THE BROOKINGS INSTITUTION

IS IT TIME TO REFORM EXECUTIVE COMPENSATION AND STOCK OPTION GRANTS?

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PARTICIPANTS:

Moderator:

ELISABETH JACOBS
Fellow, Governance Studies
The Brookings Institution

Panelists:

ELEANOR BLOXHAM
Founder and CEO
The Value Alliance

DONALD DELVES
Founder and President
The Delves Group

HOLLY GREGORY
Corporate Partner
Weil, Gotshal & Manges LLP

DAVID WALKER
Professor of Law
Boston University

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P R O C E E D I N G S

MS. JACOBS: All right. Since it's a little bit after 10, I think we'll get started. My name is Elisabeth Jacobs. I'm a Fellow in Governance Studies, and it is my pleasure to welcome you all here today for what should be a great panel on executive compensation and whether it is time to look at reforms to practices and executive pay.

We have all of you here physically in the room, but we also are webcasting this event live. So, I want to welcome our virtual audience as well. And we are live tweeting this event at #BiPay. If you're on Twitter, you should feel free to comment along, and we'll be taking questions from the Twitter audience as well as you all at the end of the session.

So, as all of you are probably aware, since you're here, executive compensation practices have shifted to a model tied to stock option grants. As a result, many corporations are focused on short-term stock gains, which have real impacts on our nation's ability to innovate and to build a long-term focus sustainable in a globally competitive economy.

This trend in executive compensation raises the question of whether there are better ways to reward executives and to make them more accountable to shareholders, stakeholders, and society. So, those are the issues that are really at the central focus of our panel today.

We have assembled a great group of experts who are already deep in debate just from our meeting session over breakfast earlier today, so I'm really looking forward to actually letting them take over and continue what they started over coffee this morning. I'll start with quick introductions.

All the way over to my right, we have Eleanor Bloxham. Eleanor is the founder and CEO of The Value Alliance and Corporate Governance Alliance, an independent board education, information, and advisory firm that she founded in 1999. She's an internationally recognized authority on corporate governance and valuation. She's also the author of two books, *Value Led Organizations* and *Economic Value Management: Applications and Techniques*, which has been called "required reading for members of the board of directors of every U.S. corporation."

Next we have Dr. Don Delves. Don is the founder and president of the Delves Group, a consultancy dedicated to working with corporate boards and compensation committees to improve their efficacy. He's a highly sought-after expert on principles-based governance, incentive design performance management, and value creation. His book, *Stock Options and the New Rules of Corporate Accountability*, has been called a must read for board members and executives and investors.

So, we have two must-read authors here. I don't know if they're selling books, but we have two that sound like everyone would want to take a look at.

Next, we have Holly Gregory who's a corporate partner at Weil, Gotshal where she counsels clients on the full range of governance issues. She's played a key role in drafting the OACD principles of corporate governance. She's advised the internal market director of the European Commission on Corporate Governance Regulation, as well as the Joint OACD World Bank Corporate Governance Forum on Governance Policy for Developing and Emerging Markets. Holly's lectured extensively on corporate governance topics around the globe, and she writes the monthly governance column for *Practical Law*: *The Journal*.

And, finally, we have Professor David Walker. Walker is a professor of the law. He's the Associate Dean for Academic Affairs and a Maurice Poch Faculty Research Scholar at the Boston University School of Law, where he teaches courses in taxation, corporate law, law and economics, and the economic structure of commercial transactions, also known as deals, which clarified it for me. (Laughter) His research lies at the intersection of taxation in corporate governance with a particular focus on executive compensation. Prior to joining academia, he had a general tax practice with a focus on executive compensation.

So, I thought I would start off the conversation by asking each of our panelists a question and giving you a chance to respond. And after they've each had a chance to speak, I'm going to open it up and give some general questions to all of them and let them continue that great debate that got started earlier. And then we'll have plenty of time for questions from you all in the audience and those of you who are tweeting with us as well.

So, Eleanor, how have compensation practices impacted U.S. competitiveness and the economy? Can you give us a broad overview of what's going on?

MS. BLOXHAM: Absolutely. I think this is actually the central question: What are the impacts of compensation? When you think about compensation, it is a signal. I often say it's a signal that the company is sending about what's important inside the company, but it has broader signaling that is happening with respect to executive compensation, and I think that's the key to figuring out what needs to happen going forward.

I think if we go back and we look at Drucker, you know, Peter Drucker thought that 25 times average worker pay was a good measure and then changed that to 20 times, and his argument was essentially that more than that and you have an issue with respect to teamwork in an organization. And this is not just a pie in the sky.

This is just not about making these broad generalizations about morale. Just last week I was meeting with a company in the Fortune 500, the head of Ethics and

Compliance, and we had put together a board education program that dealt with some of the whistle-blowing aspects, and in that program that we had put together we were able to say that more people were calling in to the whistle-blower hotline, that there was a situation in which more people were willing to not be anonymous. They really trusted what was going to happen in the process. Well, that has to be scrapped. That whole program we need to redo, and the reason we need to redo it, it took an hour and a half conversation with my asking why, why, why -- finally, Eureka. We paid out these bonuses to the top executives, and now as a result of that, morale has changed in the organization. People feel very disconnected now from the CEO. They are not willing to share with management what could be fixed or improved, and they've got a real situation on their hands in terms of how they're going to turn this thing around. It had to do with retention bonuses, and it had to do with the high pay of corporate executives, and the people on the ground don't feel that top management understands them.

But it's not just an issue with respect to the motivations and how that affects productivity, what we're able to do in corporations today. It also affects the effectiveness of the CEOs themselves, because they become very disconnected, not understanding, you know, what a real customer goes through, what their employees are really having to deal with when they're in this protective bubble.

So, I think boards actually do CEOs a great disservice through this process. And I think also what happens is we tend to then hire and people move up in the organization who are connected to money in their jobs and how much money they can earn rather than the job itself.

We used to have this notion called service, this idea that in this country a job was something intrinsic. There was something intrinsic about what one was doing. And I think we've lost that in that process.

Nuno Fernandes of IMD did a very interesting study and from 2003 to 2008 found that executives made twice as much in the U.S. as they did in global counterparts. And so he was actually, you know, sizing up companies and putting them on a comparable basis in that comparison.

The other thing that study showed was that one of the huge differentials and probably most explanatory in the difference between pay in the U.S. versus globally was equity. And the issue of equity pay is not just one related to stock options. It's related to stock, also, and restricted stock. And this -- there was a study in December from the Federal Reserve, a staff report, which I think is one of the most important studies that we've seen in a long time on this issue, and that study basically showed that in fact both stock and stock options -- those incentives contributed to our financial crisis and shows that in fact what it causes CEOs and executives to do is to take action so they're not in the economic best interest of the company itself.

Well, imagine this multiplied across the economy. It creates economic instability. So, what you have is you have managers acting in a pro-cyclical way. They start to cut costs. It increases the stock price, because their pay is tied to stock. So, they cut costs some more, and they cut costs some more in the run-up to the financial crisis -- and that's what we're experiencing now.

In the run-up to the financial crisis, it was just the opposite. Let's lever up, lever up, lever up. It's working, it's working, it's working. And because stock price provides a signal on a daily basis, you know, how many of us are somewhat at least addicted to our cell phones or our, you know, our devices? Well, to have that constant reminder of stock price, we are moving executives to looking at that one so much that the bulk of their pay is -- the idea was to align, but it doesn't align, because in fact it's not something that the manager can control. Unless you want the manager to control or manipulate numbers to create a stock price, you haven't really incented the right behavior.

So, basically this Federal Reserve report shows I think something that we knew coming out of the financial crisis, and in fact if we looked at the executives and the troubled firms, James Cayne at Bear Stearns had the most in equity and stock options. Dick Fuld at Lehman Brothers was next. After that was Stan O'Neal at Merrill Lynch, and after that was Mozilo at Countrywide, and that was from the study that Rene Stoltz did on that topic.

So, anyway, this exacerbation of the economic cycle creates volatility, and in fact what their report showed that I thought was extremely important is that stock -- restricted stock acts just as much in this fashion as stock options. Restricted stock for the executive is like an option, because they're waiting and executives do time when they're going to sell that stock.

The last thing that I would say, in terms of what's happening with executive compensation and the effects on the economy and competitiveness, has to do with our tax policy with respect to executive compensation. Currently, most of this stock and stock option pay are deductible, and so what we are doing is we're allowing deductibility of something that in fact is harmful to the economy. And I think that that is another issue for us to wrestle with on this topic.

MS. JACOBS: Great. Thank you.

So, turning to Don, can you tell us a little bit about what's happened to CEO pay over the last decade relative to the pay of the average worker, how the 2000s -- the aughts -- have compared to historic trends and why the difference or the stability? And I guess the follow-up to packaging all that is whether we're right to focus on executive compensation practices at all or whether we're focused on the wrong problem.

MR. DELVES: Thank you. Very good questions.

Let me start out with a little perspective on this, because you mentioned that I published a couple of books. My first book came out in 2003, and the first line in the first book says, "Executive compensation is out of control." And the book goes on to make a case for why we needed an expense for stock options, which we did not have at the time. Both of those statements -- executive pay is out of control and that we needed an expense for stock options -- I know for a fact I was the only executive compensation consultant saying those two things, and I risked my career and my livelihood by saying those things, but I thought they were important to say for the sake of corporate governance in America.

And I'm telling you that, because it gives me the right to tell you that today I do not think executive compensation is out of control. It's just high. There's a difference. Executive compensation and CEO compensation -- we've had two explosions in CEO pay. In the 1980s they went up very dramatically. In the 1990s it went up explosively. CEO pay increased by 400 to 600 percent in the 1990s, almost all driven by an explosion and the granting of stock options. Stock options -- if they be any other name these represented 5 percent of the stock outstanding. In most companies, by the end of the 90s it was 15 percent. So, during the '90s. We transferred the 10 percent of the future growth of the entire stock market from shareholders to employees -- mostly executives.

CEO pay has not gone up dramatically since 2001. In fact, it came down a little bit, and it has fluctuated in a range since then. It's still high. Fortune 500 CEOs make 9 to $12 million a year. They make three times the next highest paid executive. They make well over 200 times the average worker. It's high. But it's not exploding anymore. And it's not exploding for a number of very important reasons. Sarbanes-

Oxley -- they've made some very, very big changes to corporate governance. And we have to recognize the impact of these changes.

Prior to Sarbanes-Oxley, the CEO not only chaired the board, sat on the board, chaired the Compensation Committee, sat on or chaired the Audit Committee. If I as a consultant brought the compensation plan to the board, it had to get scrubbed by several layers of management before it got to the committee, and then once you got there, the CEO's are sitting there chairing the committee. You can imagine how independent that committee actually was. This changed. This changed dramatically. The CEO is not on the Comp Committee, the CEO's not on the Audit Committee, and, most importantly now 10 years hence, the CEO's not on the Nominating and Governance Committee.

So, this belief that that's still out there, that the board members are all cronies of the CEO, is just not true anymore. I mean, boards are still very collegial, but it's a far cry from how it was 10 years ago, and I think it's important to recognize that, you know, boards -- in my experience -- and I go to about 50 or 60 Compensation Committee meetings a year and have for 10 years. Most of those committee members want to do the right thing, and they're not trying to just, you know, line a CEO's pockets. They really are trying very hard to do the right thing and tie pay to performance.

Another thing that we've had that's been very important is this advisory nonbinding vote on executive pay – *say-on-pay* vote, which we had two cycles of now that came out of the Dodd-Frank Act, and that's had pretty profound effects. In particular, we've seen a significant reduction in perquisites -- you know, personal use of corporate aircraft; gross ups on certain benefits; and the granddaddy of them all, the excise tax gross up on Golden Parachutes. Actually, even the size of the Golden Parachutes is coming down and the excise tax gross up is going away. I didn't think we'd ever see that.

So, we have to recognize that there's been a significant amount of progress.

Another dramatic change is we had expensing for stock options, and you remember by the end of the 1990s stock options made up 98 percent of the long-term incentives that were granted to executives -- 98 percent. And they were being given away basically like they were free, because they essentially were from an accounting standpoint.

We now have an expense for stock options. The effect of that has been a shift away from options towards, as Eleanor mentioned, restricted stock, whole shares of stock. But the long-term trend there has been to have those shares be earned based on long-term financial performance. Again, that's a positive result.

So, the end result is that executive pay actually does now move up and down with performance. It's kind of obvious that it should, but it didn't used to and it does now.

But that then leads to the pressing question of, you know, why is this still such a huge societal problem? Why do people get so incensed about this? And probably it is that the numbers are so high. And they are. I won't argue that. But a year ago a journalist was interviewing me, and I was sort of telling him how I thought it was good that CEO pay had gone down during the recession, and as corporate profits came back up CEO pay went back up, and that that was a good thing. And she paused, and she said okay, that's fine, Don, but what do you say to the typical factory worker in Peoria, Illinois, whose pay has not increased in real terms for 20 years? You know, what do you say to the family whose, you know, average household income has actually gone down? And, you know, that got me thinking. And I think that is a very, very serious societal problem, and I don't know if this is the answer, but I think that part of the problem is not just the CEO pay and executive pay is high, it's that average worker pay is so low and that it has not increased.

In the 1980s, I used to work for the big HR consulting firms, and we spent a lot of time doing gain sharing and compensation plans and all these things that were designed to share, to help employees improve the productivity and performance of their company, their factory, their business -- you know, whatever it was -- and then share in the gains. I haven't seen much of that in a long time. It sort of got replaced in the '90s by options. We all thought that options were the answer. That was how we were going to share the wealth with everybody. And then one of the downsides of the stock option expense is that most companies took the options away from employees and just gave them to executives.

So, I do think that -- and it also bothers me that I sit in these rooms where there's an enormous amount of effort and talent and analysis and research that goes into figuring out exactly how we're going to pay and motivate the top five, ten, fifteen people in the company. We don't spend any time -- none -- talking about how we're going to pay everybody else and how we're going to, you know, help improve the productivity and the pay of the rest of the employees in the company. And I think that is a place -- I'm not saying we need to pay less attention to executive pay, but I think we need to pay a lot more attention to worker pay, and I think that's a place that boards of directors could focus a lot more attention.

Thank you.

MS. JACOBS: Great, thank you.

So, Holly, Don touched on this, but I'm hoping you can expand on the say-on-pay provision in Dodd-Frank and what that's meant for corporate governance but specifically for executive compensation practices.

MS. GREGORY: Well, thank you, and I was really glad that Don sort of outlined a lot of the key changes that have happened in compensation committees due to regulation, Sarbane-Oxley, and now we're dealing with the changes that come from Dodd-Frank. One of the changes you should be aware of before I start talking about *say-on-pay* is just two days ago the stock exchanges finally proposed the rules that they're required to under Dodd-Frank around compensation consultant independents and also around the heightened independence of compensation committee members. So, there have been efforts here to try to improve the composition and functioning and independence of comp committees, and it's not all on line yet.

But talking about *say-on-pay*, we're talking about an advisory vote that shareholders were given two years ago to opine on the compensation of the five named executive officers, the most highly paid officers in the company, as disclosed in the proxy statement every year. And this is a simple binary -- yes, we like it/no, we don't like it. Not a lot of opportunity through that vote to understand the reasons for all of that. That's a sea change in compensation, and it's having a big impact in compensation committees, I think, even though it is advisory and nonbinding.

It hasn't been either as dire or as beneficial, I think, as commentary suggested. But it certainly has been coercive. Now, when you look at it, when you think about it, boards under state law are charged with managing and directing the corporation. And they do the management part largely by hiring a professional CEO and delegating to that CEO the authority for day-to-day operations of the company. And that means that they have to select the CEO, they need to monitor the CEO, they need to evaluate and compensate that CEO. So, compensation is really a key board function. It also happens to be one of the decisions that corporate boards make that we have the most visibility into because of the intense disclosure obligations about that. And so for many shareholders, it has become a litmus test for understanding the quality of a board generally and how a board approaches their fiduciary duties.

Now, the board's challenge is to structure compensation to fairly reward effort and to also create appropriate incentives for behaviors that the board believes are going to help drive the corporation forward in the ways that the board has determined are appropriate through its strategic planning efforts.

Now, when Dodd-Frank gave this new vote to shareholders, that's really revolutionary. It's the first time shareholders really get a voice on executive compensation. Again, it's not binding but it's coercive. How is it coercive? Well, for one thing, the year following the vote, the board has to -- the company has to disclose in the proxy statement how the board considered the vote of the shareholders and if it considered it, what kinds of impact it had on policies and compensation going forward.

When you look at how the votes have actually come out in 2011 and in 2012, 72 percent, even higher I think last year, of companies received 90 percent or more of the vote in favor of their compensation efforts. So shareholders have been very, you know, significantly supportive of the compensation efforts. It's only in 2012 that 2.6 percent of the Russell 3000 companies who've had votes, who didn't pass, who didn't get a majority vote cast on that. That's about double the failure rate of last year, but it's still very, very low.

I think what's interesting to note is that the institutional investors receive advice from professional proxy advisors on how to vote, and those proxy advisors have voted against compensation at a greater rate this year than they have in the last year, and it's something to watch carefully.

Now, when we try to understand why a vote failed, we think that the reasons mostly have to do with a perceived disconnect between pay and performance. So, the shareholders, the large institutional investors, don't seem that concerned about pay levels. That isn't what we're hearing, but it's the pay in relationship to performance and how that tracks. Also, there's certain disfavored pay practices that Don highlighted that are pretty sure to get you a negative vote on compensation. And because of that, the coercive effect, we're seeing big changes.

We're seeing, you know, far more reasonable perquisites. We're seeing far less reliance on tax gross ups. We're seeing option repricing almost never. It just doesn't happen anymore, because boards know that's a key way to get ISS to recommend against and to get a lot of shareholders to adopt that recommendation.

We've also seen in this last two years that sometimes the "no" vote seems to have very little to do with compensation and maybe reactive more of other concerns about the governance of the company or the company's sort of nonresponsiveness to shareholder concerns in the past.

Now -- so, *say-on-pay* is actually influencing other kinds of governance conduct, if you will. One of the things that I find when I go in and talk with boards these days is one of the first questions a comp committee will ask when talking about structure of pay is how will ISS view that? And as an advisor, because the proxy advisors have such influence on the votes, I feel like I'm not doing my job if I don't raise the issue of how the proxy advisors will view a particular practice.

But I'm not at all convinced that that's really beneficial to companies in the long run for the proxy advisors to have this degree of influence on compensation issues. For one thing, the largest proxy advisor has a fairly rigid view of what good compensation practices are. And I like to think of all those things in the toolkit as being things that you use based on circumstances that should be available.

But ISS does have a fairly rigid view about what pay for performance should look like, what time frame to judge pay for performance in, what constitutes pay, what constitutes performance, and who relevant peer companies should be to assess a company's performance against. And these views, in my mind, are not necessarily superior to the business judgment of compensation committee members who are independent and advised by independent consultants.

Now, the good news. I think *say-on-pay* is driving increased efforts by companies to communicate decisions around compensation in a much clearer way, and that's really beneficial. We're seeing big changes in proxy statements in the last two years. We're seeing much better use of summaries, executive summaries, summary tables both in the compensation sections and also more broadly. We're seeing companies experiment with how to get their message across. For example, being a prudential for the last several years has used a letter from the board of directors in the proxy statement that highlights the beneficial kinds of governance efforts that they believe they've taken and how they've driven value for the shareholders.

We're also seeing *say-on-pay* drive, I think, largely constructive efforts by companies to engage more closely with their large institutional shareholders to try to understand their concerns and to try to also communicate how the board and the company are looking at governance issues. And that is all serving a bit as a release valve on the pressures that were developing, I think, between some of the large institutional investors and corporate boards at large.

So, you know, I think that we are in a period of improvement. I'm someone who is not a big fan of having lots more rules and regulations whether it's about corporate governance or about the form of compensation.

There is something online that will be coming that may help to focus comp committees more on the notion of employee pay relative to the CEO and senior executives' pay, and that's a provision in Dodd-Frank that told the SEC that they need to develop rules requiring disclosure about the ratio of the median worker's pay to the CEO's pay.

Now, this is one of the pieces of Dodd-Frank directives to the SEC that I believe didn't have a firm time deadline, and we don't have proposed rules on it yet. It is something that I understand lots of people are struggling with: How to define -- how do you define the median worker? How do you consider part-time workers? What about workers overseas? How are we going to define all this to come up with a meaningful disclosure? But I suggest that once this disclosure is required, compensation committees will be having the talk with Don about where CEO pay is in relationship to the workers generally.

So, I'm not a big fan of regulation. I would love to see the things that are in the pipeline and have just been announced work. I think that they will further continue to improve how compensation committees and boards in general look at these issues.

MS. JACOBS: Okay, thank you.

So, David, what's your view on how and why executive pay practices have changed in recent years and how these changes impact the debate over reform?

MR. WALKER: Okay, thanks. And thanks for inviting me. It's a pleasure to be here.

So, I'm looking forward to coming back to talking about whether pay is out of control and *say-on-pay* and some of these other things, but I'll stick to the script. And I wanted to start by talking a little bit, like Don, about changes, because I think, too, that if we're going to talk seriously about executive pay reform, if we're going to consider it, we do have to make sure we do that with respect to the facts on the ground, what's going on today. And there have been substantial changes.

I haven't been doing this as quite as long as Don, but I've been focusing on this subject for 10 or 12 years, and not only have things changed in terms of the amount of pay, but the structure of pay has changed dramatically. Don said something like at the peak of the dot-com bubble options represented 98 percent or something of performance pay? Well, I think that's right. If you look at total pay, if you look at the total aggregate compensation measured *ex ante*, at grant, of the top five executives of S&P 500 companies, in the year 2000 60 percent of that total pay was options and 10 percent of that was stock. Last year, 2011, options are down to 18 percent, and stock and stock-like instruments are over 40 percent. It's flipped.

When we talk about executive pay today, we're talking about stock. I mean, stock options are still there. They haven't gone away. Maybe they'll come back. But -- yeah, somebody has got my chart. Excellent. But stock is really the dominant vehicle today. And that matters. And so when I'm talking about stock -- let me be clear about what that is. So, most of you are probably familiar with time-vested restricted stock. You stick with the company for three or four years, you get your stock. Well, that's still there. But, as Don mentioned, we also see performance-vested restricted stock. So, not only do you have to meet the time requirement, not only do you have to stay, but the firm has to hit an earnings target or something like this in order for the stock to vest. And then there are other instruments that have the same kind of economic effect of stock -- performance shares, where it's basically a bonus paid in stock. But it's long-term, so you have a three-year performance plan, and it's paid out in stock. All of those things together I'm saying now total over 40 percent of kind of the average pay package.

Now, why this has occurred I think is a great story, and we could talk about it more. I can tell Don thinks it's largely about the accounting change, and I think that played a big role. But there are other things going on, like I think the dot-com crash changed executives' perceived risk of options. It may not have changed how risky they were, but it changed your view about how risky options were. So, there are a number of interesting things going on there.

But what I'm really concerned about at the moment is how does this shift in form affect how we should think about reform efforts? So, the two big issues I think with equity pay -- just not thinking about the amount, but just thinking about equity pay -- the two big issues I think that arise most often are concerns about risk and concerns about short-termism, and these are related, but they're not exactly the same thing.

So, let's talk about risk for a moment. A lot of commentators believe that one of the chief contributors to the financial crisis and crash were banks, financial institutions, taking on too much risk. And one reason they suggest for that is that the bank executives held too many options. Okay, I'm not sure I believe this story. The jury's out. We've got some people who yes, some people who say no. The data is not clear. But what I do think is that where we are today is a different world.

Now, Eleanor mentioned a study that shows that stock may have also contributed to the financial crisis. I'm personally very skeptical of that. An undiversified executive who holds a large stock portfolio is generally viewed as being more risk averse than the shareholders. They've got all their eggs in one basket. They're holding onto all of this stock. The reason, according to the corporate finance gurus, that we came up with options in the first place was to try to generate a little appetite for risk amongst the executives, to bring them back up to where the shareholders were.

Now, maybe we went too far. I don't know. Maybe too many options created to -- a fellow on my faculty who's arguing we should try bank security with debt securities in order to reduce our appetite for risk. Well, maybe, but I'm serving in a different world. I think that the dominance of stock alone makes a difference there, or creates an appetite for risk. What I'm telling you is that today the picture just looks very different. So, I have colleagues -- a fellow on my faculty who's arguing we should pay bank executives with debt securities in order to reduce their appetite for risk. Well, maybe, but I'm saying I think we're in a different world. I think that the dominance of stock alone makes a difference there. So, if we're going to think about reform, we have to think about it in a world in which stock at least currently dominates and what that means.

Now, short-termism -- what does that mean beyond risk? Well, I guess -- Eleanor mentioned, I think, that maybe it means focusing too much on earnings -- you know, current earnings, current stock, stock price, things like that. I'm not sure that really matters, the story I'm telling you about the shift from options to stock. Maybe a little bit. Maybe options create a little more pressure on earnings. I don't know. I don't think there's a big difference there.

So, where should we be focusing going forward on reform? I'm a big -- I'm not totally against regulation, like Holly, but I am a big fan of regulation that makes sense, and if you look at the history of our regulation of compensation, particularly equity compensation has been abysmal. So, I'm a tax guy, and you look at Section 162(m), which limited the deductibility of nonperformance-based pay, it certainly didn't reduce pay. It might have contributed to the shift into options, right? And look where that got us. Not so good. The Golden Parachute rules, not so good. So, I'm very concerned about regulation.

Now, Don mentioned the change in the accounting rules. One of the best changes we got was in 2004 where the accounting treatment of options was regularized. It's now like stock. You have to expense any of these instruments -- stock options, whatever. But we still have some regulations that result in an unlevel playing field. So, for instance, suppose one of your clients wants to give an index stock option, a stock option where the strike price moves with the performance of the market. These have been touted for years. You still can't do that under the tax rules. I think 409A would make that basically impermissible. So, there are some regulations that need to be corrected so we have a level playing field. I think it should be a big tent in terms of which instrument you use, and we don't want distortions there.

How about vesting periods, holding periods? There has been a lot of talk recently about requiring mandatory rules. I mean, what firms do amongst themselves I'm happy with, but there have been suggestions for mandatory rules requiring firms to require their executives to hold stock or options until retirement or beyond. I'm very skeptical of this kind of legislation. I think that firms would either stop using equity -- and I don't think that's the right answer, because I do think there's an alignment benefit -- or if they forced stock on undiversified executives, the shareholders would just pay for that.

So, what I've suggested and would like to think about is a disclosure -- a measurement and a disclosure regime. Currently, you know, if you look at the executive compensation disclosure, what do we focus on? We focus on the amount of pay, and we focus on what form it takes. We don't focus much on vesting, how long the executives are required to hold that equity. So, as a, I think, very modest adjustment, I would suggest that we measure and disclose the average holding period of that pay package the executive just got. Maybe it's a mix of stock and options with different vesting periods and some cash and some perks. Well, it's a pretty simple matter, I think, to come up with a metric there, and that would be useful. The shareholders and boards could compare our window for our executive compared to other executives.

Okay, I'll stop there and look forward to discussing these other topics.

MS. JACOBS: Great.

So, my favorite thing about being the moderator is that I get to ask all the millions of questions that I have. I have a lot of them, but I want to leave plenty of time for you all to ask questions, too, so I will ask a few to get you guys started, and then we'll open it up to questions from you all.

So, David touched on this, but I think the short-termism issue is kind of at the heart of what motivated us to pull you all here together today. I'm just really thinking about how existing practices -- do existing practices encourage short-termism? If so, is that a problem, and are there practices we could put in place that would incentivize more of the long-term view? And I guess, also, why a long-term view -- if you're in support of the idea of incentivizing a long-term view, why that's actually kind of a beneficial way for companies to be thinking. So, I'll let you -- whoever wants to take a stab at that, this is open to all of you, and I hope you'll all jump in.

MS. GREGORY: I struggle with this one, because it may be that stock does impose some short-term pressures, even with holding periods. But there are so many other short-term pressures that I'm not sure fixing that removes the problem. I mean, I think the bigger problem around the short-term pressures on executives and on boards are around the expectations from the marketplace and the expectations of shareholders and how the success of the company is judged on a daily basis based on where that stock price is. And that's not going to go away, and I'm not sure that -- I'm not convinced that it's the stock ownership of executives that makes the short-term pressure undue as opposed to market forces.

MR. DELVES: I've been thinking about this, and first of all there's -- I run my own business, and I suffer from short-termism constantly. It's very hard to focus on the long term when you're dealing with the day-to-day issues of running a business. And it's, you know, always why we've put long-term incentives in place -- is to try to counter that natural human tendency to only focus on what's right in front of us.

You know, certainly when we tried to get the expense for stock options put in, you know, part of the motivation for that is we thought we'll -- you know, we'll see more financial performance-based, long-term incentives -- more incentives that are based on three-year, four-year financial performance goals that are actually tied to the strategy of the company. We've definitely seen that. We definitely are seeing that more when we have also seen more stockholding requirements on the part of executives.

But, you know, these things always have two sides to them, so -- you know, and David, I think to your point, now I think in some ways we don't have enough stock options in the mix. You know, I see -- you know, outside of the financial sector I see most companies not taking enough risk. I see them sitting on a lot of cash, and there's a lot of cash on the sidelines right now. I mean, you know, corporate America is not unhealthy. Profits are good, cash balances are good, balance sheets are fairly strong. But they're not spending it. They're not taking the risks that, you know, the country needs right now, and so I think that, you know, we've almost come too far in the other direction toward being, you know, far too conservative in our compensation programs. Whether that's short-termism or just conservatism I'm not sure.

MS. BLOXHAM: I don't think it's either. I think, back to this December working paper or staff report from the Federal Reserve, what they found was this use of stock, which acts -- you know, if you've got a three- to five-year vesting period, that's like an option to the executives. Stock and stock options are what creates this pro-cyclical kind of environment. So, right when you need them to invest, they're not going to invest, and when you need them to back away they're not going to back away, and that's what created the financial crisis, and that's what's creating it. And the fact of the matter is that paying them in equity creates a situation where you've got two sets of performance measures: whatever you rewarded them for initially, and then they're going to be looking at the stock price in terms of what's that ultimately going to, you know, pan out and be worth it to them in the future. And so I think we create a distraction away from what we need executives to do and focus on over the long term.

And as you know, Don, I put in a bonus deferral program at an organization, and I think those mechanisms can work well, but it was only three years, and I would think that at this point when we look at, for example, financial institutions and we look at the time horizon for actually seeing the results, that was probably too short a time period in terms of, you know, payouts and holding back.

You know, there's this whole other issue about claw backs, you know, and are people really held accountable for what goes wrong, or is it only on the upside? And I think that it's -- I think bonus deferrals work in a better way to make a pay and performance come into line if you have created the right kind of mechanisms.

And to your point, Holly, you know, I think the issue around what the marketplace looks like and what shareholders look like -- you know, Jeff Vogle recently, you know, said to me 99.2 percent of the market is all about trading speculation today. And so when you have a market like that, you have to define, from a corporate governance standpoint, what the rule of the board is properly. And the rule of the board has to be to look to the long-term view. You know, CEOs are not in place for years and years and years like they used to be, so you have to go almost extra overboard, and you also have to think beyond shareholders. You really need a model that considers all stakeholders, and, you know, one of the things I talk about in my book is valuation from another perspective. And, you know, folks have recognized this now; it's not just me talking about valuation. But it's looking at not only what kind of value our stakeholders are creating for us, which many companies do, but if you're going to talk about long-term and sustainability, then you want to be thinking about what kind of value am I creating for my various stakeholders. And that is what is going to create those long-term measures. And Tama Copeman, who is a director in a private company, has been thinking about these issues, and, you know, one of the things she says is that what boards do not focus on in terms of executive pay are those kinds of issues that are really going to make the long-term difference in really connecting pay up with those kinds of things -- innovations, that sort of thing.

MR. WALKER: So, as I mentioned before, the more I think about short-termism, I think that, you know, as I said, the risk element is very important, and if you're -- once you've taken care of the risk element, if you have, then you're left with things, I think, like focusing on current earnings. And I, frankly, agree with Holly on that, but I'm not sure there's anything -- I'm not sure pay matters that much when it comes to that.

Now, the idea that -- I just have to disagree. The idea that holding stock that vests in three years is the same as an option -- I just don't agree with that. I think that options -- the nature of the option, the asymmetric payoff: You get the great benefit if it goes up, there's no cost -- it's an option. It's a different kettle of fish. And I think it creates different incentives than does stockholding.

MS. BLOXHAM: Well, you know, I had this intuition that stocks were creating issues and problems. But sincerely I recommend to you this staff report where I think they did a lot of extensive modeling, and I think it really -- it's the kind of thing that -- I don't know, you know, at the beginning of the last decade there were only a few people that said stock options were a problem, and I think we're going to find out that it does create these same kinds of issues. But I think there's also this issue of distraction. I know you're very concerned about behavior, and I think that it creates a distraction.

MR. WALKER: I want to speak just for a second. You know, when a company is a hundred percent stock options and, you know, tech companies, startups --

they're still a hundred percent stock options -- in that environment, there is a very intense urgency of what do we need to do right now? And, you know, I guess that's short-termism. That's not necessarily bad.

MR. DELVES: Right.

MR. WALKER: There's an urgency and a drive and a focus in a company that's a hundred percent stock options, all right? That said, a company that's, you know, the other way around tends to -- you know, it does tend to have a longer-term view, and the board does tend to, you know, balance things out more. You know, so -- I mean, in my point of view, yes, you know, the incentive program does reflect and it does influence, you know, short-term view versus long-term view, you know, but whether it's a short-term view or a long-term view is not necessarily good or bad. Each company is going to be a little bit different in terms of how it focuses.

You know, I don't want, you know, Chevron to have a short-term view. But on the other hand, I want a tech company -- they have a very short-term view. I mean, a startup.

MS. BLOXHAM: I'd like to come back to one of the comments you made in terms of workers and also this issue of compensation and risk. You know, before the financial crisis hit when we all got to write our comment letters on the new compensation discussion and analysis, I wrote in and I said we really need to have disclosure around compensation and risk. And after the financial crisis, this was implemented. But it's been implemented in such a way as it's started in a small way to get boards of directors, and Holly pointed out how important disclosure is and some of these rules are to ask the right questions. That's the reason to advocate for some of these things. And I think that what happened with the rule as it went forward is that it did not force asking enough of that question at a deep enough level in terms of the disclosure. And I think that boards could do a better job in terms of workers: What's the risks of our compensation programs overall? And what are the risks in terms of what risks they might take on but also this broader risk, this issue that you were talking about in terms of worker pay and CEO pay and morale issue and what you do about those issues?

MS. JACOBS: So, all of you have touched on this a little bit, but I thought I'd put it out there more explicitly to talk about what the role of governments -- I sit in governance studies, this is kind of the obvious question to come from me, so what the role of government, both legislation and regulation, currently is and what direction it should be taking in terms of actually incentivizing the practices that you all see as the right ones?

MS. GREGORY: You know, I think in the governance field in compensation we've approached it through two means: There are sort of the tax rules, and then there are the disclosure rules. And I think disclosure rules have been pretty effective. But I think that they take time to bear fruit. And so I comment this -- I'd like to see some slow moving -- unfortunately, you know, when we do have scandals and crises that beget more regulation. But I would like to see sort of a breathing space. Just let the rules that we have online develop. I don't see a pressing need, as I said before, for reform. But I do think focusing on disclosure is probably a good, gentle way, because it allows a company and a board to decide what they're going to do and then explain it. You know, in Europe they talk a lot about -- they have codes of corporate governance, and you have to comply or explain. Well, we have, really, an explain model, and I think that that's a good thing.

MR. WALKER: So, I've been thinking for a long time. I've had this work in project, and it's called what's the least bad way to regulate executive packages, right? (Laughter) I think this is the hardest question out there, right? Because I know the tax rules have not been effective, and I'm very scared of direct regulation. Disclosure is great. We've done some good things with disclosure. But, frankly, you know, disclosure's only going to get you so far.

So, at this point I'm going to shift over and kind of join Eleanor against these two (laughter), because I actually think that -- you know, Don mentioned that executive pay is no longer out of control. Well, I guess that's true in the sense that it's been fairly flat over the last 10 years. The bargain has also been very flat over the last 10 years. It's been up and down, just like executive pay. So, was executive pay broken in the year 2000? Well, it is not broken today. I mean -- so, to me, that run-up in the 1990s has still resulted in pay levels being, let's say, greater than where you would hope under a well-functioning market. I'm not sure, still, that we have a well-functioning market for the -- I think boards are doing the very best job they can, but it's not their money.

MS. BLOXHAM: Are you suggesting caps?

MR. WALKER: No, I'm not. Stop. Yeah, no. I think that would be a terrible idea, right? But I'm -- but I don't -- but I'm not happy just with disclosure, because I actually do think there is some market failure. So, I think although it's not a runaway problem today, I still think pay levels today are higher than they should be, higher than they would be, like I say, in a well-functioning market.

Now, we're never going to get that market because of the whole agency problem within a corporation: Disburse shareholders, you know, board of directors. You all know the drill. So, what do we do about it?

Well, here's one idea. You can hate it, but here's one idea. How about taxing the executives a little bit more? How about -- if you think -- if you're with me that there is a market failure here and that pay levels are a little too high, how about placing a surtax on that and then giving that money back to the investors through a cut in the corporate rates? So, that's one idea. Not coercive. No caps. No mandatory caps, because I think that's a bad idea. But let's extract some of that excessive pay through a surtax and give it back to the shareholders.

MS. BLOXHAM: Can I ask a follow-up question?

MR. WALKER: Sure.

MS. BLOXHAM: So, my understanding is that with -- that the taxes that executives need to pay have been paid by the board, so they just upped the bonus, right? Or they upped the compensation? I may be revealing my ignorance on the technical details, but it seems like there's no reason why that wouldn't actually just end up inflating pay, because pay would be inflated to pay that excise tax.

MS. GREGORY: The old tax gross up.

MR. WALKER: Right. Well, we're not seeing tax gross ups any longer, right? So, that is -- of course, that is a question about whether pay levels would just go up. This probably depends on what you think actually caps pay. Now, if you think the market is working, this isn't an issue at all. If, like me, you think isn't working that great and you wonder what caps pay, I think it's probably some sort of -- it's the publicity and the outrage, and I think that unless that changes somehow when you apply this surtax, you would see the same result.

MS. GREGORY: Right.

MR. WALKER: But it's certainly a risk. And, in fact, that's one reason I'd like the surtax to go back to the shareholders, because if it did they wouldn't wind up hurting.

MS. GREGORY: I think we wouldn't see tax gross ups being called that. We may see an elevation of pay. But I do think we ought to have to be talking about the other end of the spectrum and certainly minimum wage and, you know, having more of a debate around where that should be and what the other incentives are that could be used to, you know, lift the boats.

MS. BLOXHAM: Well, that kind of gets to the issue of why did we get here? Why are we here? And why is it so hard if we believe pay is too high to bring it down? And I think it really has to do with issues of governance. I mean, it's much easier if somebody asks you for something who lives right next to you to feel what compelled to give it to them than down the street. People in the boardroom have more contact today with people who are working in the company, but that's not who they're dealing with on a regular basis.

I think the other issue comes around the governance issue of succession. If you don't have people lined up who can take over that position, you kind of have gun to your head in terms of what you're willing to pay. You know, I think the notion of these peer benchmarks and that you've got a market is false. And, you know, one of my favorite stories is when Richard Breeden was the court-appointed monitor at MCI and Mike Capellas couldn't approve hiring someone at a level unless Richard Breeden signed off. And, you know, they wanted to hire a general counsel -- this was reported in the *Wall Street Journal* -- wanted to hire a general counsel, so Mike Capellas had to call Richard Breeden on his boat and ask him, you know, can I pay this much, and Richard said no, you can't, you know, offer half that. So, the person came on board for half that. And I don't think we have zero-based negotiation right now. I don't think that there are tough negotiations, because there's this closeness and we don't have the successors in the wings. And I think succession is a big issue in terms of dealing with this issue.

MR. DELVES: I completely disagree with you except for the last thing you said. (Laughter) Succession is a problem. Corporations and boards still do a terrible job of succession planning. And, you know, the data are very clear. CEOs that get promoted from within are paid significantly less than CEOs who are hired from the outside. So, debt is -- you know, and there are some data that have come out recently saying that CEOs that are promoted from within are better and better than CEOs who are hired from the outside, which also makes sense, because they know the company better and it's less challenging.

Where I disagree with you is that, you know, I've been raising this question, you know, for many years, and it's always bothered me how much CEOs get paid. But I've been in, you know, many, many negotiations, you know, where a company is hiring a new CEO from the outside and, you know, watch the searches go on and see who the candidates are and see who is available. I mean, if you think it's not a free market, go and try to hire a CEO who's qualified to run your company and you'll see what the market is. It is what it is. So, like it or not, the rates of pay -- and the rates -- you know, they don't all get 9, $10 million. Those are -- this is the Fortune 500. There are thousands -- you know, what, 6,000 public companies and, you know, way more private companies. You know, most CEOs get paid a lot, lot less than that.

So, I do think it is actually a relatively free market. I don't think that, you know, this notion that, you know, management controls and dominates the boards is remotely true. That's -- it might have been true 10, 12, 15 years ago. It's not true today. So, I think that there is a market there.

I don't really remember what the original question was.

MR. WALKER: The role of government in --

MR. DELVES: Right, right. So, what should government do about it?

MS. BLOXHAM: Yeah.

MR. DELVES: Nothing, please. (Laughter) We've got plenty of regulation that's working its way through the system, and no caps, please, and no extra taxes.

MR. WALKER: Can I ask you a question, Don? Do you think in year 2000 the market was working fine? You talked about the big pay run-up in the 1990s.

MR. DELVES: No, I don't. I don't.

MR. WALKER: But it's working better today?

MR. DELVES: Yes.

MR. WALKER: And so although pay is flat across that time --

MR. DELVES: It's --

MR. WALKER: -- moved up and -- so, did it -- you know, did it get out of control?

MR. DELVES: Right?

MR. WALKER: Was it a market force that caused it to cause CEO pay to go up by 400 to 600 percent?

MR. DELVES: Yeah. Right.

MR. WALKER: I don't think so.

MR. DELVES: Right.

MR. WALKER: I think it got out of balance, so if pay is at the same level today, why isn't it still out of control, even though it hasn't been going up?

MR. DELVES: Go to try to hire somebody that costs money.

MR. WALKER: (Laughter) I know that's what the market is, but the whole market I think is inflated. So, of course, that's what you have to do. Of course. I understand that's what you have to pay someone.

MR. DELVES: Mm-hmm.

MR. WALKER: Right.

MR. DELVES: Right.

MR. WALKER: Believe me, that question has very much been on my mind.

MR. DELVES: I know, all of us. I know.

MR. WALKER: It's harder to go up so much.

MR. DELVES: Right.

MR. WALKER: What caused it to go up? So, apparently -- I mean, it went up that much for, I think, three reasons. You know, one was that the boards were much more dominated by management at that point in time, so that the manager, a power issue, was true. Two, is it was mostly stock options in the field and then they thought they were free.

MR. DELVES: Right.

MR. WALKER: Right? And, three, the tech companies were going crazy, you know, granting --

MR. DELVES: Yeah.

MR. WALKER: There was a fundamental shift in the value of human capital that happened in the '90s --

MR. DELVES: Uh-huh, right.

MR. WALKER: -- in the technology community and the rest of the market followed.

MR. DELVES: Followed.

MR. WALKER: Right? Are those CEOs worth more? I don't know.

And then I guess the fourth thing is the size; the average size of the company has since increased dramatically. So --

MR. DELVES: Right.

MR. WALKER: You know, there's a correlation between executive pay and corporate size.

MR. DELVES: Of course.

MS. BLOXHAM: We may say that, you know, the boards have it all under control. But one of the reasons that succession --

MR. DELVES: They don't have it under control.

MS. BLOXHAM: No, or a controlling management.

MR. DELVES: Mm-hmm.

MS. BLOXHAM: But when you look at succession, succession is an example of boards wanting to do CEO succession, wanting to do extensive management succession much more than they are, and there is a force.

MR. DELVES: No, you're right. No, that's why I say I agree with you on that, and that is, you know, whether a certain manager of power argument is, I think, true -- is that it's -- you know, it's -- the board can ask all day long for better succession planning, but if the CEO doesn't really want a successor, they'll pay lip service to it and it won't actually happen. I mean, part of the problem is that CEOs don't necessarily really want, you know, a cadre of great competitors right below them nipping at their heels.

MS. BLOXHAM: No, they don't want a market.

MR. DELVES: Right.

MS. BLOXHAM: They don't want a market situation.

MS. JACOBS: So, I suspect that you guys could argue amongst yourselves for quite some time (laughter), but I want to be sure that you have a chance to engage with the audience. So, I will take questions on this in an enthusiastic manner. Is there a mic around? So, please when you ask your question, first of all, please make it a question, and also tell us who you are and if you are affiliated with an organization or corporation. Let us know when you come on.

MR. MALLOY: Yeah. Okay. Patrick Malloy. I'm a former general counsel of the Senate Banking Committee, and I'm a trade lawyer here in Washington.

Here's what I wanted to add. A corporation is an artificial creature created by society to serve its purposes.

MS. JACOBS: Mm-hmm.

MR. MALLOY: Now, you hear the whole outsourcing debate going on in the presidential election. In the old days, corporate governance had the stakeholder theory that a corporation had responsibility towards employees, to its country, to its community -- and other obligations. Something morphed in the system, with Professor Jenson and others involved in this that moved it from the stakeholder to the shareholder theory. So, corporations are focused on shareholder value. The corporation and the CEOs tied their own compensations somehow to shareholder value.

Other countries, like China for example, have figured out that they can under-price their currency and do other things and provide incentives for our corporations to move our industrial and technological base abroad and it would help their shareholders short term. I think that's an enormous issue that's out there, and we're not discussing it in this corporate governance theory.

In Germany, for example, they put labor unions on their corporate boards to help defer some of these drives.

But I think this is an enormous issue, and if the corporations and people don't start thinking about it, they're going to have things that will be forced on them.

MS. JACOBS: Uh-huh.

MR. MALLOY: And I think we need to talk about these kinds of issues.

MS. GREGORY: I agree with you absolutely. You know, we are clearly in an era of shareholder primacy, and we need to be having a discussion about whether that's right.

There's an interesting book that Lynn Stout recently put out that talks about these issues, and it is debated, and it's been debated throughout time. But there's no data. When you look at Dodd-Frank, I mean, Sarbanes-Oxley -- sort of the underlying theme of those regulations was: Let's make sure we've positioned boards to hold management accountable. Dodd-Frank was about positioning shareholders to hold boards accountable. And we probably need to think about whether shareholder primacy is the right value.

MS. BLOXHAM: And so that is in fact why when I look at valuation, I look at it from a stakeholder perspective, and ultimately I think that is the way in which boards need to look at it. So, I raise this question quite often with directors who sit on boards, and many of them are still in the mindset, as you say, of shareholders, but they're recognizing the problems with that, recognizing the issue that just shareholder primacy is not going to allow them to achieve. So, it's a divided front. It doesn't get much conversation. But, you're absolutely right, it's central.

MS. GREGORY: And, if I may, it's also the issue of which shareholders. I mean, the point was made that there's an awful lot of very short-term trading. And are those the shareholders we're talking about, the share traders? Or are we talking about shareholders in some theoretical long term?

MR. WALKER: The hedge fund --

MR. DELVES: What?

MR. WALKER: So, I share your concern, but I come back to the question of: Is anything that we're going to do about it going to make things better or worse? So, I think back to the hostile takeover wave and back when the CEO of a target company would resist a takeover on the basis of the stakeholders, right? And I never bought those stories, right? I mean -- but they were allowed to use that as a reason not to provide their shareholders with a 50 percent premium. Now, you know, I don't know whether the takeovers are good or bad systematically and for the economy. I tend to think there should be a very active market. And so I guess my concern is aggression, but my -- but the point is that if once you tell managers that they should be responsible not just to their shareholders, but to their stakeholders, does it wind up benefiting the stakeholders or does it just take the pressure off the managers. That's always been a concern, I think, amongst the corporate governance crowd.

MS. BLOXHAM: And that is the job of the board, to answer that question effectively.

MR. WALKER: Right.

MR. DELVES: I'm very much with you on this. I think -- let me take the other side first, you know, all this focus on shareholder value. The positives of that have -- then there's an accountability to, you know, a stock price that, you know, that's important and that I think, you know, adds greater accountability than we had before this in our shareholder primacy. This say-on-pay vote, you know, clearly gives much more influence to the shareholder. And I think it's had some real positive results.

That said, you know -- well, I got to interview Paul Volcker several times for a publication, and the first time I interviewed him he got pretty mad at me and he said you know, the stock -- he said 'I don't understand why you guys focus so much on stock price'. He said 'the stock market exists as a source of capital -- period, end of story -- and over the last 120 years it's not been used as a source of capital; it's been used on balance as -- you know, there's more -- it's gone more the other way. You know, there's been less capital raised than sold back. So, if that's case, why are, you know, corporations so darn focused on day-to-day, moment-to-moment stock price changes'. And he said it's because of 'you' -- he pointed at me with this big, long finger, and he said because you guys, you know, gave them all too many stock options, and it's because you, you executive compensation consultants -- and I'm also a University of Chicago MBA, so I'm even worse -- and that you guys told them that's what it's all about -- and he said you said the purpose of a corporation is to maximize shareholder value. He said that is wrong. He said that -- you know, he said I'm an economist, the purpose of a corporation is to produce goods and services that serve society period, and that's what you should be paying people for.

You know, point taken, I don't let a guy like Paul Volcker yell at me and not take it seriously. I don't know what the answer is, but, you know, to Eleanor's point, I think part of our job is to start paying executives more for serving all the constituents, including employees. And, you know, your German example is a great one. I don't have time to go into it, but they certainly pay a lot more attention in Germany to the quality of their workforce than we do here.

MS. JACOBS: Thank you.

Yes, all the way down in front.

MR. DAVIS: Thanks. Tom Davis. I'm a corporate vice president with General Dynamics, so, first of all, a great panel. I really learned a lot, and I appreciate all your perspectives. I'm not going to let you off the Paul Volcker hook here for a second.

Back in January 2009, I believe, my brother gave me a call and he said my goodness, how did you guys at General Dynamics do through all this? And I said well, we had record revenue; we had record earnings; we had the highest margin in history; our stock price went down 50 percent --- so you tell me.

Both of you made the comments here about the factors that drive the stock prices these days, and I think what I'd have to say is I've come more and more to the conclusion over the course of time that there are so many of them that are completely external to anything management might do, can do, be it short term or be it long term.

I was just looking at some data yesterday. In fact, if you go back to the August 2011 period, you could see a massive drop in stock prices across the board, all driven by the Euro Zone, driven by the political uncertainty about what eventually became the Budget Control Act. So, I've got to tell you, you know, you can go look. I'm not in the top five in the proxy statement. That's fortunate from my view, unfortunate from my wife's. (Laughter)

The question I kind of have I think, Don, is going back to your discussion there. You know, I kind of the view that -- and as I listen to the dialogue going back and forth, you know, there's an awful lot of -- the discussion is dominated by restricted stock, by stock options, by vesting periods and so forth, but maybe with the stock market being what it is right now and how it functions, you know, maybe we need to start thinking about something that just doesn't have much to do with stock --

MS. BLOXHAM: Yes.

MR. DAVIS: -- because I am rather convinced over the experience of the last four years that there is just very little that a company -- at least a company like mine -- can really do that's going to drive that in a significant way. So, what are the thoughts about other ways to maybe incentivize companies that are outside -- in management just outside of stock?

MR. DELVES: Well, I'll give a two-part answer to this, and this really goes to Eleanor's area of expertise.

If we go back 20 years, I mean before the whole stock option explosion, we're spending an enormous amount of time trying to answer exactly that question. And we -- you know, that's when EVA came into existence, although that was, you know, just a packaging of stuff we already, you know, had known. And we developed a whole science around, you know, how to really measure the true drivers of value and performance in an enterprise so that we can sort of detach ourselves from the, you know, day to day stock price and focus on producing consistent returns that are in excess of the cost of capital that we know generate value.

We're starting to see some return to that, these long-term plans, you know, the restrictive stock plans that's best based on performance. We're starting to see more of those based on, you know, the drivers of value -- return on invested capital, cash flow, those sorts of things -- whether it's EVA or the components of value. So, I think that's, you know, a very promising sign, and I think that's really -- I want Eleanor to speak to that, because it's really her expertise.

The second thing is to try to focus more on sort of some of the underlying factors that even drive those results.

MS. BLOXHAM: Yes.

MR. DELVES: We just put a plan in place. It's just being disclosed now at DeVry. DeVry is a for-profit education company. For-profit education comes under a lot of, you know, regulatory pressure right now. And we put a long-term incentive plan in place. We're calling it a mission-based, long-term incentive plan. It's based on student outcomes. It's based on graduation rates, test score rates. And the people in the company -- not the top executives, but the people in the company -- are thrilled, because they say you're finally measuring what we care about. You're measuring what we do and what we care about and what we actually feel will make the biggest difference long term in the success of the company, because if we can do a better job of educating our students, everything else should work out.

So, you know, that's another direction -- is to try to start to pay for the things that actually really do drive long-term performance.

MS. BLOXHAM: All right. I mean, that's really it. And to take out -- amen to your comments -- to take out this focus on stock price and focus it on the outcomes that people can drive and focus on those that you want them to drive. There are lots of things in the earnings statement, for example, that also are out of control of management. And I think that it's really important to get clear what you want from people and to drive performance that way. And you can use a bonus deferral mechanism, even in a cash-based plan, to extend the time horizon so that you get to see whether or not in fact those outcomes really occurred.

And so I think what you're talking about is exactly also what I experience when I put in a value-based plan in the mid-'90s -- is that all of a sudden, managers were saying wow, you know, this is really how we operate. It makes sense. It causes us to start to think about not doing the uneconomic things that we were doing before because we were trying to drive a number that doesn't make sense. And when it does, actually, going through the process -- and you may have found this when you did this with DeVry -- is it really gets people centered on what's really core and important in driving the business. So, it can be done. And it is the way to drive things longer term, and then you keep looking at it to make sure that you have those kinds of things so that you're not dealing with people trying to manipulate a number but, rather, this it is really our job, and this is what we're going after.

MR. WALKER: You know, I don't think there's anything at all wrong with what those guys are saying, but when I think about -- if I'm buying your company, I'm not buying your shares because of a play on the market. I'm not buying your shares -- I mean, I know your price is going to move with the market. I'm probably buying your shares, because I think you're going to outperform your competitors. So, it's one thing to say I know your shares are going to move with the market, but did your share price reduction -- did your drop in share price reflect your performance relative to your peers? So, where I'm going is back to the idea of index stock options. We shouldn't be paying executives based on movements of the stock market. They have no control over that. We should be paying them based on movements relative to their competitors. And I don't think that these are actually on the table at the moment, these index options. But to me, that would -- you know, that's the kind of thing that I want to put back on the table, because it seems like, to me, that's a much more rational way to pay.

MS. BLOXHAM: And I think the basis of trying to pay people based on a stock price assumes that the stock price incorporates all the information and that it's related to outcomes that managers can drive, and I just don't -- I don't buy that. I agree with you. I don't think that's the case.

MR. DELVES: Well, I'll tell you personally if I look in the morning and our stock is up, I feel fortunate to have my building. (Laughter)

I think, going to your point, Dave, you know, that should be the way it's functioning, because I just have so little control.

MR. WALKER: Right, right.

MS. JACOBS: I think we have time for one more question, so that hand all the way in the back row first.

MR. DURKIN: Yeah, Ed Durkin with the United Brotherhood of Carpenters Pension Funds.

A question. (Inaudible) comp instead of getting wrapped in the governance of kind of multi-stakeholder. If we're going to have a compensation plan that works to -- what I think you all agreed to was that we have to be more responsible to a broader range of company constituents. We have to have a comp plan that reflects that. How are we going to get there when we have a board?

Holly, the first thing they're thinking about is what ISS thinks about. When you have to come up with metrics that don't lend themselves to some regurgitation by some shareholder who's trying to vote 5,000 different -- we've got a system here, so -- but, again, you all were applauding, *say-on-pay*. But it's not a system -- it's a system that's going to kind of ratify or codify this system we have now. Again, even before we talk about the governance aspects, the legal aspects of multi-stakeholder and, you know, shareholder primacy and so forth. But just on the comp piece, it's broken.

To your point, I think what happened is we have embedded costs that rose in the '90s and we've embedded them, because the opportunity for each executive is some median of what everybody made last year. So, we've embedded the stock market rise of the '90s into today's executive comp.

So, where are we going? If *say-on-pay* -- if somebody -- if you think that's an answer to getting to more intelligent compensation, you know, I would challenge that, and I'd like to hear -- if we're going to get, Eleanor, to that point where we have comp plans that reflect this multi-stakeholder aspect, how are we going to get there from where we're at right now, because shareholders aren't supporting it. Shareholders have bought into this kind of thing.

' MS. BLOXHAM: I know.

MR. DURKIN: Directors are scared.

MS. BLOXHAM: That's right.

MR. DURKIN: Where are we going to go?

MS. GREGORY: I am concerned about *say-on-pay*. I don't think it's the best thing. I don't' think it's as dire as we worried, and I don't think it's as beneficial as the people who are doubting it. And you do have this real, sort of unintended force out there that comes about because of the heavy reliance on proxy advisors. I don't know how you unwind that. But I do think we should be having a discussion about those influences.

MS. BLOXHAM: I think the way it happens is the managers at General Dynamics sit down with you, and you start to have a real intelligent conversation, and it's not a conversation about tweeking this or that. It's about the substance of what's going on. And you start to build plans like the DeVry plan, and you work on that together, long-term shareholders who care about these issues, and I think that long-term shareholders can influence this process and have to be willing to say you know what, we thought this equity was a good way to go. We thought it would create alignment. Okay, it didn't work. Let's really talk about how we're going to align things.

MR. DELVES: I don't have a better answer, but I do want to acknowledge that Ed Durkin in the Carpenter's Union has been more willing to sit down with management and talk about these things than, you know, most shareholder groups and has led the way on that.

MS. BLOXHAM: And that's where it has to start. It has to start with the folks who are interested and who are willing to have those conversations -- just like this conversation today.

MR. WALKER: So, just for the record, I don't think I talked about *say-on-pay*. I'm not a big fan of *say-on-pay*. I mean, I think that all *say-on-pay* can do is kind of lop off the outliers, and I don't think it can do anything fundamental.

MS. JACOBS: So, I want to thank you all for coming. In particular I want to thank our panelists. This was great. I leave feeling, actually, much more optimistic about the potential for some creative, interesting solutions than I started, which is always how I like to be. So, I thank you for that, and I thank you all for coming.

MR. WALKER: Thank you.

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