.

And is there in your opinion a difference in the value of compensation to a corporate executive who lives in New York City and a corporate executive who lives in, say, Mexico or Missouri?

Mr. BREEDEN. I assume that there are considerable cost-of-living differences.

Senator DANFORTH. Amazing, wouldn't there be? I mean, if you would pay a—what is a major corporation located in New York? Just name one headquartered in New York.

Mr. BREEDEN. AT&T.

Senator DANFORTH. AT&T. If you were the President of AT&T and you were paid, say, $1.25 million a year, would that be worth as much than if you were paid $1.25 million—I am sure he is paid more than that, but—and your headquarters were located in, say, Tulsa, Oklahoma?

Mr. BREEDEN. Well, I suspect there is a bit of a cost-of-living difference in those two locations.

Senator DANFORTH. There would be a rush for the door in New York, wouldn't there? I mean, the moving vans would be packed. Maybe that is good. I mean, maybe that—we want to share the wealth around here and get these people moving their corporate headquarters elsewhere. We can get them to move to who knows where, to the bomb shelter of the Greenbriar, you know. [Laughter.]

Senator DANFORTH. The CIA facility in West Virginia. I mean, there are all kinds of places where we could dispatch our corporate executives if we make it punitive enough to corporations to continue operating in high-cost places.

Mr. BREEDEN. Well, Senator, as I tried to express in my testimony, I think that among shareholders in this country as among the general population, there is a justifiable sense of outrage at some of the practices that have occurred.

I do think that any of us would suggest that some of the pay decisions that some companies have made are outlandish, to be charitable. So I am not here to say that there is not a problem.

But, the question we have to focus on is what is the best way of addressing that problem?

I would far rather see us turn America's shareholders, who must pay that compensation, loose on the directors who are handing it out, through giving shareholders better information and a better ability to speak up in their companies, than to try and handle it through swarms of IRS agents or changing the tax code.

I think it is a question of what is the best means to try and respond to a legitimate issue.

Senator DANFORTH. I agree with that. I want to ask just one other informational question, if I can, Mr. Chairman. This limitation in this legislation applies only to so-called covered employees. And covered employees are defined to mean any employee of the taxpayer who is an officer of the taxpayer.

Is that a term of art that is clearly established in the law? Or would it be a matter of constant litigation to determine who is, in fact, an officer and who is not an officer?

In other words, is it true in the world of corporate organization that a rose by any other name smells as sweet?

Mr. BREEDEN. That is an excellent point. There are huge differences, just industry-by-industry, in the level of people who are deemed to be officers. We have several different definitions of officer for different purposes within the securities laws alone.

I am sure that, if you look through all the laws of the United States, you would probably find dozens or hundreds of different definitions of what an officer is.

In a bank, for example, it is very common to have the loan officers in every branch have a title of Assistant Vice President, for example, and be an officer of the bank. There may be many, many officers of the bank.

In other companies where you do not have a need to create this title in dealing with the customer base, you may have few so-called officers.

Senator DANFORTH. Is it conceivable also that the resident genius of a particular corporation, that person without whom the business could not exist could be paid a very, very large salary and in order to circumvent this provision be given no official title at all?

Mr. BREEDEN. Well, I think the Boston Celtics are a publicly-held company. I doubt that Larry Bird is considered to be an officer of the company, but he would fit most people's definition of an employee who is rather important to the organization and its profit-generating capabilities.

Going beyond the sports world, clearly, in high-tech industries you have the people who are vital to our competitive future as a nation, the scientists and the engineers who are responsible for inventing products in the first place and designing ways of making them at low cost and high quality. These people may not be corporate officers, but may in some cases be very highly compensated where they have scientific talent, for example.

So I think you head into a nightmarish approach of trying, in essence, run a centrally-planned economy through the tax code when you start saying who can deduct expenses and who cannot.

In fact, why should we stop at salaries? If we are going to pick out things that we think do not have social utility, well, then maybe we should not allow deductions for other types of activities.

Maybe we should not allow deductions for payment of legal bills or payment of advertising bills or other kinds of payments.

Who is to pick and choose? It is a very slippery slope. And it rejects wisdom that has been embodied in the tax code—to the extent that anyone can associate wisdom and taxes in the same breath—of trying to focus on what overall profitability was and then tax the profits that result from these activities, not the components.

Senator DANFORTH. Well, I hope to at least help the Internal Revenue Service in its regulatory capacity to deal with this present problem because the definition of officer is going to be a nightmare.

So my amendment will provide that all remuneration is going to be covered by this provision.

And I just want to serve notice, Mr. Chairman, to the Committee and anybody else who is interested that if we are going to do this, we are going to do it for all remuneration, not just for corporate officers.

Senator BOREN. Thank you very much, Senator Danforth. Let me say that Mr. Goldberg is already scheduled to testify before the Finance Committee. He had been scheduled to testify on the subject of the Unemployment Extension Bill which also include the tax provision as a possible way for paying for part of that extension.

So he will be testifying before us. And we will make certain also that his comments that specifically relate to this issue be included in our hearing record.

Chairman Breeden, again I want to thank you for being with us. And I want to commend you again for the steps which the Commission has taken in the area of greater disclosure and greater accountability for compensation decisions to shareholders.

Mr. BREEDEN. Thank you very much, Mr. Chairman.

Senator BOREN. Thank you very much.

Could I ask our visitors to please keep order?

I ask the next panel to begin to come up to the table.

And I want to thank my colleague, Senator Danforth, for highlighting the attractiveness of Tulsa as a place for corporations to locate.

It is not only a matter of cost of living, but I will also say that according to a survey of executives across the country, the last three surveys have all ranked Tulsa in the top three cities for quality of life, the cultural life of the city, as well as the cost of living. So I want to thank my colleague for pointing that out.

Our next panel is composed of 4 witnesses. The first is Mr. Graef Crystal, Bud Crystal, who is an authority of executive compensation, having served for several years as a compensation consultant, now studying the issue as a professor and as commentator and also as an author of a book on this subject.

He is an adjunct professor at the Haas School of Business at the University of California at Berkeley and the author of "The Crystal Report", a widely circulated newsletter on compensation issues.

Olena Berg is the Chief Deputy Treasurer of the State of California and here today representing the State Treasurer's Office. The California Treasurer is the trustee of the California Public Employees Retirement System and the California State Teachers Retirement System as well.

Ms. Berg represents the Treasurer in meetings of these trustees. Of course, these state pension funds are very influential and important institutional investors. And they have been outspoken on the issue of executive compensation. Ms. Berg, we welcome you to these hearings today.

I am especially pleased to also be able to welcome today Jean Gumerson, an individual shareholder who is also President of the Presbyterian Health Foundation in Oklahoma City, a person that I have known for a long time, and a very valued civic leader in our State.

She is a member of the United Shareholders Association which is a nonprofit organization that works to ensure shareholder interest. She will be representing the views of the United Shareholders Association.

I also want to welcome Mr. George Sollman who is president and chief executive officer of Centigram Communications Corp. of San Jose, CA.

Centigram was incorporated I believe in 1980. Is that correct?

Mr. SOLLMAN. Yes.

Senator BOREN. And it became a publicly-held corporation in 1991. A significant part of the compensation paid to its employees is a combination of incentive stock options and profit sharing plans.

And we have had discussion already about the importance of—providing compensation incentives, particularly for new startup companies, innovative companies.

I might say as an aside, this is one of the issues that has interested me for a long time. I have long advocated special capital gains differential tax treatment for appreciated value of stock in companies, especially those that are new startup companies, as a way of encouraging this kind of entrepreneurial activity which I think is very important in terms of maintaining the dynamism of our economy.

So we welcome all of the members of our panel here today and appreciate your taking the time to be with us.

I might ask if you could be brief because we have been going a bit overtime this morning. We want to hear everything that you want to tell us. I do not want to cut any of you short, but if you could summarize and highlight your statements as much as possible for us, I would appreciate it.

We will receive your full statements for our written record. And I think in that way, we can go to the heart of the points that you wish to make. And we can conserve some time.

I know some of the members of our panel have airplane reservations and other appointments to keep. So if we could keep our testimony within boundaries of time constraints as much as possible, it would be appreciated.

Mr. Crystal, we will begin with you. And we welcome you.

STATEMENT OF GRAEF S. CRYSTAL, PROFESSOR OF ORGANIZATIONAL BEHAVIOR AND INDUSTRIAL RELATIONS, UNIVERSITY OF CALIFORNIA, BERKELEY, CA

Mr. CRYSTAL. Thank you, Mr. Chairman. I will try to be brief. Although having been paid by the hour for 20 years, it is very difficult for me to work against my own incentives. [Laughter.]

Mr. CRYSTAL. I will not repeat the statistics which have already been eloquently presented concerning the growing differential between American CEO's and their workers and between American CEO's and the CEO's of other countries. Rather, what I would like to do is concentrate on the pay for performance issue, because to me a market is by definition something that allocates resources in an efficient and rational manner.

To the extent that you do not meet that test, then you do not have a market. A lot of people are quite fond of saying that, "Look, you should not challenge the CEO compensation market, that is the market, that is supply and demand. If Americans make $5 million a year, well, that is just the way it is."

But there is the troubling aspect of this pay for performance issue. To put this in perspective, Kenneth Lehn, who was formerly the Chief Economist of the SEC, conducted an interesting study for his dissertation. And that was to try to predict the pay of baseball

players. That is to say why does one baseball player make more than another?

And he found that he could account for approximately 75 percent of the differences in their pay if he knew such rational things, in the case of a batter, as his batting average, his runs batted in, the number of bases stolen, etc.

And in the case of pitchers, how many games he won, his earned run average, whether or not he won the Cy Young award? Very rational.

You can never explain 100 percent of the market because all of us make dumb buys from time to time, but 75 percent is pretty good.

Now, let me contrast that with a study that I just finished, using data from Forbes magazine's current issue in June on the pay of some 800 CEO's. I concentrated on some 200 CEO's who are among the CEO's of the 300 largest companies and all of whom had been in their company jobs as CEO for at least 5 years.

So I had 5 years of aggregate pay data on these CEO's, not just in any year, but all 5 years taken together: their 5 years worth of salaries, their bonuses, their stock options, exercised profits, their free share grants. You name it, it was in there, at least according to Forbes.

And so I thought to myself, here is an interesting test. Let us see what the relationship might be between the pay of these CEO's on the one hand and the performance of the company. And in this case, my performance measure was the 5-year total, shareholder returns counting stock price appreciation and dividends.

You would think there ought to be a robust connection. That is to say, the higher the performance, the higher the pay. Well, you would be totally wrong. You can only explain 0.8 of 1 percent of the difference in pay if you know the performance of these companies.

Let me put it another way, if I were to take a spreadsheet and go down one column with the 200 companies and list in each case their compounded total returns for 5 years, that is one column.

In the second column, I get out a table of random numbers and I pick a number somewhere between $250,000 a year and $12 million and just put it down next to the companies. That would be the result that I obtained.

There is no relationship whatsoever. And if there is no relationship, to my mind, there is no market.

Furthermore, if you look at the unfortunately, you see too cozy relationships between CEO's and their boards, where the CEO selects the directors, where the directors seem to see the CEO as the boss because he is the chairman of the board, rather than the reverse, and where you see the tremendous barriers to entry for qualified women and minorities into top-management ranks.

I am sure that any number of talented women would probably gladly turn their back on the protection of the Equal Pay Act and take the job for $1 million a year instead of the more normal, say, $2 million, just to get the market going.

So we have a serious problem. But whether the problem involves the solutions, some of them contemplated by this Committee, is another issue. I certainly applaud Senator Levin's work in the area of better disclosure and in charging and earnings for stock options.

The issue of deductibility of compensation is one I have some problems with. I do not think, in contrast to perhaps some earlier speakers, that it will be the end of western civilization if you actually enact this provision. It will probably have a relatively modest impact.

But nonetheless, from a conceptual standpoint, you are sort of going for a one-size-fits-all approach. And so if you say $1 million is the cut point, if $1 million is the right number for an outstanding performing CEO, it is clearly the wrong number for a poor performing CEO.

And if it is the right number for a poor performing CEO, it is clearly the wrong number for an outstanding performing CEO.

I am not saying that you should not do this. My own preference would be, if it could be done, to unleash the Internal Revenue Service into this area.

I was very disheartened to learn in talking with senior officials of the Internal Revenue Service that they have had only the most modest success in challenging the reasonableness of executive compensation. And that is only where we are talking about closely-held corporations and where we have involved the so-called disguised dividend issue.

But when it comes to challenging the reasonableness of the pay of a CEO of a huge corporation, a huge publicly-owned corporation, and where the pay may be as much as $80 million a year, the IRS has told me that they just do not even bother to try because they have no basis they feel to even assert what this standard of reasonableness is.

So to my way of thinking, if it were possible—and I am not a lawyer—if it were possible for your Committee, for the Congress to provide some better standards for the IRS, where based on the facts and circumstances they could go up against a specific company and say, "Look, this is too much," and if they could then, in effect, cause other companies to look at this and say, "Hey, whatever this barrier is, let's stay a good way away from it," that would be an approach that I would myself prefer.

I think I have used enough time. So I will just stop at this point. Thank you, Mr. Chairman.

[The prepared statement of Mr. Graef S. Crystal appears in the appendix.]

Senator BOREN. Thank you very much, Mr. Crystal. Next we will hear from Ms. Jean Gumerson. And as I have indicated, she is representing the United Shareholders Association. I am told that she is also accompanied by Mr. Ralph Whitworth from the Association.

And Mr. Whitworth, we welcome you as well. And if at any point you wish to add a comment during our question period, please feel free to do so.

Ms. Gumerson, we are very glad to have you.

STATEMENT OF JEAN G. GUMERSON, OKLAHOMA CITY, OK, ON BEHALF OF THE UNITED SHAREHOLDERS ASSOCIATION, ACCOMPANIED BY RALPH WHITWORTH, PRESIDENT, THE UNITED SHAREHOLDERS ASSOCIATION, WASHINGTON, DC

Ms. GUMERSON. Thank you, Chairman Boren and members of the Subcommittee. I am pleased to be here today.

I am Jean Gumerson, appearing as a member of the United Shareholders Associa tion to offer the perspective of an individual shareholder on executive compensation in American corporations.

USA is a nonprofit, grassroots, shareholder rights, and advocacy group. USA works to improve the competitiveness of American corporations through greater corporate management accountability to shareholders.

USA has 65,000 members nationwide and local chapters in 40 American cities. I am one of those members. And as an individual shareholder, it is a privilege for me to share my concerns with you.

I am concerned about what often appears to be irrational executive compensation. In other words, executive pay that has no apparent correlation to performance. And I as a shareholder am less concerned with how much executives are paid than how they are paid.

After all, when resources of a company are used for irrational compensation packages, the shareholders, the owners of that corporation, ultimately pay the price.

I am alarmed at all the attention devoted to the pay that seems to have done so little to actually align compensation with performance.

According to Business Week's recent survey, average total CEO compensation last year rose 26 percent to an average of more than $2.4 million, while corporate profits fell by 18 percent.

I am concerned that the real problem of executive pay is often misunderstood. This is reflected in some of the remedies that have been proposed, which could end up creating more problems than they solve.

Any solution must start from an understanding of why executive compensation is out of control to begin with. In fact, executive compensation is only the most dramatic symptom of a deeply-rooted problem, the lack of management accountability.

Studies show that this same problem is also sapping this country's competitiveness and contributing to our economic doldrums.

Let me make it clear, shareholders do not want to micro-manage executive compensation decisions. What they do want is a system that gives them the ability to demand compensation packages that link pay to performance.

Several pending proposals offer a tax solution to irrational management compensation. These proposals, no matter how well intentioned, miss the point. But what is worse, if passed, these misguided proposals will end of costing shareholders more than they are already paying in a system that has no accountability.

For example, one proposal would deny corporate-level tax deductibility to executive pay over $1 million. This may sound appealing, but it will not change any compensation decisions. It will not work because we must remember that corporate officers and directors do not pay corporate taxes.

It is not their money. It is the shareholder's. Tax penalties will not impact compensation decisions, especially when you consider it is the executive's own personal wealth at stake.

With higher taxes, shareholders would be hit twice: once for their irrational executive pay and again when higher taxes lead to lower returns, reduced dividends, and a higher cost of capital.

Chairman Boren stated that this would be a revenue raising proposal, raising $2 billion. This revenue estimate assumes that the new tax will not impact executive decisions. And that is correct, but shareholders will have to pay the $2 billion, not the executives. Why penalize those who already paying? Let us fix the real problem.

There are 50 million shareholders in America. That does not include those who benefit from stock ownership through pension funds, insurance policies, and mutual funds.

Placing a tax penalty on compensation, even if it does not work, would send the wrong message to the many creative and hard-working corporate executives who are creating jobs, expanding the tax base, and helping to improve America's competitiveness.

Corporate executives should have the incentive to earn rewards if justified by corporate performance. Again, the problem with executive compensation today is not high pay for superior performance. The problem is high pay regardless of performance.

And finally, attempting to limit compensation through higher corporate taxes would send the message that government has addressed the problem and found a solution. When in reality, government has missed the point and did nothing to foster discipline pay for performance in American corporations.

Some have even suggested giving more power to the Internal Revenue Service to regulate against excessive pay packages Please, whatever you do, we urge you not to appoint the IRS as an executive pay czar.

Why replace the proper function of a corporation's owners with a vast, government bureaucracy? The IRS would have only the most narrow basis for judging the proper pay of thousands of corporate executives.

But even worse, in cases where the IRS did not act against an executive's pay package, it would be signaling that the pay is appropriate and placing the IRS' stamp of approval on it. This is not a judgment call for the government.

Fortunately, there is a clear solution. And Congress should play a role. Congress should act to strengthen shareholder participation in corporate governance through market-based reforms that would create real accountability.

Shareholders are supposed to elect a board of directors to represent and advance their interests in the corporation, including setting management's compensation.

But the way corporate governance really works is that for all practical purposes, management appoints the members of the board. There is no accountability to the shareholders because there is no competition for the board seats and no mechanism for direct shareholder nomination of directors. That is the crux of the problem, corporate directors beholding first and foremost to the CEO, not the shareholders.

So when you get to the heart of it, the CEO's are setting their own pay. It is not a tax issue. It is an accountability issue.

We are encouraged that the Securities and Exchange Commission is taking the first important steps toward reform. We are anxious to review the forthcoming SEC proposals for improving com-

pensation disclosure and reforming its proxy voting rules to allow more communication among shareholders.

These are steps in the right direction, but more fundamental change is required. Congress should consider legislation giving qualified shareholders the ability to directly nominate truly independent representatives to corporate boards of directors.

Rather than seeking arbitrary pay limits or putting our faith in IRS as compensation watchdogs, we believe market forces offer the best solutions.

Empowering shareholders with the authority that reflects their ownership in American corporations is the key to resolving irrational executive compensation.

I, for one, do not want my children to have to take care of me nor do I want the government to take care of me. I want to be a responsible shareholder and take care of myself.

I want less government and not more. It is obvious, we cannot afford what we already have. Thank you.

[The prepared statement of Ms. Jean G. Gumerson appears in the appendix.]

Senator BOREN. Thank you very much, Ms. Gumerson. I think it is an important point that you make—which I do not believe it has been made previously in the hearing—that it is the shareholders who end up bearing the major cost, assuming there is no change in behavior, for the nondeductibility of the compensation above the $1 million level—if that happened to be the figure that is chosen. Thank you very much.

Mr. SOLLMAN.

STATEMENT OF GEORGE H. SOLLMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, CENTIGRAM COMMUNICATIONS CORP., SAN JOSE, CA, ON BEHALF OF AMERICAN ELECTRONICS ASSOCIATION

Mr. SOLLMAN. Mr. Chairman and members of this distinguished Committee, I am George Sollman, President and Chief Executive Officer of Centigram Communications Corporation in San Jose, California.

We are a profitable, publicly-held company employing about 240 people in the United States. Last year, we had revenues of about $36 million. We develop, manufacture, and market voice processing equipment that provides voice messaging capability, as well as integration with electronic mail and fax messaging.

I am appearing before you this morning on behalf of the American Electronics Association. The AEA represents over 2,700 companies in all sectors of the information technology industry.

The U.S. electronics industry has become the nation's largest manufacturing industry, directly employing over 2.4 million Americans.

Mr. Chairman, I appreciate the opportunity to contribute to the hearing today. I want to devote most of my statement to one specific part of the executive compensation debate which is unusually important to the global competitiveness of America's technology companies, that is the treatment of employees stock options.

We are especially concerned about legislation and regulatory proposals that would change stock option accounting rules to force

companies to carry estimates of the present value of their outstanding options on their financial statements as a charge against current earnings.

This accounting change could severely damage the entrepreneurial culture of America's vital, high-technology industries. One of the foundations of that culture is the large percentage of employees at all levels who receive stock options.

By dramatically reducing their reportable earnings, this accounting change that would force many companies to abandon their broad-based, employee stock option plans.

There is a lot more at stake here than a debate over arcane accounting procedures. The global preeminence of America's vital high-technology industries was achieved by the enterprise and innovation of young entrepreneurial firms.

Neither Japan nor Europe can match the job-creating vitality of America's growth-oriented companies. We are serious when we tell you that this change would threaten the ability of our system to continue to spawn those companies.

As you have just heard from Chairman Breeden, the SEC is developing a serious proposal to improve the information that companies disclose to shareholders. Additional disclosure of stock option plans is scheduled to be included, as we understand.

We believe this is a positive approach. And it is the right answer. The returns of shareholders should not be hammered down just to offer them a new form of unflawed data.

Because companies in other industries tend to grant stock options only to their most senior employees, stock options have taken on a "fat-cat" image in the press and in many government circles.

That reputation is seriously misleading when it comes to the high technology sector. Employee participation in stock option plans is broad and deep in Silicon Valley and other technology areas. I came prepared today with a chart on the left to illustrate that.

Plans like Centigram's that cover large percentages of employees, in our case 100 percent, are common especially among venture-backed companies.

A 1990 Radford Associates survey of 300 electronics companies found 85 percent of the companies using options they gave to middle managers and 30 percent included non-salaried employees. Only 15 percent limited their options to officers.

Let me explain why stock options are so unusually important to technology companies. One, employees stock options allow young, cash-strapped firms to compete against more established companies for scarce technical talent.

Two, stock options merge the interests of employees and the investors.

Three, stock options enhance productivity, innovation, and shareholder value.

And four, stock options stretch the very scarce, venture-capital dollars.

The last time FASB proposed stock option accounting was in 1987. At that time, Coopers and Lybrand conducted a study of the impact of this accounting treatment for the AEA. The average re-

duction of the earnings of companies participating in that study was 43.5 percent.

We readily concede there is an element of compensation involved in the granting of employee stock options. These are equity transactions. They already appear in the footnotes of the P&L statement as well as in the balance sheets.

You have heard stock option critics contend it is somehow unjust that the exercise of stock options can generate tax deductions while no corresponding entry is required in the company's financial books.

You should remember that the only reason companies get to take deductions on the tax side is to match the tax their employees are having to pay as they exercise nonstatutory options.

The critic's standard solution to this alleged inequity is to impose "present value" accounting on the financial side. We believe this is a misleading comparison. It mixes apples and oranges to justify a lemon.

First, I believe it is incorrect and misleading to try to equate the treatment required on the tax side with a different set of principles of financial accounting.

Second, even if it were valid to compare the two accounting systems, in no way would the existence of a difference between the two justify the kinds of penalties against the earnings that are being sought here.

But this is a debate that we should be allowed to pursue with FASB, not before Congress. We need your help on the tax side, where you have expertise and jurisdiction. It is very important that Congress not let itself be stampeded into legislating the fine points of financial accounting.

Mr. Chairman, you have requested our opinion of the pending proposal to cap the deductibility of compensation for corporate officers. I have to tell you we think this proposal would be both harmful to our industry and poor public policy for the following reasons.

One, it is a form of retroactive taxation. It would do little to alter executive compensation in the near term. Instead, it would raise taxes on companies who issued stock options in prior years and thus harm the very shareholders supposedly being protected by this.

Second, we think it unjustly singles out the business community for a new tax burden while explicitly exempting athletes, entertainers, or even lawyers, as Senator Danforth indicated.

The provision generates an unfair bunching effect by taxing the appreciation on stock that has been held over multiple years as if it were earned in a single year.

In conclusion, Mr. Chairman, we would ask you to consider what effect both the accounting provision and pay cap would have on the industrial policy of the United States? We think they would both be very negative and should be carefully avoided.

We hope our industry will be able to work with you and your colleagues to develop some positive alternatives to these damaging proposals. I would be pleased to respond to any questions you may have.

[The prepared statement of Mr. George H. Sollman appears in the appendix.]

Senator BOREN. Thank you very much, Mr. Sollman.

And the concluding member of our panel from the Treasurer's Office, Ms. Berg, we are very happy to have you.

STATEMENT OF OLENA BERG, CHIEF DEPUTY TREASURER, STATE OF CALIFORNIA, SACRAMENTO, CA

Ms. BERG. Thank you, Mr. Chairman. On behalf of California's Treasurer, Kathleen Brown, I appreciate the opportunity to appear before you today. I do not want to waste my few minutes on introductions, but I think it is important to explain that I wear a couple of hats as I appear before you.

First of all, Kathleen Brown is the trustee on the two California State pension funds which together invest over $100 billion in assets.

Second, she is Co-Chair of the Council of Institutional Investors which represents institutional shareholders on such issues.

And third, she is the Chief Fiscal Officer of the seventh largest economy in the world. And in California, of course, we depend on healthy corporations for a healthy tax base and to provide good, solid-paying jobs for our citizens.

Wearing each of these hats, we care about executive compensation. And our position can be stated pretty briefly. Executive compensation is primarily a matter of concern between the owners of corporations and the management, their employees.

In U.S. corporations, it is the board of directors representing the interests of shareholders who are responsible for executive compensation. And in our view, their major responsibility is to be sure that compensation fairly reflects performance.

Unfortunately, as we have heard about today, boards sometimes fail in this responsibility. At that point, it is the obligation of the shareholders as owners to step in and do something about the situation. And we at the Public Funds in California have been active in doing so.

I would just like to give you a couple of examples of the kinds of things we as owners have tried to do.

First of all, when there is a compensation-related issue on a proxy, we make an analysis of whether or not we believe it is in the best interests of shareholders and we act accordingly.

Second, when we believe that there is a compensation problem that is linked to the lack of independence on the part of directors of the board or on the compensation committee, we will sponsor shareholder proposals to try and change the composition of either the board or those committees.

And finally, there are cases where executive compensation abuses occur at companies with long-term performance problems, and we ultimately determine that the abuses are systematic of the more general absence of accountability on the part of the board and management to shareholders.

In those cases, we do one of two things. We will either work quietly with management and the board behind the scenes to try to effect change or we have withheld votes from the board of directors in order to make our views known.

Shareholders have a responsibility to insist on good corporate governance. Walking away by selling, waiting for a takeover, or a

bankruptcy is not responsible behavior on the part of shareholders. Using the vote to keep companies at the cutting edge is what we should responsibly do.

We are fiduciaries for millions of workers and retirees. And it is their interests that we have to actively represent.

What I am trying to do here is make the point that if we do not do our jobs, there is no amount of regulation that you can impose that would do it for us. But that does not mean that there is not an appropriate role for government in these areas.

And much of the discussion today has already addressed this, so I will try and be brief and say that we care very much about the SEC's current effort on proxy reform.

We believe that the changes that are being proposed will go far to enable us to do our job as owners, which is to manage the boards and management of corporations.

Second, and I will take off my institutional investors' hat here for a moment and say that Treasurer Brown as an individual and as Treasurer of California does believe that there is a proper tax policy role in considering the sorts of options that you are considering today.

And I will only say in that to the extent that there are proposals that could be fashioned, some of which Mr. Crystal has already suggested, that might differentiate between types of compensation and the relationship between pay and performance that we would encourage those for your consideration.

Finally, there is certainly a role for government in the disclosure area. And I can only applaud Senator Levin's efforts in this regard. You cannot determine whether or not you are paying for performance if you cannot even determine what you are paying.

And I just offer as an interesting example, at our last Council of Institutional Investors' meeting, we took three proxy statements and gave them to our group of institutional investors and analysts who are experts on the subject and asked them to determine from the proxies—and gave them overnight—how much the executives of the corporations were being paid.

There was a frightening disparity, not so much because these people do not know how to evaluate stock options and the other kinds of compensation, but because it was so difficult to find the information in the documents. So again we applaud the efforts of Senator Levin and SEC to improve disclosure.

And finally, we do also support the efforts, again undertaken by Senator Levin, to have FASB quit treating options essentially as "funny money". Options have real fiscal effects and those ought to be considered in all of these deliberations.

So I thank you, I thank the SEC, and I thank Senator Levin for their encouragement of reform. And again we as active shareholders look forward to working with you on this issue.

[The prepared statement of Ms. Olena Berg appears in the appendix.]

Senator BOREN. Thank you very much, Ms. Berg.

And I want to thank all the members of the panel for the comments that you have made today. They have been very helpful to us.

The perspectives that you have expressed will certainly be of benefit to us as we consider not only this legislation, but as we continue to provide oversight of the reactions of the SEC as well.

Let me go back and just ask each one of you two or three questions. And maybe you can just give a brief response. I will just sort of go down the line again.

You heard our discussion earlier about our concern. I think it is a general concern we all share that pay and performance do not seem to be linked nearly as closely as they should be.

Mr. Crystal said there is almost no relationship in his statistical studies between the level of pay, rate of increase of pay, and the level of performance of companies.

This is certainly alarming. It is alarming not only to shareholders, it has to be alarming to us from the point of view of public policy in terms of encouraging and providing incentives for improved productivity to make our country more competitive. And all four of you have expressed that point of view.

We also have general agreement that greater accountability, greater disclosure of information in a form that the shareholders can understand it and then participate more meaningfully in the process, is a very good thing.

And that action is already undertaken by the SEC, or a good start has begun. We hope they will continue along, down this path.

We discussed one other issue, of course, and that was this disparity between the level of executive compensation in this country compared to the level of compensation of the average employee.

The ratio given is 100 times as much in this country compared to much lower ratios in other countries. And while there is some reason to perhaps question whether all the statistical comparisons are exactly right, obviously 100 to 1 is a lot different than 17 to 1 or 23 to 1, even if we were off, let us say, by a factor of 100 percent. It will still be 50 to 1 versus 100 to 1.

So obviously, there is a much greater differential here in the United States as compared to other countries. This has impact on morale of workers, on the corporate culture, and indeed the social culture of our country.

Should this be an item that should also be included in the disclosure by the SEC either as a ratio or as a statement as a benchmark comparison of the compensation of the average employee of the company so that when shareholders take a look at that and the boards of directors and compensation committees take a look at it, that would also be something that they focus upon?

I will just go down and ask the four of you your views on that.

Mr. CRYSTAL. Well, I think, Senator, the notion is compelling. However, I take Chairman Breeden's point that if you are going to have a company provide the ratio, we are going to get right into a Vietnam-thicket evaluation of executive pay packages and all that sort of thing.

Senator BOREN. Yes.

Mr. CRYSTAL. But it might be very simple to just put a little item somewhere in the proxy statement, or it could be in the annual report, as to the average wage of the lowest 1 percent of workers in the company.

That is easy to calculate because all they get are salaries, amounts per hour. And then you can leave it to other people to try to look at those ratios.

But I think it would be useful to do that because among other things it requires the board to look down.

Senator BOREN. Right.

Mr. CRYSTAL. And the boards do not look down. They look out. And by looking down, maybe they won't do anything about it; maybe they will. But it is useful information for their decisionmaking process.

Senator BOREN. So perhaps not ratios, because this may be difficult to figure, but at least some statement as to what your lowest paid category of employees are making or perhaps also maybe an average.

Mr. CRYSTAL. Well, the average, of course, is going to be influenced by the top and then we get into the other forms of compensation.

Senator BOREN. That is true.

Mr. CRYSTAL. But if you just provided the bottom. And then if you could pass a law to keep me from being fired as a journalist, I will do the analysis for you. [Laughter.]

Senator BOREN. Ms. Gumerson.

Ms. GUMERSON. I think it would be interesting to see how the shareholders responded to something like that. I, for one, would appreciate seeing that.

I feel I can make a better decision if I knew that. I do not feel that I am connected at all with any of the stock and any of the decisions at this stage.

Ralph, do you have any comments?

Mr. WHITWORTH. I would just say that Ms. Gumerson's statement as a shareholder may be the best piece of information that you could receive here.

I think if I were going to look at it and step back in a more theoretical way, it could be that such comparisons could be misleading or lead to some inflammatory results that may not be well based.

But otherwise, I always feel that in the area of disclosure, you really cannot hurt yourself because I do not feel that shareholders are as foolish or as misinformed or outright stupid as people often would suggest by saying that, "Well, you might mislead them or you might confuse them by giving them this information."

They are pretty sophisticated folks. And they should take care of themselves as she said. And this kind of information, I do not see how it could hurt. I have not really decided how productive it would be either though.

Senator BOREN. Thank you very much. Mr. Sollman.

Mr. SOLLMAN. It is an interesting concept. I think if you applied it in the high-tech industry, you would probably come out with very different results than 100 to 1.

Senator BOREN. Yes.

Mr. SOLLMAN. In our company, it is dramatically different from that. So the issue I think at the end of the day is to what use will all of these ratios be put? As a shareholder, which I also am, I am more concerned about earnings per share at the end of the day.

Senator BOREN. Right.

Mr. SOLLMAN. And I would like to keep everybody focused on earnings per share primarily so I can see appreciation of my stock.

I am afraid there will be abuses made of those employee ratios and some very interesting cases that will come up that will destroy the inherent value that had appeared earlier as we discussed it.

Senator BOREN. So focus on performance accountability as to performance is what you think the emphasis ought to be?

Mr. SOLLMAN. Yes. I was very heartened by the direction that I see the SEC taking.

Senator BOREN. Ms. Berg.

Ms. BERG. Yes. Two comments. One is I would underscore what Chairman Breeden said this morning in answer to the same question that probably the most important statistic to us as shareholders is the relationship of the compensation and changes in compensation to performance.

On the other hand, I will also say that one of the most important assets of any company is its employees. And you so aptly pointed out earlier today that the effects of the issue that we are talking about is the negative potential effect on the morale of employees and their feelings about how the company for whom they work treat them.

And so I would say that this would be an important indicator that would be useful to us in a disclosure that would help us to understand if there is a problem there that should be further addressed.

Senator BOREN. I think it is important that we think about the effects on morale and how we build team work. I know some of the companies that I have visited personally where I felt there was a high level of morale have been our younger, high-tech companies in California. There has been a sense of team work. We are all in this together. There is a real team environment.

And even in terms of the way the hierarchy is structured, simple things are important, such as whether people enter the facility or the corporate headquarters by different doors, park in different areas, have eating facilities that either impede or encourage mixing and mingling of all the employees from the officers up and down.

All of these things have an effect. And it does seem to me that if the differential is just huge in terms of what some members of the team are making compared to other members of the team, this is bound to impact after awhile their attitude. "Are we all devoted to the company? Or are we all devoted to the same objective? Or are we really more devoted to ourselves individually?"

And there has to be a balance. I understand that. You want to encourage entrepreneurship. You want to encourage the right kind of leadership, the right creativity. And you want to reward that, but I think it is something that we have to think about.

Let me go back to the stock options and talk about that issue and whether or not there should be some increase disclosure. As we provide the information on which there is a lot of common agreement, providing general information about the compensation levels to stockholders, how far we should go in terms of providing information about stock options?

And again this is not to discourage the use of stock options because I think in many cases, as it has already been indicated, it

is a very appropriate method of compensation, if it is used within reasonable bounds in the sense that it tends to tie performance and compensation together in the interest of the shareholder and the managers.

But clearly there is some value attached. And it seems to me that if the shareholders are going to meaningfully participate, they ought to at least have some kind of general idea about the possible value that an option might have.

We have heard Mr. Breeden discuss several possible options. One of the things that he indicated could be considered, certainly without speaking for the Commissioner at this point, is you might provide a range of possible values as opposed to one particular statement of the value.

Assuming the stock goes up ten-fold, assuming the stock doubles, assuming the stock goes up at the rate of return over the average of the last 5 years or 10 years, what would be the value of the option of exercise?

Would that seem to be an appropriate way to provide information in terms of ranges under different scenarios as opposed to, say, one number under a one-set formula?

Or are there better ways of doing that that would not follow either one of those two options?

Ms. Berg, let me begin with you this time.

Ms. BERG. Certainly. And I will put in the disclaimer that we have heard several times today which is I am by no means an expert on this. I would say it is less important whether or not there is a range or one-set formula than there be some kind of provision that applies equally across companies so that you know the same methodology is being used everywhere because, again, one of the primary things that we are trying to do is look across industries, across companies and see what their policies are relative to their peers.

So I think either of the suggestions that have been mentioned could work. The important thing is getting the disclosure.

Senator BOREN. Would another element be helpful in terms of disclosure? And we heard Mr. Breeden talk about the statements from the compensation committees or the directors, the requirement that these statements be signed in terms of giving rationale about compensation decisions.

Would some data included in the compensation committee statement about performance of this particular company as compared to the performance of the industry segment be helpful?

Is there a disparity of other companies in their own industries and their own line of work, their own markets?

Ms. BERG. I think certainly the views of the board on that kind of matter are important and would be helpful.

Senator BOREN. Mr. Sollman.

Mr. SOLLMAN. I am not sure which question you are asking.

Senator BOREN. Why don't we start with the stock option evaluation question first.

Mr. SOLLMAN. Yes. The evaluation as proposed by Chairman Breeden is something that we support. We are following his efforts on it, whether it is single point or multiple point. I would agree

with the comment made previously that uniformity is probably in our best interest at the end of the day.

Senator BOREN. Thank you. Listening to your opening statement, you are not opposed to disclosure of information about the value of stock options?

Mr. SOLLMAN. Not at all.

Senator BOREN. You are concerned about how it is accounted for in terms of tax policy generally. Is that the way I understand it?

Mr. SOLLMAN. I think our concern is the intermixing of financial accounting policies together with tax accounting policies.

Senator BOREN. Right. I understand. So really, as long as we are talking about disclosure, you are not opposed to it there?

Mr. SOLLMAN. We have no problem.

Senator BOREN. Ms. Gumerson.

Ms. GUMERSON. If I remember correctly, at one time CEO's were criticized because they did not own stock. Does this have anything to do with the fact since they did not own stock, this was the way of solving that problem: by stock options? Because I remember a lot of criticism several years ago.

Senator BOREN. I think the companies have moved toward stock options partly for this reason. In other words, that the ownership of companies it was felt had become too divorced from the management of the companies.

And if managers are also stockholders, they will have much more interest in the performance of the company than they will if they are just simply paid employees.

And so it is an attempt I think to try and join the interests of the owners with the interests of the managers.

Ms. Gumerson. If that is the case, then I want to be sure that the board are people that I respect and trust as a shareholder.

Senator BOREN. Right. Mr. Crystal.

Mr. CRYSTAL. Senator, I think it is important to distinguish between the disclosure of stock option information and the accounting for it.

On the disclosure, I certainly take Chairman Breeden's point that if you put in some present value estimate or whatever and people are going to go bananas if they saw the actual number never turned out to be what you predicted.

Senator BOREN. Right.

Mr. CRYSTAL. It will never turn out to be what you almost predicted, never.

Senator BOREN. No.

Mr. CRYSTAL. So the idea of providing what you might think of as a sensitivity analysis and, say, "Well, if we get this much performance, a person earns this. If we get this much, a person earns that," I do not think that would be unuseful to know, especially if you combine all of the past options that had been granted together, not just the current grant.

Hence, you could say of all the options that the person has outstanding today, if the stock rose by 12 percent a year, here is how much would a person eventually earn. I think that would be useful.

On the accounting side, I think you have to come up with a single number. I firmly believe that you have to have some discipline

here to charge earnings for a cost. I mean, the cost may be socially useful, but it is still a cost nonetheless.

And if you ignore it, you ignore it at your peril. Everywhere in economics you find where the cost of something is too low, you get excessive consumption. And you have seen this in stock options where we have mega grants of 4 million shares at a time.

If you stop someone and say, "Pardon me. Are you charging the earnings?" They say, "No. That is why we gave 4 million shares because we do not have to charge the earnings."

And, in fact, the issue that options are a tremendous incentive needs to be examined, too because in my long experience as a consultant, I found companies' decision process being shifted by this sale that the accountants have been holding on stock options.

And they say, "Well, it may be that it would be better to give someone in a division of a company an incentive based on their division's performance. But if we do that, we have to charge the earnings because that is cash. Why don't we give them an option on the company's stock?"

And someone might say, "Pardon me. But this is 1 of 83 divisions. And this person has almost no influence on the market prices of the stock." They reply, "Well, that may be, but it is cheap. Let's give them one anyway."

So I think you get that sort of distortion. So I think you need to separate the two issues.

Senator BOREN. You are saying it really depends upon the ability of the person getting the stock options, the relationship between that option and the overall performance. In other words, in your last example, it may be appropriate in some circumstances. Is that what you are saying?

Mr. CRYSTAL. Oh, absolutely.

Senator BOREN. But not be appropriate in others?

Mr. CRYSTAL. That is right. And if you create a level-playing field of cost where the company says, "Well, if we do this, here is the cost. If we give an option, here is the cost," then I think you have a better chance for the company to come up with the informed, right decision, and not the one that seems to be cheaper.

Senator BOREN. Well, let me ask this. And I am going to let Mr. Sollman comment on this because he may disagree with you in terms of the accounting matter.

But let me just ask Mr. Sollman. Do you agree with what Mr. Crystal has just said about the importance of charging this in some way against the company so that you do not encourage options as opposed to bonuses or whatever, you do not really bias it in favor of options because there is no cost to the company currently at least?

Mr. SOLLMAN. There really are several issues that are intermingled in this. We could start off with the separation of financial accounting and tax accounting.

But why don't we go way, way back in terms of how the high-tech industry uses options. Options for us, Mr. Chairman, are used for capital formation.

The reason why so many companies, that is the smaller companies on the left-hand side of this chart have used so many options is this is a way to attract employees to the company to be able to

grow the company and use stock incentives in lieu of salaries. This has allowed us to generate many, many jobs.

To the extent that we now start having heavy charges against those stock options, we are now going to seriously dislocate the way in which we have job formation today.

Today we have proven ourselves successful, competing against Japan and Europe in terms of job creation. I think it would have a very adverse impact.

Senator BOREN. Let me ask Mr. Crystal to respond to that.

I have talked to people at some of these new startup companies that might have left a $1 million-a-year job to go to work for, say, $100,000 in the hope that by being part owner of the company or receiving an option that they might make even more.

And it is a way for companies starting out to start out with very little capital, low annual cost and charge-off and cash flow.

That is one of the reasons that I have always believed in the capital gains differential, if you had a long enough holding period, particularly as it relates to newer startup companies.

How do you answer what Mr. Sollman said?

Mr. CRYSTAL. Well, again I come back to noting that the argument seems to be that if something is socially useful and it happens to be a cost, then we can ignore it because it is socially useful. And someone is going to say, "Pardon me. It is still a cost."

Mr. Sollman had mentioned, I believe, something to the effect that if you did charge earnings, the profits of many of these high-tech firms would drop by an average of about 43 percent. That is a rather startling revelation. It seems to me the shareholders ought to know that.

I would also point out that based on studies I have done and others have done, I do not think we will see the end of western civilization, no matter what we do here.

Markets look beyond the actual financial statements. There is no evidence that I can see that if you did charge earnings, stock prices would drop. Stock prices already impound the future dilution from option grants, which, of course, as Mr. Sollman indicated, are already discussed in the annual report.

What would happen is you just get a higher price earnings ratio. The earnings would drop. The price would stay the same. You would have a higher price earnings ratio.

I do not think it would have much effect at all, except the effect of causing a board to think harder about the question, "Should we give the CEO 4 million option shares?" Someone might then say, "It will cost us $120 million charged to earnings." They will say, "Maybe we won't give the 4 million shares." That might be useful.

Mr. SOLLMAN. Mr. Chairman.

Senator BOREN. Mr. Sollman, you can have a brief last word on this matter.

Mr. SOLLMAN. I totally disagree with Mr. Crystal on this. The markets will make an adverse judgment as they see reported corporate profits plummet by 43.5 percent. What is at stake here, I believe, is American competitiveness.

As our industry becomes a less attractive investment vehicle in the international marketplace, you will see less investments made

in our companies and we will lose the edge we still have in high-technology.

It is simplistic at best to believe that analysts and investors would back out the cost of options. If they are required to back out the cost of these options, why do we put those costs in there in the first place? It makes no sense.

Senator BOREN. Thank you very much. I again want to express my appreciation to all members of the panel.

If our discussion today on any of the issues that we have raised and the testimony of our earlier witnesses have sparked any additional thoughts or comments you would like to make to the Committee, let me say that we will hold the record open.

If you would like to make any additional comments beyond what you have already made in your full statements, which will be in the record as well, we welcome you to do so.

While there are some disagreements on the tax deductibility question, while there is some difference of opinion obviously as we have just heard on the question of the standard of evaluation and charge against earnings on stock options, there seems to be a very high level of agreement from all of our witnesses today about the need to continue on the disclosure path so that the owners of the companies, the shareholders, will have the best possible information in the most usable and understandable form as decisions are made about executive compensation.

And this certainly gives us reason to want to continue to encourage the SEC along the path that they have started and to monitor this action very closely.

And more accountability and more openness in terms of how these decisions are reached in terms of compensation is bound to be good for the country, bound to be good for the economy, the owners of these companies, the shareholders, and for our ability to compete in the international marketplace.

So there was much very useful information given today. And I know that all of my colleagues on the Finance Committee will want to study the record of this testimony before we reach decisions on the issues that are before us.

So again I want to thank all of you.

Ms. GUMERSON. I would like to make one more comment. Biotechnology is very important. It is economic development. And stock options are extremely important in that situation.

Senator BOREN. Right.

Ms. GUMERSON. And so I do not want anyone to forget that.

Senator BOREN. That is certainly an area very similar to the computer technology and others in the country right now, an area where we are on the cutting edge and have an opportunity to stay there.

Again, I want to thank all of you for being here. It has been a very interesting and stimulating hearing. And we appreciate your participation in it.

The committee will stand in recess.

[Whereupon, the hearing was concluded at 1:00 p.m.]

APPENDIX

Additional Material Submitted

Prepared Statement of Olena Berg

Mr. Chairman, on behalf of California's Treasurer, Kathleen Brown, I thank you for this opportunity to discuss an important subject. I do not want to waste my few minutes here on introductions, but I do think it is important to explain that I am here wearing a number of hats.

First, as Treasurer, Kathleen Brown represents two of the ten largest owners of corporate America: she is a trustee of both of California's two largest pension plans, which invest over 100 billion dollars. Second, she represents the main organization that addresses shareholder investment issues: Treasurer Brown is Co-Chair of the Council of Institutional Investors. Third, she represents the seventh largest economy in the world: Treasurer Brown is responsible for the finances of California's government, which depends on a healthy corporate tax base for its revenue and for stable, high-paying jobs for its voters and tax payers.

Wearing each of these hats, Treasurer Brown cares about executive compensation. There is no question that executive compensation both **affects** and **reflects** the health of US companies and their ability to provide jobs and shareholder value.

Her thoughts on executive compensation can be stated very briefly. First, executive compensation is primarily a subject that owners must address with their employees.

In US corporations, boards of directors—which represent corporate share owners'—are responsible for executive compensation. In the compensation area, a board's primary job is to tie pay to performance.

There are still too many cases in which boards fail to tie pay effectively to performance. When this happens shareholders should step in. They should not step in to set the pay themselves. But there **are** things they **can** do to insure that boards set it properly. I will give you three examples, all three of which we at the California Public Employees' Retirement System and California State Teachers Retirement System are pursuing actively.

First, in the past, shareholders routinely voted for management proposals that allowed boards to set pay without regard to performance. For this, we shareholders have only ourselves to blame. But these automatic votes for management pay proposals are changing, and we are leading the way: we are adopting proxy voting policies that provide that we only vote for executive pay proposals that are in shareholders' and employees' interests.

Second, when we discover an executive compensation problem that is linked to an absence of independence on the board or its compensation committee, we sponsor shareholder proposals to remedy this problem. We were the first to do so successfully. We did it at ITT, where the introduction of our proposal led, after a number of interim steps, to a newly negotiated pay package that was more consistent with shareholder and employee interests. We will continue to use shareholder proposals when appropriate in the future.

Third, when executive compensation abuses occur at companies with long-term performance problems, we tend to conclude that these abuses are symptomatic of a more general absence of accountability by the board to its shareholders. In these situations we do one of two things. In some cases we work quietly, behind-the-scenes, as we did over the past few years with GM, until the board begins to do its job. In other cases we withhold our votes from the board to remind them that they are working for us and that we expect them to do a better job. We did so this year at Champion International where a record number of shareholders—nearly 10%—voted against the board. This kind of action is critical: we all know in our day-

to-day lives that if we do not insist on good performance from our employees we will not get it.

Shareholders must get used to insisting on good corporate governance. Walking away by selling, or waiting for a takeover or a bankruptcy, is not responsible. Using the vote to keep companies at the cutting edge is responsible. We are fiduciaries for millions of workers and retirees: if we do not act like owners, we, and the US economy generally, will suffer.

Our first point to you, then, is that if we, as owners, do not do our jobs, no amount of legislation or regulation will solve, the problems that excessive executive compensation packages reflect. But this does not mean that there is not an appropriate role for government in these areas. There is. In fact, current laws and regulations **already** heavily influence corporate governance and executive compensation issues, so it is only proper that governments look at those laws and regulations to try to get them right. I will therefore spend one minute on each of three areas in which Treasurer Brown believes it is currently important that government examine or alter its role.

First, we care very much about the SEC's current effort to reform the proxy rules. The current rules are the single biggest barrier preventing us from acting like the long-term owners we are. Under the current rules, we, as owners, cannot even talk to other owners about our concerns without making expensive government filings and incurring unacceptable risks of litigation. Indeed, under the current rules we cannot even find out who our fellow owners are—our employees can, but we cannot. So the first step must be proxy reform, because the first step must be to let us do our jobs as owners.

Second, Treasurer Brown definitely believes there is a proper tax policy role in the executive compensation arena. We have all read of abusive pay packages that raise legitimate questions about whether such payments are "ordinary" business expenses. Most of us could agree that there is no reason that US tax policy should encourage such payments.

Therefore, I would urge you to consider the approach that Mr. Crystal describes in his testimony. We owners need room to address unusual situations with unusual compensation packages, so we must be very careful in defining the payments that tax policy will deem to be abusive.

Third, there is certainly a role for government in the disclosure area. Senator Levin should be commended for leading the way here. There can be no question that one of the things that allows executive compensation abuses to occur is the current ability of managements' and boards' to obscure what is really being paid.

I will give you one example. At a recent Council meeting, our members reviewed proxy statements from three companies. These proxy statements are supposed to be the documents that tell shareholders what they need to know as owners, including what they need to know about what they are paying their executives. We asked members to read the proxy statements and tell us what the CEO was being paid. They could not do it, even though we are as expert a group of owners as you are apt to find. Members could not even consistently differentiate between a package paying one million dollars and one paying over fifty million! You shouldn't have to be an executive compensation consultant to know what you are paying your own employees.

This problem occurs for at least two reasons. The first is that compensation proposals are needlessly complex—indeed many are so complex that I can only conclude that the reason they are complex is to obscure how much is really being paid. The second reason is that current disclosure rules are flawed. Surely there can be little point to any disclosure rules concerning executive pay if they do not provide shareholders the answer to one key question: "What are we paying these people?" Or, to state this differently, what is the approximate value of the total of all types of compensation, including options, that shareholders are paying. Until shareholders know what they are paying, they cannot begin to judge whether it is performance related or anything else.

In this area I must thank Senator Levin for his crusading work pushing FASB to stop allowing companies to treat options like "funny money." I must also thank Chairman Breeden for the Commission's on-going effort to reform the executive compensation disclosure rules. I trust these efforts will bear fruit shortly. And, Finally, I thank you and the Committee for giving me this opportunity to address an issue affect us all.

[Submitted by Senator David Boren]

PROPOSAL TO LIMIT DEDUCTION FOR EXECUTIVE COMPENSATION

[Joint Committee on Taxation, June 3, 1992, JCX-19-92]

I. PRESENT LAW

Under present law, a deduction is allowed in computing Federal income tax liability for ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered.

II. DESCRIPTION OF PROPOSAL

Background

The provision described below limiting the deduction for executive compensation has been included in the following bills that recently have been passed by the Congress or reported by committee.

The conference report on H.R. 4210 ("Tax Fairness and Economic Growth Act of 1992") was passed by the House and the Senate on March 20, 1992 (see H. Rept. 102-461), and was vetoed by the President on that date. H.R. 4727 was reported by the House Committee on Ways and Means on May 27, 1992 (H. Rept. 102-536, Part 1), and H.R. 5260 was reported by the House Committee on Ways and Means on June 2, 1992 (H. Rept. 102-543, Part 1). H.R. 4727 and H.R. 5260 provide an extension and revision of Federal unemployment compensation benefits.

Explanation of Provision

For purposes of the regular income tax and the alternative minimum tax, the otherwise allowable deduction for compensation with respect to a covered employee is limited to no more than $1 million per year. A covered employee means any employee of the taxpayer who is an officer of the taxpayer, other than an employee-owner of a personal service corporation.

For purposes of the provision, whether an individual is an officer is determined upon the basis of all the facts, including, for example, the source of his or her authority, the term for which elected or appointed, and the nature or extent of his or her duties. Generally, an officer is an administrative executive who is in regular and continued service, regardless of the employee's job title. An employee who has the title of an officer but does not have the authority of an officer is not considered an officer. Similarly, an employee who does not have the title of an officer but has the authority of an officer is an officer for purposes of this rule.

An employee-owner of a personal service corporation is generally defined as under section 269A of the Code. Thus, a personal service corporation is a corporation the principal activity of which is the performance of personal services if the services are substantially performed by employee-owners. An employee-owner is any employee who owns more than 10 percent of the outstanding stock of the personal service corporation.

The provision applies only to compensation of employees who are officers (or, in the case of former employees, who were officers at any time while active employees). The provision does not apply to payments to partners in a partnership because they are not employees. The provision also does not apply to payments to independent contractors.

The term covered employee includes former employees. Thus, for example, the provision applies to compensation of a former employee for services performed as an employee (e.g., nonqualified deferred compensation that is not received until after termination of employment).

The deduction limitation generally applies to all remuneration for services, including cash and the cash value of all remuneration (including benefits) paid in a medium other than cash. The limit does not apply to fringe benefits excludable from income under section 132, meals and lodging furnished on the business premises of the employer that are excludable under section 119, or any payment made to, or on behalf of, an employee or beneficiary (1) from or to a qualified pension, profit-sharing, or annuity plan, or (2) under a simplified employee pension (SEP) or tax-sheltered annuity (other than elective deferrals to such a plan or annuity). The deduction limitation applies to all compensation paid to a covered employee, regardless of whether the compensation is paid for services as an officer.

The deduction limitation applies at the time the deduction would otherwise be taken by the employer, whether or not the remuneration to which the deduction relates is for service performed during the taxable year.

Certain related employers are treated as a single employer for purposes of the provision. In particular, employers treated as a single employer under section 52(a) or (b) or section 414(m) or (n) are treated as a single employer. An employee who is an officer of any of the members of a group of employers treated as a single employer is treated as an officer of the single employer. Similarly, compensation from related employers is aggregated for purposes of the $1 million limit.

The report language on the H.R. 4210 conference agreement, H.R. 4727, and H.R. 5260 indicates that it is intended that the Secretary will prevent avoidance of the rule through the use of arrangements other than employee-employer arrangements or through other means.

Effective Dates

The provision in H.R. 4210 would be effective for taxable years beginning after December 31, 1991.

The provision in H.R. 4727 would be effective for amounts paid or accrued on or after July 1, 1992.

The provision in H.R. 5260 would be effective for taxable years beginning on or after January 1, 1992.

PREPARED STATEMENT OF RICHARD C. BREEDEN

Chairman Boren and members of the Subcommittee: I appreciate the opportunity to testify before the Subcommittee on Taxation on behalf of the Securities and Exchange Commission regarding the issue of executive compensation. While the SEC does not have any responsibility for tax policy, we do have responsibilities for administering the proxy voting system pursuant to the Securities Exchange Act of 1934, and for overseeing generally accepted accounting principles ("GAAP"). Pursuant to this responsibility, the SEC will shortly be proposing for public comment new rules designed to improve the public disclosure of information concerning executive compensation packages. We also plan to require boards of directors to explain the specific rationale for compensation decisions.

PUBLIC CONTROVERSY OVER COMPENSATION

The subject of executive compensation has aroused considerable public concern. Rightly or wrongly, there is a perception of abuse when a company whose financial results have been deteriorating awards its senior executives substantial compensation increases. The same perception may arise when a particular company has seriously underperformed the market as a whole (or its principal competitors) for a sustained period, yet the CEO continues to receive multimillion dollar compensation. "Mega-grants" of stock options or restricted stock with a value of tens of millions of dollars have also raised questions of proportion and perspective even where the issuer itself has had positive earnings and increases in its stock price.

In at least some specific instances, it is difficult to understand what factors a board of directors could have relied on in reaching compensation decisions. Some particular practices, such as "resetting" the price of management's options where a company's shares have plummeted in value, are difficult to justify as consistent with shareholder interests. Similarly, interlocking compensation committees, where one CEO serves on the compensation committee of another company, whose CEO in turn serves on the compensation committee of the first company, create outright conflicts of interest.

USE OF STOCK OPTIONS

Stock options are the source of some of the largest amounts of compensation for managers of large, publicly traded corporations. However, stock options are absolutely vital to small and high-tech businesses. Smaller companies—especially the high-tech startup companies that provide a significant portion of new U.S. technology—use options in recruiting and retaining executive and scientific talent. Indeed, many small companies utilize options widely, often providing for participation by all employees, as a means of motivating employees to work for long-term corporate growth.

Stock-based incentives are particularly vital for companies in a high-growth phase, where every possible dollar needs to be reinvested in the business. These companies often use options to avoid cash demands for benefit or pension programs, purchases of technology rights or for many other purposes. Options are widely used in venture capital situations to attract and compensate employees, and also as extra incentives for investment in highly risky companies. Since the U.S. tax code now

fails to create any incentives for investing in small startup companies, it is vital for these companies to be able to utilize other economic incentives, such as stock options, to attract investment.

Increasingly, large companies like G.E., Pepsico, Merck, General Mills and others are using stock options as a means of providing entrepreneurial incentives to a large number of employees throughout the company. Once thought of largely as compensation for executives, stock options have become a common and widely used means of instilling the pride and economic incentives of ownership in literally thousands of employees. This use of stock options parallels incentives for widespread employee stock ownership that Congress has traditionally provided, such as favorable tax treatment for Employee Stock Ownership Plans. However, unlike indirect ownership of company stock through a pension plan, options are provided to selected individuals and result in economic incentives that are identical to direct ownership of stock. From a policy perspective, converting employees into owners is highly desirable, and we should be facilitating, not impeding, this trend.

Many companies—large and small—go to great efforts to seek to align the incentives for executives with the long-term interests of shareholders. Here, the stock option is one of the very best tools for creating management incentives to improve shareholder value. Unlike straight cash salary or bonus, with stock options the executive does not usually profit unless the shareholders also profit.[1] Some of the largest amounts of "executive compensation" have also corresponded with enormous increases in shareholder wealth. Furthermore, the growth in value of options, though it may be realized in a single year, may represent the fruits of many years of work for an executive.

Though use of options as compensation (as well as to encourage investment) seems very desirable, the current pricing of huge option grants may be less than optimal from a shareholder's perspective. During a time of steadily rising stock market levels, stock prices should be expected to rise as a consequence of inflation and other market factors rather than company-specific factors. From the end of 1981 through the end of 1991, the Standard & Poor's 500 stock index rose 240%. Thus, an option granted in 1981 at a company's then-current market price for a term of 10 years, for example, did not require good corporate performance in order for the executive to profit handsomely. That option would have had considerable value even if the company's stock had underperformed the market by 200%. Recently, some major companies such as AT&T have begun to issue options whose exercise price includes a "hurdle rate" that requires the company's stock to improve *more than* a specified amount before the option becomes exercisable. From a shareholder perspective this represents a major improvement, because the company's stock must *rise* by varying amounts over time before the option becomes valuable.

DETERMINING PERFORMANCE AND COMPENSATION

Though abuses have undeniably occurred in some companies, it is important to keep these cases in perspective. America's economy includes several million corporations, with approximately 13,500 publicly owned companies. These firms include tiny startup companies with only a few employees and stockholders. They also include some of the world's largest corporations with billions of dollars of shareholder investment and tens of thousands of employees.

The appropriate level of compensation of corporate officers depends on the specific circumstances of each particular company in a particular time period. Compensation that might seem excessive in one company could be inadequate in another, and what is deemed "appropriate" must be constantly adjusted to reflect the circumstances of the company at the most recent times. For example, a company that lost money, but moved from tenth to second in market share or earnings in a particular industry, could justifiably be deemed to have had an extremely successful year. A company might wish to increase compensation for an executive who was successful in substantially reducing defects in the company's products, or who developed unique and valuable technology for future products, even if the company lost money that year. By contrast, another company that actually had some profits, but seriously underperformed the market or the company's competitors, could possibly be deemed to have had inadequate (though profitable) performance.

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[1] This is why "resetting" or "swapping" options is a questionable practice. In such a case, the stock price may have fallen significantly, yet by lowering the strike price the board has permitted the executive to profit even where the company's value to stockholders has fallen. Investors, of course, cannot simply "reset" their acquisition cost for stock. In such a case the executive profits if the company does well, but the executive also profits when the company does badly, measured by changes in stock value.

Who can say what the exactly "appropriate" level of compensation would have been for Sam Walton, Walt Disney, or Henry Ford? Each of these entrepreneurs created businesses from nothing that went on to employ hundreds of thousands of Americans over many generations. Typically, such entrepreneurs benefited through the creation of value of their shareholdings, thereby aligning their own personal interests with those of other shareholders.

For example, few shareholders who purchased shares in Wal-Mart's initial public offering in 1970 at $16.50 per share would complain about their board's compensation decisions. Each of those shares is now worth $27,840. An investment of only $602.50 in Wal-Mart stock then would be worth $1 million today.[2] Similarly, investors in Microsoft's IPO in March of 1986 at $21 are unlikely to complain about the value of CEO Bill Gates' compensation. Each of their shares is now worth over $700.

The same problem arises in deciding what pay is appropriate for an executive of a mature corporation, who frequently must oversee the deployment of billions of dollars in shareholder investment. Again, who can say for sure what is the "correct" amount of pay for running G.E. or AT&T? These executives have an enormous impact on the 284,000 and 317,000 employees, respectively, of the two companies, and on their 490,000 and 2,426,354 shareholders. Obviously the same could be said for trying to specify exactly what network newscasters, fashion models, sports stars or others who typically earn enormous salaries are really "worth."

Determining how much compensation is appropriate is, fundamentally, a market decision. Companies that make shareholders wealthy and provide opportunities for their employees have a greater rationale for offering significant rewards to their senior managers than do companies that are performing miserably. Since there is not any universal measure of what is appropriate, under our traditional system of corporate governance, the board of directors is charged with deciding issues of executive tenure and compensation in the best interests of the corporation. To play this role successfully, a director should have both the knowledge and the independence necessary to serve as an informed and active representative of the shareholders.[3]

If directors do not take that responsibility seriously, the system will fail to produce an appropriate result, at least in the short term. However, at that point directors should expect that their actions will be publicly reported, and that they will have to justify those decisions to well-informed shareholders. Enabling shareholders to provide effective oversight of the board's performance is more likely to produce the best decisions over time than any system that tries to substitute the federal bureaucracy or the federal tax code for private market decisionmaking by those with a direct stake in the matters at issue.

Limiting compensation to some bureaucratically devised formula (such as 25 times the salary of entry level workers) or arbitrary amount (such as $1 million) would certainly damage incentives for risk-taking, and result in a general loss of valuable flexibility. A company consisting of Albert Einstein and three clerks might justifiably want to pay its CEO more than 25 times the lowest salary. Similarly, a company ranked first in the world in its industry should perhaps want to be able to keep its management or scientific team intact, even though it might have to pay $1 million in order to match domestic or foreign competitors trying to recruit them. Indeed. no sooner did legislation proposing a $1 million cap on salary deductibility come before Congress than legislation proposing a $500,000 cap on deductibility was introduced. One need only look to the quality of the Russian economy to see the ultimate results of government rather than private control of pricing in an economy.

These examples are not meant to ignore the reality of excess and abuse that have occurred in specific companies. Certain types of practices do need to be corrected by the corporate community. However, we need to recognize that use of the tax code or any absolute set of rules to govern every company, irrespective of its particular situation, will involve enormous costs and unintended negative results. Thus, if ever

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[2] Many employees of Wal-Mart became millionaires in exactly that fashion. Starting from one store in Bentonville, Arkansas, Wal-Mart has grown into a company that employs 366,000 people.

[3] In a recent speech, William T. Allen, Chancellor of the Delaware Court of Chancery noted:

> "Outside directors should function as active monitors of corporate management, not just in crisis, but continually; they should have an active role in the formulation of the long-term strategic, financial, and organizational goals of the corporation and should approve plans to achieve those goals; they should as well engage in the periodic review of short and long-term performance according to plan and be prepared to press for correction when in their judgment there is need."

Speech to the Ray Garrett Jr. Corporate and Securities Law Institute, April 30, 1992. p. 10–11.

there were a decision that would appear best left to the flexibility of the market, this is it.

The ability of numerous companies to compete for executive talent, or to use stock options to lower cash outlays or reduce capital costs, could be prejudiced by attempts to use the tax code to constrain decisionmaking that appropriately belongs with the board of directors. Many small, high-growth companies could have their very survival imperiled if the use of stock options became financially prohibitive. Though Congress might think it was shooting at CEO pay, the first casualty would most likely be broad-based employee stock option plans that really benefit both workers and companies. Even for large companies, tax legislation could only raise the cost to shareholders of compensating management. Creating the equivalent of an excise tax on CEO pay would only penalize shareholders, not executives, since companies will still have to pay what their board determines to be a market value to their executives.

PAY OR PERFORMANCE—WHAT IS THE REAL ISSUE?

In many respects, the most serious problem is not the amount of pay, but rather whether our current system demands adequate accountability for producing good corporate performance. Indeed, where an executive has not been able to produce superior earnings for the company and increased value for the shareholders for a period of years, the issue should not be pay, but tenure. Too many shareholders, employees and others depend on the performance of a large corporation for the board of directors to allow it to deteriorate indefinitely without forcing a change in management. When executives don't perform, board action to replace them is a far better way to promote economic growth than creating new taxes.

The recent action of the board of directors of General Motors in forcing senior executive personnel changes after a period of adverse results is an example of forceful action by a board that may help to restore a greater sense of accountability for performance. Board action with respect to inadequate management may ultimately avoid replacement of management through a hostile acquisition or a bankruptcy proceeding at vastly higher cost to the company, its employees and shareholders. If boards are not adequately vigilant in either replacing management or making reasonable compensation decisions, public pressure will certainly mount for stronger action—preferably through increased shareholder participation in decisionmaking.[4]

In my personal view, it would be best to focus our efforts on removing impediments to the workings of market forces in dealing with these issues. Here, improved public disclosure concerning both corporate performance and compensation awards, and better opportunities for shareholder input to the board of directors, should help control abuses without creating significant new problems.

ENHANCED DISCLOSURE FOR INVESTORS

The SEC is currently working on amendments to the disclosure requirements concerning executive compensation. Our proposals will be designed to get the facts out into the open in a clear and unambiguous manner. Since the shareholders ultimately pay these compensation packages, they have every right to know exactly what decisions the board has made, and what the company that they own is paying to the officers. Today proxy disclosure is all too often a very lengthy, obtuse narrative filled with legal boilerplate that obscures the relevant facts. In its place, we plan to require summary charts and graphs that will clearly set forth, in detail, the components of compensation awards to senior officers.

In addition to enhancing disclosure, the SEC will propose to require the members of the compensation committee of the board of directors to state publicly the performance factors in the company that were relied on in granting specific compensation packages. If companies do not have a compensation committee that is exclusively composed of outside and non-interlocking directors, we will propose even more detailed disclosures concerning the facts that went into these decisions, and the value of interrelationships among the decisionmakers.

Especially where a company is losing money, this requirement for directors to explain publicly their actions will enhance their accountability for the decisions that they reach. It will also permit shareholders to understand better the board's actions where there are perfectly legitimate factors in particular compensation decisions.

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[4] Executive compensation is frequently analogized to compensation for baseball players. It is generally (though not universally) true that pitchers with an E.R.A. that is extremely high will find themselves looking for another team, and managers whose teams consistently finish in last place may receive the opportunity to explore another line of work.

Another step that the SEC has already taken should complement better disclosure. Effective earlier this year, the SEC began to require all public companies to include resolutions setting forth shareholder views concerning compensation for senior executives in corporate proxy statements. While these resolutions are only advisory in nature, they allow shareholders to provide direct input to the board concerning the board's compensation decisions without the need to mount an expensive and disruptive proxy election contest to oust the members of the board.

Though seeking to replace members of the board who do not adequately represent shareholder interests is the ultimate recourse under the proxy system, the ability to vote on proxy resolutions concerning compensation should result in a better-informed board. Pursuant to the new voting policy interpretation, ten companies were required to include resolutions regarding senior executive and director compensation in their 1992 proxy statements,[6] and an additional 33 shareholder proposals were submitted to shareholders regarding executive compensation disclosure and golden parachutes.

The SEC's program is simple. Our goal is to assure that shareholders are well-informed, and that all the facts regarding the compensation that the shareholders are being asked to pay are out in the open. At the same time, we seek to foster better accountability of the board of directors to the shareholders for the decisions that they reach, because the board is legally responsible for protecting the interests of the shareholders. Through these steps, we hope to allow shareholders, directors and management to work out for themselves, in a totally open process, what is the best decision for each particular company. Market forces, not governmental dictates, should decide what is best for America's publicly owned corporations.

In keeping with this philosophy of market disciplines for compensation decisions, the SEC strongly and unequivocally opposes direct government regulation of compensation. We also oppose the indirect use of the tax code or legislatively mandated accounting rules to try to accomplish the same objective. Artificial tax rules might provide regulation that would be better camouflaged, but it would still represent government regulation.

In our view, shareholder interests in corporate performance should be at the forefront in decisionmaking on compensation. Boards of directors should be prepared to reward executives who perform well, but they must also be prepared to act with respect to those who simply never perform. Well-informed shareholders and independent and active board members can help achieve greater accountability for performance in corporate governance, thereby putting the appropriate focus of concern back on devising the best ways for America's businesses to be successful global competitors.

Prepared Statement of Graef Crystal

Mr. Chairman, I very much appreciate the opportunity to appear before your subcommittee and to present my views on the subject of senior executive compensation.

There clearly is one serious problem here, and there may be a second serious problem as well. The first concerns the fact that there is hardly any correlation between what a senior executive receives and either the short- or long-term performance of his company. The second concerns the possibility that senior executives in America, taken as a group, are earning substantially more compensation than they should be earning, with possible adverse consequences for our economy.

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[6] Of the twelve proposals that the Commission decided should be included under the new policy, only nine have come to a vote. Proposals for Battle Mountain Gold Co. and Grumman Corp. were not voted upon because the proponents did not make revisions necessary to bring the proposals within the requirements of Rule 14a–8. A proposal for Gerber Products will be voted upon in August. The voting on the other nine proposals was:

	For	Against	Abstain
Aetna Life & Casualty Co.	7.5%	80.3%	12.2%
Baltimore Gas & Electric Co.	12.2	83.6	4.2
Bell Atlantic Corp.	10.9	74.6	14.5
Black Hills Corp.	36.9	47.6	15.5
Chrysler Corp.	5.6	79.5	14.9
Eastman Kodak Co.	15.9	67.8	16.3
Equimark Corp.	16.5	81.4	2.1
Int'l Business Machines Corp.	16.7	83.3	Not Avail.
Reebok Inc.	19.2	51.9	28.9

Let me start by addressing the pay-for-performance issue. In study after study, I have found that about 15% of the differences in CEO pay can be accounted for on the basis of differences in company size. However, I have also found that typically less than 5% of the differences in CEO pay can be accounted for by differences in company performance, specifically compounded annual total shareholder return (counting both stock price appreciation and dividends), whether the time window of return is defined as one-year, two-years or any wider time window up to and including ten years. I have also found that separating my global database into various industries does not, on balance, result in any discernible improvements in the relationship between pay and performance.

To illustrate, permit me to note the findings I just obtained using a database published by Forbes, in its issue of May 25, 1992. Forbes defines total compensation to mean the sum of the CEO's base salary, his bonus for annual performance, payouts under so-called performance unit plans, the value of restricted stock grants, measured at the time the restrictions on such grants lapse and the paper profit on stock option exercises, measured on the date of exercise. The magazine also reports, where possible, the aggregate total compensation a CEO has received in the past five years.

Surely, total compensation, as Forbes has defined it, ought to be sensitive to company performance. After all, total compensation includes bonuses for annual performance, the increase or decrease in the value of restricted stock grants and the gains obtained from stock options through appreciation in the market price of the company's stock. And when total compensation is measured, not over a single year, but over a sufficiently long period, like five years, the correlation between pay and performance ought to be even better.

Sadly, however, I found there to be no significant relationship whatsoever between five-year CEO pay, as just defined, and the company's five-year, compounded annual total return to shareholders.

This finding is particularly compelling, because lately a number of compensation experts have claimed that though there may be a problem in the area of executive compensation, that problem is confined to just a few "bad apples." Remove the bad apples from the barrel, the argument goes, and, voila, you will find a robust relationship between CEO pay and company performance. The bad apples are generally claimed to constitute no more than 10% of CEOs.

Yet when I eliminated from my database the 5% of CEOs with the highest total compensation and also the 5% of CEOs with the lowest total compensation, I found that no more than 0.8% of the differences in pay among the remaining 90% of CEOs could be traced to differences in their companies' five-year returns to investors.

This dismal relationship between pay and performance needs to be examined in the light of two other findings:

- Research conducted by Professor Charles O'Reilly of the University of California at Berkeley, Professor Brian Main of the University of Edinburgh and me show that there is a significant and positive relationship between the pay of a CEO and the pay earned in their own companies by the CEOs who sit on that CEO's board compensation committee. Indeed, a cynical CEO would quickly discover that a raise can be obtained far more easily by packing his board with high-paid CEOs than by struggling to increase his own company's performance
- In his doctoral dissertation, Kenneth Lehn, formerly the Chief Economist of the Securities Exchange Commission, found that he could account for more than 70% of the variation in major league baseball players' salaries if he knew salient facts about their performance, facts like the batting average for a hitter and the number of games won for a pitcher. Explaining 70% of pay variation on the basis of performance is a far cry from explaining 0.8% of pay variation.

Supporters of the current system of senior executive compensation contend that pay is set in a free market. Yet how can we seriously believe that a free market is operating here when there is almost no relationship between pay and performance and when some 80% of the differences in CEO pay seem to be virtually random? A free market is supposed to allocate economic resources in a rational manner, and by that definition, there is no free market for senior executive talent in the U.S.

If there is no free market, that in turn raises the question of whether senior executive pay levels are too high. Look abroad and you will not find the average CEO in any major industrialized country earning anywhere near the level of pay of the average major-company CEO in the U.S. Various analyses suggest that an American CEO of a major company earns about five to six times more than his Japanese counterpart and perhaps three to four times more than his German counterpart. Moreover, there is a widening gap between the pay of American CEOs and their very own workers. In a study of ten major-company CEOs, who were chosen at random

and who had held their jobs at least between 1973 and 1990, I found that the median CEO earned 34 times the pay of an average American manufacturing worker in the period 1973–75 and 109 times the pay of an average American manufacturing worker in the period 1987–89.

One cannot also fail to note the barriers to entry that exist in the labor market for senior executive talent in the U.S., if indeed there is a labor market. Talented women and minorities seem to be systematically excluded from the CEOs' chairs in major companies. Does anyone doubt that if the market were opened to these capable people, pay levels would drop substantially before reaching a new, lower equilibrium level? Though the pay for a given CEO's job may currently be $2 million per year, I have little doubt that many a talented woman would willingly turn her back on the protections afforded by the Equal Pay Act and take the job for $1 million per year.

The problems that exist in executive compensation today, if not solved, can lead to some serious consequences and perhaps already have led to some serious consequences. First, there are the added costs involved. Here, it is important to note that the pay of a CEO, like a 4,000-horsepower vacuum cleaner, has the effect of sucking up the pay of other executives as well. In one study I conducted, I found that if you give the CEO a $1,000 raise, you also give the Chief Operating Officer, on average, a $400 raise, and you give the Chief Financial Officer a $250 raise and you give the Chief Legal Officer a $150 raise. So the cost of the $1,000 raise has almost been doubled, yet we have looked at only three other senior executives. Can anyone doubt that the ultimate cost of the raise is going to be much higher when its impact on all a company's executives is taken into account?

These added costs would perhaps not be so unbearable if there were a close relationship between pay and performance. But as I have already indicated, the relationship is virtually non-existent, and because that is so, the added costs become a dead hand on the proceedings. They must of necessity either be passed on to the company's shareholders in the form of lowered profits or on to other employees in the company in the form of lower salaries or on to consumers in the form of higher prices. Any of the three outcomes is patently undesirable.

But the greatest damage of excessive pay cannot be measured, and that is the impact on workers. Unfortunately, we have lately witnessed case after case of abuse of power. We have CEOs who lay off thousands of workers and yet are rewarded with extra bonuses in the millions of dollars. We have heads of charitable organizations awash in pay and perquisites. And we have university presidents who receive substantial pay raises at the same time they are increasing the tuition for their students who, like students of all generations, are perennially poor. Then we read statistic after statistic about how the top earners in our economy have garnered the lion's share of increased income during the past decade, while the lowest earners have seen their income drop in relative terms. And then we wonder why so many people in this country are so cynical and, as a result, less than willing to pitch in and improve our economic prosperity.

Having set forth the problems, what are the solutions? First, I endorse wholeheartedly Senator Levin's attempts to reform the system. He has proposed fundamental changes in proxy disclosure, and these will go a long way in helping shareholders to understand how much CEOs and other senior executives are really earning. Equally as important, he has been moving to require the Financial Accounting Standards Board to impose charges to corporate earnings for the cost of stock option grants. It is these grants, more than any other element of executive compensation, that have contributed to the explosion in senior executive pay.

Parenthetically, I would observe here the efforts of entrepreneurial companies, typified by those in Silicon Valley, to scuttle Senator Levin's efforts in the accounting area. These companies would have you believe that stock options are the only factor fueling their productivity and that by forcing a charge to earnings, the United States will be doomed in its competition with Japan and Germany. In a way, they are arguing that if a cost, like the cost of stock options, is socially desirable, then it need not be charged to earnings. Paradoxically, it is this sort of Alice-in-Wonderland reasoning that, in my opinion, is more likely to be the cause of our economic doom.

I would also note that many of the companies arguing for a continuation of the no-charge-to-earnings approach are more than willing to call in formerly-granted options and lower their strike prices whenever the market price of their stock falls out of bed. It is not unheard of for a Silicon Valley firm to engage in such "option swaps" two times in a single year. If a firm is willing to abide by the judgments of the market only when the market is rising, but not when it is falling, can that firm really be serious about paying for performance?

In short, I applaud the work of Senator Levin. He has aimed at the heart of the problem, and that he is under so much fire from corporate America, shows that his arrow has found its mark.

A primary issue before your committee, of course, lies in the taxation of various forms of executive pay. It is to that issue that I would like to address the remainder of my remarks.

In recent months, legislation has been introduced to curb the corporate deductibility of high executive pay. Under legislation sponsored by Representative Sabo, a company would not be permitted to deduct pay in excess of 25 times the pay of the lowest worker in the company. And under the comprehensive tax bill passed in March, a company would not be permitted to deduct executive compensation in excess of $1 million.

All of this legislation seems to be addressed to the concept of reasonableness. Whether the standard is 25 times the pay of the lowest worker or $1 million, the underlying notion seems to be that there is some point beyond which executive compensation is patently unreasonable.

Though I agree fully that there has to be some line of reasonableness drawn, I personally do not favor either of the above two approaches, for both incorporate a "one size fits all" type of reasoning. Thus, a high-performing company, which might well be justified in paying its CEO more than 25 times the pay of his lowest worker, is denied some tax deductions, while another company, which, because of its poor performance, ought not to pay its CEO anywhere near the 25-times limit, is given a green light.

To me, the solution to this issue of unreasonableness lies with the Internal Revenue Service. In its work in the area of closely-held corporations, the IRS has introduced the notion that executive compensation is deductible only to the extent that it is necessary and reasonable. This same concept of reasonableness of executive pay has also been introduced into Defense Department contract negotiations and into the determination of allowable public utility rates.

Yet it is my understanding that the IRS is effectively hobbled when it attempts to apply the doctrine of pay reason ableness to a large, publicly-owned company. Officials of the IRS with whom I have spoken have indicated that the Service has become do dispirited that it has all but given up trying to convince a court that there is some level of pay in a publicly-owned corporation beyond which no tax deduction should be allowed.

I am not a lawyer, and I am especially not a tax lawyer, and therefore I am not competent to suggest to your committee specific changes in tax law. But there must be a way for the Congress to introduce into law the notion that executive pay that is unreasonable may not be deducted and thereby to give the IRS the legislative support it needs to go after those companies that cross the line. For example, the Congress might shift on to a company the burden of proof of compensation reasonableness whenever the total pay of the executive being examined exceeds by three or more standard deviations the pay of executives with similar responsibilities in a comparable group of companies, none of whom is himself being paid in a totally aberrant manner.

To me, this approach is far preferable to the "one size fits all" approach, because it allows for a case-by-case evaluation of all the facts and circumstances. Moreover, because the line between reasonableness and unreasonableness will of necessity be fluid, it may have the effect of encouraging companies to think twice before even getting close to the line. That sort of encouragement would be amplified if any new legislation required the company to disclose in its proxy statement the name of any executive for whom compensation had been disallowed by the IRS, as well as the amount of such compensation.

Another tax possibility would be to apply different rates of tax to different forms of executive compensation. For example, a favorable tax rate, combined with continued corporate deductibility, might be offered for a non-swappable stock option that could not be exercised for, say, seven years and which carried a strike price that embedded a minimum return at least equal to what a shareholder could have earned by placing his funds in zero-coupon Treasury bonds. At the same time, other and less productive forms of executive compensation such as base salaries, annual bonuses and free share grants might be taxed at marginal rates much higher than currently exist. The idea here would be to achieve revenue neutrality for the Federal government but to tilt the balance of executive compensation towards long-term, risk-oriented decision making and away from forms of compensation that, for all practical purposes, offer pay for little or no performance. However, having suggested this possibility, I am troubled by the complications of drafting legislation which assures that exactly what is desired will be accomplished, and for every company and in every circumstance. It is entirely possible here that the best of intentions

will, at the end of the day, accomplish very little and may even, on balance, prove harmful.

In summary, I again applaud the thinking of Senator Levin. His legislation will go a long way to make the market for executive compensation the free market that many people keep saying it is. At the same time, I believe it is important to give the IRS such legislative tools as it requires to challenge the deductibility of executive pay when the same has passed the point of reasonableness. I would also favor further Congressional study as to whether the pay-for-performance process might be enhanced by imposing different levels of taxation on different types of executive compensation, but without causing any net loss of revenues to the U.S. Treasury.

Mr. Chairman, I thank you again for giving me the opportunity to appear before your sub-committee.

Attachment.

In Question

Perspectives on business issues-in-progress

In the current media feeding frenzy, pay for performance has been replaced by political correctness.

Who Should Set CEO Pay? The Press? Congress? Shareholders?

by Andrew R. Brownstein and Morris J. Panner

For the past several years at proxy time, executive compensation has become the *issue du jour*. Business magazines compete to print the starkest black-and-white photos of the "highest paid" CEOs. Experts tease out of the data evermore refined determinations: who was the "best bargain," the "worst buy," the "most valuable player."

This year several new factors have brought executive compensation even more attention. The first is the politicized arena for corporate control. Now that the tender offer wave of the 1980s has subsided, institutional investors, who control on average over 50% of the voting stock of the largest U.S. corporations, cannot rely on raiders or takeover fears to "discipline" management. Instead they promote various techniques – such as proxy rule reform, shareholder resolutions, and shareholder services groups – to gain access to the boardroom and make their positions known. Indeed, the threat of a proxy battle over compensation is a powerful club. Companies like ITT, UAL, and General Dynamics have been forced to negotiate with large institutional investors over executive pay.

That in itself would be news, but add in a second factor – the recession – and you have a front-page story. Readers can't hel[p b]ut notice the sharp contrast between million-dollar paydays for CEOs and a growing number of layoffs for other workers. Poignant and painful stories of economic hardship underline the obvious inequalities.

> Rampant populism has turned CEO pay into a political issue.

And a third factor is closely related to news of the recession. The perception of America's declining competitiveness, particularly in comparison with the Japanese, has fueled public anxiety. When President Bush made his ill-fated trip to Japan this past January, he took with him a dozen CEOs who together earn approximately $25 million a year. The difference between highly paid U.S. CEOs and Japanese executives, who are reportedly better performers for lower paychecks, made for good television but bad public relations.

Finally, rampant populist feeling in this election year has turned executive compensation into a favorite topic for politicians. The compensation debate has been bolstered by recent studies showing that, over the past decade, the wealthiest Americans have made the greatest gains, while the poorest citizens and the middle class have lost ground. Most people believe the rich have gotten richer and the poor poorer and that CEOs are now lining their pockets at the expense of everyone else.

As a result, politicians on both sides of the aisle have taken shots at executive compensation. Arkansas Governor Bill Clinton has proposed changing the tax code to curb high salaries, Vice President Dan Quayle has criticized excessive salaries as a drag on American competitiveness. Congress is considering legislation that would limit the deducibility of "excessive executive salaries." Meanwhile, both the Securities and Exchange Commission and the Financial Accounting Standards Board are under pressure to preempt such ill-advised legislative initiatives with actions of their own.

The last time executive compensation commanded the attention of so many elected officials and bureaucrats was in 1939, when President Franklin D. Roosevelt railed against the "entrenched greed" of corporate executives. Taking its cue from the president, the Treasury Department caused a national scandal by publishing a list of American executives who made more than $15,000 a year. At the height of the controversy, more than half of the respondents to

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a public-opinion poll felt that executives of large corporations were overpaid. No one, they argued, could be worth *$15,000 a year.* The Securities and Exchange Commission started requiring corporations to submit a detailed disclosure of executive compensation to their shareholders – and the debate over executive compensation began in earnest. Thus Chairman Richard Breeden's recent announcement that the SEC may require more extensive compensation disclosure is a replay of events that took place over 50 years ago.

Little has changed in the terms or argumentative style of this debate. Today's populists agree with their 1939 counterparts: no one, they insist, could be worth *$25 million,* even if this represents earnings accumulated over a lifetime. And surely anyone who makes that kind of money must be doing something either illegal or immoral. Many Americans distrust the rich, and corporate executives are obvious targets.

Very simply, it is politically correct to consider executive compensation excessive. And, as is often the case with political correctness, its adherents tend to oversimplify the issues and sensationalize the debate. First and foremost, they make the usual mistake of misdefining the issue. The question is not "Are executives paid too much?" The real question is "Are shareholders getting their money's worth from their executives?"

So far, the public has heard only the populist answer to these questions. However, we will consider a more refined analysis that shows a link between pay and performance. We will also uncover arguments that cast in a dubious light the issue of whether American CEOs are truly paid more than the Japanese. In short, we seek to remove the sensationalism and put the debate over executive pay back where it belongs: in a business context, not a political one.

The Populist Case

The argument against the current system of executive compensation consists of two distinct but related points. First, populist critics state that American CEOs are paid altogether too much and that their salaries bear almost no relation to the performance of their companies. Second, critics suggest that this irrational system of executive incentives saps the competitiveness of U.S. companies and is a major contributor to U.S. economic woes.

Like all good political movements, the current populist crusade has its own patron saint – reformed sinner Graef Crystal, author of the compensation basher's bible, *In Search of Excess: The Overcompensation of American Executives.* In his previous life, Crystal reportedly pulled down $850,000 a year devising the very compensation schemes he now attacks. But having seen the error of his ways, Crystal has undertaken a new mission to reveal the sins of executive pay. And he brings to his calling the zealousness and self-righteousness that often accompany those who have repented and now seek to inflict their conversion on everyone else.

In his first and major argument, Crystal asserts that the average pay of an American CEO is $2.4 million a year, or 130 times the average pay of an American worker. According to Crystal, this amount is only loosely tied to corporate performance. Crystal cites a 1990 compensation study in which he found that long-term executive compensation was almost completely unrelated to total returns to shareholders (defined as capital gains plus dividends). He claims that only a paltry 4% of the salary differential among executives can be explained by the performance of their companies.

By not linking pay to performance, American CEOs have created a risk-free compensation system, says Crystal. "CEOs get paid hugely in good years," he writes, "and, if not hugely, then merely wonderfully in bad years." To make the point, Crystal conjures up numerous anecdotal examples of what he characterizes as "win-win" situations for corporate executives. For example, Crystal points to option-repricing schemes in which the "strike price" – the price at which an option can be exercised – is lowered as the stock price falls. Option-repricing schemes reward managers even when the performance of

A Short Course on Compensation

In Search of Excess: The Overcompensation of American Executives
by Graef S. Crystal
New York: W. W. Norton, 1991

"Executive Compensation in the U.S.: A More Objective Evaluation and Examination," a speech by Michael S. Kesner of Arthur Andersen & Co. to the National Association of Corporate Directors, December 12, 1991.

Executive Compensation: A Strategic Guide for the 1990s
edited by Fred K. Foulkes
Boston: Harvard Business School Press, 1991.

"Congress Can Put Executives on a Diet," by Martin O. Sabo
New York Times, March 7, 1992.

"Stealth Compensation of Corporate Executives: Federal Treatment of Stock Options"
hearings before the Subcommittee on Oversight of Government Management of the Senate Committee on Governmental Affairs, January 31, 1992.

Value at the Top: Solutions to the Executive Compensation Crisis
by Ira T. Kay
New York: Harper Business, forthcoming in 1992.

The Conference on Corporate Governance: Performance and Compensation
Kellogg Graduate School of Management, Northwestern University
January 13, 1992
(proceedings in press).

Notice of 1992 Annual Meeting and Proxy Statement
American Telephone & Telegraph Company
February 25, 1992.

"CEO Incentives–It's Not How Much You Pay, But How"
by Michael C. Jensen and Kevin J. Murphy, *Harvard Business Review,* May-June 1990.

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their company slips. Such techniques have been used to compensate executives like Frank Lorenzo of Texas Air and Armand Hammer of Occidental Petroleum.

In Crystal's worldview, executive compensation, American-style, is the ultimate insider's game: everyone involved wins – except the shareholders. A cynic about the conduct and competence of corporate boards of directors, Crystal claims that the CEO appoints his or her friends to the board, caters to them, keeps them happy, pays them handsomely, and expects to have the favor returned when it's time for the board to ratify a compensation plan. The CEO hires high-priced compensation consultants, who report that the market for executive talent requires the board to deliver yet another tidy fortune to the CEO. Since these compensation consultants define what the market for executive talent is or is not, this finding is good news for CEOs everywhere – and for the consultants who line their own pockets by telling CEOs exactly what they want to hear.

Politicians carry this cynicism into the political arena, where they make a second argument about the state of the U.S. economy. They blame America's competitive decline on its top executives, who apparently benefit from a compensation system that leaves them overpaid and undermotivated. This was clearly the message sent home by the media from President Bush's trip to Japan.

A Reality Check: You Get What You Pay For

Certainly, Crystal's arguments and those of the politicians who have pressed his case score an emotional hit. Yet a more thorough examination of the evidence suggests that these conclusions are open to question. While Crystal asserts only a minor link between pay and performance, studies based on a more refined analytical framework have shown dramatically different results. Take, for instance, the work of Michael Kesner, a national director on compensation and benefits at the accounting firm of Arthur Andersen & Company. Kesner presented his study, "Executive Compensation in the U.S.: A More Objective Evaluation and Examination," in a recent speech to the National Association of Corporate Directors. Kesner assembled a database of 129 companies in 7 industry groups, from retailing to manufacturing. What he understood – and what most critics refuse to acknowledge – is that the jobs of all CEOs in all companies in all industries are not the same. Consequently, Kesner's approach carefully adjusted the compensation formula and accounted for such factors as industry complexity, the importance of management initiatives, and business risk. And Kesner's findings contradict the claims of critics like Graef Crystal: a minority of CEOs are overpaid, and a minority are underpaid;

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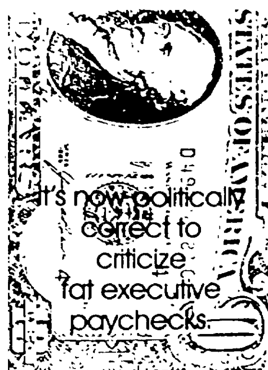
but 80% of U.S. executives are paid in line with their performance.

In other words, unlike those who express moral outrage simply at the size of a CEO's paycheck, Kesner reminds us that the paycheck is attached to a real job and that we have to assess executive compensation in terms of a company's business situation. Taken out of context, any pay plan will appear nonsensical and unfair. But when viewed in the proper business context, the relationship between pay and performance reemerges.

This failure to appreciate the business context of compensation accounts for a second failure of logic on the part of populist critics: their inability to recognize that the rise in executive pay during the past decade was a direct result of stock-based compensation plans designed to link pay with performance. In the 1980s, apostles of good management in the United States argued successfully that CEOs and top executives should manage for shareholder value. Furthermore, to tighten the link between this corporate goal and the CEO, a large portion of his or her compensation should come in the form of stock or stock options. In other words, the compensation carrot for the CEO should correspond to shareholder interests.



That is, in fact, what has happened. Theodore Buyniski, Jr., a consultant for Sibson & Company, points this out in "The Past, Present, and Possible Future Role of Executive Stock Compensation." Buyniski's essay is part of the useful and comprehensive *Executive Compensation: A Strategic Guide for the 1990s*, which was edited by Fred Foulkes of Boston University. Buyniski calculates that more than 80% of the largest U.S. companies now use stock compensation to link long-term performance of a company to executive salaries. And when you look at some of the most controversial pay packages, it is the stock element rather than base pay that accounts for the largest total compensation amounts. For example, in 1990, Anthony J. F. O'Reilly, chairman at H. J. Heinz, received $71.5 million in gains on stock options held for years compared with an annual salary and bonus of $3.6 million.

Ironically, these stock-option plans were designed to focus executive attention on shareholder value. There-

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their money, will they get it from you?

the terrain in which they operate.

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fore, the run-up in stock market prices and the resulting increase in shareholder values was in some ways an intentional consequence of the change in executive compensation plans. Yet it is the very effectiveness of these plans that has made them controversial.

In order to make this point more clearly, let's look at one of Crystal's favorite targets, Time Warner's Steven Ross. As Crystal would have it, Ross was overpaid. However, a closer look at Ross's pay package reveals that a large portion of his compensation came from stock-price increases that benefited all shareholders. By Crystal's own admission, Ross delivered a 23.9% compounded total annual return to shareholders for each of the years between 1973 and 1990. In other words, $100 invested with Ross in 1973 turned into more than $4,000 in 1990.

Indeed, those who doubt Ross's worth to the company and its shareholders should consult their brokers. In December 1991, on rumors that Ross was seriously ill, Time Warner's stock dropped 4.75 points in five days. Even a one-point drop in Time Warner's stock price costs its shareholders more than $90 million, a sum that far outstrips Ross's annual compensation package.

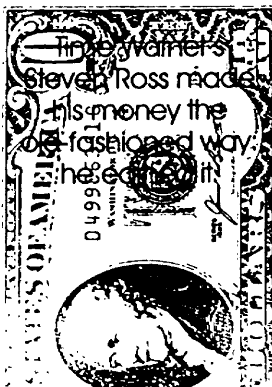
The critics are also wrong when they say bad performance does not translate into cuts in pay. CEOs are not insulated from the upheavals that have shaken the U.S. economy. Many companies, including Eastman Kodak, Avon Products, General Dynamics, and UAL have recently announced changes in their executive pay packages. At IBM, for example, Chairman John Akers expects his pay to be cut by about 40%. The reduction results from a pay-for-performance formula IBM has used for over a decade. After suffering its first loss in history – $2.8 billion in 1991 – IBM said that the cuts in executive compensation simply reflect the company's decision to leave a large portion of management's compensation "variable and at risk."

Still, these facts have not satisfied politicians, who have settled on executive compensation as an important source of competitive disadvantage in the United States. The politicians keep searching for an easy explanation for America's inability to compete with the Japanese in critical industries like automobile manufacturing and consumer electronics. But again, the facts are not as clear as many suggest.

Contrary to conventional wisdom, when perks and other cultural features are taken into account, U.S. executives do not appear to be paid more than their Japanese counterparts. Wesley Liebtag, a former personnel director at IBM and now a professor at the University of Illinois, has compared the compensation levels of U.S. and Japanese executives in "Compensating Executives: The Development of Responsible Management," another essay from *Executive Compensation: A Strategic Guide for the 1990s*.

As Liebtag points out, Japanese executives benefit from extensive perquisites, lifetime job security, and lifetime pay. Also, according to Liebtag, Japanese companies typically use a team-management approach that places much less emphasis on a CEO's individual abilities and importance than U.S. companies do. Therefore, comparing the salaries of chief executives at U.S. and Japanese companies isn't really relevant. Rather, the compensation of an American CEO should be compared with the collective compensation of the group of top executives who run a Japanese company.

Given what we know to be true about executive compensation, it is hard to imagine that the primary cause of America's competitive disadvantage lies in the way U.S. executives are compensated. In these recessionary times, corporate executives and their big paychecks make inviting targets. But the competitiveness problem that the United States faces is complex. And neither CEO bashing nor legislative regulation of compensation is the solution.



Political Problem, Business Solution

There is an old saying among lawyers that bad cases make bad laws. In this circumstance, "good" politics may very well lead to bad laws. Much of the current criticism surrounding executive compensation is simplistic and sensationalistic. Our fear is that the current public outcry could lead to unnecessary and even damaging intervention by governmental and regulatory bodies. Broad-based legislative solutions may be good politics, but too often they result in bad policy. Consider the following "solutions" now under consideration.

From Congress. Legislators have put forward a number of new bills that seek to influence executive compensation. The bills that are most controversial would limit the deductibility of executive pay, either by capping it at some absolute level or at some multiple of what the lowest paid worker earns.

In his recent *New York Times* article, "Congress Can Put Executives on a Diet," Minnesota Congressman Martin Sabo explains why he introduced a bill that would disallow tax deductions for executive salaries in excess of 25 times the salary of the lowest paid employee in the same organization. "This proposal doesn't cap executive pay," Sabo writes. "It would just mean that companies that want to compensate executives extravagantly wouldn't be subsidized through tax deductions for doing so."

Let's put aside the question of what constitutes "extravagant" compensation. The fact is that legislation that limits tax deductions for executive salaries will not result in lower pay. It will only make these salaries more expensive for shareholders. By imposing what is, in effect, an excise

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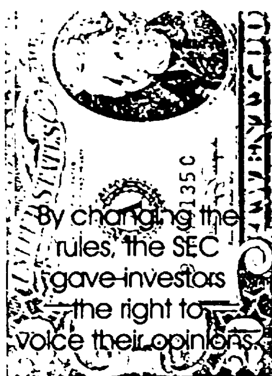
tax on executive salaries, Congress may satisfy populist political demands. But it will hardly improve the economy or respond to the interests of shareholders.

A tax penalty may discourage a corporation from paying an executive an extra dollar, but it will not radically change the underlying economics of the executive compensation market. In this regard, the history of Congress's attempt to legislate a tax penalty against "golden parachutes" is instructive. In his article Congressman Sabo cites the tax penalty against golden parachutes as a precedent for his proposed law "In 1984, Congress set a formula for determining if a golden parachute was excessive and took away business tax deductions for any settlement over the allowed amount," Sabo writes. What he neglects to point out is that this law failed in practice. Corporations simply added a "gross up" to their pay packages for executives – that is, companies paid an additional tax on behalf of the individual receiving the golden parachute. Rather than eliminate golden parachutes or reduce their size, the excise tax just made them more expensive for the company and ultimately the shareholder.

From the FASB. Meanwhile, as politicians attempt to respond to populist critics, professional groups and regulators are trying to head off the politicians. From 1984 to 1988, the Financial Accounting Standards Board, the professional board that sets public accounting standards, studied the accounting treatment of stock options granted to executives. The FASB tentatively decided that the cost of stock options should be treated as an expense and deducted from company profits during the period in which they were granted. However, FASB members were unable to agree on exactly how the options should be valued, and the initiative was tabled in 1988. Feeling the political heat, the FASB is now considering this issue again.

The desire to portray accurately the true costs of granting stock options is understandable, and the FASB's early pronouncements on this topic may reflect the correct technical accounting approach. But



will this approach serve larger policy goals?

For example, the decision to move ahead with this issue may threaten a significant and important trend in compensation: granting stock options at all levels of an organization. The threat applies particularly to startups, which are precisely the type of companies whose growth should be encouraged. Startups rely on stock options to attract a high-quality work force, encourage ownership in and commitment to the new company, and create an entrepreneurial environment. But some older, established companies are also beginning to spread stock options throughout their organizations. In this respect, the FASB approach may be in direct conflict with Congressman Sabo's espoused goal: to reduce the disparity between top executives and lower level employees.

To see how the FASB change might hurt startups, consider the case of Centigram Communications, a California manufacturer of voice-mail equipment with roughly $40 million annually in sales. The company maintains a stock-option plan in which every one of its 250 employees participates. In testimony before the Senate during the "Stealth Compensation" hearings on executive compensation, George Sollman, president and CEO of Centigram, explained that stock options were "crucial to the founding, growth, and success" of high-technology entrepreneurial companies like Centigram. Sollman's company began as a venture capital startup in 1980 and conducted an initial public offering in 1991. All along the way, Sollman relied on stock options – and the fact that granting them had no negative effect on the earnings of his company – to motivate employees. The options held out the prospect of very large returns at a time when the company lacked the cash flow to pay competitive salaries. Forcing companies like Centigram to reflect the value of options granted to employees in their profit and loss statements would deter them from granting options to *all* employees – not just top executives.

From the SEC. Chairman Richard Breeden recently announced that the Securities and Exchange Commission would no longer permit corporations to exclude from their proxy statements nonbinding shareholder proposals concerning executive or director compensation. By changing the rules, the SEC gave individual investors the right to voice their opinions, via proxy, about how much senior executives should earn. Because of the rule change, ten companies are facing shareholder proposals on executive compensation in 1992.

While significant, this change in long-standing SEC policy is dwarfed by the already powerful force of institutional investors. Even before the regulatory changes were made, companies met with their largest shareholders to discuss the way senior executives should be compensated. In September of 1991, ITT, after meeting with the United Shareholders Association and the huge California pension fund CALPERS, announced that it would change its compensation system to more closely link pay and performance. UAL, the parent of United Airlines, and General Dynamics have done the same.

The SEC is now considering a second rule change that would require disclosure of the present value of stock-option grants and data that show the relationship between CEO compensation and corporate performance. Although it is hard to argue with the principle of more disclosure, in this particular case, it's not clear what type of additional information would help. There are many ways to value a stock option, which represents the right but not the obligation to purchase a stock at some fu-

ture date. Indeed, there are so many different ways that the FASB, comprised of some of the best technical minds in the United States, has been stumped by this issue for years. Oversimplifying the process by coming up with one valuation may be as misleading as leaving out a number altogether.

Clearly, the whole debate over executive pay must be informed by a more sophisticated analysis that includes the complexities of structuring appropriate compensation programs. All of this political haggling distracts from the real issue of how you motivate your employees, from the CEO to the custodian.

The Real Issue: Pay for Performance

In a public corporation, managers act as agents of the owners, who are the shareholders. Compensation plans seek to motivate the agents to do the best job possible for the owners. However, and this is a critical point missed by many critics, different types of incentives will create different kinds of performance. Ira Kay, managing director at the Hay Compensation Group, contends in his new book, *Value at the Top: Solutions to the Executive Compensation Crisis*, that executives who are granted stock options will take more risks than executives who are only given cash compensation.

Stock options represent the right to buy a stock at a fixed price during a set period of time. Therefore, in order for the options to be worth anything, managers must make the stock move past the strike price of the option within that time. That turns managers who were once caretakers into risk takers.

Kay goes further by asserting that the absence of down-side risk in stock options makes managers more risk-prone than shareholders when it comes to acquisition strategy; he even suggests that the prevalence of stock options was a primary cause of the 1980s takeover craze. While Kay takes this particular concept to its extreme, his basic thinking is sound. Strictly based cash-compensation schemes do cause caretaking because executives won't take risks that result in short-term hits to the income statement and their annual bonus. And stock-option schemes do encourage risk taking because executives will benefit from long-term strategies and results.

Consider for a moment the new compensation package being offered to top executives at AT&T. Formerly a regulated monopoly, AT&T has recently increased its competitive stretch by making major acquisitions, such as its 1991 takeover of NCR. To create a compensation system in line with its current aggressive thrust, at least five corporate executives, including CEO Robert Allen, have been awarded "premium priced" options. The most important feature of these options is that a large portion can be exercised only if the stock price rises 20% to 50%. Under this plan, AT&T executives have much to gain; but the premium element is designed to factor out the effect of overall market performance on company performance. Allen's options, for example, could be worth millions of dollars in the year 2001 – if AT&T's stock were to perform impressively. But the options also send a clear message to top management about the strategic direction of the company: management will be rewarded *if* true shareholder value is created.

Such premium priced options were created in response to criticisms of stock-option plans that allowed executives to profit from broad changes in the stock market. However, they're an open target for new criticism when they result in bigger paydays for executives. In an attempt to diffuse such controversy, we suggest that companies take two important steps that make both business and political sense. First, corporations should design plans that allow workers throughout an organization to share in the large bonuses and generous rewards of stock-option plans. Second, corporations should create plans that encourage employees to continue to hold the shares awarded to them in stock-option programs.

By expanding the employee eligibility pool for stock options, companies will solve two problems simultaneously. They will take the principle of pay for performance and spread it throughout the organization. And they will address the political problem of pay disparity between workers and executives. The proper response to this issue is not to cut the pay of top executives arbitrarily. Rather, it is to create incentive-based plans throughout the company.

Indeed, in *The New Owners: The Mass Emergence of Employee Ownership in Public Companies and What It Means to American Business*, Joseph Blasi and Douglas Kruse of Rutgers University document the trend toward increasing employee ownership. Blasi and Kruse list 1,000 companies in which employees own more than 4% of the outstanding stock. The average employee holding in these companies was over 12% in 1990, and Blasi and Kruse predict that, by the year 2000, one-quarter of all U.S. public corporations will be more than 15%-owned by their employees.

The second step major corporations should take to reform their pay plans involves encouraging CEOs and other executives to use stock-incentive plans to acquire large blocks of shares that they hold onto. As Michael Jensen and Kevin Murphy wrote in their article, "CEO Incentives – It's Not How Much You Pay, But How" (HBR May-June 1990), the most powerful link between shareholder wealth and executive wealth is direct stock ownership by the CEO. Yet Jensen and Murphy also noted that CEO stock ownership for large public companies has actually declined over the past 50 years. Using the percentage of total shares outstanding as their yardstick, Jensen and Murphy found that CEO stock ownership was ten times greater in the 1930s than in the 1980s.

Although business has changed dramatically in the last 50 years, that trend has recently been confirmed by Kay, who found that less than 50% of the shares acquired through option programs are held for any significant period. We agree with Kay's assessment that this problem represents a major shortcoming of stock-option programs. Even given certain complexities (for example, the need to

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come up with cash to pay taxes on option exercises), stock-option plans would be much more effective if executives were required to hold onto their shares after exercising their options.

The Process of Compensation

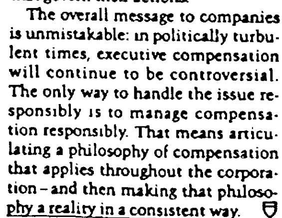
While we believe that these should be the guiding principles behind pay for performance, we also recognize that all companies are different. There is no one right way to compensate employees, and each company's needs are unique. Indeed, this is a fundamental fact that compensation critics ignore and another reason why legislative regulation of corporate compensation is not a good idea. Yet, unless boards do a better job of setting compensation, Congress may attempt to do it for them. Thus the focus for boards and executives must be on *process:* the role and performance of the compensation committee in making intelligent, well-informed decisions. Based on our experience in advising boards, we have come up with the following three guidelines.

Establish Independence. Compensation committees should be composed of independent, outside directors. Corporations should avoid the practice of interlocking compensation committee memberships; CEOs should not sit on each other's compensation committees. The appearance, if not the reality, of "you scratch my back, I'll scratch yours" compensation is a political liability that companies cannot afford. Nor should individuals who provide substantial services to the company, such as outside legal counselors, investment bankers, or representatives from suppliers, be included on compensation committees.

Articulate a Mandate. The job of the compensation committee is to adopt a specific compensation plan and philosophy that supports the strategic objectives of the company. Therefore, the compensation committee should have a clear picture of the strategic plan and the human resource requirements of that particular plan, always recognizing that the corporate plan and needs will change over time. To develop a mandate, the compensation committee should meet regularly during the year and not only when salaries and bonuses are set or incentive grants are made. Committees should consult with qualified advisors. However, we don't recommend that committees retain their own set of adversarial advisors.

Communicate to Constituencies. Finally, the board of directors and the compensation committee have an important responsibility to communicate their decisions, rationales, and strategies to shareholders. In light of the current controversy over executive pay, compensation committees cannot be blind to the preferences of the marketplace. Thus simplicity is important in designing a compensation plan. Institutional investors distrust complexity per se, so a straightforward plan will automatically allay some criticism.

Compensation committees must not only articulate how compensation packages have performed during previous years but also justify results in relation to industry standards. To shore up shareholder relations, compensation committees and boards of directors should be prepared to articulate the company philosophy on compensation and to lay out an understandable explanation of the compensation system. Committees should also be able to demonstrate the link between pay and performance. And compensation committees must clearly communicate who they are and the basic procedures that govern their actions.



The overall message to companies is unmistakable: in politically turbulent times, executive compensation will continue to be controversial. The only way to handle the issue responsibly is to manage compensation responsibly. That means articulating a philosophy of compensation that applies throughout the corporation – and then making that philosophy a reality in a consistent way.

Reprint 92302

PREPARED STATEMENT OF JEAN GUMERSON

Chaiman Boren and members of the subcommittee, thank you for inviting me to testify today. My name is Jean Gumerson. I am testifying today as a member of the United Shareholders Association to present an individual shareholder's perspective on executive compensation in American corporations. I am accompanied at today's hearing by USA's president, Ralph V. Whitworth, who will also be available to answer your questions.

The United Shareholders Association is a nonprofit grassroots organization working to advance shareholder interests and improve the competitiveness of American corporations by advocating greater corporate management accountability to shareholders. USA has 65,000 members nationwide and local chapters in 39 American cities.

As an individual shareholder, I am very concerned about what often appears to be irrational executive compensation. After all, when the resources of a company are used for irrational compensation packages, the shareholders—the owners of the corporation—ultimately pay the price.

Obviously the current system is not producing rational results. Last year, according to *Business Week's* recent survey of executive pay packages at 363 of the largest American corporations, total CEO compensation rose 26%—to an average of more than $2.4 million—while corporate profits fell by 18%.

This disparity between pay and performance in such a broad cross section of American corporations is a clear indication that something is terribly wrong. I am concerned, however, that amid all of the attention now devoted to executive pay, the real problem is often misunderstood. This is reflected in some of the remedies that have been proposed which, although well-intentioned, could end up creating more problems than they solve.

Any solution must start from a recognition of why executive compensation is out of control. In fact, executive compensation is only the most dramatic symptom of a deeply rooted problem—the lack of management accountability to shareholders in American corporations. This lack of accountability in the most prominent American corporations is sapping America's competitiveness and contributing to our economic stagnation.

Shareholders are not interested in dictating precise levels of executive pay or in placing arbitrary caps on compensation. For shareholders, the real issue is not how much, but how. What we need is a rational system that demands accountability from management and gives shareholders the ability to encourage compensation packages that link pay to performance.

There have been certain proposals in Congress which seek a tax solution to irrational management compensation. These tax proposals, however, would not address the fundamental accountability issues at the heart of irrational executive compensation, and would actually result in a greater burden falling on the shoulders of the shareholders.

The tax bill recently passed by Congress would deny corporations tax deductions for compensation paid to any executive in excess of $1 million. Although the comprehensive tax package was vetoed by President Bush, this compensation provision is included in legislation recently approved by the House Ways and Means Committee.

Another proposal, introduced by Representative Martin Sabo, would disallow corporate tax deductions for any executive's compensation which exceeds by more than 25 times the salary of the lowest-paid employee in the corporation. For example, if the lowest-paid worker has an annual income of $10,000, deductibility would not be allowed on compensation over and above $250,000 paid to any manager.

We do not believe it is the proper role of government to set arbitrary limits on executive pay. Attempting to do so through higher corporate taxes would be the wrong policy approach, for these reasons:

1. It would fail to achieve the desired results. Placing a tax penalty on compensation would create the impression that the government can do something that it cannot do: use corporate taxes as leverage to control the personal compensation of executives. Corporate officers and directors do not pay corporate taxes. It's not their money—it's the shareholders. Thus, tax disincentives will have no real impact on management compensation decisions. With higher taxes, the shareholders would be hit twice—once for the irrational pay and again when higher taxes lead to lower returns, reduced dividends, and a higher cost of capital.

2. Attempting to arbitrarily cap compensation—even if it doesn't work—would send the wrong message to the many creative and hard-working corporate executives who are creating jobs, expanding the tax base, and helping to improve America's competitiveness. Corporate executives should have the incentive to earn high

rewards—if justified by corporate performance. The problem with executive compensation today is not high pay for superior performance. The problem is high pay regardless of performance.

3. Attempting to limit compensation through higher corporate taxes would do nothing to foster a disciplined, pay-for-performance philosophy in American corporations. Instilling such a philosophy requires that accountability be brought into the system.

One approach that has been recommended by some observers would be to give more power to the Internal Revenue Service to determine whether compensation is excessive. This would, in effect, establish the IRS as a compensation czar. We believe such an approach is profoundly wrong-headed.

Giving the IRS such power would be a futile effort to replace the proper function of a corporation's owners with a vast government bureaucracy that would have only the most narrow basis for judging the proper pay of thousands of corporate executives. In cases where the IRS did not act against an executive's pay package, it would be signaling that the pay is appropriate and placing the IRS stamp of approval on it. But that is a judgment that can only be made by the shareholders.

Although irrational executive compensation does not lend itself to a tax solution, Congress can play an important role by strengthening shareholder participation in our corporate governance system through market-based reforms that create real accountability for executive compensation decisions.

Shareholders are supposed to elect a board of directors to represent and advance their interests in the corporation, including selecting a management team, setting management's pay, formulating corporate strategy, and overseeing management's day-to-day operation of the business.

But far too often, members of the board are management appointees. There is no accountability to the shareholders because there is no competition for board seats and no mechanism for direct shareholder nomination of directors. The incumbent chief executive dominates the director selection process and then, in the overwhelming majority of cases, serves as the board's chairman.

This is the crux of the problem—rather than functioning as an independent monitor of management on the shareholders' behalf, the corporate director serves at management's behest and is beholden first and foremost to the CEO, not the shareholders.

Is it any wonder that at many companies there is no discipline on executive compensation decisions and compensation is virtually out of control? In this system, corporate executives are virtually free to set their own pay, with no accountability for their decisions. The restraint that shareholders are supposed to impose through the board of directors has been eliminated from our system.

The solution lies in a market-based approach that establishes a meaningful role for shareholders to exert accountability, reflecting their position as the corporation's true owners. With accountability, rationality will be restored to executive compensation.

We are encouraged that the Securities and Exchange Commission has begun to take the first important steps toward reform. The SEC is developing new rules that will require disclosure of more complete, accurate and clear compensation information to shareholders in the proxy statement. Improved disclosure will produce greater discipline in executive compensation decisions by corporate boards. USA urges the SEC to swiftly begin formal consideration of these vital rule changes.

USA applauds the Commission's February action to allow votes on shareholder proxy proposals relating to executive compensation at corporate annual meetings. These shareholder proposals, while non-binding and advisory in nature, allow shareholders more direct input on management compensation decisions.

The SEC is also working on revisions to the shareholder communication provisions of the proxy voting rules to allow more open communication among shareholders. This will be a great aid to shareholders who wish to participate in the proxy system but are stymied by the SEC's burdensome review and approval procedures.

But even more fundamental reform is required to expose executive compensation to market-based disciplines and incentives. For any market to function properly, there must be free choice and open competition. As I've already stated, however, in the selection and election of corporate directors, there is no choice and no competition.

Government regulation of the corporate proxy voting system, hand-in-hand with long-standing traditions and practice, have prevented development of truly independent boards of directors.

The ultimate remedy to restore management accountability in our corporations and sanity to executive compensation is a mechanism allowing shareholders to elect

truly independent directors who will unquestionably act on behalf of the owners' interests.

In its 1990 proxy reform rulemaking petition to the SEC, USA proposed allowing qualified shareholders to place independent director nominations in the corporation's proxy materials. But the Commission has not indicated whether it will act on this recommendation. We encourage Congress to consider legislation that would give shareholders the ability to nominate and elect truly independent representatives to corporate boards of directors.

Rather than seeking arbitrary pay limits, or authorizing the IRS to become a national compensation czar, we believe market forces offer the best solutions. The problem is that a freely functioning market has not been allowed to operate because shareholders have not had the ability to demand accountability from their corporate directors and officers. Empowering shareholders with the authority that reflects their ownership role in American corporations is the key to resolving the executive compensation problem.

Prepared Statement of Senator Carl Levin

Mr. Chairman, thank you for inviting me to speak to the Subcommittee today about the issue of executive pay.

First, some facts:

- —In the 1980s, while corporate profits stagnated or fell, CEO pay skyrocketed. The same pattern is holding in the first two years of the 1990s. In 1990, while corporate profits fell 7%, CEO pay rose 7%. In 1991, while corporate profits fell twice as fast, by 15%, CEO pay rose by another 4%.
- —CEO pay in America is 100 times that of average workers, triple the pay gap of just 15 years ago. Even J.P. Morgan, one of America's leading capitalists, advocated limiting CEO pay to no more than 20 times the pay of average workers. The pay differential in Japan is only 17 times, while in Germany it's 23 times. But in America, it is 100 times.
- —CEO pay in America far exceeds CEO pay in the rest of the world. At mid-sized companies with $250 million in assets, US CEOs typically receive twice as much pay as CEOs in Japan and Germany—even though many of their companies are beating our socks off.

The disconnect between CEO pay and corporate performance was the subject of hearings held before my Subcommittee on Oversight of Government Management in May 1991 and January 1992. These hearings showed that CEO pay in America is out of whack—it is out of line with corporate performance, out of line with the pay of other workers, and out of line with CEO pay in the rest of the world.

The hearings also showed that the federal government is part of the problem. At least three federal policies have contributed to executive pay excesses, and that's why I introduced legislation a year ago to change them.

- —First, until my bill was introduced, the Securities and Exchange Commission acted as a roadblock to stockholders trying to put the brakes on runaway executive pay in their own companies. It did so by supporting corporate actions that denied stockholders even an advisory role in how CEO pay is set.
- —Second, SEC disclosure regulations haven't produced easy-to-grasp information on executive pay. Today, even compensation experts need hours of research to figure out the bottom line pay of many CEOs.
- —Third, stock option accounting rules, backed by the federal government, do not reflect their true cost to companies and stockholders. In fact, most stock option compensation is never included as an expense in a company's books, even when claimed as an expense on the company's tax return.

The bill I introduced last June, the Corporate Pay Responsibility Act, S. 1198, would change these federal policies. And while the bill has already spurred several reforms or promises for reform, more needs to be done. I'd like to summarize for you what's happened so far.

The first reform involves the federal government's interaction with stockholders who want to recommend pay reform in their own companies. For decades, the SEC staff had ruled that, if a corporation objected, a stockholder had no right to circulate an advisory resolution on pay reform for a vote at the annual meeting. My bill directed the SEC to reverse this policy and allow advisory stockholder proposals. Eight months later, in February of this year, that's exactly what the SEC did. About 10 stockholder proposals urging pay reforms have now been presented for votes at

companies across the country. Each has sparked a spirited debate. That's a healthy development.

The second reform involves improving SEC regulations on pay disclosure. Right now, even experts can be confounded by pay information in company proxy statements. For example, last year, the *Wall Street Journal* variously reported the same CEO's compensation at $7.3 million and $11.4 million. In the case of another CEO, *Business Week* reported his 1990 salary at $8 million, while *Fortune* said it was $2 million. These are not small discrepancies. Much of the confusion is due to proxy statements filled with legal jargon and inadequate disclosure of the value of stock option grants.

To clarify the situation, my bill would require proxy statements to provide a single chart listing all the types of pay and a bottom-line total for each executive. It would require the SEC to provide a uniform method for valuing stock options and companies to provide pay totals from prior years to-permit pay comparisons. Again, in February, eight months after my bill was introduced, the SEC announced its intention to issue disclosure regulations along these lines. The proposed regulations are expected this month.

The third and final reform involves accounting for stock options. Stock options give an executive the right to buy company stock at a set price for a period of time, usually 10 years. While companies in other countries like Japan rarely use stock options, over 90% of large corporations in the United States grant them to their executives. And they provide a significant portion of CEO pay—not 5% of total pay, but 30%, 50% and sometimes more.

Many of the 1991 pay increases for CEOs were due to stock options. One business publication recently ran a story entitled, "If CEO Pay Makes You Sick, Don't Look at the Stock Options; It featured a CEO who received a 1991 stock option grant valued at $120 million, on top of previous grants valued at $225 million, for a 4-year total of $345 million. Each time the company's stock rises $1, this CEO stands to gain $6 million. Stock option gains for other CEOs in 1991, a recession year, also ran sky-high, in one case topping $70 million.

Part of the reason companies can afford to provide these levels of stock option compensation is that stock options are the only type of executive pay which a company can deduct as an expense on its tax return, but doesn't have to list as an expense in the company books. Keeping stock options off the books as an expense means even huge option grants leave corporate earnings untouched.

For example, a company that pays its CEO $1 million in cash must reduce its earnings to reflect that expense. But a company that gives its CEO stock options valued at $10 million doesn't have to charge even a penny against the earnings reported on its profit-loss statement. And it can still claim a tax deduction for millions of dollars.

Charles hunger, vice chairman of a leading investment firm, Berkshire Hathaway, has called this accounting system "contemptible." A *Barron's* commentator has criticized stock option rules for creating a "tax subsidy." Because stock options never appear on company books as an expense, I call them stealth compensation.

Everyone agrees that the current accounting rules—which assign the typical stock option a dollar value of $0—don't make sense. Since 1984, the Financial Accounting Standards Board, which issues generally accepted accounting principles, has put reforming stock option rules on its agenda. Each time it has considered the issue, FASB has voted unanimously that there should be a charge to company earnings for issuing stock options. When the FASB board met last month, the vote was again unanimous, and exactly what my bill would require.

But waiting for real action on that issue has been like waiting for Godot. After eight years, FASB has yet to change its rules. The SEC, which has been considering the issue since my bill was introduced one year ago, is waiting for a recommendation from its chief accountant, due this month. It's time for the federal government to bring stock options under the rules of ordinary compensation. And if FASB and the SEC don't act promptly, Congress should.

Some critics complain that accurate stock option accounting will hurt businesses that issue stock options to all employees or pay stock options in lieu of cash when they are starting up. They say stock option charges will skew their profit picture which is important to attract new investment.

First, we've found that stock options are almost always limited to top executives. A 1991 review of more than 1,000 U.S. companies (by *Executive Compensation Reports* which tracks compensation trends) found that only 16—or less than 0.02%—issued stock options on a company-wide basis. The *Wall Street Journal* has recently reported that less than 5% of U.S. companies give stock options to anyone below top executives.

New companies that want to use stock options will continue to be able to do so. The FASB and SEC are well aware of the unique circumstances applicable to new companies and can design accounting rules to take those circumstances into account. For example, since the stock options of a new company will usually be worth less than those of an established company, new companies should be able to take a lower charge to earnings. The rules are also likely to value stock options on the date they are granted or vested, rather than on the date they are exercised, which will further reduce the charge to earnings. The resulting charge can also be identified in the financial statement as due to stock options so that investors can take that fact into account. Finally, it is worth noting that all other forms of executive pay already appear in a new company's books as an expense; there is no reason to treat stock options differently.

Executive pay unrelated to corporate performance is a threat to American competitiveness. It rewards poor results, causes workplace resentment, and raises red flags in international trade negotiations. Federal policies have been part of the problem. That's started to change, but more needs to be done. I congratulate the Subcommittee for holding this hearing to move us in that direction.

Attachment.

CARL LEVIN
MICHIGAN

United States Senate
WASHINGTON, DC 20510

June 5, 1992

The Honorable David Boren
Chairman
Subcommittee on Taxation
S.nate Committee on Finance
2 5 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

Thank you for the opportunity to testify on June 4, 1992, before the Subcommittee on Taxation about executive pay in corporate America and my bill, the Corporate Pay Responsibility Act, S. 1198.

At the hearing, a question was raised as to whether perquisites were included in one of the charts I used providing pay totals for CEOs in the United States and other countries. I can now confirm that they were included. Because my chart was based on a world-wide compensation comparison prepared annually by Towers Perrin, a leading compensation consulting firm, I have enclosed a copy of the relevant Towers Perrin chart from which all of the figures were taken. The Towers Perrin chart presents pay data on 20 countries, and it clearly indicates that perquisites were considered in calculating each of the CEO pay totals.

In addition to this explanatory material, I ask that you include in the hearing record my complete statement, copies of the three charts I used in my presentation, and a recent article from Business Week magazine containing thoughtful suggestions for pay reform. These materials are enclosed.

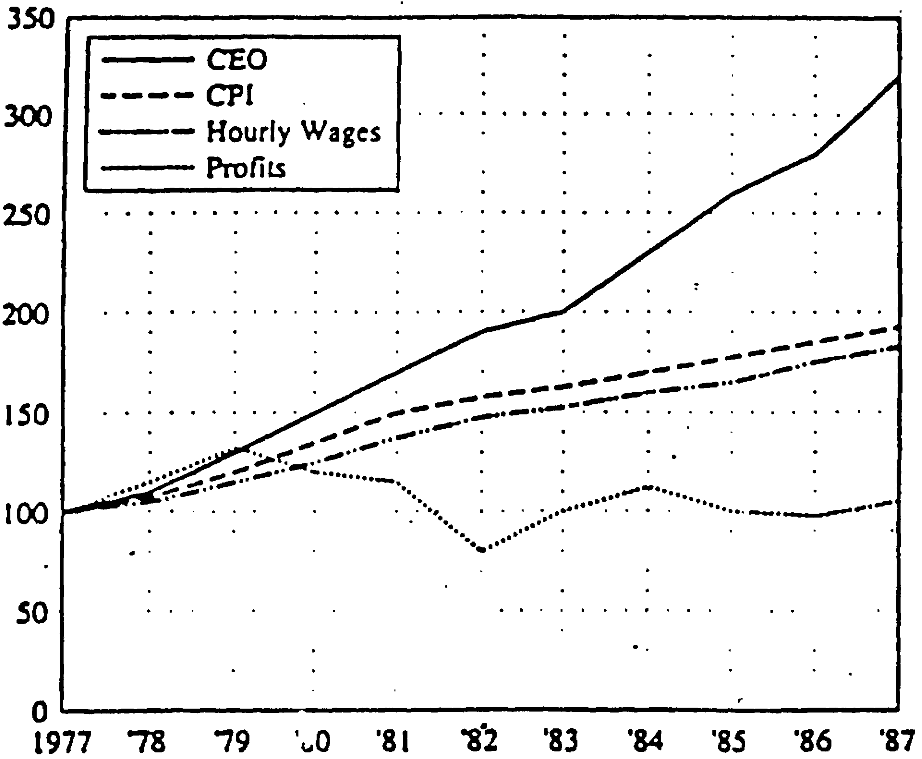
I hope this additional information is of assistance. Thank you again for the opportunity to address the Subcommittee.

Sincerely,

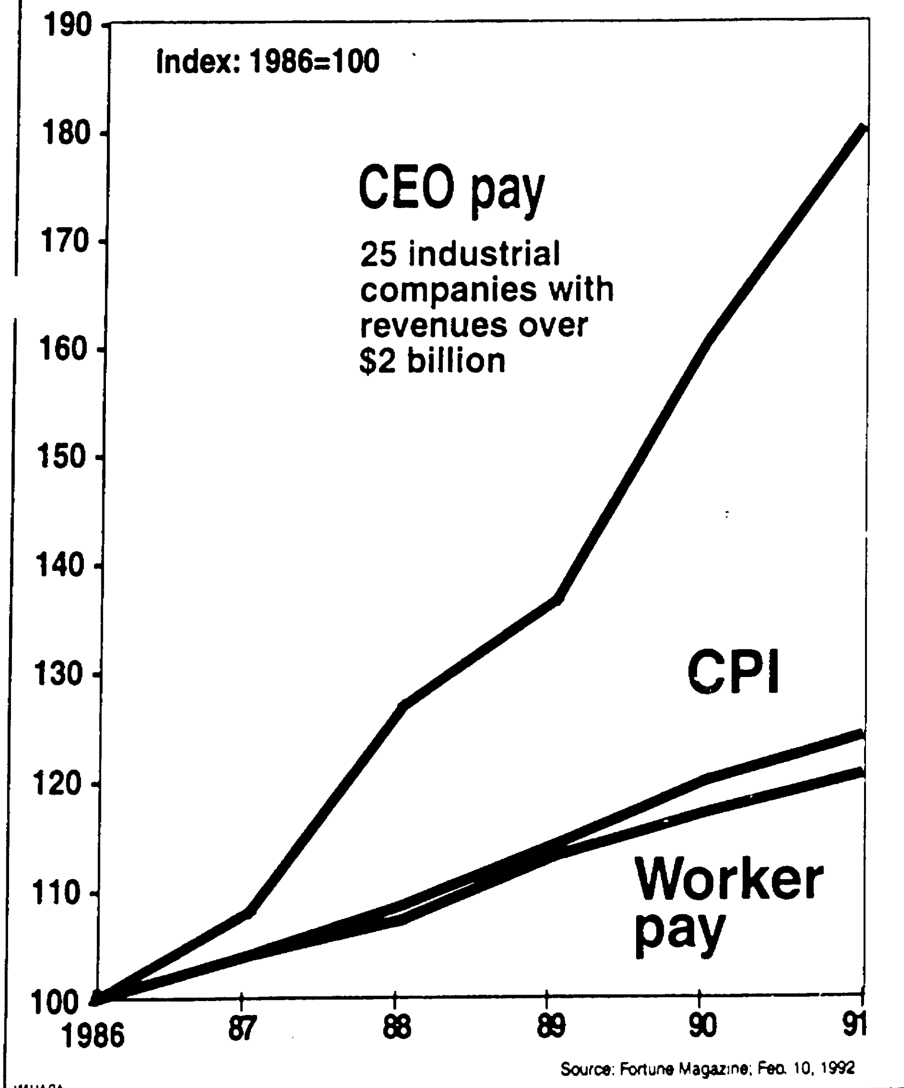
Carl Levin

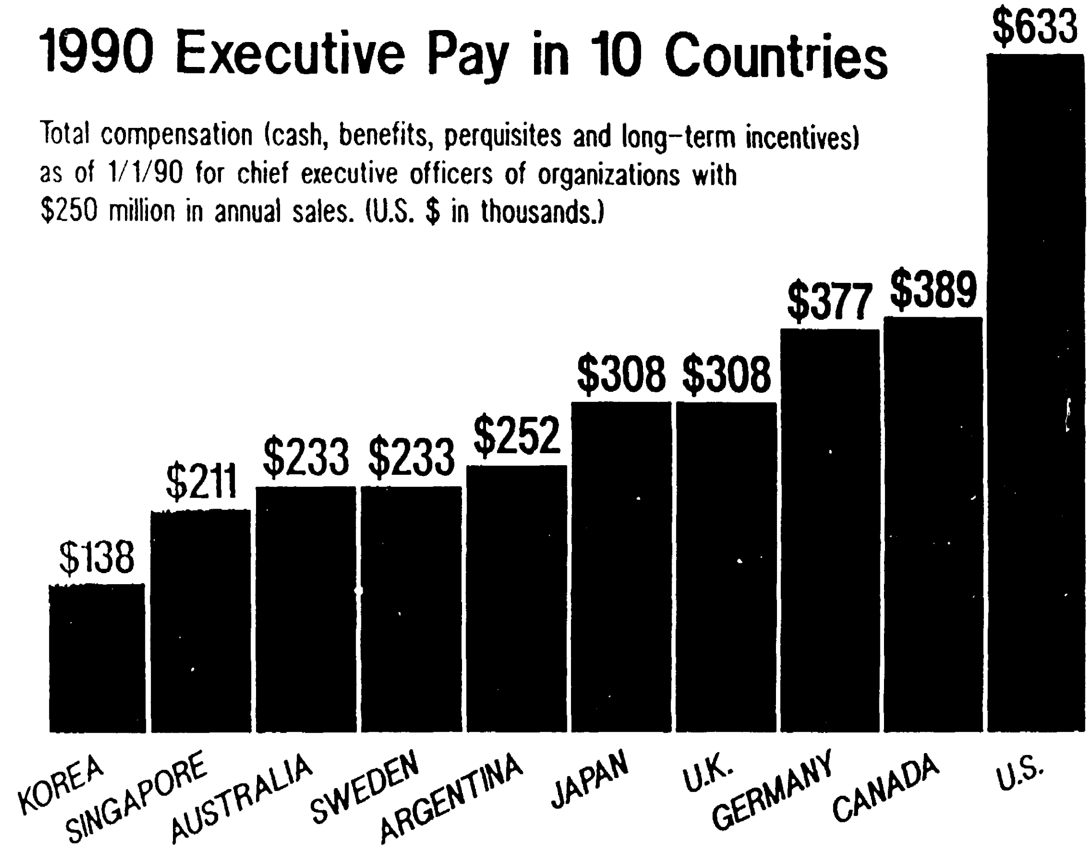
CL:ejb
Enclosures

CEO Compensation Rate Compared With Inflation, Wage, and Profit Rates, 1977—'87



(1977 = 100). SOURCE: Sibson & Co.


THE WIDENING GAP
Index: 1986=100
CEO pay
25 industrial companies with revenues over $2 billion
CPI
Worker pay
190
180
170
160
150
140
130
120
110
100
1986
87
88
89
90
91
Source: Fortune Magazine; Feb. 10, 1992


1990 Executive Pay in 10 Countries
Total compensation (cash, benefits, perquisites and long-term incentives) as of 1/1/90 for chief executive officers of organizations with $250 million in annual sales. (U.S. $ in thousands.)
$138
$211
$233
$233
$252
$308
$308
$377
$389
$633
KOREA
SINGAPORE
AUSTRALIA
SWEDEN
ARGENTINA
JAPAN
U.K.
GERMANY
CANADA
U.S.

1990 Executive Pay Update

Worldwide Total Remuneration

TPF&C
a Towers Perrin company

About TPF&C

TPF&C, a Towers Perrin company, is an international organization of management consultants and actuaries specializing in total remuneration – pay and benefits – actuarial, communication and related human resource consulting services. Our worldwide actuarial practice is devoted primarily to helping companies manage the financial aspects of their pension and other employee benefit plans. We serve clients of every size in virtually every industry as well as in the government, education and not-for-profit sectors.

TPF&C has been advising clients since 1917. At present, we provide counsel in the following fields:

- executive remuneration
- salary management
- sales management
- employee benefits
- actuarial services
- benefit administration
- communication
- employee statements
- human resource management
- human resource information management.

Two other Towers Perrin companies provide services that complement TPF&C's. Cresap offers general management consulting services in the areas of strategy and organizational effectiveness. Tillinghast offers management consulting and actuarial services to life and casualty insurance companies and related enterprises. Tillinghast also provides risk management counsel to help all types of organizations evaluate their exposures to accidental loss and develop programs to manage them effectively.

Towers Perrin has a total staff of 5,000 in over 60 locations throughout the United States, Canada, Latin America, Europe, Australia and the Far East and serves almost 8,000 clients worldwide. Among them are more than 100 of the 500 largest companies outside the U.S., and 405 of the *Fortune* 500 industrials.

Management Consultants and Actuaries

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São Paulo

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Calgary
Montreal
Toronto
Vancouver

France
Paris

Germany
Frankfurt
Reutlingen

Hong Kong

Italy
Milan

Japan
Tokyo

Mexico
Mexico City

The Netherlands
Amsterdam

Singapore

Spain
Madrid

Sweden
Stockholm

Switzerland
Geneva

United Kingdom
London
Newbury
St. Albans
Woking

United States
Atlanta
Austin
Boston
Charlotte
Chicago
Cincinnati
Cleveland
Dallas
Denver
Detroit
Houston
Irvine, Calif.
Kansas City
Los Angeles
Milwaukee
Minneapolis
New York
Philadelphia
Pittsburgh
Saddle Brook, N.J.
St. Louis
San Antonio
San Francisco
Seattle
Stamford
Tampa
Valhalla, N.Y.
Washington

Venezuela
Caracas

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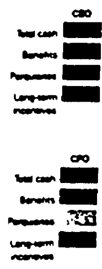
BEST AVAILABLE COPY

Exhibit

4

Total Remuneration (In U.S. $000)



Source: TPF&C

Argentina
Australia
Belgium 171
Brazil 327 171
Canada 173
France
Germany 377
Hong Kong 152
Italy
Japan 140
Korea 91
Mexico 251
Netherlands
Singapore 211 113
Spain 304
Sweden
Switzerland
United Kingdom
United States
Venezuela

Cover Story

EXECUTIVE PAY

COMPENSATION AT THE TOP IS OUT OF CONTROL. HERE'S HOW TO REFORM IT

Our incomes are like our shoes: if too small, they gall and pinch us; but if too large, they cause us to stumble and to trip.
—Charles C. Colton, English clergyman, 1822

One by one, some of Corporate America's most lucratively paid executives have been making the pilgrimage to the spartan offices of United Shareholders Assn. In recent months, the parade has included ITT Corp. Chairman Rand V. Araskog and UAL Corp. Chairman Stephen M. Wolf. The uneasy topic: how much money each is paid.

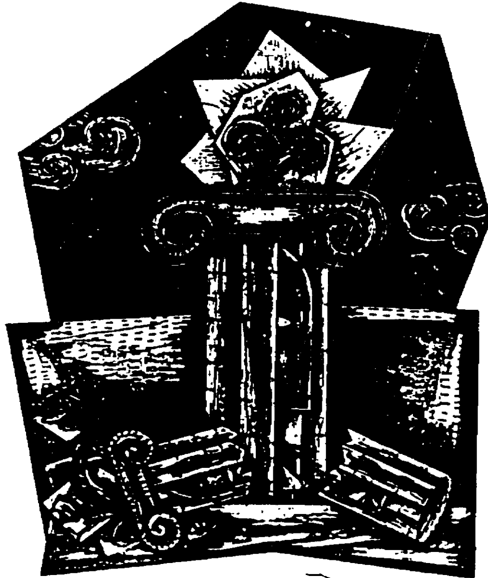
After the executives' visits to the Washington-based shareholder-advocacy group, both of their companies announced changes in their pay practices. At ITT, executive stock options cannot be exercised for 10 years unless the company's stock rises by 40%. At UAL, executives agreed to improve the disclosure of pay policies to shareholders.

SHRILL CHORUS. The episodes underline the current tension over the issue of executive pay. Throughout the 1980s, a hefty runup in compensation for chief executives sent many swaggering off to the bank. The CEO of a large American corporation now earns about $2 million a year—a sum that has more than tripled in the past decade, while the pay of factory workers has failed to keep pace with inflation. As American companies lose ground to foreign rivals, whose chiefs are often paid pittances by U.S. standards, the debate over executive pay is reaching fever pitch. Now, CEOs are on the defensive, stumbling about in those too-big shoes—and maybe headed for a fall.

Even some of the country's most prominent executives have joined the critical chorus. "The American public is tired of seeing executives make many, many millions of dollars a year when the stock price goes down, the dividends are cut, and the book value is reduced," says Stanley C. Gault, chairman of Goodyear Tire & Rubber Co. Too often, he adds, pay isn't linked to how well the company's owners do, and "the only one who gets the short end of the stick is the shareholder."

Not every corporate leader sees it that way. For some, the furor over executive pay is media-fueled, populist hooey. They argue that a free market for wages appropriately rewards productivity and talent, to the ultimate benefit of the economy and the nation. "The prize goes to the person who sees the future the quickest," says William P. Stiritz, chairman of Ralston Purina Co., who earned $13.8 million in salary, bonus, and stock awards last year.

LOW CRIMES. Of course, there's merit in both positions. The prospect of justly rich rewards remains the greatest incentive to innovation, risk-taking, and hard work. But the executive-pay derby has become, in some cases, an excessive free-for-all, divorced from the reality of corporate results. What the boss gets paid has ceased to be an issue of economics and has become instead one of leadership, competitiveness, and fairness. The swelling chorus of public and political outrage makes it increasingly



STRIVE FOR SIMPLICITY 1. Return to the basics. Pay the boss a salary, bonus, and stock options. Throw every other ·ry gimmick out, from performance shares to stock-appreciation rights. **2.** Limit perks, golden parachutes, and million-dollar pensions. **3.** Fire every consultant who tells you to do otherwise. **4.** Don't fudge by repricing stock options if your company's shares fall below their exercise price

ILLUSTRATIONS BY RICHARD DOWNS

likely that Corporate America will feel the obtrusive hand of government if it doesn't clean up its act on its own.

What to do? The right answer won't be the easy one. Already, both the House and the Senate have passed broad tax packages that would prevent companies from taking a deduction on pay in excess of $1 million per executive, a cap that includes stock options and perks. Representative Martin O. Sabo (D-Minn.) would have established a ceiling at 25 times the salary of a company's lowest paid employee.

But controlling pay by taxation would lead only to higher costs for the shareholders. Many companies would simply foot the bill for the tax, just as many did for the most richly embroidered golden parachutes of the 1980s. Ultimately, the answer is intertwined with a wide range of other issues involving corporate governance, shareholders' rights, leadership, self restraint, and proxy disclosure.

Like all other contracts wages should be left to the fair and free competition of the market and should never be controlled by the interference of the legislatures.
—David Ricardo, 1817

Ricardo is still right: Executive pay doesn't require a legislated fix. Reform needs to begin in the boardroom. Even Senator Carl Levin, the liberal Michigan Democrat who instigated Senate hearings on pay, agrees to that. "I don't support the government setting CEO pay in the tax code," he says. "Government should not be making decisions as to what the right levels of pay should be."

UP THE ANTE. The traditional regulator remains the best one: the board of directors. But now more than ever, directors who serve on the compensation committee must begin to assert a higher degree of independence. Lawyers, investment bankers, and consultants who draw fees from the company should not sit on the committee that sets the CEO's pay. Neither should such committees be composed entirely of other chief executives who might be chummily open to upping the ante. Indeed, some critics suggest that no CEOs should sit on a compensation committee at all.

Now pay consultants are typically hired by the CEO. But when reviewing a new pay plan for top executives, the compensation committee should routinely be able to hire its own outside consultant for an independent second opinion. At a minimum, the chief executive should excuse himself from the room so his hired adviser and the directors can speak more freely on the boss's pay—still a rarity in the boardroom.

Besides changing the process by which pay plans are considered, boards should change the principles that govern the process. Compensation levels should be based not on what other companies do, but on what a management team accomplishes. For years, compensation surveys have served only to ratchet up pay. If each company seeks to pay its own executives in the top quartile of the industry, compensation is perpetually forced upward. Instead, if a company's performance is average for a given group, pay should be only average. Then, eliminate the bewildering array of safety nets and giveaways that puts cash and stock into the hands of top executives regardless of how their companies perform (table, page 55). Stock-appreciation rights, performance shares and units, and restricted stock—except when used in lieu of cash—should be relegated to the scrap heap.

MISSING LINK. In chopping these giveaways, directors should aim for simplicity. The intensity of today's debate over pay has opened the gates to a drove of hungry consultants peddling novel and quirky ideas—ways to index stock options, link corporate cash flow to bonus payouts, or offer nonrecourse loans to executives to buy stock. Mostly, what they do is further complicate a process that is too complicated to begin with and make it all the harder for shareholders to figure out who's really getting paid what. "I'm frustrated by layers of compensation programs that are difficult to understand," says Donald S. Perkins, the former chairman of Jewel Cos. and a director on seven compensation committees. "What we ought to be preaching in corporate halls is simplicity. As soon as a program doesn't

PAY FOR PERFORMANCE—FOR REAL 1. Limit the boss's base salary to $1 million a year, even for the largest companies. Every cent beyond that cap should be paid only when the CEO meets tough performance targets. Set financial goals against an industry peer group. **2.** Give boards discretion to reward improvement in such key areas as quality, customer satisfaction, and management development. **3.** Charge stock options against earnings, because they do have a value. **4.** Price large option grants at a premium, so shareholders benefit before executives. **5.** Encourage stock ownership among executives

Cover Story

work, we need not invent a new one."

Simplicity does not necessarily mean low pay. But it should mean understandable pay and compensation justified by a job well done. For decades, the clamor has been for pay for performance, an often-empty slogan for legions of consultants selling the latest newfangled plan. The missing link—between pay and the corporation's performance—has mystified investors, employees, academics, and politicians.

INCREASE BOARD SCRUTINY 1. Add non-CEOs to the compensation committee. Exclude investment bankers, lawyers, and consultants who draw fees from the company. **2.** Hire an outside consultant to provide directors with a third-party opinion on the CEO's package. **3.** Pay directors in stock to forge better links with the company's shareholders

What's badly needed is clarity. Compensation should be composed of a salary, a bonus, and a single stock-option plan that encourages ownership. Consider the example of paying a base salary of $600,000 with a cash bonus of equal amount. Half the bonus would be contingent on meeting stringent standards of financial performance. The compensation committee would hand out the rest not for so-called pay for performance, but for what Cyrus F. Freidheim, vice-chairman of Booz Allen & Hamilton Inc., calls "pay for competitiveness."

That means directors should not reward executives for short-term runups in stock price or earnings per share but for the long-term intangibles that create competitive advantage. "That can be anything from becoming the leader in electronics to staying alive in the steel industry," notes Freidheim. True, it can be hard to measure objectively how well an executive has improved comparative quality, enhanced a company's reputation, developed its management depth, or boosted its productivity. But it's vital to do so—and vital to try to link executive pay to such yardsticks.

Detroit's Big Three are an object lesson in the distinction between pay for earnings or stock performance and pay for competitiveness. During the apparent prosperity of the 1980s, auto makers racked up years of record earnings, while their CEOs raked in ever-more-lucrative pay packages. But much of the profit was the result of voluntary import restraints set by the Japanese. In fact, even as U.S. carmakers posted record results, they were becoming less competitive because they were losing ground in quality, customer satisfaction, and productivity. Such notions still remain largely absent from the pay-for-performance debate.

Nothing has contributed more to the disjunction between pay and performance than the stock option. When it came into vogue after Congress granted it favorable tax treatment in 1950, few could imagine the impact stock options would eventually have on the compensation game. In the early days, stock-option awards were fairly conservative, even miserly. But since the late 1960s, the average size of an option grant has tripled, as boards began doling out stock options like Monopoly money. In 1989, Walt Disney Co.'s Michael D. Eisner was handed a then-unprecedented 2 million options—a record broken a year later when Anthony J. F. O'Reilly, chairman of H. J. Heinz Co., received a 4 million grant in one fell swoop. And earlier option grants have made O'Reilly the winner of this year's pay derby so far, with a new one-year record of $75.1 million in pay, bonus, and stock options (page 58).

The sad truth is that accounting rules make options as free as those tinted dollars in the Parker Brothers game. It's funny money. Everyone agrees that a stock option has real value, yet companies are not required to charge them against earnings. Because option awards are essentially free, they're "never measured, never managed," says Raymond C. Lauver, a former member of the Financial Accounting Standards Board (FASB).

SHARP UPSWING. The grants grew beyond the imaginations of directors, many of whom were as surprised or shocked as the public to see what value they eventually had. "This stock-market escalation has meant that some of these numbers aren't what we all meant them to be," says Donald P. Jacobs, dean of Northwestern's J. L. Kellogg Graduate School of Management and a director on several compensation committees.

What that means is that much of the vast rewards reaped by chief executives has been a product not of their performance but of the general upswing in the market or inflation. American Telephone & Telegraph Co. partly acknowledged this problem in adopting a new stock-option plan, under which most options are priced at a premium of between 20% and 50%. In the case of Chief Executive Robert E. Allen, for example, one of every four of his options bears a price of $58.03, 50% more than the $38.69 value of the stock at the time of grant.

The upshot: AT&T shares must rise by more than 50% before a quarter of Al-

ies's options will be worth anything. In crafting the plan, AT&T rejected the use of restricted shares or a stock-option megagrant without any strings attached. "We're trying not to give somebody a gift," explains Harold W. Burlingame, an AT&T senior vice-president. "Only after you deliver something to the shareholder do you reach a new plateau." Directors would do well to follow AT&T's lead, pricing all sizable option grants at a premium to market.

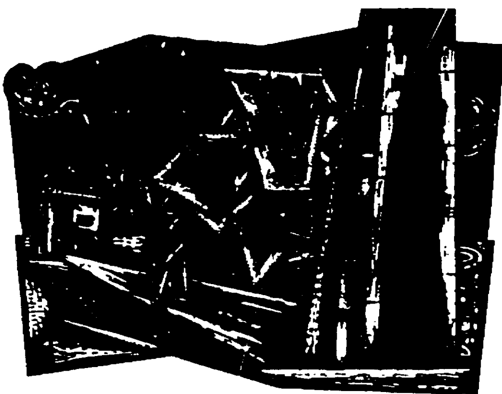
VALUE LINE. The idea of charging options against earnings is hardly outlandish or unprecedented, either. Figuring out a value for stock options was an important issue in the early 1950s, although accountants couldn't agree on any approach. When the Accounting Principles Board took a look at it in 1972, it was dropped again for much the same reasons. "It was obvious then that the option was a valuable privilege," says David Norr, a board member at the time. "The right to issue stock is a license to print money. It is compensation, and it should be measured." When the succeeding FASB, heavily lobbied by business interests, took the issue up again in 1984, it went nowhere and was again put aside three years later. Yet each time the issue was raised, FASB board members voted unanimously that options result in an expense that should be recognized in a company's financial statements.

Treating options as an expense would have a noticeable impact on some corporate earnings in this day of megagrants. Hay Group Inc., a consulting firm, uses the example of a company with 100 million shares outstanding, a $40 share price, and $200 million in pretax profit. If the company grants a typical 1% of its shares a year as options, the charge to earnings would be 6% of reported profits. That sort of penalty would almost certainly curtail the abuses that have become too prominent. If some companies with broad-based option plans believe they are still important for morale and motivation of the work force, they'll continue to pay for them.

All the rhetoric claiming that stock options are important in forging a link between the chief executive and the shareholders is just that: rhetoric. It is stock ownership, not options, that forge the connection. As Warren E. Buffett once observed, the executive does not lose any money on an option when the stock price plummets, because he is not required to invest. Or as the well-known pay critic Graef S. Crystal puts it: "While the shareholders' boat is parting the waves and going down to Davy Jones's locker, the CEO is sitting on the QE2 in a plush deck chair."

To build a better link with shareholders, directors must formally or informally encourage executives to hold on to their stock for a defined period of time. There are some signs of change taking place here. So far, one company in 10 boasts that it has specific stock-ownership objectives for executives, and one in four restricts or discourages its executives from selling the stock. At a few companies, according to a recent survey, a stock sale by an executive will affect the number of future stock options he or she receives and might even be regarded as corporate disloyalty.

SMOKE AND FOG. Finally, companies must improve the disclosure of their pay plans. A good deal of the skepticism over pay results from the public's inability to understand it. Many companies have contributed to the problem by making the proxy statement an exercise in obfuscation. "The growth in long-term compensation was largely because it was far less disclosed and certainly far less understandable," says Jerry K.



IMPROVE DISCLOSURE 1. Report pay, bonus, and options in a single, easy-to-read table. 2. Include data for three years to allow investors to make comparisons. 3. When a new option plan is adopted, include an "impact statement" detailing the potential value of the plan to the top officers if the stock annually appreciates by 5%, 10%, or 20% over the 10-year period of the grant

A GUIDE TO THE GOODIES

SALARY AND BONUS The average pay and bonus for the chief executive of a major U.S. corporation is more than $1.2 million

STOCK OPTIONS With other long-term incentives, these rights to buy a fixed number of shares at a fixed price bring the average CEO's pay to about $2 million a year

RESTRICTED STOCK Full ownership of these stock grants is restricted based on certain time periods or performance goals

STOCK-APPRECIATION RIGHTS These permit an executive to take out the gain in a stock option without making any investment

PERFORMANCE SHARES Executives get a grant of free shares if the company hits certain performance targets

PERFORMANCE UNITS Rather than stock, cash awards based on 'units' of stock are doled out to executives if the company meets its performance goals

PERSONAL FINANCIAL COUNSELING Many companies now foot the bill for the CEO's own financial consultant. H.J. Heinz, for example, paid CEO Anthony O'Reilly $471,350 for financial advice from 1987 to 1990

GOLDEN PARACHUTE If they lose their jobs, most big-company CEOs now get at least three times their annual pay and bonus as a final goodbye payment, as well as immediate access to most of their stock options

DATA: BW

Pearlman, chairman of Zenith Electronics Corp.

Some companies have already taken a leadership position. Citicorp, for example, now reports on pay, bonus, and stock-option payoffs in a single, easy-to-read table in its proxy. Another table includes pay totals for each of the past three years, so investors can figure out on their own whether the top executives received increases or cuts in pay.

When a company installs a new stock plan, it should include a short "impact statement" similar to the one that is used to estimate pension benefits. The table would detail the potential value of a stock-option grant under three different scenarios, given annual rises in the stock of 5%, 10%, and 20%. If Heinz had made such calculations public in giving O'Reilly a 4 million-share option grant, investors would know that he stands to gain roughly $75 million at 5%, $190 million at 10%, and $620 million at 20%—over the 10-year period of the option. Put another way, O'Reilly stands to reap $75 million of reward if the stock price rises by less than the return on a Treasury bill. That's a strong argument for premium pricing of options.

People of privilege will always risk their complete destruction rather than surrender any material part of their advantage.

—John Kenneth Galbraith, 1977

The debate over pay has moved out of the boardroom and squarely into the political arena—a fact reinforced by the concerns over compensation raised from such disparate quarters as both Democratic front-runner Bill Clinton and Vice-President Dan Quayle. "If you can have that much unanimity from that wide a gap on the political spectrum, that prob-

IS THE TOP BRASS OVERPAID?

PAY CRITIC GRAEF S. CRYSTAL His detractors dub him the darling of the corporation-bashers. The former pay consultant and business-school professor has done more than anyone else to heighten sensitivity over executive pay in the boardrooms of Corporate America. Even so, he's skeptical about recent disclosures by several companies, including Westinghouse Electric Corp., that they've cut CEOs' pay. "To appease the public," he says, "they're cutting the cash and then coming through the back door with a big option package. It's not a cut. It's a huge increase, in drag."

To increase accountability, Crystal believes no chief executives should sit on compensation committees of other companies' boards. "One way for a CEO to assure he's paid at the maximum is to pack his compensation committee with other CEOs."

What those committees might explore are two approaches to pay: One alternative, says Crystal, is to pay plenty, but only when the chief executive delivers big rewards to his shareholders. The other is to adopt the Japanese model. "They don't even try to pay for performance," he says. "They don't have any long-term incentives. At the end of the year, the CEO gets about $500,000 in Japan . . . and that's it."

KPMG PEAT MARWICK'S PETER T. CHINGOS For two decades, he has been a top pay consultant working with major corporations on the design of packages for chief executives. As the partner who heads the big accounting firm's compensation practice, he can't recall a time of greater furor over the issue. "We're reaching hysterical levels of concern," he says. "It's more of a knee-jerk reaction and a paranoia. There are clear examples of abuses out there, and we need to contain those, but they make up only a small minority."

For the first time in his career, Chingos says some compensation committees are asking the CEO to leave the room so that directors can speak with the consultant privately about the boss's pay package. "Even companies that pay their executives conservatively now want validations, second opinions, and more data."

Chingos believes that high pay reflects the limited number of executives who are able to run large organizations successfully. "How many Michael Eisners are there in the world?" he asks. "Companies have to pay a premium for business luminaries. If a CEO can create the kinds of shareholder gains created by an Eisner or [H. J. Heinz's Anthony] O'Reilly, boards are happy to give him what he deserves."

SENATOR CARL LEVIN (D-MICH.) When he held his first hearing last May on what he termed "runaway" executive pay, the chairman of a governmental affairs subcommittee could persuade only one other senator to attend the session. A third stopped by long enough to read a statement and leave. Undaunted, Levin became a key player in the pay debate, introducing a bill to require better disclosure of compensation practices. So the liberal Democrat must have taken some personal pleasure when the issue made headlines during President Bush's trade mission to Japan and when the Securities & Exchange Commission subsequently proposed new disclosure rules on pay.

Levin, who earns roughly $125,000 a year, says he found it appalling that "companies were laying off workers, asking workers for sacrifices, while at the same time their CEOs were significantly increasing their own salaries. When there is no relationship between pay and profitability of the company, you are in an anticompetitive position."

Intrigued by studies that show executive ownership of stock falling in recent years, he wants the government to require executives to hold exercised stock options for a minimum period to "maintain a link between performance and an executive's own financial situation."

lem needs a solution," Securities & Exchange Commission Chairman Richard C. Breeden warned a group of corporate leaders at a recent conference on pay. "I can only advise you: Buckle your seatbelts."

Corporate America's bumpy ride is already at hand. As the latest batch of proxies tumbles out, many observers expect to see rising numbers, as executives, spurred by the surprising vigor of the stock market, exercise options. In February, the SEC agreed to allow nonbinding shareholder votes on compensation at such companies as Bell Atlantic, Chrysler, and Eastman Kodak. Together with the latest paychecks, that shift will make this year's annual meetings a lively show, as disgruntled laid-off employees and corporate gadflys confront management. "You are going to see shareholder meetings turn into pay free-for-alls," predicts Michael S. Kesner, a partner at Arthur Andersen & Co.

To blunt the reform movement, the Business Roundtable has weighed in with its own lukewarm agenda that includes measures already practiced by many boards. And some of the best-known corporations, including Avon

HOW COMPANIES ARE REFORMING PAY PRACTICES

AT&T Linking option awards to stock performance. Pricing most options at a 20% to 50% premium

[illegible] Freezing the salary and slashing by half the bonus of CEO for five years in return for stock options

CITICORP Disclosing three years' pay data for top executives in proxy. Includes data on cash bonuses, restricted stock, and options in one table

ITT Requiring stock prices to rise by at least 40% or wait 10 years before executives can exercise any options

BAL Improving disclosure of pay practices in proxy statements; providing its compensation committee access to an independent consultant

DATA: BW

SIX BIG GUNS SOUND OFF

RALSTON PURINA CEO WILLIAM P. STIRITZ Like many top executives, the chieftain of one of the world's leading food companies blames the current brouhaha over executive pay largely on media hype. "It's the lowest form of yellow journalism," he told reporters, after a shareholder asked a question about his pay—$13.8 million last year in salary, bonus, and stock awards—at the company's annual meeting in January. "It's an easy hit... a red herring. It raises highly divisive issues among employees, shareholders, and management."

To Stiritz' way of thinking, critics often overlook what he considers the "most critical factors" in setting pay: the size of the company and its competitive position in an industry. "The popular press and executive-pay pundits often mislead and oversimplify," Stiritz says in a written response to BUSINESS WEEK. "They ignore that to be assessed fairly, executive compensation needs to be viewed in relation to assets under management.... Incentive compensation needs to be aligned with the unique challenges and degree of difficulty of the tasks at hand. No generalized industry-pay ratios, ranges, or caps can effectively be applied as mechanisms to control management compensation while still expecting high risk-reward performance."

UNITED SHAREHOLDERS ASSN. PRESIDENT RALPH V. WHITWORTH As the head of this shareholder-advocacy group based in Washington, Whitworth believes executive pay is a symptom of what he considers the larger problem of lack of accountability in Corporate America. Founded in 1986, the association boasts 65,000 members, mostly small investors who often feel they constitute the silent majority of shareholders. "The CEOs are, by and large, setting their own pay," Whitworth says. "They pick the board of directors, and they pick the compensation consultant. The ultimate solution is to have a truly independent board. Today, you can't find a board member in America who was nominated and elected by the shareholders.

"Executive pay is irrational. There's no connection between pay and performance. Instead, compensation is based more on the size of a company, and that only encourages empire-building. [Companies would] like you to believe that high salaries must be paid to attract and retain these chief executives. It's not true. About 80% of all CEOs come from within their own companies, and they have been salivating for the job for years. In a free market, they would probably take the job for a pay cut, because of the perks, power, and prestige."

SANYO ELECTRIC PRESIDENT SATOSHI IUE As a leader of one of Japan's first-rank consumer-electronics giants, Iue doesn't earn nearly as much as the typical American corporate chieftain. Average pay for the CEO of a big company in Japan is roughly one-fourth as much as his American counterpart's—a fact that often surfaces in the debate over executive pay. But Iue cautions against making such simplistic comparisons.

"It's very hard to compare America and Japan, first because we don't have enough information, and second because the job is so different in the two countries," he says. "In many cases, the president of an American company is carrying 90% of the responsibility for making decisions attached to that office. That's rarely the case in Japan, where so much of the burden of decision-making is distributed among subordinates and where so much is ultimately decided by group."

Iue says his frequent travels to the U.S. have led him to the conclusion that American chief executives put in more hours on the job than many top executives of Japanese concerns. "My feeling is that American company presidents work extremely hard and are under a lot of stress. If I had to work in America, it's quite possible I'd want to be compensated like an American."

Products, IBM, and Westinghouse, have taken to trumpeting CEO pay cuts. "It used to be that you announced your earnings," adds Kesner. "Now, you say: 'Earnings are down, and so is the CEO's pay.' It's the new disclosure."

But with much of the disclosure still of the old, ever-upward variety, the debate over compensation is unlikely to find a quick resolution. Greed knows no bounds. Compensation is a complex and controversial issue. Few critics agree even about the precise nature of the problem, let alone its solutions. Yet substantial reform is sorely needed, and some companies are beginning to move. "This is a battleship, and I think it's turning in the water," says Perkins. "But it's going to take time to turn, for a very simple human reason: It's hard to take away a benefit." That may be. Sooner or later, however, Corporate America's chieftains will have to settle for shoes that fit.

By John A. Byrne in New York, with Dean Foust in Washington, Lois Therrien in Chicago, and bureau reports

TONY O'REILLY: TURNING KETCHUP INTO BIG DOUGH

He's charming, worldly, and shrewd. Now add superrich to the adjectives often used to describe Anthony O'Reilly, chief executive of H. J. Heinz Co. O'Reilly may have set a new record in executive pay last year by collecting $75.1 million in salary, bonus, and stock options.

Is any business executive worth that much dough? Heinz directors certainly think so. "I'm not a hero worshiper normally, but I tell you this guy really is unusual," says Heinz director F. James McDonald, a former General Motors Corp. president who heads the compensation committee. "We feel that we've got for the company—for the shareholders—an excellent contract with an outstanding CEO."

The vast majority of O'Reilly's $75.1 million, of course, was the result of an exercise of stock options, some of which were granted to him as far back as January, 1982. O'Reilly's base salary, at $514,000, certainly wouldn't break any pay records. "I probably have one of the lowest base salaries in Pittsburgh for someone who runs a company of Heinz's size," says O'Reilly. Add his short- and long-term bonuses based on operating goals, and his cash compensation came to $3.6 million for the fiscal year ended May 1. Stock options, he says, are the ultimate performance incentive. "As a manager, I believe it, and as an owner of a publicly traded company, I practice it," says O'Reilly, who is Heinz's third-largest shareholder, with a 1.8% stake worth $152.5 million.

SUPREME GAINS. There's no doubt that O'Reilly has done well by Heinz investors. Including reinvested dividends, shareholders gained an annual return of 27.5% for the 10 years ended Dec. 31, far outstripping the 16.8% for the Standard & Poor's 500-stock index. Even so, Heinz's impressive record trails those of such key food-industry competitors as Sara Lee, Philip Morris, and Kellogg, which boasted annual shareholder returns of over 30% for the past 10 years. For the first nine months of fiscal 1992, Heinz reported a 14% drop in operating income, after excluding a $221 million gain from the sale of its corn-milling business.

O'REILLY MAY SET A NEW RECORD

Year	Highest-paid CEO/Company	Total pay/Millions
1991	ANTHONY O'REILLY H. J. Heinz	$75.1
1990*	STEPHEN WOLF UAL	18.3
1989	CRAIG McCAW McCaw Cellular	53.9
1988	MICHAEL EISNER Walt Disney	40.1
1987	CHARLES LAZARUS Toys 'R' Us	60.0
1986	LEE IACOCCA Chrysler	20.5
1985	VICTOR POSNER DWG	12.7
1984	T. BOONE PICKENS Mesa Petroleum	22.8
1983	WILLIAM ANDERSON NCR	13.2
1982	FREDERICK SMITH Federal Express	51.5

*[illegible]

DATA: BW

As extraordinary as his income was in 1991, O'Reilly stands to gain much more. In March, 1990, he signed a five-year contract that awarded him the largest single grant of stock options ever: 4 million shares. Heinz's board anted up because they were afraid of losing him—partly because of a conversation more than a decade ago. When O'Reilly, now 55, was named CEO in 1979, the board asked him what he would like to be doing 10 years down the road. "He said, 'When I reach my mid-60s, I would probably leave business work and get into something else,'" recalls McDonald.

RUMORS. Besides his work at Heinz, O'Reilly is a majority shareholder in a publicly traded company with newspapers in Ireland and Australia. What's more, with all the consolidation in the food industry, directors dared not ignore rumors that O'Reilly was being wooed by any number of unnamed competitors.

Still, some criticize O'Reilly's megagrant as overkill. "I don't think there's any question that O'Reilly is tremendous merchandise, but at some point, somebody ought to say enough is enough," argues pay critic Graef S. Crystal. "The reward that he will now receive is far in excess of the risk that he's taking."

O'Reilly insists that what's good for him will pay off for the shareholder. "Heinz Co. was worth $900 million in 1980, and it's worth $10 billion today—with the same number of shares issued," he boasts. Now, everyone is wondering if O'Reilly can continue squeezing out those results as routinely as Heinz squeezes ketchup out of tomatoes.

By Maria Mallory in Pittsburgh

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Prepared Statement of George Sollman

Mr. Chairman, and members of this distinguished committee, my name is George Sollman. I am President and Chief Executive Officer of Centigram Communications Corporation of San Jose California.

About Centigram

Centigram develops and manufactures voice processing equipment that provides voice messaging capability. as well as integration with electronic mail and FAX messaging. Our equipment widely used by the telephone industry. government offices, universities, and businesses, large and small. We were incorporated in 1980 with the backing of several professional venture capital investors, and became a public company in 1991. We currently employ 240 people in the U.S. and several abroad. Last year we had revenues of about $36 million. We have generated about 15 percent of our revenue from export sales, and devote 16 percent of our sales to R&D.

Centigram is typical of many young, growth-oriented technology companies in this country in that *one hundred percent of our regular employees participate in employee stock options plans*. We motivate and reward our employees with a combination of incentive stock options and profit sharing.

About The American Electronics Association

I am appearing before you this morning on behalf of the American Electronics Association (AEA). AEA is the nation's largest electronics association, with over 2,700 member companies. In addition to the leading U.S. computer, semiconductor, and software companies. AEA also represents the industry's emerging companies. Over 80 percent of our membership consists of small, entrepreneurial firms with fewer than 200 employees.

Introduction and Summary

Mr. Chairman, I very much appreciate the opportunity you have given me to contribute to your hearing today. I want to devote the bulk of my statement to one specific part of the executive compensation debate which is unusually important to the global competitiveness of America's technology companies: the tax and financial accounting treatment of employee stock options.

The global preeminence of America's technology industries was achieved by the enterprise and innovation of young. entrepreneurial firms like Centigram. Neither Japan nor Europe can match the jobs-creating vitality of America's growth-oriented companies. I am convinced, and my CEO colleagues are convinced, that without the ability to grant employee stock options to large percentages of our workforce, firms like Centigram would no longer be able to start-up and make their vital contribution to the economic future of this nation.

The SEC is developing a series of proposals to improve the information companies provide to their shareholders. Additional disclosures of stock option plans is scheduled to be included. We believe this positive approach is the right answer. Shareholder returns should not be hammered-down just to offer them a new form of flawed data.

I want to devote most of my written statement today to explaining the positive case for retaining the current financial accounting treatment of employee stock options because I believe we have an excellent story to tell. I will explain why employee stock options are crucial to the founding, growth and success of companies like mine. I also hope to communicate to you the severe damage that could be inflicted on America's vital technology industries by some of the proposals being advocated at this hearing.

After I make the positive case for employee stock options, I think it's important to respond to the highly publicized and misleading comparison between the tax and financial accounting treatment of options which is being used to justify imposing a major reduction in our earnings. I also want to answer several of the most frequently asked questions about our position on stock options.

I will then respond to your invitation for our views on the limitation on deductibility of officer compensation.

I. THE POSITIVE CASE

Stock Options are Essential to the Entrepreneurial Culture of Silicon Valley

Mr. Chairman. the American electronics industry is proud of the entrepreneurial culture we have developed in Silicon Valley and other technology centers around the country. That culture is one of this county's most important comparative advantages in the battle for global competitiveness. We need you to understand that the high percentage of our employees who share in the ownership of our companies through

stock options is one of the basic foundations of that culture. We believe widespread use of employee stock options is an important social policy goal that should be actively encouraged by our government.

We are well aware of the unfavorable publicity that has surrounded the compensation of certain high profile corporate executives lately. Although we think these perceived abuses are the exception, and not the norm, under these circumstances, it is entirely appropriate for regulatory agencies and Congress to examine the issues involved in corporate compensation.

In the course of your study, however, it is important that you consider the crucial contribution employee stock options make to the dynamism and success of America's vital high technology sector. This group of industries—upon which the U.S. is depending for much of its economic success in the future—is uniquely vulnerable to ill-considered efforts to discourage the use of employee stock options.

A Powerful and Pervasive Incentive in High Tech Companies

Because companies in some industries tend to grant stock options only to their most senior employees, stock options have taken on a "fat cat" image in the press and in many government circles. That reputation is seriously misleading when it comes to the high technology sector.

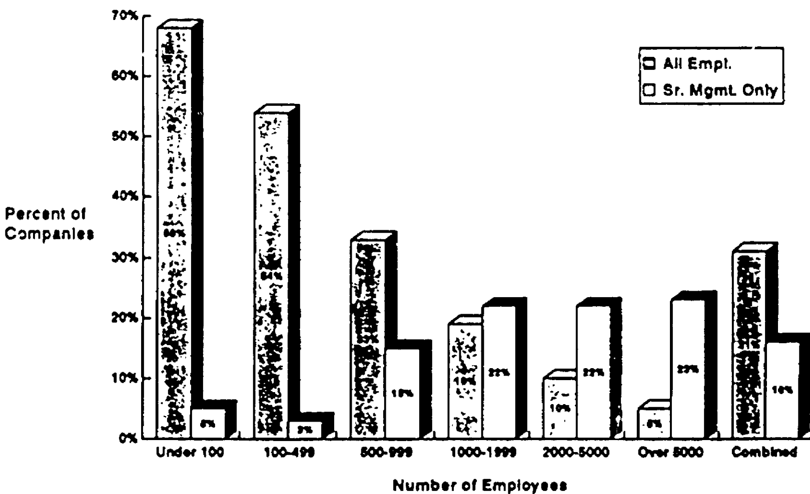
Employee participation in stock option plans is broad and deep in Silicon Valley and other technology areas. Plans like Centigram's that cover large percentages of the employees are common, especially among venture-backed companies.

A 1990 Radford Associates survey of 300 electronics companies found 85% of the companies using options gave them to middle managers, and 30% include non-salaried people. Only 15% limited their options to officers.

Our colleagues in the Industrial Biotechnology Association report a similar experience. According to IBA, 75% of their companies use stock options. Fully 60% grant options to their entire workforce. Only 8% limit their options to officers and a few managers.

In 1991, ShareData, Inc., makers of a widely used PC-based stock option management program, conducted a formal survey of their 800 company users group. They received 300 responses. The following chart dramatically illustrates both how important and how pervasive broad-based stock option plans are to smaller companies.

COMPANY SIZE VS. OPTIONS GRANTED LEVEL



1991 ShareData, Inc.

Why Stock Options are Vital to America's Entrepreneurial Sector

Stock Options Allow Small, Risky, Cash-Strapped Enterprises to Compete Against More Established Companies for Scarce Technical Talent.

Studies, have repeatedly shown that small, high technology companies grow faster and create more jobs than mature industries. Yet despite their disproportionate contribution to technological innovation and economic growth, young companies frequently have difficulty competing in the job market for talented managers and scientists.

Smaller companies can ill afford to pay the salaries necessary to compete with Fortune 500 companies for talented employees. But they can partially offset that disadvantage with stock options. Because the value of stock options depends on growth in value of the company's shares, the stock price of smaller companies can rise, on a percentage basis, far faster than that of established companies. Thus, options are potentially more rewarding for small business employees than for people in larger companies.

Young companies also rely on broad-based stock options to make up for their inability to offer generous retirement and employee benefit plans. If they lose their ability to grant options to the bulk of their employees, the cost of these benefits will come crashing down on America's young technology companies. And I can promise, you will hear a lot about it.

The initial employees at Centigram came from established corporations like IBM, Xerox, and Rolm. We used stock options to attract them. *Without stock options we could not have attracted those key people.*

Employee Stock Options Promote Risk-Taking, Innovation and Job Creation.

Normally, few employees would have the capital needed to become significant owners in the companies that employ them. But stock options can give them the opportunity to achieve the benefits of ownership without having to make the up-front cash outlay. Instead of cash, they invest their time, careers and talents.

A stock option only has value to the employee if the price of the company's stock increases through growth in its sales and profits. Therefore, options give employees a strong incentive to find ways to expand the company's business and conduct that business more efficiently. Business growth creates more jobs. Increased efficiency also results in greater productivity and competitiveness.

Stock Options Promote Capital Formation and Broaden the Base of Corporate Ownership.

The exercise of employee stock options provides additional equity capital for both private and public companies. This is especially important for small businesses whose rapid growth creates an insatiable demand for working capital. The use of stock options also increases the probability that a private company will go public to create additional liquidity for its options. This cycle results in more people owning equity in American corporations. It can also lead to faster growing stocks which are prime candidates for investments by employee pension funds.

What FASB Proposed Last Time

We haven't yet seen the specific changes the Financial Accounting Standards Board (FASB) may soon propose. But apparently the board has revived an earlier effort that sought to require companies to treat stock options as a compensation expense and assign a continuous value to each option until it is exercised. That expense would directly reduce the profit and earnings per share that companies with stock option plans could report.

But since the size of this stock option expense would be directly affected by the market price of the company's stock, natural swings in the market that have nothing to do with the company's performance would be fed back into the company's books and cause dramatic and erratic fluctuations in profitability.

Ironically, on the upside, the better a company's stock performed, the greater the charge that would be levied against earnings because of the increased value of unexercised stock options. At the same time, disasters like 1987's "Black Monday," could actually cause a huge profit to be reported!

This would greatly distort the true picture of the company's performance, and damage our ability to raise capital. Although "present value" accounting is put forward as a way of presenting a more accurate picture of a company's performance, in the real world it could introduce significant new distortions for financial analysts.

A High Degree of Subjectivity Would be Unavoidable.

Debating this issue at the conceptual level is easy for supporters of the previous FASB approach. The difficulty comes whenever an actual model is put forward that

purports to tell companies how they should periodically estimate the value that today's unexercised options will hold in the future when they are exercised.

Among the impossible-to-predict issues that have to be predicted are: future earnings, cash flow, and capital spending requirements. How great a factor should be left for a general bull or bear market? How should the valuation account for employees that will leave the company without ever exercising their options? Is it possible to predict technological breakthroughs that will help or hurt the company's position in the future?

If corporate executives could see into the future with this kind of precision, they wouldn't need to work long hours in their companies. They could simply make a killing in the stock market.

Any valuation model that seriously tries to grapple with issues like this will be unavoidably arbitrary and subjective. The FASB version attempts to artificially construct stock option value using historical stock price volatility to predict the future. Although the Board is reported to be proceeding on the assumption that this will generate an acceptable estimate, we strongly doubt it can. We look forward to analyzing FASB's new proposal when it is released.

All "Big Eight" Accounting Firms Opposed the Earlier FASB Project.

Because of these and other considerations, all of the major accounting firms publicly stated their opposition to the earlier FASB proposal for vesting date stock option accounting. They were joined by the Financial Executives Institute, the National Venture Capital Association, the Pharmaceutical Manufacturers' Association and the American Electronics Association.

Why "Present Value" Accounting Hits High Technology Especially Hard

The negative impact of this proposal would fall disproportionately on America's vital high technology industries. The profile of these industries coincides exactly with the types of firms that would suffer the most harm:

- A large percentage of U.S. high technology firms are small companies with fewer than 200 employees. More than two thirds of AEA's membership falls into this category. In small companies a higher percentage of the firm's total value would be affected by erratic and unpredictable changes in reportable earnings.
- An unusually high proportion of the employees in high technology firms enjoy the benefits of employee stock option plans. So a much higher percentage of the firms total compensation package would be affected by the new accounting standard.
- A high percentage of these companies are privately held, with no public market price for their shares. The added volatility injected into their earnings would delay or prevent many of them from going public. And that could be fatal. The uncertainty of an Initial Public Offering can easily prevent companies from attracting crucial second-tier financing from venture capitalists, who depend on public offerings to recover their investments.
- While only a relatively small number technology start-ups achieve sufficient success to offer their stock to the public. a significant percentage of those that do go public have experienced rapid growth in their share prices. Whatever growth or decline would otherwise occur would be dramatically distorted by the new accounting requirement.

The 1987 American Electronics Association Study

To assess the impact of the valuation model previously suggested by FASB, twelve companies belonging to the American Electronics Association opened their books for the years 1982 through 1985 to the accounting firm of Coopers and Lybrand. These companies came from a variety of electronics sectors, including computers, semiconductors, and instruments.

Under FASB's proposed stock option reporting rules, the companies profits were reduced an average of 43.5 percent from those actually reported. In some cases the company's earnings were completely obliterated and companies were required to report losses despite significant operating profits.

How Would The Technology Industries Be Injured?

The injury caused by this seemingly insignificant accounting treatment would have been so great that this country's technology companies would have been forced to give up their broad-based stock option plans. That would have severely damaged the pervasive entrepreneurial culture those plans have spawned in our country's centers of technology.

The professional venture capital industry would have lost much of its ability to create the amazing start-up companies like Apple Computer, Sun Microsystems, or

Federal Express, that go on to spawn whole new industries. Much of the dynamism of Silicon Valley would have been dissipated.

No Charge to Earnings Should be Required

We readily concede there is an element of compensation involved in the granting of employee stock options. But we are satisfied that the "costs" associated with granting stock options do not meet the financial accounting definition of an expense and accordingly no charge to earnings should result. These are equity transactions. They already appear in the footnotes to the P&L, as well as on the balance sheet.

But this is a debate we should be allowed to pursue with FASB, not Congress. We need your help on the tax side, where your have expertise and jurisdiction. It's very important that Congress not let itself be stampeded into legislating the fine points of financial accounting.

II. REBUTTING THE CRITICS

Why the "Tax Deduction Without a Financial Expense" Charge is Misleading

The most often-repeated charge against employee stock options these days is that they generate a tax deduction, without requiring a corresponding expense deduction against earnings on a company's financial books. The recommended response to this "offense" is to force companies to reduce their reportable earnings by the amount of their outstanding options.

In the opening statement to the January 31 hearing on the federal treatment of stock options, which he chaired, Senator Carl Levin said: "A company gets the tax deduction, but it doesn't have to list the expense on its books. There is no other form of CEO pay which is a deduction on a corporation's tax return but not expense on the corporate books."

Senator Levin's solution, as described in the summary of his bill, S. 1198, is to mandate the Securities and Exchange Commission, to "require the cost of this compensation to be included in a corporation's bearings statements and reduce corporate earnings."

First, I believe it is incorrect and misleading to equate the treatment required on the tax side with the very different principles of financial accounting.

Second, even if it were valid to compare the two accounting systems, in no way would the existence of a difference between the two justify imposing the kind of penalties against our earnings that are being sought here.

It's Wrong to Compare Tax Accounting With Financial Accounting

As the members and staff of this committee know very well, tax accounting is very different from financial accounting. Tax accounting is mandated by Congress to raise revenue and maintain a sense of political equity in the tax system. Financial accounting policy, on the other hand, is promulgated by FASB, which is primarily concerned with the fair and consistent presentation of financial statements. Not surprisingly, there are hundreds of differences between the two systems.

A few examples: When a company acquires another firm, financial accounting requires that goodwill be expensed, while goodwill is not deductible for tax purposes. In that same situation, financial accounting requires assets acquired to be stepped-up to current market value, while the tax code requires the original basis be carried over. Various costs expensed for financial accounting are required to be capitalized for tax accounting as inventory. Asset reserves, expensed for financial accounting, are not deductible for tax. Many financial accruals on financial statements are not currently tax deductible. In many cases pension and benefit accruals are not tax deductible until paid. Capital losses are recognized on financial books, but may not be deducted from taxes. The list goes on and on.

A very visible current example is the new tax depreciation treatment under consideration for intangible assets. Financial accounting looks at the useful lives of intangible assets and writes them off accordingly. Software, for instance, is written-off immediately or in three years or less. Tax accounting works much the same way right now, but Congress may soon require intangibles to be written-off over 14 years (or whatever period of time is needed to raise sufficient revenue).

The question I ask you to consider is should the creation of such a difference on the tax side trigger some sort of penalty on the financial side, Just for consistency sake? Once the intangibles bill passes, should Congress go on to punish companies with intangibles by requiring that financial accounting be changed to require them to be written off over 14 years as well—just to make it consistent with the tax law? Hardly. Yet that is exactly the argument Senator Levin and others are making in the case of stock options.

Does The Punishment Fit The "Crime?"

And now that a difference between the two accounting systems has been discovered for stock options, what should be done about it?

As members of this committee well understand, the reason employers are allowed a deduction for certain stock option transactions is because the employee in those cases is treated as having received taxable compensation from his company and must therefore pay a tax on it. The deduction to the company only reflects the tax its employee is forced to pay. There is no windfall to the company. But even if there were, the existence or absence of such a rule, created by Congress on the tax side, certainly would not justify imposing an extraordinarily expensive new form of accounting on the financial side.

Because technology companies share stock options with such a high percentage of their workforces, forcing them to reduce their earnings by the estimated "present value" of those options would wipe-out huge portions of their reportable earnings.

An Analogy: Trucks vs. Trains

Let me pose Senator Levin's argument for you in a different context and see what you think. I suggest that the difference between tax accounting and financial accounting can be likened to the difference in the regulation of trucks and trains. Both trucks and trains are designed to carry freight, but with different modes of operation. They have different rules of the road, which are handed down by separate regulatory agencies (State highway commission, vs. State Railroad commission). Trains and trucks may run parallel some of the time, but no one is surprised that they have separate rules, and that those rules can differ.

Now suppose hypothetically, the trucking industry came to Congress and said it just isn't fair that trucks have to stop at surface-level railroad crossings while trains don't have to. They contend this gives trains an unfair advantage over trucks. That certainly sounds wrong on its face doesn't it? But if the truckers then asked you to remedy this alleged injustice by cutting in half the reportable earnings of the railroad companies, how long would it take you to see through that proposal? You would certainly ask the truckers to explain how this minor difference in treatment could possibly justify this tremendous penalty.

My point is that just because tax and financial accounting differences are a little more subtle than trucks and trains doesn't change the principle one bit.

Senator, Levin's is comparing apples and oranges here, to justify a lemon. You should not be misled.

Have The Critics Clearly Identified Who Is Being Hurt By Today's Financial Accounting Treatment?

Once the famous, but misleading tax vs. financial accounting comparison is gone, it's fair to ask, who exactly is being injured by the current financial treatment of employee stock options? The cost of employee stock options is borne entirely by the company's shareholders through dilution of their shares. If anyone is being hurt, it's the shareholders. Yet investors willingly approve these plans because they know stock options motivate stimulate greater returns by motivating a company's employees.

Stock option plans are the only element of compensation that currently requires the express approval of shareholders. Further, they are already subject to annual proxy disclosure and footnote treatment in financial statements. These disclosure requirements are about to be expanded and simplified by the new SEC proxy reform project. It seems to us that critics of option accounting have identified no victims, and quantified no real injury.

Will We Really Be Hurt? Why Can't We Expect Investors To Overlook These Changes When They Decide Where To Invest?

The question often comes up, since mandating present value accounting for stock options won't affect anything "real," in a company, like its cash-flow, why won't sophisticated investors simply back these changes out and follow our companies just as accurately as they do today?

First, even if we were confident that investors would go to the trouble of researching our companies to offset these changes, it's fair to ask, why should we make them do that? Will financial statements really be improved by introducing changes that have to be backed right back out? We don't think so.

Second, we believe that in the real world, with 5 or 6 thousand public companies competing for scarce capital, any company or industry that has to ask potential investors to hop through extra hoops to understand its true performance is at a clear disadvantage in the global competition for investment. Investing in technology companies is already famous as "not for the faint of heart," We can't afford still another

dimension of uncertainty for investors, if we want to hold on to our global market share. We would simply have to stop granting stock options to so many of our employees—which is exactly the opposite of what our government should be trying to achieve.

Economic Nationalism

But the most important answer to this so-called "perfect market" theory is that it overlooks a fundamental policy imperative: American national interest.

It's easy to forget that while the U.S. Government establishes the network of policies that American companies have to compete within, the market only looks at efficiency, and gives no weight to national affiliation.

The perfect market theory suggests that American technology companies are somehow competing in an academic "state of nature," against firms from other countries that treat their companies just as arbitrary as the United States Government does. That is a dangerous fallacy.

In the real world, American firms today are competing nose-to-nose against corporate giants from countries that deliberately target their tax and trade policies to help their companies capture world markets—especially ours. Those foreign companies know exactly which American technologies and companies they would like to buy to maximize their global market share.

If our government hobbles America's most competitive companies with a horrendously expensive accounting change, which destroys our entrepreneurial culture, the market won't care. It will keep right on rewarding efficiency, and hand America's share of the global technology markets to our more efficient foreign competitors.

"Present value accounting" for stock options would introduce a major disruption into the chronically weak capital market for American technology companies. We believe that while the market was "adjusting," many key U.S. firms, with vital technology, would disappear or have to sell their technology to foreign competitors.

We simply do not believe that any potential improvement in financial reporting can outweigh this damage.

III. THE CAP ON DEDUCTIBILITY OF CORPORATE REMUNERATION

Mr. Chairman, in your letter of invitation to appear here today, you expressed an interest in our views on the cap on deductibility of corporate remuneration which was included in the comprehensive tax bill that passed the House and Senate in March. Since we received your request, this compensation limit has been added by the House Ways and Means Committee to an extension of unemployment benefits.

The Accounting Concern

First, though it may not be apparent on its face, we believe that this provision would generate the very same kind of damaging accounting treatment for employee stock options which we have just described and asked your help avoiding.

Because the bill covers "all remuneration, both cash and non-cash," it clearly covers employee stock options. We are concerned that applying such a cap to Incentive Stock Options, which have no tax basis at present, would force the creation of an arbitrary option valuing formula. Once an option valuing formula is imposed in the tax arena, we expect that the same kind of demands for equivalency on the financial side, which we are hearing today, would lead to that valuation formula being used to impose present value accounting on America's vital technology industries.

Retroactive Taxation

We believe this proposal is both harmful to our industry and poor policy. This proposal is driven, in large part, by concerns that corporate shareholders are being robbed by excessive compensation paid to corporate executives. However, instead of helping shareholders, this provision would only hurt them.

Many of today's outstanding stock options were issued as part of binding contracts entered into with executives years ago. Companies cannot simply choose to unwind these contracts and revoke existing stock options. Consequently, this proposal would do little to alter executive compensation in the near term. Instead, it would raise taxes on companies who issued stock options in prior years, and thus harm the very shareholders reportedly being protected. We believe that much of the revenue that might be raised by this provision would come from this unfair, retroactive taxation.

Discrimination Against Business

We believe that having Congress set fixed levels of "reasonable" compensation applicable to all businesses simply is poor policy. The drafters of this proposal have acknowledged that compensation in excess of $1 million paid to owner employees of personal service corporations (athletes, singers, etc.) is reasonable. It is absurd

to argue that corporate executives, who manage companies with tens of thousands of employees, are, in all cases, worth less than entertainers and athletes. This is a distinction that demonstrates the absurdity of setting an absolute dollar limit on the deduction for corporate compensation. This is certainly the kind of provision that has generated our government's reputation for having an adversarial attitude toward business.

Penalizing Risk-Taking

The problem of a fixed annual dollar limitation is compounded greatly when stock options enter into the picture. As mentioned earlier, stock options typically impart substantial risk to the employee receiving the option. This risk factor is further compounded in cases where skilled talent must be attracted to smaller start up companies and troubled companies needing restructuring. While much focus is placed on seemingly generous compensation arising from the stock options of successful companies, frequently unnoticed are the many companies that fail, rendering their employees' options worthless. This "risk premium" paid to persons who succeed is not abusive or harmful to shareholders. In fact, it is exactly the tie between pay and performance that shareholders want and expect.

Unfair "Bunching"

A fixed compensation limitation creates additional problems with stock options. Typically, employees receive a lump sum benefit when stock options are exercised. This lump sum represents, in effect, many years of income for the employee who has been waiting for the stock price to rise and his option to become exercisable. The corporation's tax deduction however is deferred and calculated as if this compensation were all paid for and received for a single year's work. Thus, this "bunching" effect can cause the income for a single employee to easily exceed any fixed compensation limit.

We believe the risk element and bunching effect created by stock options render a fixed limitation on compensation both unworkable and unfair. Tax law changes are no substitute for informed shareholders in executive compensation matters. The market should be allowed to set pay in corporations as well as in athletics and entertainment. The compensation limitations proposal should be abandoned.

IV. CONCLUSION

What Kind of Industrial Policy Shall We Have in This Country?

Mr. Chairman, even though we don't have an overt, planned, industrial policy in this country, it's clear we've long had a defacto industrial policy. This nation's industrial policy is comprised of the cumulative effects of the policies contained in our tax code, our capital formation climate, our trade and anti-trust policies, and our environmental regulations.

This committee needs to recognize that the accounting change Senator Levin and others are calling for today would have an enormous impact on the de facto industrial policy of the United States. Therefore, it is important that you carefully consider whether the treatment being advocated would contribute to the international competitiveness of American industry.

Would this "improved" disclosure of compensation expenses contribute to the ability of American companies to create jobs and economic growth for our nation? Would the users of financial information derive enough benefit to justify the costs this proposal would inflict?

I believe the answer to each of these questions is a clear and emphatic NO.

COMMUNICATIONS

STATEMENT OF THE INDUSTRIAL BIOTECHNOLOGY ASSOCIATION

The Industrial Biotechnology Association (IBA) appreciates the opportunity to submit this statement to the Taxation Subcommittee of the Senate Committee on Finance. We welcome the opportunity to work with this Committee on the issue of employee compensation an other issues important to the U.S. biotechnology industry.

Biotechnology companies widely use employee stock options to attract and retain talented employees. Senator Carl Levin has proposed that companies calculate the value of employee stock option compensation and include it in their corporate earning statements. This would reduce corporate earnings for 75% of the independent biotechnology companies, and thereby make it more difficult for biotech companies to start-up, grow, and create jobs. While we support SEC action to simplify and improve shareholder disclosure information, we strongly oppose proposals to change the tax treatment of employee stock options.

As the leading voice of biotechnology the Industrial Biotechnology Association (IBA), represents companies of all sizes engaged in every aspect of this emerging industry, including agriculture, health care, food, energy and environmental applications. Collectively, IBA's 135 members account for more than 80% of all private U.S. biotechnology research and development expenditures which total over $2.4 billion.

U.S. BIOTECHNOLOGY: AN INDUSTRY OF SMALL FIRMS

The U.S. biotechnology industry is vitally important to America's global competitiveness position. The U.S. is the world leader in the research, development, and manufacture of biotechnology products.[1] In 1991, the U.S. biotechnology industry produced sales of $4.0 billion, including net exports of $640 million. Industry sales have nearly doubled in each of the past four years and the President's Council on Competitiveness projects that biotechnology will be a $50 billion industry by the year 2000. Even through the economy's recent sluggish years, our industry has created new jobs and wealth. In a May 7, 1992 presentation to the Congressional Biotechnology Caucus, Selig Solomon, Maryland's Director of the Office of Technology said the direct employment of biotechnology workers in the U.S. was about 87,000 and is expected to reach 415,000 by 2001.

Biotechnology is an industry of small businesses. Of approximately 1,100 biotechnology firms in the U.S., more than 99% qualify as "small companies" using the Small Business Administration criterion of fewer than 500 employees. In fact 90% of all biotechnology companies employee 135 or fewer employees, yet neither Japan nor Europe can match the job creating vitality of these growth oriented firms.

CAPITAL REQUIREMENTS OF BIOTECHNOLOGY COMPANIES

Not withstanding the small size of these companies, they have formidable financing needs, owing to the fact that it typically takes a company 10 years to research, develop, and obtain regulatory approval to market its first product. The costs of developing any biotechnology product runs in the millions of dollars and the usual biopharmaceutical costs in the range of $100 to $200 million. To finance this long and expensive product development cycle, biotech companies need to both raise and conserve substantial amounts of capital in order for any product revenues to occur.

The average biotechnology company has $28,829,000 in paid-in capital. At its present rate of expenditure, the average biotechnology company will run out of funds in 46 months. Because product development cycles are so long, most compa-

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[1] Except as otherwise noted, all data are derived from Ernst & Young, *Biotech '92: Promise to Reality*, an industry annual report by G. Steven Burrill and Kenneth B. Lee, Jr.

nies will need to raise an additional $50 to $100 million within the next two years to finance their continued operation.

In addition to financing their product development and growth, biotechnology companies need to attract and retain highly trained employees. These employees are often among America's brightest, most innovative, and entrepreneurial. Biotechnology companies compete worldwide drawing from established industry and academia for talent. In our high-risk high-tech industry, job performance is demanding and compensation plans and practices are tailored to recognize that companies' biggest assets wear tennis shoes. These talented managers and scientists are what enable small, high technology companies to grow faster and create more jobs than the more established mature industries.

USE OF EMPLOYEE STOCK OPTIONS

To conserve needed capital and yet attract and continue to motivate its employees, most biotechnology companies offer employee stock options and avoid high salary and benefit compensation plans. It is precisely these stock options which allow small risky cash-starved start-ups to compete against established companies for scarce technical know-how.

Employee participation in stock option plans is both broad and deep. In an IBA/Radford-survey of biotechnology companies, 75% of the companies responding use stock options as a long-term incentive plan for employees.[2] Fully 60% grant options to their entire' workforce, while only 8% limit participation to officers and top management. By granting an option at time of employment or awarding an employee with options, a company is saying, "if you stay with us and help the company get results that are recognized in the market, then you will share in the benefits. Are you willing to work hard and take that risk?" It is important to note that few biotechnology companies offer cash bonuses or company funded retirement plans.

At date of grant (award), options are generally granted at the then-publicly traded market price. This means that the employee is granted a right to buy a specified number of shares at that price. This also means that only if the public perceives greater value, and the stock price goes up, will the option have any value. If the stock price goes up—the employee and all other stockholders benefit. If the stock price remains the same or drops below the option price, the employee gets no benefit.

Restrictions on grants usually require a vesting period, typically 4 to 5 years. This means an employee must remain with the company over a long term and the stock price must rise. Should the employee leave the company prior to vesting, or the stock value fail to rise, the employee's option would be worthless. In our industry, stock prices are very volatile and uncertain. Employees, like investors assume risk in the biotechnology field and stock options are an important employment compensation tool. Talented people are attracted to young biotechnology companies despite the risk because stock options enable an employee to share in the ownership of his or her company.

The exercise of stock options by employees provides additional equity capital for young companies. Unlike any other form of compensation, upon exercise an employee pays into the company treasury, money that is equivalent to the price per share at the time the option issued. This cash infusion can be a great benefit to young cash starved start-ups.

In summary, stock options are as much a benefit to the employee as they are to the employer. Stock options afford employees the opportunity to become owners in the companies that employee them. Perhaps best of all, stock options allow employees to obtain ownership by investing time and talent in lieu of up-front cash. Stock options put the employee in the same shoes as the company's shareholders and provide an incentive for employees to work hard, as an option only has value if the company does well and the stock price increases.

PROBLEMS WITH PROPOSED CHANGES TO STOCK OPTION ACCOUNTING RULES

The current accounting treatment of employee stock options allows high-risk high-reward technology companies to form, thrive and create jobs yet both Senator Carl Levin and the Financial Accounting Standards Board (FASB) may threaten all of this. They are considering a proposal that would require companies to treat stock options as a compensation expense and a charge against earnings. Companies would be required to assign a value to each option and treat that value as an expense for

[2] Results of the IBA/Radford Associates/Alexander & Alexander Consulting Group Biotechnology Compensation and Benefits Survey—1991. A total of 172 companies submitted data in the survey.

financial reporting purposes. This expense would be a body-blow to many biotech companies. Lowering the profit and earnings per share that companies with stock options plans could report, companies would find it difficult to raise funds from investors. Option use would therefore be discouraged. Replacing stock options with higher salaries and better benefits is not an alternative available to cash starved companies in our emerging industry.

Some of the proposals considered by FASB would tie the size of the stock option expense to the market price of the company's stock and be a serious deterrent to small company use of stock options. If a company performed well it would have to increase the charge against earnings. And if the market price took a great tumble, the expense would drop. In other words, swings in the market that have nothing to do with company operating performance would be fed into the expense column and cause irrational fluctuations in reported profitability.[3] Ironically, this is more likely to mislead investors than to inform them.

Furthermore, it is unclear how stock options should be valued for financial statement purposes. Some of the proposed valuation formulas require an entirely speculative look into the future. FASB has not been able to recommend a valuation procedure even though it has reviewed the issue for more than ten years. Employees individually place an imputed personal value on stock options based on their risk taking ability, when assessing a job offer and when offered options in performance incentive plans. And companies grant stock options as a form of compensation in lieu of cash. However, this does not qualify the granting of a stock option as an expense for accounting purposes. This is purely an equity transaction and we oppose changes to accounting procedures.

It is ultimately the shareholders, not the taxpayers that bear the cost of employee stock options. This cost is borne through dilution and the creation of additional stock. Investors willingly approve employee stock option plans in their annual stockholders proxy vote because they know that stock options attract and help retain top personnel and motivate employees to produce greater value in the company. Unlike salaries and benefit packages, stock options are expressly approved by shareholders. The number of optioned shares and the exercise price are completely divulged in proxy statements and financial statements.

DISCLOSURE: A BETTER ALTERNATIVE

The SEC is developing a series of proposals to simplify and improve the information companies must provide their shareholders. We understand that one of these proposals will address stock option disclosure. Our industry believes that this SEC approach is correct and is all that is warranted. Because the current financial accounting treatment of employee stock options (no expense) is working very well, let's not fix what is not broken.

Finally, there have been proposals by Senator Levin to reduce the tax deductions currently available to companies for certain stock option transactions. The current tax law is equitable and revenue neutral with respect to these stock options transactions. The company receives a deduction only when and if the employee is deemed to have taxable income. Over time, the company's stock option tax deductions accumulate to provide biotechnology companies a powerful incentive to invest in research and development—at no net cost to the government. Thus current stock option deductions provide important public policy incentive without placing a burden on the taxpayers.

CONCLUSION

The Industrial Biotechnology Association is convinced that without the ability to grant employee stock options to nearly all of our workforce, biotechnology firms would no longer be able to start up and create the promising economic future so many have projected for our industry. We are convinced that changing the accounting rules for employee stock options would have this negative result. We, therefore

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[3] E.g. The AMEX Biotechnology Index dropped from 180 on March 31, 1992 to 130 on April 30 and on May 29 it closed at 160. (As reported regularly in *BIOWORLD TODAY*).

This two month look at the index highlights the problem in the volatile biotechnology industry. Using this index as if it were the price of one stock rather than a basket-full, the company's financial statement at the close of business on March 31 would have a much greater stock option expense (38%) than it would on April 30. As the stock price drops so drops the stock option expense, yet our market moves up and down in large swings with nothing to do with company operating performance.

urge Members of the Subcommittee to reject proposals to change the tax treatment of and accounting for employee stock options.

STATEMENT OF LEVI STRAUSS & CO.

I am George B. James, Senior Vice President and Chief Financial Officer of Levi Strauss & Co. ("LS&Co"), the manufacturer of Levis jeans and other apparel. I appreciate this opportunity to present the views of LS&Co in writing on the executive compensation issue. I also appreciate having the opportunity to outline LS&Co's desire to eventually award stock options to all of the Company's employees, and why an amendment to the tax code is needed before this plan can be implemented. I look forward to working with the Subcommittee and welcome any questions my statement may raise.

LS&Co is a 150 year old company with its headquarters in San Francisco, California. The Company has been privately held during most of these years. As the world's largest apparel company, we have annual sales of approximately $4.9 billion. These sales represent the efforts of our 23,000 employees who have manufacturing, sales and administrative positions in more than 30 locations throughout the United States, and more than 8,000 employees in 40 locations around the world. We are a global company.

EMPLOYEE COMPENSATION GOALS

LS&Co's worldwide sourcing philosophy has always been based on our belief that manufacturing operations should be located whenever possible in the country where the goods are to be sold. Accordingly, a majority of the products we sell in the U.S. are manufactured here; the goods we sell in Europe are generally manufactured in those countries.

The apparel industry is labor intensive and highly competitive throughout the global marketplace, which places increasing pressure on LS&Co's sourcing philosophy. The largest number of our industry employees do not have extensive educational or training experience, and they are typically at the low level of the industrial pay scale. Though our employees represent our greatest costs, we also view them as our greatest resource. We want our U.S. employees to have incentives to work to their fullest potential and to help us to identify and implement ways to enhance production. If we are not successful with these efforts, we face increasing pressure to cut back on domestic pay and benefits or move our manufacturing operations overseas, where the cost of labor is considerably cheaper. This is why we continue to seek innovative employee compensation plans that help us reward employees for their contributions and enable us to be competitive internationally.

We believe that our ultimate success depends on our ability to align the interests of our employees and our shareholders so that both benefit when the Company does well. We share Chairman Breeden's view that stock options can provide "entrepreneurial incentives to a large number of employees throughout the company" and that "we should be facilitating not impeding, this trend." [1]

Accordingly, as the Subcommittee reviews the impact of the tax code in addressing executive compensation and stock option concerns, we hope that attention will be given to employer stock arrangements that cover employees at all levels. Such arrangements are valuable tools for companies which must meet and beat foreign competition and should not be unintentionally impeded by the tax code. I describe below an impediment that all private companies face, including LS&Co. We hope that the Subcommittee will eliminate this obstacle during their deliberations on the executive compensation issues.

PROPOSED COMPENSATION PLAN

In 1991, a task force of LS&Co's employees, representing a wide range of income levels in the Company, developed a new single, "seamless" compensation system to support our employee incentive philosophy. If fully implemented, our employee compensation would include a base salary, annual bonus and long term bonus. The long term bonus would involve nonqualified stock options, bonus stock, phantom shares or performance units, which would be granted on the basis of each employee's performance. Each employee would be eligible to receive the options and shares. However, because LS&Co is privately held, the Company would be the only permissible market for the stock.

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[1] Testimony of Richard C. Breeden, Chairman, U.S. Securities and Exchange Commission at 3 (June 4, 1992).

CURRENT LAW

As the task force developed this compensation plan, it became clear that the Internal Revenue Code ("Code"), as interpreted by the Internal Revenue Service ("IRS"), would present insurmountable obstacles. As previously described, the task force wanted to provide stock to all of the Company's employees under a plan which would allow the employees to sell their stock back to the Company. A major problem for a privately held corporation, however, is achieving liquidity for the employees' stock. The only feasible market for the employees' stock is the company. The Code, however, impedes such a corporation from providing this market. As described more fully below and in the attached memorandum, current law can impose an unwarranted and burdensome task on the employee that is both unfair and bad policy. The Code should be amended so that private companies like LS&Co can provide a reliable, liquid market for their employees' stock.

Current law, under Section 302 of the Code, states that if a company buys back its own stock, that transaction is a "redemption." For employee ownership, these rules mean that each employee is required to determine if the redemption is treated for tax purposes as a dividend or as a sale. If treated as a dividend, the entire proceeds from the sale, not just the gain, are taxed as ordinary income. The amount paid by the employee to purchase the stock (i.e., "basis") is allocated to all other outstanding shares held by the employee. This means that until the employee completely terminates ownership of the company's shares, he or she is given no "credit" for their basis. The employee must determine the amount of any gain or loss from the stock sale as if nothing had been paid to purchase the shares (if a stock option) or if they were taxed on the receipt of the stock as compensation.

As an example, consider Employee A who owns 200 shares of Company B stock. Employee A paid $50 for each share of that stock which now has a fair market value of $100. When Employee A asks Company B to redeem 20 shares of this stock (10 percent of the total), the employee would expect to be taxed only on the amount received in excess of the amount he or she paid to obtain the stock, or $1000 as a capital gain. Instead, if the redemption is treated as a dividend, Employee A is taxed on the full $2000 as ordinary income.

In summary, the Code currently presents serious obstacles to a privately held company with a stock ownership covering all employees. These rules often do not allow the employee to recover his or her basis when the stock is redeemed. In most cases, the only way to recover basis is for the employee to make a complicated, after-the-fact calculation, as described in the attached memorandum. Sewing machine operators and other workers should not have to hire lawyers and accountants to understand and comply with a benefit that is readily available to their counterparts in public companies. They should not be required to "hold their breath" until they learn what other employees have done with their stock in order to know what their tax treatment will be.

PROPOSED AMENDMENT

The IRS has been as flexible as it could be in light of the statutory language of section 302(b) of the Code. In order to fix this problem, we need a legislative *de minimis* safe harbor rule, e.g., protection for employees with stock ownership of one percent or less. This is consistent with the previous legislative history under section 302, as more fully described in the attached memorandum. Under such a rule, an employee who owns less than a small percent of a privately held company's outstanding stock, would not receive dividend treatment when redeeming shares. This treatment is appropriate because the employee would never be able to control the corporation, even though a minuscule increase in ownership may occur as a result of a redemption. An additional limitation could exclude employees who are directors, director nominees or executive officers. If enacted, the rule would place qualified de minimis employee shareholders on the same ground as if they were employees in a publicly held company. Complicated calculations and temporary double taxation would be eliminated.

COMPANIES WHICH BENEFIT FROM A DE MINIMIS RULE

Without the *de minimis* rule, employees of privately held companies (with no public market for their shares) are not treated the same as employees of public traded companies. Specifically, when an employee of a publicly traded company receives stock of his or her company, the employee can either keep the stock as a long-term investment or sell the stock in the open market. In the event of the sale, the transaction is treated as an exchange with either short term or long term capital gain, subject to the appropriate holding period. The same employee of a privately held

company has no comparable opportunity to control the tax treatment. Instead, he or she is unfairly subject to the whims of other shareholders' actions.

The addition of a *de minimis* rule under section 302 would resolve problems under current law for all privately held companies wanting to establish compensation plans involving stock. Such companies may be small or large, family owned or otherwise privately held. In many cases, start-up companies would particularly benefit from this type of compensation plan which provides a substitute for current cash payments.

CONCLUSION

LS&Co strongly supports the use of employer stock, including stock options, as an effective way to encourage employees to be creative and committed to working efficiently over the long term. This belief applies not only to LS&Co's executives, it applies equally to our sewing machine operators. In both cases, an employee, who is also a shareholder, has a true, vested interest in their employer and benefits directly from the employer's growth.

The Code currently prevents privately held corporations, like LS&Co, from implementing compensation arrangements which include employer stock for all employees. Although executives are in a position to fairly assess their risks on redemptions, other employees (particularly those with de minimis holdings) cannot confront that risk. A new safe harbor rule under section 302(b) would eliminate this impediment to privately held companies. The rule would allow such companies to provide stock or stock options to all their employees under rules comparable to public companies whose stock is sold on the public market.

APPLICATION OF SECTION 302 TO EMPLOYER STOCK PLANS

GENERAL RULES

Section 302 of the Internal Revenue Code of 1986, as amended, ("Code") provides rules applicable when a privately held company redeems its employee's stock. In order to calculate the tax consequences of a redemption, the employee must make a determination whether his or her individual transaction is an exchange or a dividend. See Treas. Regs. §1.302–2(b). Subsection (b) provides a general rule and three safe harbors which, if applicable, allow a taxpayer to avoid dividend treatment. The general rule under paragraph (1) requires that the distribution be "not essentially equivalent to a dividend." Paragraphs (2), (3), and (4) provide safe harbors for the following specific types of redemptions:

Paragraph (2): "substantially disproportionate redemption"—requires the shareholder to compare ownership percentages before and after the redemption, requiring knowledge of other shareholders' transactions.

Paragraph (3): complete termination of shareholder's interest—requires the shareholder to redeem all of his or her stock.

Paragraph (4): partial liquidation redemptions—requires the redeeming corporation to partially liquidate.

Privately held companies cannot rely on these safe harbors to protect an arrangement covering a large number of employees. These safe harbors mandate that either (i) the unsophisticated employee must make a complicated, after-the-fact calculation, or completely terminate their interest in the company, or (ii) the company must partially liquidate. Accordingly, under these safe harbor rules, taxpayers cannot know, in advance of a redemption, whether they will have to pay tax on the full amount they receive from the redemption. In general, they must calculate their tax based on what other employees are doing with their stock in order to assure that the percentages are appropriate, or be required to redeem all their stock at a time.

OFFICIAL INTERPRETATIONS

Treasury and courts rely on a Supreme Court holding to interpret section 302(b)(1), as applied to redemptions not qualified under the safe harbor rules of (b)(2), (3), or (4). The Court held that the section 302(b)(1) test requires the shareholder to determine whether, in fact, a "meaningful reduction" in the interest of the shareholder occurs vis a vis the other shareholders. *U.S.* v. *Davis,* 397 U.S. 301 (1970). The facts in that case required the Court to consider a shareholder who had control over the corporation. The Court discussed whether a "business purpose" test was incorporated in the section 302(b)(1) rule. In rejecting such a test, the Court provided the "meaningful reduction" test, but there was no discussion on how this section should apply to *de minimis* shareholders. The IRS has applied the legislative history and the Supreme Court's "meaningful reduction" test in a ruling in which

it held a *de minimis reduction* in stock ownership in a corporation from 0.0001118 percent to 0.0001081 percent should not be considered a dividend. Rev. Rul. 76–385, 1976–2 C.B. 92. However, the IRS has also held that a .2 percent shareholder, whose *interest remained* .2 percent after a redemption of multiple shareholder interests, does not satisfy the section 302(b)(1) test. Rev. Rul. 81–289, 1981–2 C.B. 82.

LEGISLATIVE HISTORY

The legislative history of the 1954 act, which codified section 302(b), indicates that Congress was concerned primarily about certain redemptions which might not receive dividend treatment, even though the shareholder had control over the redemption. According to the legislative history, the House passed section 302(b) to eliminate "the considerable confusion which exist[ed] in this area." H.R. Rep. No. 1337, 83rd Cong., 2d Sess. 35. Accordingly, the House bill included only the more specific safe harbor tests of section 302(b)(2) and (3). The Senate Finance Committee believed that a broader rule was needed because the House provisions

> appeared unnecessarily restrictive, particularly, in the case of redemptions of preferred stock which might be called by the corporation *without the shareholder having any control* over when the redemption may take place.

S. Rep. No. 1622, 83rd Cong., 2d Sess. 44–45 (emphasis added). The Finance Committee's broader rule, section 302(b)(1), was accepted in the final package.

MAYER, BROWN & PLATT,
Washington, DC., June 10, 1992.

Hon. DAVID L. BOREN, *Chairman,*
Committee on Finance,
Subcommittee on Taxation,
SD-205 Dirksen Building,
Washington, DC.

Re: Proposed Limits on Tax Deductions for Executive Compensation

Dear Senator Boren: This is submitted for the record of your June 4 Subcommittee hearing on proposed limits on deductions for executive compensation.

In summary, whatever problems exist regarding excessive executive compensation can best be addressed through greater corporate responsibility, not through arbitrary limits on compensation enforced or encouraged through deductions allowed by the Internal Revenue Code. If, however, the Congress decides to limit deductions for executive compensation, consistent with the focus of the perceived abuses, any such limit should apply only to publicly-held corporations.

At your June 4 hearing, all witnesses expressed concerns over present levels of executive compensation and endorsed ongoing efforts to increase accountability in corporate governance through means such as improved communication on compensation issues between corporations and their shareholders. No witness supported any limit on deductibility, and all but one characterized such proposals as misguided and potentially damaging to corporate performance and shareholders.

Our clients generally support these views. The proposed "one size fits all" approach is fundamentally flawed because it ignores the fact that executives make vastly different contributions to their corporations. Some may be worth less, and some much more, than $1 million per year.[1] The proposed limit, however, applies regardless of the particular executive's performance. Moreover, even where executives are overcompensated, the proposal seeks to "remedy" the problem by increasing taxes (by partially disallowing the deductions) on the victims of excessive compensation, the corporation's shareholders.

Should the Congress, nevertheless, decide to limit deductions, any limit should apply only to publicly-traded corporations.[2] This approach is consistent with the

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[1] Indeed, one of our non-publicly traded corporate clients was recently audited by the Service, but no adjustment was proposed where the corporation had paid its majority shareholder and president $1.1 million, $3 million, and $2.9 million, respectively, in three recent taxable years. The Service concluded that the compensation paid was reasonable in light of the corporation's performance and dividend history and, thus, was fully deductible.

[2] The proposal should apply only to C corporations and partnerships that are publicly traded under section 7704, and, thus, taxed as corporations. The limit should not apply to S corporations or to partnerships which are not publicly traded.

limited deductions and excise taxes triggered under sections 280G and 4999 by excessive "golden parachute payments" made by large, publicly-traded corporations. In this regard, we note with limited approval that the bill recently introduced by Senator Harkin (S. 2329) to limit deductions for executive compensation would apply only to public corporations.

Problems with unreasonable executive compensation are generally attributed to a lack of effective accountability on the part of corporate executives and directors. The disclosure of information to shareholders on executive pay is often incomplete or incomprehensible. Moreover, collective action on the part of the myriad, diverse shareholders of large corporations is inherently difficult. As a result, executives may receive compensation in excess of what their performance warrants.[3]

Privately-held corporations do not face these problems because they have relatively few shareholders (who often manage the corporation themselves). As a result, information about executive pay and performance travels relatively easily and accountability is greatly enhanced.

Moreover, the potential for unreasonable compensation payments by private corporations is minimized by Internal Revenue Service audits. The Service regularly investigates the reasonableness of compensation by private corporations through analyses of corporate earnings, dividend history, comparisons to salaries for comparable work by like entities, and other factors.[4] In contrast, compensation paid by public corporations is assumed to be reasonable and uniformly goes unchallenged.[5]

Thus, it is our suggestion that (i) limits on deductions for executive compensation are inappropriate, but (ii) if enacted, should be limited to publicly-traded corporations.

We would welcome the opportunity to answer any question you or your staff may have.

Respectfully,

JERRY L. OPPENHEIMER.

STATEMENT OF THE NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. Chairman and Members of the Subcommittee: We appreciate being given the opportunity to submit for the record the following statement concerning tax and accounting treatment of executive compensation. This statement is submitted on behalf of more than 12,000 members of the National Association of Manufacturers (NAM).

I. USE OF THE TAX CODE TO LIMIT EXECUTIVE COMPENSATION

The current Congress has seen several proposals to employ the tax code in an effort to limit the compensation paid to senior corporate executives. Congressman Martin Sabo introduced H.R. 3056, a bill to disallow tax deductions by companies for executive compensation that exceeds 25 times the salary paid to the lowest compensated company employee. The Tax Fairness and Economic Growth Act of 1992, which was vetoed by the president, contained a provision limiting the deductibility of compensation that exceeds $1 million, and a near identical provision was recently adopted by the House Ways and Means Committee and is receiving consideration by the full House as part of H.R. 5260, the Unemployment Compensation Amendments of 1992.[1]

We believe each of these proposals represent flawed tax policy and Congress should reject use of the tax code in such a fashion.

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[3] As Chairman Breeden noted in his testimony, the SEC has recently promulgated new rules, and will adopt additional rules shortly, which enable shareholders to advise corporations on the propriety of executive compensation and require clear and full disclosure on these matters.

[4] *See, e.g.*, Kafka, 390–2nd T.M., Reasonable Compensation, p. A–5 ("[I]t is safe to assume that any compensation arrangement between a closely held corporation and one of its shareholders will receive close audit and judicial scrutiny."). These audits are premised on the concern that such corporations may be too accountable to shareholders and, therefore, might attempt to pay out nondeductible earnings as disguised deductible salaries.

[5] *See id.* ("This suggests that any amount of compensation paid by a large, publicly held corporation, such as IBM, would be per se reasonable.").

[1] Two additional related proposals were introduced this year in the Senate. S. 2201, sponsored by Senator Daschle, would limit deductions to $500,000, indexed for inflation, and S. 2329, sponsored by Senator Harkin, would limit deductibility of executive compensation for publicly-traded companies to $500,000.

A. Misguided Movement Away From Taxing on a Net Income Basis

As a general proposition, NAM opposes employing the tax code in a manner that departs from the longstanding approach of taxing business income on a net basis. Official NAM policy reads:

> [a]s applied to business taxpayers, the federal income tax has traditionally been a tax on net income, i.e., on gross income less deductions for all costs incurred in producing such income.
>
> Denial of a deduction for all or part of costs incurred in the ordinary course of trade or business changes the nature of the tax system from a tax on income to a tax on gross receipts. Gross receipts are an inappropriate and inequitable base for the imposition of federal taxes on business income, leading to widely disparate tax burdens among business taxpayers. * * * Singling out a particular type of business expenditure for non-deductible treatment is objectionable in principle. * * *[2]

While we appreciate there exist numerous provisions in the code that arguably violate the net income taxation principle, NAM believes it is a sufficiently important policy to merit continued fidelity. We believe its preservation is reason alone to oppose introducing a compensation deductibility limitation into the tax code beyond the current "ordinary and necessary" general limitation on tax deductions and the "reasonable" limitation on compensation deductibility.[3]

B. Will Undermine Ability of Companies to Compete for Executive Talent

In addition to being inconsistent with a net income system of taxation, introduction of a deductibility limit will harm the ability of many companies to compete for executive talent. Whether one believes that current executive pay is too high or too low, the pay levels de facto represent the current going rate as judged by the marketplace. Establishment of an arbitrary ceiling will put certain companies at a competitive disadvantage because a sufficient number of firms will place the importance of attracting and retaining talent on a higher plain than reducing income tax liabilities. Those companies not in a position to sustain the tax consequences of paying market salaries will have a diminished ability to compete for the pinnacle of executive managers and may ultimately be plagued by higher than necessary turnover rates. The disadvantaged firms, moreover, will more often than not be the smaller entrepreneurial firms who arguably have the greatest need for stellar talent. The most dynamic, yet fragile, sector of the U.S. economy will therefore be the final "beneficiary" of deductibility limitations.

The consequences of below-market compensation likely will manifest themselves not only on a company-to-company basis but also on an industry-by-industry basis. In what has now become a seminal work in the compensation area, Professors Michael Jensen and Kevin Murphy decry a "brain drain" that afflicted the traditional corporate sector during the 1980s. Pointing out that "[b]y 1987, more than half of all CBS [Harvard Business School] graduates entered investment banking or consulting [occupations paying significantly higher salaries], while under 30% chose careers in the corporate sector,"[4] they argue the "simple proposition" that "[i]f some organizations pay more on average and offer stronger pay-for-performance systems than other organizations, talent will migrate to the higher paying organizations."[5]

Retarding the ability of all companies in all market segments to pay market-compensation thus may have harmful inter-company as well as inter-industry consequences.

C. Deductibility Limitations Will Ultimately Punish Shareholders

Whether coming or going, shareholders will ultimately bear the burden of the proposed tax code changes. Shareholders who invest in firms that opt to limit tax liability rather than competing for superior executive talent will not realize the gains that may have otherwise been derived from obtaining the desired quality of executive talent. Similarly, shareholders who invest in companies which are committed to competing in the marketplace for the best available executives irrespective of tax consequences will be harmed by the company having to sustain significant new tax liabilities.

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[2] *Official Policy Positions*, National Association of Manufacturers, at 94 (Mar. 1992)

[3] See 26 U.S.C. Sec. 162(a).

[4] Jensen and Murphy, CEO Incentives—It's Not How Much You Pay, But How, Har. Bus. Rev. 145 (May–June 1990).

[5] *Id.*

Proponents who believe shareholder interests would be served by establishing deductibility limits are gravely mistaken.

D. Proposals Are Unnecessary

If the purpose of these tax code proposals is to bring greater scrutiny to the compensation practices of industry, recent and contemplated policy changes render them unnecessary. Most significantly, the Securities and Exchange Commission (SEC) announced a major change in its policy regarding shareholder resolutions. Under its previous interpretation of Rule 14a–8(c)(7),[6] resolutions dealing with executive compensation were deemed to relate to the conduct of "ordinary business" and therefore excludable from a company's proxy statement and ballot. In February 1992, the commission indicated that because "there is now widespread public debate concerning compensation policies and practices relating to senior executives and directors, and an increasing recognition that these matters raise significant policy issues . . . ,"[7] companies may no longer exclude such resolutions on the basis that they concern ordinary business. This revised shareholder resolution mechanism will doubly assure that shareholder interests are reflected in the compensation policies of publicly-traded companies.

The SEC is also undertaking yet another review of its rules governing disclosure of executive compensation. Stating that "the appropriate amount and structure of compensation for corporate employees—whether on the shop floor or in the executive suite—is a question that should be resolved in the private marketplace[,]"[8] SEC Chairman Breeden announced that the commission is revising its rules to give "shareholders information about executive compensation that is easier to understand and more relevant."[9]

On the issue of accounting treatment of stock options (see Sec. IV below), the Financial Accounting Standards Board (FASB) has again placed the topic on its 1992 agenda. Although NAM disagrees with the proposition that accounting treatment should be altered and opposes a significant deviation from the current standard, the fact that FASB is revisiting the question should indicate to Congress that this aspect of accounting policy and all others will continue to receive review, study and, if need be, updating.

II. THREE MYTHS ABOUT STOCK OPTIONS

There has been considerable focus on the role of stock options in executive pay packages. During the course of debate over their effectiveness at aligning the interests of management with those of the shareholders, several myths about stock options have wrongly become "common knowledge."

Myth No. I: CEOs Incur No Risk Under Stock Options

Compensation critics would have us believe that CEOs incur no risk under stock option compensation programs because if the stock doesn't increase in price, the executive simply chooses not to exercise his or her options. Therefore the executive has no "down-side" risk. The argument is of limited merit. Options granted to executives represent a significant, and increasing portion of average CEO pay. The executive exchanges labor for the stock option grant. If the price of the stock on which the option was granted does not increase in value, the total compensation received by the executive is directly reduced by the percentage amount represented by the option grant.

As an example, assume an executive's annual total compensation package was reformulated to create stronger incentives to pursue long-term share value by replacing 50 percent of direct compensation with a grant of stock options. The executive here has clearly put half his annual pay at risk. Should the stock not increase in price, or goes down in price, the executive has lost half a year's pay. The outlay is real, the down-side risk is substantial, and the ultimate outcome is highly variable.

Myth No. II: Stock Options Shortchange the Company and Shareholders

Although it is technically true that stock options have a "diluting" impact on all other outstanding shares, it is erroneous to describe it as "shortchanging" shareholders. First, shareholders approve most stock option plans as well as issuance of authorized, unissued stock. The market has therefore discounted the existence of unissued stock and the share price reflects that "dilution." Second, the difference in financial consequence between a grant of stock options and simply paying the execu-

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[6] 17 C.F.R. 14a–8(c)(7).

[7] International Business Machines Corporation (Feb. 13, 1992) (SEC "no-actions" letter).

[8] Statement of Richard C. Breeden on Executive Compensation Issues at 1 (Feb. 23, 1992).

[9] *Id.*

tive out of the corporate treasury for the intrinsic value of the option is insignificant. The capital "forgone" by the company due to the grant is equal, albeit accounted for differently. And third, rather than being harmed by stock options, shareholders generally applaud their use, recognizing that management's interests thereby become more closely aligned with those of the shareholders.

Myth No. III: Stock Options are "Stealth Compensation"

Critics have erroneously described stock options as "stealth compensation" because of an apparent anomaly between accounting and tax treatment. Generally accepted accounting principles treat equity-based compensation differently from other forms of compensation, which results in options being accounted for indirectly through statement footnotes rather than directly by a charge to the company's earnings statement. At the same time, the exercise of stock options results in a tax deduction for the corporation and a tax liability for the option recipient. Some have suggested this "anomaly" holds public policy significance. The concern is misplaced. Annual financial statements are intended to be a substantially accurate portrayal of the actual financial activity (cash flow, profit & loss, etc.) and position (assets, liabilities and shareholders' equity) of the firm. In other words, they represent reality as closely as possible. Tax documents, on the other hand, are best described as "working papers" that are merely used to determine a "taxable income" figure. They are not parallel documents by any stretch of the imagination. As the Supreme Court recognized,

> [t]he primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested . . . . The primary goal of the income tax system, in contrast, is the equitable collection of revenue. . . . [A] presumptive equivalency between tax and financial accounting would create insurmountable difficulties of tax administration.[10]

Any attempt to compare a company's tax returns with its financial statements, or the assumptions they both reflect, thus, is to compare apples with oranges and to needlessly confuse important issues.

Accounting treatment aside, rather than being "stealthy," stock options are in fact just the opposite. Indeed, they are the only element of compensation explicitly approved by the shareholders.[11] Stock options are thereafter subject to annual proxy form disclosure, footnote treatment in financial statements, and the estimated present value of options annually grace the pages of numerous business publications. A virtual cottage industry of proxy advisors and analysts, moreover, has sprung up to inform the world about the compensation practices of publicly-traded companies.

Under the SEC's new Rule 16,[12] furthermore, stock options acquired, disposed of, or beneficially owned must be reported 10 days after the end of the month during which a change in ownership of such options occurs, as well as on an annual basis. The disclosure must include in tabular form the date and type of transaction, the exercise price, market price and amount of securities involved. To suggest there is anything but the fullest disclosure and public discussion of stock options, therefore, is to deliberately ignore plain truths.

III. Disclosure and Valuation of Stock Options

A. Present Valuation of Stock Options Will Not Serve the Purposes of Disclosure

Senator Levin's Corporate Pay Responsibility Act would require companies to include in their annual proxy statement the estimated "present value" of all forms of deferred, future and contingent compensation provided during the disclosure period as well as comparable estimates for total compensation to be paid in each of the succeeding five years. The SEC also is exploring requiring use of a stock option pricing model to value stock option grants at the time of the grant award. Because all such valuation methods are fundamentally conjectural, we believe requiring use of such a method would result in the diminution of the quality and reliability of disclosure.

Policymakers should not stray from the principle that disclosure should be generally free of conjecture. The entire edifice of disclosure policy is based upon the principle that, for the protection of investors, disclosure must be full, fair and accurate. Implicit in the requirement of accuracy is that disclosure based on conjecture should be eschewed, unless accompanied by "key assumptions," which "are of such

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[10] *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 542 (1979).
[11] See NYSE Company Manual, Sec. 312.
[12] See Rule 16, Form 4 and Form 5, 17 C.F.R. 249. 104, 105.

significance that their disclosure is necessary" to meet reasonable basis and good faith standards.[13]

We believe the pertinent facts relating to option grants are those currently required to be disclosed—the shares granted, the exercise price, and the net proceeds realized from options exercised.[14] An estimate of the present value of options granted is simply not a factual matter.

Even if accuracy could be assured, it is not clear the market would place any value on this type of disclosure. Notwithstanding a few vocal commentators, there is scant, if any, interest among the investor community for present value disclosure. Not only is investor demand for such disclosure uncertain, there is a strong likelihood that rather than serving to inform investors and the market, it would confuse the issue of executive compensation—overstating it in one instance and understating it in another. Using present valuation in the disclosure context would bestow upon it an imprimatur of accuracy and faithfulness it is incapable of rendering.

Irrespective of the technical requirements of disclosure rules, investors are free in any case to use a valuation method of their choosing to make independent calculations of the value of stock options. To the extent that current disclosure requirements are insufficient to permit such-independent valuations, NAM has indicated its willingness to work with the SEC to develop alternative disclosure rules. It should be pointed out, however, that disclosure of executive compensation is not a new area of commission focus. Over the course of the last decade, the disclosure rules have been the subject of repeated commission attention, being reformulated in several material respects.[15]

At bottom, the business community and the investment community share the same common goal: full disclosure of accurate, meaningful information relevant to investment decisions. Any more or any less hampers the effective functioning of our capita markets.

B. Valuation Models are Hopelessly Conjectural.

No matter what method one uses to determine the present value of stock option grants, they all suffer from the same fatal flaw. Namely, central elements in predicting the future price of a company's stock are unknown, and unknowable, variables. Similarly, the specific variables in the present value equation are themselves "best guesses." Indeed, as FASB eloquently stated:

> [p]resent value measurement is always based on estimates of the future. Because the future cannot be known in the present, those estimates will usually turn out to be "wrong" to some extent. Choosing present value does not, as sometimes suggested, imply an ability to make estimates with great precision. Indeed, the opposite is true.[16]

"Reasonably" accurate estimates, moreover, are not themselves sufficient, since "[s]mall changes in estimates of interest rates or the amount and timing of future cash flows [dividends] can produce significant changes in the measurement." [17]

Although we recognize that option valuation has become far more sophisticated in recent years, and presumably marginally more accurate, stripped of its technical cloak option pricing will never serve to predict future earnings, cash flow, market share, capita spending requirements, the vagaries of economic and market trends, or governmental policy. In short, until a model is developed to predict those factors that determine the future price of a company's stock, calculating the present value of stock options with any degree of certainty will remain an elusive goal.

Realistically, present valuation should be viewed merely as a tool among several to value an asset or liability. When viewed in the appropriate context, and their limitations fully understood, present valuation techniques are useful. To import this valuation tool into the realm of disclosure policy, and to present it as a factual representation that may be relied upon by investors, is to greatly diminish the value of disclosure.

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[13] Securities Act Rel. No. 6084 (June 25, 1979). At one time the commission's own rules made the inclusion of projections *per se* misleading. *See* Note to Securities Exchange Act Rule 14a–9, 17 C.F.R. Sec. 240.14a–9 (1968). Overly optimistic projections, furthermore, can result in liability under Sec. 10(b) of the Securities Exchange Act.of 1934. *See, e.g., Elkind* v. *Liggett & Myers, Inc.* 635 F.2d 156 (2d Cir. 1980).

[14] *See* Item 402(a), Regulation S–K, 17 C.F.R. 229.402(a).

[15] *See* Ex. Act Rel. No. 20220 (Sept. 23, 1983), Ex. Act Rel. No. 17301 (Nov. 14, 1980), Ex. Act Rel. No. 15380 (Dec. 4, 1978).

[16] *Present Value-Based Measurements in Accounting,* Financial Accounting Standards Board, at 20 (Dec. 7, 1990).

[17] *Id.*

NAM has recommended that if the SEC feels compelled to seek public comment on a particular valuation method, the release should contain a historical demonstration of the method's accuracy and predictive value by selecting a sample group of stocks representative of the broad market (i.e. cyclical, growth, mid-cap, as well as across industry sectors). By then choosing a hypothetical exercise period (1982–1992, for example) and option grant, the commission will be able to test the degree to which the model accurately predicts the future stock price.

A demonstration of this kind will either powerfully answer the critics or demonstrate the futility of attempting to meaningfully express the present value of stock options.

IV. ACCOUNTING TREATMENT OF STOCK OPTIONS

Senator Levin's corporate pay bill directs the SEC to "require the issuer to reduce its earnings, as reflected in its earnings statements to its security holders, by the estimated present value . . . of stock options and other forms of deferred, future, or contingent compensation paid to the directors or senior executives. . . ."[18] The exact diagnosis this section is intended to remedy is not entirely clear. Nevertheless, in an effort to be responsive to the concerns of Congress, the SEC recently directed its chief accountant, in consultation with the Financial Accounting Standards Board and other pertinent accounting bodies, to study the adequacy of current accounting rules for grants of stock options and to report to the commission within 120 days.

A. Current Treatment of Stock Options is Appropriate.

The issue of accounting for stock options appears to have arisen primarily as a result of misunderstanding of the seeming anomaly between tax and accounting treatment of stock options. As discussed above, we do not believe the differing treatment of stock options is anomalous and thus find no fault with current accounting standards.

B. Accounting Changes Could Harm Growth and Mature Companies Alike.

Not only are we unable to discern any problems with current practice, we are deeply concerned that requiring the present value of stock options to be charged against earnings will profoundly harm many companies. The most palpable result would be felt society-wide. Stock options as a pay-for-performance mechanism would greatly diminish in use. For a great number of smaller, growth-oriented enterprises, moreover, a standard requiring an earnings charge would all but force the abandonment of significant use of stock options.

One of the great success stories of managerial innovation, the widespread use of stock options has brought entrepreneurial instincts to a wide range of companies. Enhanced productivity, innovation and shareholder value have been the direct consequence of the increase in option-based compensation. Whether through tax code or accounting changes, it would be a tragic mistake to encourage or adopt a policy that would make it economically impracticable to gain the pay-for-performance benefits of stock options.

C. Shareholders Would Face an Economic "Catch 22."

Critics advocate accounting changes in the name of protecting shareholders, yet it is the shareholders who would bear the brunt of such changes. Shareholders would face an economic "Catch-22." They would either lose the benefits of stock options as a means of aligning management interests with those of the shareholders, or alternatively, by retaining stock options they would suffer the share price consequences that would result from requiring a charge to earnings. The ultimate loser, of course, would be the U.S. economy.

CONCLUSION

For all the foregoing reasons, we oppose limiting the deductibility of legitimate compensation expenses.

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[18] Corporate Pay Responsibility Act, Sec. 2(h) 3(B).

REAL ESTATE BOARD BUILDING OF NEW YORK, INC.,
New York, NY., June 2, 1992.

Hon. DAVID BOREN, *Chair,*
U.S. Senate Finance Committee,
Subcommittee on Taxation,
U.S. Senate,
Washington, DC.

Dear Senator Boren: We are writing on behalf of the nearly 5,000 members of the Real Estate Board of New York, Inc., to ask your assistance in obtaining clarifying language to H.R. 4727 as amended by the House Ways and Means Committee and now under discussion in both the House and Senate as the deadline to extend the unemployment compensation program draws near.

Our concern stems from the current bill's lack of clarity regarding the treatment of real estate brokerage commissions which may exceed $1 million in a given year when the broker who receives that level of commission income is also an officer of the brokerage agency ("house"). It does not appear to us that the bill intends to capture such circumstances which would inadvertently penalize the "house" itself, operating on just a narrow 5–10% profit margin before taxes. The "house" generally acts as a pass through entity for 50–66% of the commission income which is given directly to the individual broker. Therefore, to create certainty in this regard, we would like to suggest that language be added to the definition of "remuneration" in section (3)(B) of the original H.R. 4727 to the effect that, "amounts based upon or in the nature of brokerage commissions shall not be included in the term "remuneration."

We hope that you will agree with our suggestion and include this technical enhancement to the bill as it moves forward.

Sincerely,

DEBORAH BECK, *Executive Vice President.*

STATEMENT OF STERN STEWART & CO.

MAKE MANAGERS INTO OWNERS: THE ANSWER TO THE EXECUTIVE COMPENSATION DILEMMA

INTRODUCTION

Recently, American CEOs have been in the spotlight—not for superior performance or visionary leadership in uncertain times, but for their compensation. In the U.S., regulatory and legislative bodies are taking actions, shareholders are voicing dissatisfaction, and the media continues to create controversy. Many cite skyrocketing compensation as contributing to the deterioration of U.S. competitiveness in a global economy.

Regardless of claims that CEO pay fails to correlate to corporate results, there is only one performance measure that matters—increasing shareholder value.

The problem is quite clear—how to link pay to shareholder value-added performance for the CEO and the entire management team. Currently, a dysfunctional system rewards a few senior executives for results delivered by hands-on operating managers.

Solutions offered to date are merely bandaids. The real answer to linking pay to performance is to make managers into owners. An ownership imperative for managers is certain to align the interests of management and shareholders. Corporate America must adopt a financial management system which both measures performance and compensates executives based on shareholder value creation.

Stern Stewart's answer is "Economic Value Added" or EVA™, the performance measure most directly tied to market value. An EVA-based compensation system powerfully aligns shareholder and management interests. (See Exhibit 1 for an overview of Stern Stewart & Co.)

THE SINGULAR FOCUS ON CEO PAY IS WRONG

The preoccupation with CEO pay is wrong and overlooks the real issue. *CEO pay is the merely the visible tip of the iceberg. Problems with CEO pay will not sink the Titanic of U.S. productivity and competitiveness.*

Consider an example: General Motors. *Fixing the CEO pay of General Motors will not fix GM.* In 1990, Chairman Stempel's pay was .002% of GM revenues and was

merely .02% of the $10 billion in shareholder wealth destroyed by GM over the past five years. Obviously, slashing his pay will not rescue the shareholders.

Other factors serving to cloud the real issues include:

- CEO pay is established by a unique supply-demand marketplace, in which "position" dictates pay more than performance. Pay for CEOs, like that of royalty, is inherently more ceremonial than economical.
- *The root of current confusion is the failure to distinguish between "pay" from "payoff."* "Pay," the value of an executive's compensation at grant date, is a before-the-fact, calculated determination of worth. Alternatively, "payoff" is the after-the-fact realized reward to management based on corporate and market performance. Ultimately, *a company's objective should be to minimize pay and maximize payoff*—maximizing payoff means gains for shareholders. (See Exhibit 2 for an elaboration of "pay" versus "payoff")
- Accountants are the culprits of this confusion. FASB's insistence that options have no pay value when granted forces a focus on payoff, a value that accountants measure.

THE REAL PROBLEM: HOW TO LINK PAY TO PERFORMANCE FOR THE ENTIRE MANAGEMENT TEAM

What will sink the Titanic of U.S. competitiveness is the bulk of the iceberg lurking beneath—the failure to address pay-for-performance throughout the organization.

Traditional financial management systems emphasize convoluted and often conflicting performance standards that are only minimally tied to stock prices. Use of such inappropriate measures—EPS, ROE, earnings growth—results not only in inaccurate CEO pay, but nore importantly, poor business decisions that undermine American competitiveness.

For shareholders, the key problem with compensation lies not in the CEO's office, but, in the fact that the compensation of the entire management group is not aligned with shareholders.

- Currently, 85% of management compensation represents senior liabilities of a company (e.g. wages, retirement and medical benefits). Only 15% can be considered equity equivalents (e.g. profit sharing, options). To align interests of management and shareholders, the liability-equity balance should be 50–50%.
- Stock options, popularly lauded as management's link to shareholders, is also more compensation than true incentive. Because managers typically pay nothing for their options, they bear no direct risk of cash loss. Moreover, the commonly employed fixed exercise price lets managers accumulate wealth just by sitting around long enough to watch the stock market escalate.

In addition, the *haphazard construction of executive compensation packages is also at fault.* Incentive bonus plans designed by compensation consultants, who typically lack financial theory expertise, result in substantial discrepancies between executive and shareholder rewards.

Moreover, compensation experts developed a proliferation of pay packages during the flat stock market of the 1970s. At any point in time and under any economic climate, management could be assured of payout regardless of any shareholder benefit.

THE ANSWER: MAKE MANAGERS INTO OWNERS

Much of the pay-for-performance problem stems from too much emphasis on compensation and not enough on incentive. The answer must make managers think and act like owners—risk takers with upside potential, around for the long-term, enthusiastic managers with vision.

The answer is "Economic Value Added." EVA™ is the centerpiece of an integrated financial management system focused on value creation—the solution to aligning interests of management and shareholders. As a performance measure, EVA allows key management decisions to be clearly modelled, monitored and motivated in terms of value added to shareholders' investment. Specifically, EVA can be used to: set goals and measure performance, evaluate corporate strategies and capital projects, value acquisitions, communicate with investors, and structure executive compensation.

With an EVA plan, managers are offered unlimited bonuses tied to incremental value creation, or EVA. Therefore, when bonuses are large, shareholders have nothing to lose, and indeed much to gain—higher EVA generated by managers means more value for shareholders. With unlimited upside, managers become highly motivated to pursue aggressive plans. By rewarding the end of creating value rather

than the means, EVA bonus plans represent the ultimate in pay-for-performance and the empowerment of line managers.

The EVA incentive system is a vast simplification of both the number and complexity of current plans, and both simulates and creates real ownership with only two essential plans: (1) cash bonus plan—concurrently a short- and long-term plan, and (2) equity plan—a redesigned option plan that powerfully aligns shareholder and management interests.

The EVA Cash Bonus Plan

The EVA incentive system breaks the link between budgets and bonuses. It is a catastrophic mistake to tie bonuses to fixed budgets—managers are motivated to minimize risk, avoid change, increase empires, and diffuse responsibility. In the EVA system, bonuses are based simply on growing economic value, not on a goal of expected performance negotiated with the corporate office. Also, a deferral mechanism, whereby payouts are contingent upon sustained performance improvements over several years, makes the EVA bonus both a short and long-term program.

A New Option: The Leveraged Equity Purchase Plan (LEPP)

Stock option plans should be constructed to provide both a real risk of cash loss as well as gain (the carrot-and-stick principle). In addition, management should participate only in excess returns for superior performance. To do this:

- Instead of a grant, management pays for the option at a price equal to 10% of the stock price. Initial exercise price is equal to the stock price less the 10% purchase price.
- Management faces a rising standard of excellence: the option's exercise price increases annually to adequately protect shareholders' interests.

The flexibility of such a pay-for-performance system gives managers autonomy to devise and successfully execute value enhancing strategies. LEPP's can be used at the corporate level for top management, or applied at the business unit level, using an appraised value, to rightly reward division management.

EVA IN ACTION

Several leading companies have already successfully adopted elements of the EVA™ Framework. Exhibit 3 profiles five companies—Quaker Oats, CSX, Coca-Cola, Briggs & Stratton, and Ball Corporation—illustrating market performance pre-and post-announcement of EVA plans.

For further information about the EVA financial management system and executive incentives, please contact Deborah A. Cohen, Director of Marketing and PR, at (212) 836–0476.

EXHIBIT 1.—STERN STEWART & CO.

Adding Economic Value Through Superior Financial Management Systems, Executive Incentives, Financings and Transactions

Stern Stewart & Co. is a unique corporate financial advisory firm founded by Joel Stern and Bennett Stewart in 1982. Our financial management and executive incentive systems focus managers on the critical link between corporate strategy and shareholder value creation. We also help senior management and boards of directors assess and execute value-adding transactions.

Stern Stewart & Co. originated and popularized the concept of "economic value added," or EVA™. Very simply, EVA is operating profit less the cost of all capital employed to produce those profits. Optimally, EVA should be used as the basis for setting goals and assessing performance, communicating with investors, evaluating capital projects, pricing acquisitions, formulating strategy, and structuring compensation truly linked to market-value-adding-performance. The firm's proprietary EVA framework is documented in *The Quest For Value* by Bennett Stewart (Harper Collins, 1991, 800 pages), and is presented in an ongoing series of public forums.

Evidence that EVA is the single performance measure that drives market price is provided by the Stern Stewart Performance 1000. This annual survey ranks prominent publicly-traded companies according to the market value they have added to or subtracted from their shareholders' investment.

To introduce EVA to a senior management team, we offer customized one-day presentations. Afterwards, we frequently advise a corporate steering committee on how to implement EVA financial management practices and incentives. To internalize EVA, we also offer PC software, FINANSEER®, and provide training and applications recommendations.

Reflecting our commitment to staying abreast of leading developments in corporate finance, we publish the highly-regarded Journal of Applied Corporate Finance on behalf of the Continental Bank. This quarterly publication communicates the best of recent academic financial research to senior corporate practitioners.

Our EVA-based corporate financial advisory services are offered independently or in conjunction with transaction planning and execution. We emphasize diligence, personal attention, and the highest of analytical and ethical standards. Regardless of the assignment, our overriding goal is to identify and pursue for our client the alternative that maximizes shareholder wealth creation.

JOEL M. STERN

Mr. Stern has been Managing Partner of Stern Stewart & Co. since its co-founding in 1982. Prior to that, he served as President of Chase Financial Policy, the financial advisory arm of the Chase Manhattan Bank, which he joined after completing graduate studies in Economics and Finance at the University of Chicago. In addition to his consulting work, Mr. Stern is also the keynote speaker at Stern Stewart's management seminars. He has served on the faculty of several graduate business schools, including Columbia, Fordham and the University of Witwatersand, Johannesburg, South Africa, and is currently an advisor at several other institutions. Mr. Stern is the author or co-author of six books on economics and corporate finance. He has appeared on the television business news programs, "Wall Street Week" and CNN's "Moneyline."

G. BENNETT STEWART III

Mr. Stewart is Senior Partner of Stern Stewart & Co. Prior to co-founding the firm in 1982, he was a vice president with the financial advisory arm of Chase Manhattan Bank. Mr. Stewart has an M.B.A. from the University of Chicago, and a B.S. in electrical engineering from Princeton University. He is a principal speaker at the firm's executive seminars, and spearheads development of FINANSEER[R], the firm's value-planning software. Mr. Stewart is the author or co-author of four books, including "The Quest for Value" (Harper Collins, 1991, 800 pages). He also serves as co-executive editor of the firm's publication, "The Journal of Applied Corporate Finance."

EXHIBIT 2.—"PAY" VERSUS "PAYOFF": WHAT'S THE DIFFERENCE?

Outsized executive payouts under any true pay-for-performance plan are a measure of success in all respects, not a cost to shareholders. A failure to distinguish "pay" from "payoff" is a root cause of much confusion over proper executive compensation.

"Pay" is the value of an executive's compensation at the time first granted, a before-the-fact estimation of expected cost. "Payoff" is the after-the-fact reward management realizes based on corporate and market performance. Ultimately, a company's objective should be to minimize pay and maximize payoff—maximizing payoff means management is sharing in the gains realized by shareholders, too.

The accountants are to blame. The FASB's insistence that options have no pay value encourages compensation critics and the media to focus wrongly on the payoff from stock options as a cost when in fact that is a reflection of the gain realized by the shareholders.

Proxy statements are unhelpful, too. Reporting stock option gains that executives may have been earned over a long time frame does nothing to clarify whether pay for performance is at work.

The flaw in both accounting and regulatory disclosures is that the true effectiveness of an executive's pay package can only be assessed before-the-fact, not after-the-fact. What's needed is a schedule that plots prospective annual executive compensation as a function of shareholder returns. Consider the following hypothetical compensation schedule for two executives:

CUMULATIVE 3-YEAR SHAREHOLDER RETURN

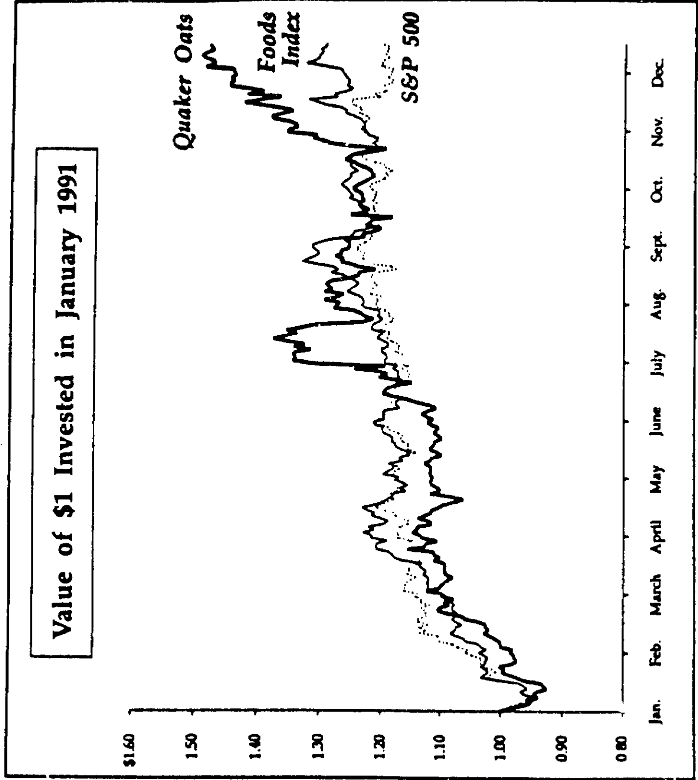
	–25%	0%	+25%	+50%	+75%
EVA CEO	$50	$75	$125	$200	$300
Traditional CEO	100	100	100	100	100

Though in this example the "EVA CEO" is likely to earn more, possibly far more, than his counterpart, his payoff profile is actually far better for the shareholders.

Pay suffers when performance is poor or mediocre, but climbs rapidly for good and great performance. That's the essence of pay-for-performance—a highly leveraged payoff profile that goes hand-in-hand with shareholders' wealth. The "EVA CEO" has a combination of salary, EVA-based bonus, and leveraged options. The "Traditional CEO" has straight salary, pension, perquisites, and a lot of explaining to do. Shareholders should overwhelmingly approve the "EVA CEO's" pay package, and send the "Traditional CEO" back to the drawing board.

EXHIBIT 3

QUAKER OATS FOCUSES ON VALUE CREATION



In fiscal 1991, Quaker adopted a management framework focused on value creation. Using the concept of "Controllable Earnings" as its primary financial performance measure, Quaker not only combined components of both the income statement and balance sheet, but also tied bonus compensation to this measure.

Quaker believes this new system enhances its ability to track progress against business goals consistent with shareholder value maximization; gives managers added incentive to create economic value in each line of business; and helps promote a culture of ownership among key managers.

Sales
- Cost of Goods Sold
- Advertising & Merchandising
- Period Costs (Depreciation)
- General R&D, Profit Sharing Expenses
- Assigned Corporate Expenses
= Operating Income

Over the decades, Quaker has delivered value to its shareholders in the form of stock appreciation and dividends. The Company has created this value by profitably growing its businesses and improving its results. Behind the scenes, Quaker has continually fine-tuned its approach to financial marketing and operating management. As the needs of markets, consumers or customers have changed, Quaker has changed with them.

CONTROLLABLE EARNINGS

A Better System for Assessing Value

Today the competitive environment has every public company, including Quaker, focused on maximizing value for its shareholders. In fiscal 1991, the Company introduced a new financial management system — "Controllable Earnings" — to give managers a better tool for measuring their contributions to shareholder value.

Controllable earnings holds each business unit accountable for ... [illegible] ... According to John Boynton, Vice President-Corporate Controller and Planning, the new system brings something different to Quaker's business managers. "Quaker is integrating the capital cost of using assets more explicitly into the calculation of each division's profitability."

Controllable earnings goes beyond accounting-based measures ... [illegible]

Beginning in fiscal 1992, bonus compensation for Quaker managers will be tied to improvement in controllable earnings. ... [illegible]

Controllable earnings equals adjusted operating income less a pretax capital usage charge. The capital usage charge is calculated as each division's average invested capital multiplied by Quaker's pretax cost of capital. ... [illegible]

Operating Income
+/- Working capital cost differences
+/- Lease adjustments
= Adjusted Operating Income

Cost of Equity
+ Cost of Debt
= Cost of Capital

By factoring the cost of using capital into financial results," says Boynton, "we're helping managers see how different business decisions affect shareholder value. Not only will managers get recognition for successful asset management, but the division's contribution to shareholder value creation will be more readily apparent."

How can managers generate greater value from their businesses? Here are a few examples:

1/ Investing ... capital to expand businesses, as long as incremental returns more than cover the cost of obtaining new capital.

2/ Reducing inventory levels without negatively affecting sales or customer service improves the business' economic profitability and frees up cash to reinvest.

3/ Optimizing a plant configuration. An example would be producing the same quantity of goods in two plants instead of three — a change Golden Grain made this year.

Ultimately, it is the cumulative value added by each of our businesses that drives Quaker's stock price. Because controllable earnings encourages investments and growth in economically profitable businesses and encourages better asset control in all of our businesses, managing for higher controllable earnings over time can lead to a more profitably run business overall. Creation of value can be accomplished by either growing or downsizing a given business if the action serves to improve controllable earnings over the long term.

Providing incentives that focus our people — our most valuable asset — on economic value creation will lead to better productivity and better use of every dollar Quaker invests. "Ultimately, it is the operating divisions running the businesses more effectively that improves shareholder value," Boynton says. "This new performance management system will help guide our decisions and track our progress toward that end."

The Quaker Oats Company
1991 Fourth Quarter Report, pp. 10-11

Controllable Earnings Glossary

Operating Income (OI):
Sales minus all costs directly related to manufacturing and marketing the product sold including salaries and benefits of employees whose jobs are related to running the business.

Another way of looking at operating income is: Profits before financing costs (interest and foreign exchange), taxes and unallocated corporate overhead expense.

Adjusted Operating Income (AOI):
Operating Income +/- Working capital cost differences +/- Lease adjustments +/- Other adjustments = Adjusted Operating Income

Invested Capital:
A mini balance sheet for each business unit including all the working capital and fixed assets over which a Division has control. Invested Capital does not include cash or debt, which is controlled on a corporate-wide basis.

Cost of Capital:
The benchmark we use to ensure projects undertaken promise a suitable rate of return. Our cost of capital is calculated using the approximate market-value weightings of debt and equity used to finance the Company. Our cost of debt is approximately 9.5 percent and our cost of equity is approximately 12 percent.

Capital Usage Charge (CUC):
Average Invested Capital x Pretax Cost of Capital

Shareholder Return:
This measure conveys simply, directly and without distortion, the value a shareholder receives from owning a company's stock.

Dividends + Stock Appreciation
÷ Beginning Stock Price
= Shareholder Return

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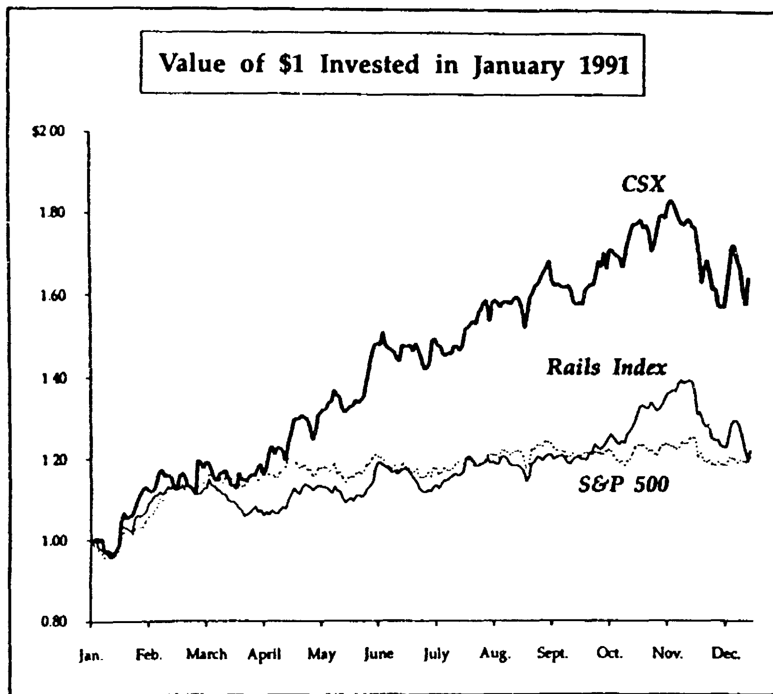
CSX ADOPTS A LEVERAGED EQUITY PURCHASE PLAN

CSX has stated that its overriding goal is to increase shareholder value. To support its mission, The CSX Way, the Company amended its executive compensation programs to encourage and reward exceptional performance more actively. CSX shareholders approved a powerful stock purchase plan designed to increase management's stake—both as employees and shareholders—in the future success of the Company.

CSX's new leveraged equity purchase plan (LEPP) functions as an "internal LBO." Approximately 160 managers purchased CSX stock leveraged 20 to 1. In other words, with an average personal investment of $35,000, a manager has upside opportunity of $700,000 of CSX stock.



BENEFITS

CSX MAKES MANAGERS INTO OWNERS

With its novel compensation scheme, the railroad is making sure that management and shareholders share the same rewards.

A radically new program for executive compensation at CSX may have solved one of the most vexing corporate governance issues of the day: how to make managers think like owners. In an era when executive compensation schemes often pay up even if stock prices fall, CSX has won applause from some very demanding critics. "It is most certainly something that should be tried," says Kevin Murphy, associate professor at Harvard Business School and an expert on executive compensation. "It's necessary for executives to align themselves more with the interests of shareholders and the way to do that is to make their wealth change when the wealth of shareholders changes," he says.

But though the objective is laudable, finding a way to put substantial ownership of a company in the hands of managers is not easy. Most managers can't afford to buy a big enough chunk of their employer's stock to make a real difference in their incentive to perform. Outright stock or stock option grants that don't require managers to pony up cash not only dilute shareholders' equity, they also fail to make managers think like other shareholders. Even when such grants are made in lieu of salary increases, "there's a visceral difference between forgoing salary increases and actually writing a check to put that money at risk," says Bennett Stewart, a senior partner of the financial consulting firm of Stern Stewart.

Under the program, approved by shareholders in the spring, CSX loaned management most, but not all, of the money they needed to buy about 2 million shares of newly issued stock at market prices. The amount of stock available to each manager depended on the manager's rank in the executive hierarchy. Managers who chose to participate received a nonrecourse loan from CSX for 95 percent of the stock price, but had to put up 5 percent of the price as a down payment. Down payments ranged from $10,000 to $100,000, depending on how much stock the manager bought, but the average down payment was about $35,000. The down payments and the loan obligations add up to a significant chunk of wealth at risk for participating managers. "This is a for-real loan," says Alan Rudnick, vice president, general counsel, and corporate secretary of CSX. "People were amazed because they got real loan documents."

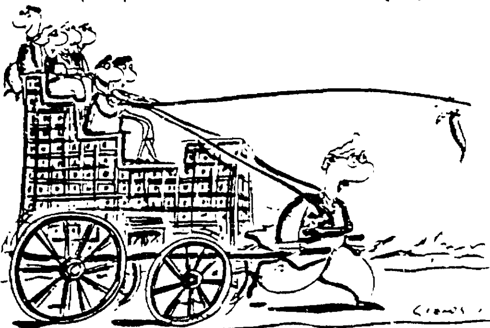
CSX duplicates one effect of an LBO without actually leveraging up the company. Instead, CSX leveraged up the managers. One advantage of LBOs is that a highly leveraged capital structure makes it possible for managers to buy a significant stake in their company at an affordable price. The discipline of interest payments ensures that managers-owners will earn a minimum acceptable return on capital, or else they will watch their equity melt down in a bankruptcy or a restructuring. If the LBO is successful then the managers-owners are rewarded with an almost unlimited upside potential profit.

The upside more than matches the risk. An executive who put up $35,000 to participate in the CSX program is leveraged at 20-to-1, which means that the executive has potential wealth of $700,000—provided that stock appreciation outpaces interest on the loan. "It creates a sense of urgency to create value and create value now," says Stewart.

Rudnick says that the program was well received, with 98 percent of eligible managers electing to buy into the company. "Two million shares were offered under the plan and we had requests for 1.4 million additional shares," he says. He stresses that this is not an option program. "Those who subscribed to the program are shareholders of record and they vote their shares at meetings," he says.

Yet the CSX program minimizes dilution of existing shareholders by requiring managers to pay 7.9 percent interest that provides shareholders with, at worst, a minimum return on their investment. Taken together, these elements add up to a strong incentive for management to build shareholder value. "Today's executives control billions of dollars worth of wealth and it's crucially important to not only get the right people at the helm but to make sure they have the right incentives," Murphy says.

—*Gregory J. Millman*



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December 10, 1991

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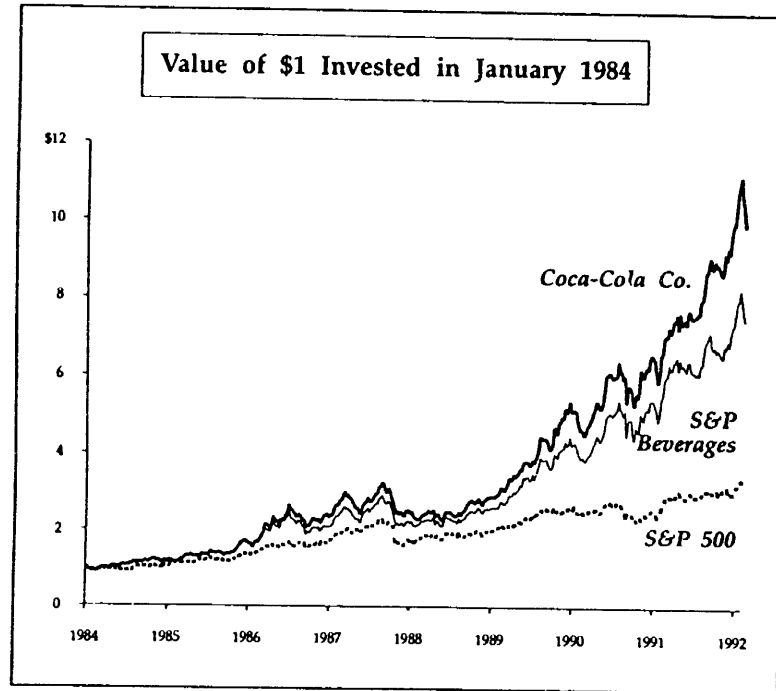
COKE: AN EVA LOYALIST PERFORMS

Since the early 1980s, The Coca-Cola Company has practiced EVA financial management. As stated in its 1991 Annual Report, "management's primary objective is to maximize share-owner value over time" (see attached). Such commitment and focus has propelled Coke to the #4 ranking in the *1991 Stern Stewart Performance 1000*, a ranking of leading companies according to "market value added" (MVA) to shareholders' investment over time.

So how does Coke stand in the Pepsi challenge? PepsiCo, Inc. ranked an impressive #11 overall, created $27 billion of market value from $13 billion of capital invested, for MVA of $14 billion. However, Coke, an EVA company, performed even better. At #4, Coke created $34 billion of market value from merely $6 billion in capital, less than half that of Pepsi, for "market value added" of $28 billion.



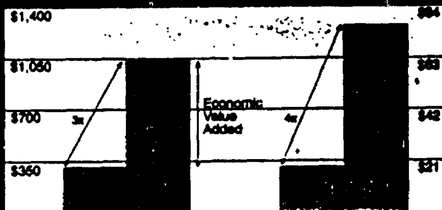
Financial Review Incorporating Management's Discussion and Analysis *The Coca-Cola Company and Subsidiaries*

Management's primary objective is to maximize share-owner value over time. To accomplish this objective, The Coca-Cola Company and subsidiaries (the Company) have developed a comprehensive business strategy that emphasizes maximizing long-term cash flow by increasing gallon sales, optimizing profit margins, expanding global business systems through investment in areas offering attractive returns and maintaining an appropriate capital structure. The success of this strategy is evidenced by the growth in the Company's cash flow and earnings, its increased returns on total capital and equity and the total return to its share owners.

Economic Profit and Economic Value Added: A significant portion of the increase in the rate of growth of the Company's earnings, returns and cash flows can be attributed to the Company taking actions to (a) increase share and gallon-sales growth for its products, (b) increase its investments in the high-margin, high-return soft drink business and (c) manage its existing asset base effectively and efficiently. Economic Profit and Economic Value Added provide a management framework to measure the impact of these value-oriented actions. Economic Profit is defined as net operating profit after taxes in excess of capital charges for average operating capital employed. Economic Value Added represents the growth in Economic Profit from year to year.

Over the last five years, Economic Profit has grown more than 3 times, resulting in Economic Value Added to the Company of $732 million. Over the same period, the Company's stock price has increased more than 4 times. Management believes that, over the long term, growth in Economic Profit, or Economic Value Added, will have a positive impact on the growth in share-owner value.

Return to Share Owners: During the past decade, the share owners of the Company have enjoyed an excellent return on their investment. A $100 investment in the Company's common stock at December 31, 1981, together with reinvested dividends, would be worth approximately $1,902 at December 31, 1991—an average annual compounded return of 34.3 percent.



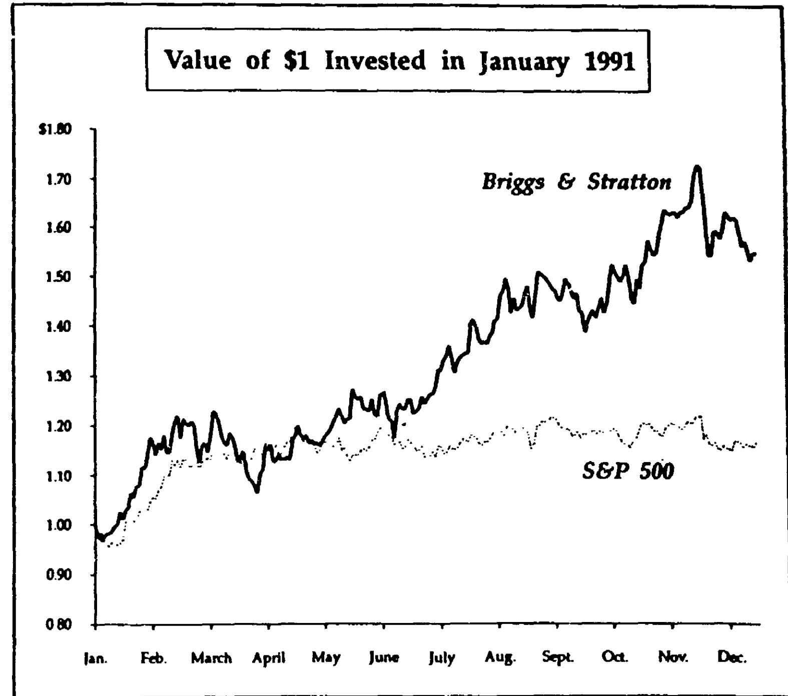
Economic Profit and Economic Value Added vs. Stock Price Appreciation

The Coca-Cola Company
Excerpts from
1991 Annual Report

BRIGGS & STRATTON BECOMES AN EVA COMPANY

Briggs & Stratton's stock value has increased 70% in the past year. In his remarks to shareholders at the 1991 Annual Meeting, the Chairman cited the Economic Value Added performance measurement and incentive compensation system as a key to the Company's success.

Economic Value Added, or EVA, is defined as net after-tax cash income from operations less the cost of capital employed. Briggs & Stratton is committed to adding value for its investors, and believes that EVA is the performance measurement most indicative of market value. In addition, by measuring both corporate and division performance, EVA provides the backbone of an incentive compensation program that effectively encourages management decisions that maximize the value of investors' capital.



BRIGGS & STRATTON CORPORATION

REMARKS

by

FREDERICK P. STRATTON, JR.

Chairman

at the

BRIGGS & STRATTON CORPORATION

1991 ANNUAL MEETING

OF SHAREHOLDERS

OCTOBER 16, 1991

On the day of our Annual Meeting a year ago, the price of our stock was 22 1/2. Today it is about 38 1/2. That's a significant improvement. It is useful, I think, to comment on some of the things that may have contributed to this increase. An important factor is the improvement in the market as a whole. A year ago the stock market was in a slump, from which it has recovered. The S&P 500, of which our stock is a component, is up 30%. Our stock is up 70%, so clearly the increase is more than just the market. From listening to the investment analysts and money managers who call us, we conclude that the increase is a result of the increased earning power we are demonstrating, the free cash flow we are generating and their expectation that we will use it wisely, and the increased accountability they see in our new performance measurement system and our new compensation system, which better links pay to performance.

I will spend a few minutes discussing that new measurement system, which we, and a few others, call Economic Value Added, or "EVA." EVA is net after tax cash income from operations less the cost of the capital employed to produce that income. It is the value added to, or subtracted from, the capital provided by shareholders and lenders. Value is added by earning a return greater than these investors require. Value is subtracted by earning a return less than they require. EVA is the performance measurement we believe is most closely related to market value. Under an EVA measurement system, there are three basic ways to improve performance. The first is to increase cash earnings without increasing the capital employed in the business. The second is to withdraw capital from operations that do not provide an adequate return. The third is to invest capital in activities that provide a return greater than the cost of capital.

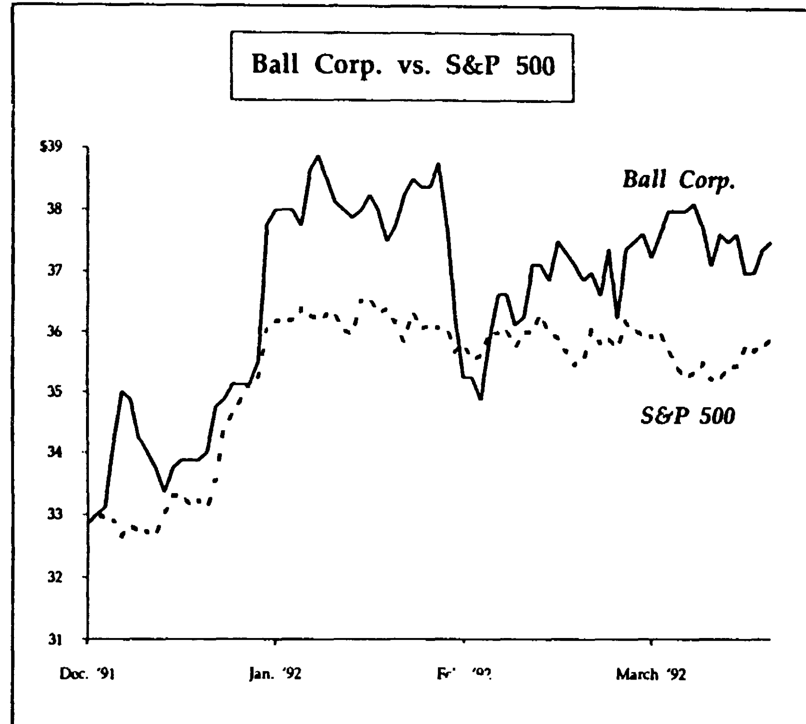
We use EVA concepts to measure the performance of our operating divisions. We also use EVA concepts to measure our corporate performance. You can find a presentation of our corporate results for fiscal 1991 on page 25 of our 1991 Annual Report. You will see that our net cash after tax income from operations as a percent of average capital employed was 8.2% in fiscal 1991, which is less than our 12% cost of capital. This is an unacceptable return. However, our return improved in fiscal 1991 despite a number of unusual expenses, and we expect it to improve further in fiscal 1992. We are committed to adding value for our investors.

We are using EVA not only to measure performance but also to determine management compensation. We are now using an incentive compensation system that ties the pay of corporate officers and division managers directly to corporate economic value added and to the economic value added by the operations for which they have responsibility. We believe that this measurement, and incentive compensation linked to it, can effectively encourage management decisions that maximize the market value of the capital contributed by investors.

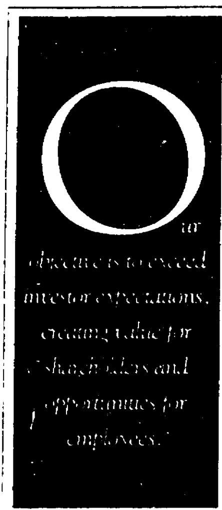
BALL CORP. INSTITUTIONALIZES EVA

Ball Corporation is a manufacturing company with principal interest in metal and glass packaging products sold to the food and beverage industries. Headquartered in Muncie, Indiana, Ball also provides aerospace products, professional services and industrial products to government and commercial customers. Stern Stewart worked with Ball Corporation to develop an EVA-based management incentive compensation plan to be implemented during 1992. The plan was announced in the fourth quarter of 1991.

"Focus on Shareholder Value Increased: The maximizing of long-term wealth by providing an attractive total return to investors remains the overall objective of Ball. During 1992, we will be implementing Economic Value Added (EVA) financial management concepts throughout the company. Since changes in EVA are highly correlated with changes in a company's share price, it's appropriate to adopt EVA as the principal measure of operating performance and to link incentive compensation to this measure." — *Letter to Shareholders, 1991 Ann... ..eport.*



Ball Corporation
1991 Annual Report



To achieve Ball's overall objective of maximizing shareholder wealth, management has begun to monitor the Economic Value Added (EVA) of our operations. EVA is the amount of operating profit left over after deducting taxes and a charge for the use of capital. The capital charge is based on Ball's weighted average cost of capital.

Under EVA, growth in sales, market share and even earnings per share are not necessarily measures of success. What counts is value creation. Companies with increasing EVA create value; those with declining EVA are destroying value. Changes in a company's share price are highly correlated with changes in EVA. Those corporations that have focused attention on EVA, with resulting improvement, have seen their stock price respond accordingly.

Ball's adoption of Total Quality Management (TQM) principles throughout its operations complements EVA. While one focuses on *continuous* improvement of products and processes, the other emphasizes *continuous* value creation. Under EVA, efficient use of capital is the yardstick by which operating performance will be measured. Long-term business plans, incentive compensation, capital investments and new business development will all be linked to EVA.

The value-creating drivers for Ball's operating segments will include improvement of profit margins, better utilization of existing assets, and the identification of new, value-creating investments. Senior managers will see their incentives tied to identifying opportunities where investment will likely yield returns in excess of capital costs. EVA can also be improved by increasing the rate of return on existing capital and by eliminating investments which are not earning the cost of capital and which are not likely to be improved.

Over time, we believe this philosophy will enable Ball to generate consistent returns in excess of its cost of capital, resulting in enhanced shareholder value. In turn, this kind of performance will also ensure the company's access to the capital necessary to sustain and grow the business.