

# **Balancing Act: Short Term Pressures vs. Sustainable Compensation Programs.**

The Conference Board  
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**William Keiper**  
**FirstGlobal Partners LLC**  
**[www.firstglobalpartners.com](http://www.firstglobalpartners.com)**

# Balancing Short-Termism & LT Comp

- As a key executive or independent consultant addressing the challenge of bringing your comp committee as close as possible to the market reality of attracting and keeping top talent in your company—in a marketplace that is more fluid, perhaps, than ever before...how do you balance short-term pressures with a measured, longer-term approach to your comp programs and practices?

# The Conference Board Keynote Speaker

- “My perspective has been shaped by having been a board chairman, lead director and member of 6 US public company boards. I have served as chairman and member of all standing board committees including 5 compensation committees.
- As a trusted advisor, I have represented the interests of active investors, shareholders, owners and management; and I have myself been CEO/President of 4 US public companies....
- My name is William Keiper, and my company is FirstGlobal Partners LLC.”

[www.firstglobalpartners.com](http://www.firstglobalpartners.com)

# Three Points

I offer three concepts that I believe can make a difference in your perspective and success in compensation practice...

1. Understanding the place of “short-termism” in play today;
2. Actively reaching out to key shareholders for their views about comp and related issues; and
3. Leading your compensation committee more actively.

# 1. Short-Term Pressures

# Short-Termism

- Do you believe that board governance and compensation practice should change; when long-term, buy-and-hold *investors*, are replaced by short-term, “buy-and fly-by,” *traders*?
- You had better start considering the implications, because *it has already happened*.
- The capital markets today are high velocity electronic trading-based markets.

# High Churn Rate in Equities

- The average time that investors hold shares traded on the NYSE has dropped from 4 -5 years in 1980 to ~2.5 to 4 *months* today.
- Translation: On average, your shareholder base could turn over 3 times in the next 12 months.
- Not all shareholders, but the rate of equity churn today is far greater than most realize.
- What is the segmentation of your shareholder base?

# Stock Holding Periods At All Time Low

Average holding period for a stock on the NYSE (years)



Source SG Global Strategy Research

# High Frequency Trading

- Of the trades that got those “investors” into and out of an ownership interest in your company, over 70% of the trades were initiated by software programs executing complex algorithms in high frequency trading.

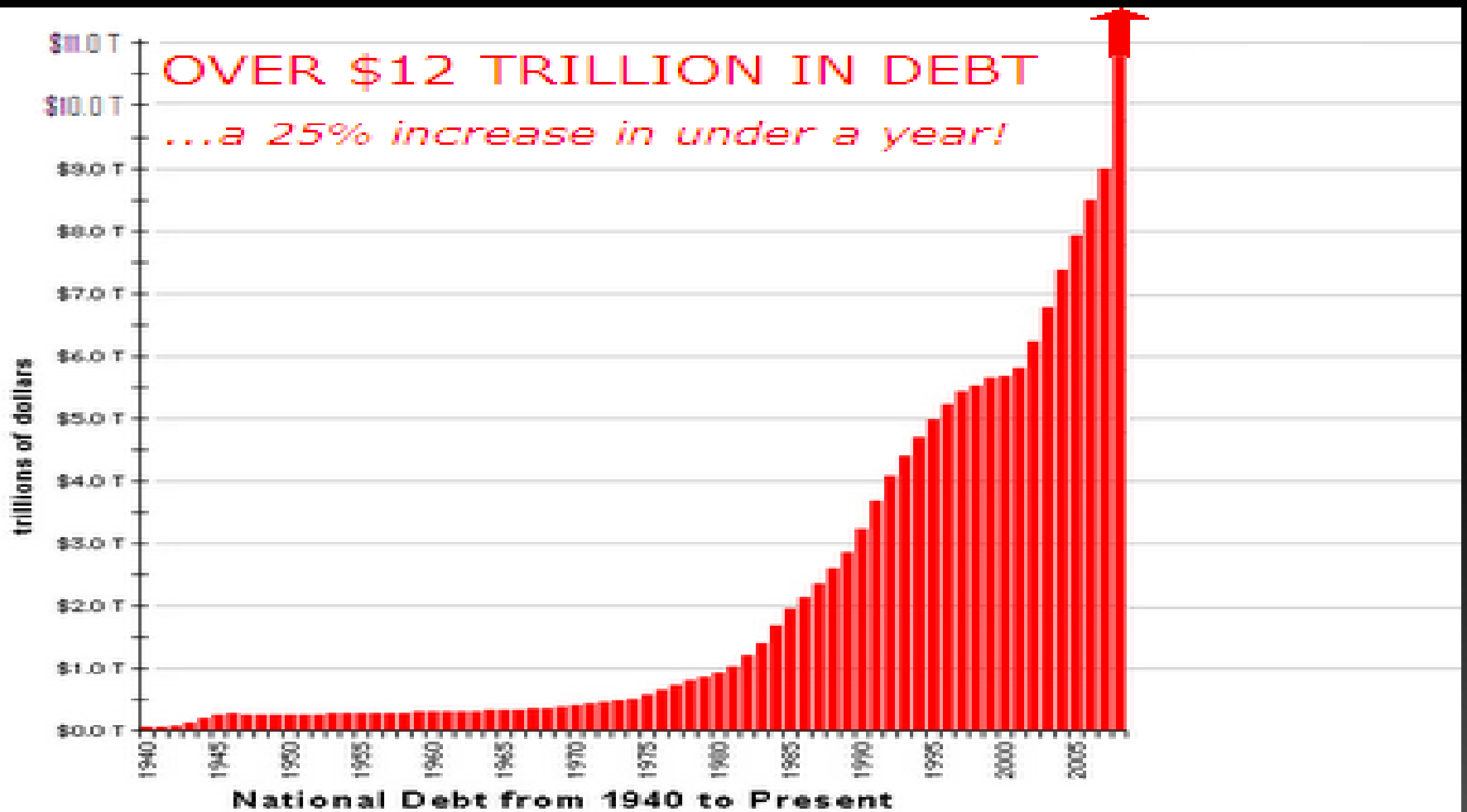
## Shares Bought Using Margin

- For the payment for those trades, it is quite likely that the stock was bought on margin (a form of debt for purchasing shares). Margin debt is at a historical high—now topping the record levels of the Internet bubble.

# Record Margin Borrowing

- Feb. 20, 2011 (Bloomberg) -- The amount of money borrowed from brokerages that do business on the New York Stock Exchange to buy stock reached a record \$285.6 billion last month, topping the prior high set at the peak of the so-called Internet bubble.

# Margin Debt Symptomatic of U.S. Debt (now \$14+ TRILLION)



Source: U.S. National Debt Clock  
[http://www.brillig.com/debt\\_clock/](http://www.brillig.com/debt_clock/)

# ...and the Dollar is Worth Less Today



# Where is the Sanity?

- You would expect that since the Great Recession isn't even totally in the rear view mirror, that financial constraint and conservatism would rule investor thinking...
- It is difficult to equate any of the facts just recited with such concepts.
- The activity resembles 'market as casino' with some gamblers still out there still believing they can break the bank on the next roll.

# Flash Trading

- You may be saying---"Yes, but these factors really don't apply to my company...it is large and profitable and not subject to those short term factors...OH REALLY?
- What about the faster form of high speed trading known as 'flash trading'?
- It is legally permissible front-running of the market by certain traders who get milliseconds of advantage over all others---offered in the service of market liquidity.

# The 2010 Flash Crash Affected the Entire Market

- On May 6, 2010, a single algorithmic-based trade valued at \$4.1B caused the Dow to drop more than 700 points over just a few minutes...as the SEC said, "...exposing flaws in the systems of high speed trading".

# Flash Trading is Still a Risk

- A year later (the SEC weighed in on trading limits to avert extreme volatility. It says it will *consider* limits on the amount by which a stock's price can move in any **five-minute period** (a limit-up, limit-down rule).
- I understand the absence of regulation for this---it is exceedingly complex...and this is one place where the exception driving rulemaking is very tough for anyone to get their arms around.

# Serve the Buy-and-Hold Shareholders

- All shareholders are **not** created equal. The millisecond and slightly longer short-term traders do not give much weight to strategy, executives or employees.
- As a compensation professional, is it even possible to serve a “shareholder” who owns a stake in your company for a few milliseconds, or even for today’s estimated average equity holding period of ~2.8 months?

# You Already Serve the Traders

- My view is that you cannot serve these *miniscule-term holders* more than you already are...
- You are providing an enterprise with a strategy, a board and management team and employees and capital; and creativity and innovation;—without which—there would be nothing underpinning the capital market system it is their purpose in life to exploit.
- Be aware of their influence; but you have to put them at the back of the line as it relates to compensation program influence.

# CEO Turnover

- The CEO turnover rate in large companies is something between 14 and 16% or so.
- In fact, according to a survey sponsored by Chief Executive magazine, 40% of new CEOs are gone within 18 months, and 64% fail to achieve the objectives for which they were hired.
- This is another key indicator of the short-term pressures exerted on all parts of management and governance.

# Short Termism is a Factor— not THE Factor.

- These are some of the very real aspects of short-termism underpinning capital markets today.
- How do address your “*responsibilities*” as a compensation executive or advisor in this kind of high speed, high stakes, short-term focused environment?
- These factors are, a highly relevant consideration in your comp planning and practice...but *not the primary factor*—*simply* deserving of your awareness and attention.

## **2. Talk With Shareholders**

# Talk with Shareholders

- Your compensation program development and management must include an in-depth understanding of your company's shareholder base.
- Understand, plan to engage, engage, integrate feedback.
- In other words, talk with your key shareholders and gain their candid insights.

# Shareholder Activism & Engagement

- A first-of-its-kind study, The State of Engagement between U.S. Corporations and Shareholders, was recently published. It was conducted last year by Institutional Shareholder Services (ISS) for the Investor Responsibility Research Center Institute.
- The principal conclusion is that engagement between issuers and investors is more and more common, is increasing in frequency and covers more subject areas than ever before.
- And the issue at the forefront, is compensation.

# Record Level Of Equity Churn

- The irony is that this increase in shareholder engagement with boards coincides with the all-time high in the rate of investor equity churn.
- So, the longer holding shareholders are getting more vocal in getting their thoughts across to management and the board of directors.

# Start by Making Contact

- A *starting point* for changing the current shareholder dynamic is proactive, unfiltered communication with key investors.
- Shareholder conversation not only serves the interest of high performance governance and management, but also the common interest of company value creation.
- I believe this represents excellent investor relations practice as well as forward-thinking compensation practice.

# Segment the Shareholder Base

- Today—being a responsible part of the compensation brain trust for a company, means being conversant with the who, what, where and why of your shareholder base....
- You must include the rise in the willingness of shareholders to make their opinions known—very directly--in your thinking about comp policy and programs and in your interaction with your CEO and the Comp Committee.
- Better yet, how about really understanding who they are, and then talking with them?

# Know Your Shareholder Base

- Understand the shareholder base at large; understand turnover; who is in, who is out, how long are they holding...trends...etc.
- You can start by knowing your key shareholders--- learn their profiles...there is a lot of information at your fingertips.
- Who are they, what is their investing strategy, what other companies do they have an interest in...do they have an activist track record, what % of their portfolio do your shares represent...who speaks for them; what are their interests and priorities.

# Activist Target?

- As a part of this process, take the time to objectively identify the issues that make your company a target—specifically, those issues relating to executive pay, incentives, comp practices, succession, turnover, etc.
- Are there other current issues or attributes that might make the company an activist target...?

# Listen to Shareholders

- There is a strong case to be made that every company can be more effective by listening firsthand to shareholder perspectives on at least selected issues.
- Consider the value of hearing firsthand and on purpose, shareholder opinions about compensation planning and structure, LT incentives and CEO assessment and succession.

# Ground Rules Are Mandatory

- Due to public company regulatory and disclosure requirements, professional legal and financial advisors will almost without thinking urge you to keep your distance from shareholders. You obviously must be carefully guided in how to participate in such communication without creating potential liability for the company.
- But most rational investors will completely understand that specific ground rules for this kind of constructive engagement must be established in advance and adhered to during discussions.
- Getting over the hurdles can lead to important inputs...

## Discomfort is OK

- Even if the process of talking with shareholders is somewhat uncomfortable, objective inputs are crucial to functional and professional representation of shareholder points of view in your compensation practice...

# Feedback Drives Improvement

- I have experienced firsthand the value and the challenge of open dialogue with shareholders, even when it is uncomfortable. Intel refers to these types of communications as “constructive confrontation”.
- If managed correctly and with purpose and care, these kinds of interactions can add perspective and fuel to the creation of improved business value for all stakeholders.

## Shareholders Should Weigh In

- Wouldn't you agree that failing to actively engage and 'hear' shareholders is completely at odds with having assumed responsibility for investors' capital--with a mutual expectation of risk-adjusted returns...?

### **3. Change the Game with the Compensation Committee**

# Executive Compensation Leadership

- As the responsible management executive or independent professional advisor, you certainly must assure that executive management and the comp committee is seeing and supporting comp programs that address “current” industry, sector, market and company requirements—and the short-term mentality that is a part of the landscape.
- But the longer-term is where your principal focus must be...even as you KNOW that your approach will have to be adjusted along the way...
- How can you make sure the comp committee is on the same page?

# Coaching the Comp Committee

- You are not in charge of the governance game—but you still have to play....So, what do you do? What play do you run?
- You provide leadership to educate your board on the reality of your shareholder base, the need to select and get to know key shareholders, and to stay the course of long-term thinking...

# CEO Backing

- It is crucial to be on the same page with your CEO.
- All CEOs feel the pressures for quarterly results—but may not understand all of the factors *underlying* that pressure.
- You can make it real with the facts about declining holding periods, margin debt, HFT and flash trading, and the need for continuous, in depth monitoring of and dialogue with key shareholders as a part of the process.

# Create the Strategy to Improve Comp Practices

- Agree with your CEO on a strategy to educate and involve the comp committee. I assure you that most committee members --even the good ones, who take the time to study and learn-- will likely not understand or appreciate the issues underlying short-termism; and will not understand the shareholder base in depth; and will be surprised at the level of turnover in your company shareholder base.
- Providing this information to the committee—with the support of your CEO, is a great first step in engaging the comp committee at a different level.

# Long Term Perspective

- When all is said and done, the relationship between investors and boards is one of owners dealing with other owners. Consequently, board governance should reflect a long-term ownership mentality.
- Without your proactive and on-purpose leadership and insights, the comp committee has little chance of being in alignment with your longer-term thinking about comp programs as a part of strategy.

# Change the Game with the Board

- When you are able to change the way you interact with the comp committee; the requisite shift *will already be in motion*.
- Help them understand the reality of short-termism in the capital markets; and help them engage in dialogue with shareholders.
- You will have proactively placed yourself in the position of owning the problem, *and* helping create a thoughtful solution, armed with the facts.

# Serve Long Term Shareholders

- I believe that the stakeholders you really want to serve foremost, are those who have a long term buy-and-hold mentality; or as an employee, a long term ‘buy-in and commit’, mentality.
- These constituents *want to know* ‘there is a there, there’ with responsible humans that are driving daily with an eye toward long-term value creation.
- This simply has to be the premise for your thinking, and that of your board.
- Otherwise, compensation schemes are going to be ineffective, and will end up whipsawing your organization.

# Conclusion

- Governance was not designed for speed. In fact, corporate governance is badly trailing the revolution in capital markets that has already occurred.
- My parting thought, is to suggest you seek to understand short-termism; and the profile of your entire shareholder base. Work more closely with your compensation committee.
- Spend as little time as possible on the shareholders that are represented by high speed algorithmic software programs.
- Frankly they can't hear you anyway!

**William Keiper**  
**Founder and Chairman**  
**FirstGlobal Partners LLC**

[will@firstglobalpartners.com](mailto:will@firstglobalpartners.com)

[www.firstglobalpartners.com](http://www.firstglobalpartners.com)

602 300-1162