

“Too Soft on Stock Options . . . ”

By Sebastian Mallaby

It's sometimes said that executive stock options would be fine -- almost patriotic -- if only they were properly disclosed in corporate accounts. After all, options reward executives for great performance, and what could be more American than that? This is a bit naive, unfortunately. Options, at least as they exist currently, do not reward performance. And their accounting cover-up is not incidental -- it is central to the real goal of many options schemes, which is to disguise bosses' absurd pay from the rest of us.

This insight comes from an article by Lucian Bebchuk, Jesse Fried and David Walker that will appear in the *Chicago Law Review*. The authors point out that if options schemes aimed to reward performance, they would avoid several features that interfere with that goal. They would not reward stock price rises that reflect a general rally in the market rather than the boss's own performance. They would not allow bosses to undo options' incentive by selling an off-setting chunk of company stock. They certainly would not indulge bosses who preside over a falling stock price and then expect their options to be rejigged so that they can cash out.

In practice, however, stock-option plans do all of these things, so they clearly aren't aimed at spurring performance. Instead, their point is to make executive pay appear legitimate. They do this partly by encouraging the myth that the pay is linked to merit and partly by keeping the pay hidden.

Why should bosses hide their pay packets? First, because they're enormous: A century ago J.P. Morgan said that top managers' pay might reasonably be 20 times that of the average worker; today the ratio is about 500 to 1. But second because the mechanism for setting CEO pay is an embarrassment. Even film stars have to negotiate their pay with studio managers who have an incentive to constrain it. Bosses negotiate with buddies who have no reason to get tough.

At most public companies, CEO pay is decided by a compensation committee made up of "independent" directors. Independent means that they do not work

for the company, they are not related to one of the top managers and so on. But independent also can mean that they were invited to join the board by the chief executive, that they are friends of his and that they are themselves chief executives with an incentive to bid up CEO pay nationwide. What's more, the pay comes out of shareholders' profits. Unless the directors are substantial shareholders, they don't care how much they lavish on the boss.

In theory, there's an external discipline on this process: If a company wastes profits by overpaying executives, the share price will suffer, and the firm will be taken over. But a variety of legal obstacles make hostile takeovers difficult, and the takeover threat is in any case a weak deterrent. If a boss increases his own pay by \$10 million, the cash goes straight into his pocket. That bonanza easily outweighs the small additional risk of takeover resulting from \$10 million less in profits.

The main discipline on bosses' compensation turns out to be shame. CEOs feel sheepish about asking for multi-millions if their demands will be splashed over the newspapers; directors feel shy about risking their reputations by signing off. This is why options are so useful. Rather than asking for unseemly sums of money, bosses award themselves options packages that are too complicated to make headlines. A few years later, when the options prove to be worth a zillion, the boss hides behind the fiction that extraordinary compensation reflected extraordinary merit.

What to do about this scamming? President Bush has proposed that options plans should require shareholder approval, an idea that sounds as if it gets around the cronyism of company directors. But the tax rules already drive most companies to run their options schemes by shareholders, and this process has proved useless. Shareholders have to vote yes or no on the outlines of the policy without knowing how much money they are approving for the boss.

We need something more than this Bush tokenism. Today Sen. Carl Levin (D-Mich.) will introduce a measure that might change options accounting, so that the cost of executive compensation would be dragged into the open. But even this provision, which will probably be killed by Silicon Valley lobbyists, is not the whole answer. The rules need to be changed so that the chief selectors of company directors are not the bosses but the shareholders. It's their money, after all.