Rewarding Executive and Board Performance – Alignment of Shareholder Interests

By Forbes J. Rutherford, President, Rutherford International Executive Search Group Inc.
www.rutherfordinternational.com – www.rematrix.com

May 2008

"Double, double toil and trouble; fire burn, and cauldron bubble"
MacBeth's Witches, Scene 1

Little has changed – the pursuit to disavow the existence of financial gravity inflated the Dot Com bubble, continued into a home equity bubble and will likely feed the commodity bubble. We've learned little - the manipulators of corporate stock values slipped from the constraints of Sarbanes Oxley and moved downstream to apply their talents at excavating middleclass wealth by pump/priming home values and debt. This time, instead of engaging stock brokers to sell the phantom values, they used real estate agents and mortgage brokers to sell the American consumerist dream which eschews sacrifice and toil. Dupes or "useful idiots," the retail financial services sector sold debt and empty dreams utilizing fraudulent financial mechanisms that were created by "financial grifters" on Wall Street.

The sub-prime melt down, the predictable collapse of a 140 year old investment bank, the approaching derivative tsunami that is expected to sweep away more historical investment banks is simply a consequence of monetization of ethics and delusional deception of financial principles – all with the assistance of the Federal Reserve, a fawning supplicant which colluded by selling cheap money by accepting junk bond quality mortgage backed securities as collateral. The system is cracking under the weight of this inflationary madness.

August 2002

This following commentary on creating shareholder value by linking staff bonuses, business unit managers and first tier executive compensation through the establishment of a hierarchy of performance measurements was written in 2002.

My horoscope suggested today was a good day to sit down and read books on mysticism, metaphysics and ancient religions. It went so far as recommending the "Tibetan Book of the Dead" as a suitable summer read. I'm not in the habit of stocking the corporate library with such titles, although I do have a few executive resumes that might qualify. However, the daily reports on Enron, Worldcom and various "mini-ron's and com's" in the financial press of late, should suffice as a comparative alternative. Certainly, there will be no lack of reading material over the ensuing months, as further accounting distortions are reported by financial forensic investigators.

How has the executive suite and investment community of corporate America reached such an all-time low in the eyes of stakeholders with respect to 'trust', that a politician feels obliged to lecture Wall Street on ethics! A politician lecturing on ethics is akin to the philanderer expecting their spouse to be virtuous. The political response will result in increased regulation, and conveniently eschews a loosely held belief in the principle of 'market forces'. The solution to regaining the retail investors trust in our financial markets is not by increasing the regulation of business, nor is it a vacuous promise to take a few unscrupulous executives out to the symbolic woodshed.

The mugging of investors and sabotage of our trust in public financial statements and analytical reports has less to do with fraudulent capitalization, and more to do with a veritable abandonment of the values and belief systems upon which our nation was founded. Milton Friedman was quoted as saying, “the main problem with capitalism is capitalists.” I would submit, the main problem with capitalism is capitalists and their courtiers that are driven more by avarice, sloth, vanity and envy rather than the desire to build an enterprise that will last longer than the exercise date of their stock options. The fundamental flaw in our capital markets is not in the free market system itself, but the in willingness of many in positions of accountability to let ‘corporate grifters’ monetize their ethics and deceive their principles.

To be fair but not an apologist, one might include self-preservation as an underlying factor in the current debacle. Approximately twenty-two percent of America’s major corporations dumped their CEO’s in 2001 for not meeting their earnings targets. This attrition is not restricted to the CEO’s office but usually results in a decapitation of the top tier executives. When a CEO’s average tenure is only four or five years, should we be surprised that some in the executive suite collude to spin a web of deceit. This annual cleaving of corporate leaders head’s is a strange paradox, when one considers only thirteen percent of companies worldwide according to Bain and Company, achieved a 5.5 percent real growth in earnings over the past ten years

To reclaim a position of credibility and trust, those responsible for governance within our public companies will have to conduct a serious examination as to how executive and board performance should be rewarded. Beginning in the early nineties, corporate boards determined that superior shareholder value could be achieved if the interests of management were aligned with that of shareholders. Options and grants became ubiquitous in the executive pay packet with little thought given to their structure. A majority of these options are of a fixed price or conventional nature, and are proven to have little correlation in increasing shareholder value. Their exercise price is established at the market price on the day granted and stay fixed over the option period, usually ten years. If the share price rises above the exercise price, the holder can cash in on the gain. This structure, based solely on share price conveniently rewards both the superior and under-performing executive. It rewards the option holder even when the share price increase is below a competitor’s increase realized over a similar period of time.

Beginning late 1995, most major stock indices enjoyed a one hundred percent increase. Share price was driven not only by management, but as well by factors outside of management control such as low interest rates, declining inflation and an ocean of unencumbered and undisciplined wealth transferred to a post-war generation. With all boats in the harbor rising with the same tide, the weakness of fixed price options became glaringly evident as they rewarded both the superior and under-performing executive. The need to find relevant methods for measuring executive performance is paramount, as awarding a windfall to an under-performing executive is tantamount to picking the shareholders pocket.

This inability to distinguish between good and bad performance is contrary to the CEO’s over-riding responsibility in providing superior total returns to shareholders. It is possible to align management’s interest with that of the shareholders. Shareholders expect their boards to only reward management for achieving superior returns relative to the company’s competition or a relevant industry index. The most effective structure rewards for superior performance relative to competitive indices in both rising and declining markets. This structure is known as an “indexed option” and should be given serious consideration as an alternative to expensing stock options.