STORM & COMPANY

Balancing Tough Choices

*Tips from one of Silicon Valley's top boutique executive search firms.**

**Eighty-eight percent of all respondents commented that Storm & Company exceeded their expectations when contrasting the firm to other known search firms.*

Executive MOTIVATION

French writer Alexis Charles Henri Clerel de Tocqueville, a student of American democracy, became enamored with the American character in the 1830s. He understood that Americans had not changed in 200 years, and they didn't change in the subsequent 150 years. He also observed that Americans were always on the move, searching for greater freedom, greater wealth, and greater happiness. In America, he noted, whoever gets the most money wins the highest status. So each person tries to distinguish himself/herself by competing for wealth — a constant passion and never-ending thrill. Business, not baseball, he said, is the great American sport.

Despite dynamic energy, passion for change, and creativity, deTocqueville observed, Americans are motivated not by fulfillment of work, family, or religion; they are fueled by self-interest and personal enrichment. They want quick fixes and lack a long-term vision. Every problem is treated as a separate event, not part of a larger plan.

"What is to be feared is not so much the immorality of the great, as the fact that immorality *may lead* to greatness."[1] And indeed it has.

Business Habits

Today some executives pursue wealth to tragic ends in courtrooms—capturing global headlines. But the inequity practice has a history since 1940; it's hardly new.

A Booz Allen Hamilton study revealed that approximately 35 percent of the CEOs who left a U.S. company last year were forced out. That percentage is up from 12 percent in 1995. Also last year, one in seven of the world's largest companies made a change in leadership—up from one in 11 in 1995.

This year the computer industry logged 98 CEO departures—the second highest number of departures of five industries examined.[2] (Only healthcare topped tech at 153 CEO departures.)

Why is this happening? How did CEO compensation become one of the hottest issues of Boards and shareholders? Why were all these CEOs forced out? How did they fail? *Why* did they fail? Did they *know*

"She understood the business, had a good sense of what to communicate and when."

Marshall Mohr
Chief Financial Officer
Intuitive Surgical, Inc.

[1] De Tocqueville, "Democracy in America," vol. 2

[2] 2006, through August, research from Booz Allen Hamilton, SpencerStuart and Challenger, Gray and Christmas presented to the *Wall Street Journal*, Sept 16-17, 2006. Industries examined include healthcare, computers, government/non-profit, services and financial.

"One of Danelle's strengths is her ability to provide the proper image of the company to prospective candidates."

Keita Mori
Founder and
Co-Chief Executive Officer
SanBio, Inc.

"The value of Storm & Company is Danelle's very large network; she is in a good position to know who is available."

Alain Couder
President and
Chief Executive Officer
Solid Information Technologies

how they were being judged? How *could* such talented individuals fail? How did they get *hired*? Was there a compensation plan or agreement that specified measurements?

Interestingly, most American companies don't have any intentions to change their compensation plans. Only one in ten firms said it would make changes.[3]

A Process

Tim Sparks, president of Compensia, a management consulting firm that advises compensation committees and senior managers how to create appropriate compensation packages, said that a final candidate can engage the services of a very sophisticated attorney to negotiate a package; the Board is simply outmatched.

Maybe it's not the compensation *plans* that need changing.

According to Mr. Sparks, there are two challenges to the compensation issue today. Both revolve around the *process* a Board uses to discuss the issue.

1. **Market Definition** There is a great fear of having a CEO walk out the door. Many tech companies don't have succession plans, so candidates have leverage. Candidates often want the pay of competitors; but what *is* the market? What *is* the company?

2. **Lack of Independence Among Board Members** Some members have been on Board compensation committees for decades; they "rubber stamp," agree with colleagues, and remain silent.

At one time, Board members were "good 'ole boys" and politics ruled. But today more Board members are speaking up, such as Ms. Bonnie Wachtel, CEO of Wachtel & Co., an investment banking firm.

Ms. Wachtel was extremely vocal about executive compensation policy and governance matters at Integral Systems, Inc., where she was a director. "The best antidote for all corporate governance problems, including compensation, is adequate shareholder representation on Boards," she told the New York Times. "No amount of consultants' reports or peer review studies can substitute for directors who have skin in the game."

"More discussion won't drive total CEO pay levels down," noted Patrick McGurn, executive vice president of proxy advisers Institutional Shareholder Services. "It will just change the currency used."

Mr. Sparks believes in developing and following a *detailed* process that a Board strictly adheres to when recruiting CEOs. If the Board doesn't follow it, members must be prepared to resign, or be prepared to let the potential, or current, CEO go.

New Rules

In July 2006, the Securities and Exchange Commission (SEC) unanimously voted in new rules, which will become effective December 15th. These rules require most companies to publish extremely detailed information about executive pay – such as the value of club memberships and/or the value of the use of corporate jets. Additional rules that require specifics of stock-option grants are currently under consideration by the SEC; these latter rules apply to *several* of a firm's top executives, not only CEOs. Maybe rules such as these will lead committees and Boards to embrace Mr. Sparks' process approach.

As reported here, some executives think all this disclosure won't change the practice because the underlying cause is that Boards barely monitor CEOs. "Disclosure is like aspirin," Charles M. Elson, the director of the John L. Weinberg Center for Corporate Governance at the University of Delaware, told the New York Times. "It can make you feel a little better, but it can't even cure the common cold. The fact is, a Board that overpays the CEO is, in all probability, not minding the store on other issues either."

But changes should result—designed or otherwise: "When Congress passes a law, it usually works out in a way that wasn't intended," Mr. Sparks noted.

What About Small Companies?

Although rules like those the SEC imposes don't apply to private companies, the truth is that in proportion to market cap and earnings, CEO pay is

[3] Human resources consulting firm Watson Wyatt Worldwide February 2006 survey of 112 human resources executives at large public companies; seven of ten firms said they would not make any changes, and the others were unsure.

much larger at small and midsize firms—for a variety of reasons:[4]

- Smaller companies often outperform larger firms if you believe in the "s-mall effect theory,"[5] which considers three factors: the market return, companies with high book-to-market values, and small stock capitalization.
- CEOs play a more significant role at smaller firms, or
- Smaller firms are just not watched as closely as larger firms.

Compensation plans vary of course—by industry, by company size and by individual—but smaller firms are more likely to have agreements than larger firms—public or private. Boards don't often appreciate this fact.

How to Recruit Now

Do companies have to submit to candidates' demands for pay to attract talent? Will a super-star *get* results? Will a CEO only perform if he/she is a weighty shareholder and master? How do you measure the effectiveness of a CEO? *What* do you measure? What is a perquisite, and would you object to see it in print? How do you choose a CEO for the long term? What's the right thing to do for your company?

These are all very serious questions to consider when hiring a CEO or searching for Board members. They were never easily answered—and aren't any easier now with new SEC rules and the eyes of the Fourth Estate focused on them.

One safe place to turn is to an experienced recruiter.

Finding the Right Executive

Retained search consultants—especially those with long and solid track records—will, much like journalists, know their audiences, and have a network of star executives to approach for every search. After years of successful placements, consultants and executives have mutually beneficial and respectful relationships.

High caliber consultants will know which of these celebrated individuals should be contacted, and how to contact him/her. Great people always have many opportunities, and the best people are consistently, gainfully employed—if they choose.

Competition for the most talented professionals is always cut-throat, however, regardless of the business climate. But connecting with this caliber of talent requires thorough knowledge of the individuals, their values, and their career goals.

Senior executives, of course, have full, busy lives, but most appreciate being apprised of coveted employment opportunities. Conversely, they bemoan indiscriminate calls about opportunities that don't match their goals. Professional goals can range from promotions, to more cash or equity, different geography, more advanced technology, or even a change in industry.

Everyone is unique —even if executives sit in the same functional role, at the same level, in the same industry.

Capturing the attention of these capable people demands that the recruiter understand fully the value of the vacancy to be filled.

French financier Albert Frere, for example, acknowledges that "'deals' are his drugs," he told the New York Times. "It's so enriching and really amusing to succeed at a deal. It's like when little children receive gifts. For me, it's the same thing."

Marketing the search is the most important aspect. Once the value of the situation has been established, the recruiter must know the company's charter, its success in executing that charter, its technology, its marketplace, culture, its executive team, its Board. This information paints a comprehensive picture a recruiter presents to a candidate, to put him/her in the landscape. This picture is explained only to the top tier prospective candidates and presented by a trusted, eloquent communicator to entice these executives to consider the opportunity. It is a complex undertaking.

"I am very familiar with the standards in the executive search industry. I was very impressed with Danelle and her operation — it's first class!"

Casey Case
Vice President Research and Development
SanBio, Inc.

"My experience with Danelle was very positive. She is extremely professional, knowledgeable and intelligent."

Bernie Zeisig
Director
VIMAC Ventures

[4] "Pay Without Performance: The Unfulfilled Promise of Executive Compensation," by Lucian A. Bebchuk, a Harvard law school professor and Jesse M. Fried.

[5] The theory claims that smaller companies have a greater amount of growth opportunities than larger companies. Small cap companies also tend to have a more volatile business environment, and the correction of problems — such as a funding deficiency — can lead to a large price appreciation. In addition, small cap stocks tend to have lower stock prices, and these lower prices mean that price appreciations tend to be larger than those found among large cap stocks.

"The question is: Can you get four qualified candidates, choose one, and close the deal? Danelle did that and more — in a timely manner."

Gary Guthart
Chief Operating Officer
Intuitive Surgical, Inc.

An Uncommon Market

The tech market and culture are unique…as are the U.S., California, and Silicon Valley, Mr. Sparks noted. "Tech talent is mobile. There *is* more risk-taking, but it can lead to great things. We create jobs better [than other industries or countries], and the infrastructure embraces that model and supports it."

Once a candidate is selected, and compensation guidelines are being established, all concerned must be cognizant that a *win-win* on all sides is the goal. Regardless of the components—timing, size, technology—everyone involved must feel like a winner.

An Uncommon Culture

"Perseverance," deTocqueville said, "is maintained only by a distinct view of what one is fighting for."[6] So if specific guidelines and measurements aren't in place, no one really *knows* what he/she is fighting for.

The thrill in American business lies with Americans loving challenges and looking for them everywhere. To that end, deTocqueville's belief appears true: American executives never leave things the way they found them.

[6] "Democracy in America," vol. 2

Recommendations from Compensia

Implement a decision-making process that ensures regulatory compliance and provides a competitive business advantage.

Establish executive pay privileges grounded in best practice, yet customized to specific business needs.

Provide competitive pay opportunities with a proper risk/reward profile that is aligned with key business initiatives.

Tailor compensation programs to address shareholder concerns without sacrificing the ability to attract and retain high-caliber talent.

Develop an effective equity strategy that balances performance requirements, dilution concerns, accounting/cash flow impact, and competitive labor pressures.

Implement Board of Director compensation programs that recognize the Directors' fiduciary roles, increasing responsibilities and various skill-sets required to serve this function.

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