all of the new, fancy financial products and they are closely related to all of the issues this chapter will discuss.

CREDIT DEFAULT WHAT?

Ominously, we have a large number of hedge funds that are unregulated and operating outside the view of any regulation, often with high debt and substantial risk. The total value of hedge funds is estimated at up to or even over $2 trillion. But that really understates their importance. Those hedge funds are responsible for fully *one-half* of the daily trading on the New York Stock Exchange.

The financial collapse in 2008 undoubtedly had a big impact on hedge funds. Some estimate as many as one thousand of them would not survive the downturn. As this book is being written, no one yet knows how extensive the damage was to the hedge fund industry. But we do know how profitable hedge funds were leading up to the financial collapse.

Hedge funds have been deep into something called credit default swaps. *Forbes* magazine's Daniel Fisher explained them this way: "A credit swap is an insurance policy on a bond, often a junk bond. The fellow selling the swap—writing the policy, that is—collects a premium. If nothing goes wrong, he pockets the premium and looks like a financial genius. But if the bond defaults, the swap seller has to make good."

According to the International Swaps and Derivatives Association, there are over $60 trillion of these swaps floating around and no one knows whether in an economic downturn those who provide the guarantee for the swaps will ever be able to pay, because the whole scheme is held together with massive borrowing from all sorts of institutions and possibly some duct tape. The economic collapse in 2008 demonstrated how dangerous it is to have the credit default swaps out in the economy with no regulation and no transparency.

Those who knew all of these facts and were still unconcerned about the future were going to live a life of blissful ignorance. The

fact is, it all added up to serious economic trouble and we experienced the full effect of it in 2008.

Now about those hedge funds: All of us have heard the phrase "hedging your bets." In most cases that is our only acquaintance with the financial term "hedge." And hedging against the risk of loss is an important, legitimate business strategy for big and small businesses as well as family farmers. It goes on every day, and the financial markets and institutions that create the opportunities for hedging risk are a necessary business tool. And many hedge funds are responsible and necessary and provide an essential service to the world of finance.

In recent decades, however, we have read about the dramatic growth of hedge funds. It is a way for big investors to pool money, and in most cases the hedge funds operate outside of the traditional regulated financial markets. Hedge funds are generally available only to very wealthy investors, often requiring $1 million minimum investment. And they have grown large and powerful in recent years.

As I said earlier, it is estimated that hedge funds are somewhere near the $2 trillion level. That sounds like a lot of money. But mutual funds totaled about $9.2 trillion in 2008. And the stock and bond markets totaled over $40 trillion during the same period. (Their value is lower now following the collapse in late 2008.) But sheer size is not the only way to measure the impact of hedge funds. Because hedge funds are responsible for half of the daily trading on the New York Stock Exchange, *their influence far exceeds their value.* One expert called it trading on steroids. The important fact about hedge funds is that they are hyperactive in the bond market and the derivative markets.

Many hedge fund managers are looking for anomalies in the market they can exploit and turn into a profit. Some are becoming more aggressive by taking positions in big companies and pushing for business strategies that might serve the hedge fund even if it is not consistent with the public interest.

Hedge funds are deep into derivatives such as credit default

swaps. It is estimated that hedge funds account for 58 percent of trading of these derivatives. Derivatives have been around almost forever. Essentially, traders are betting on the rise or fall of markets and commodities that they do not own outright, and they are allowed to bet millions by putting only thousands on the table.

For instance, Party A may agree to sell a million Widgets on a certain date to Party B for $1 each. Keep in mind, he doesn't necessarily have a million Widgets; he's just making a promise to deliver.

If the price of Widgets has fallen to 75 cents when the contract is up, Party B loses because he is paying higher than market price. But in some circumstances, that may be acceptable. Essentially Party B has taken out a sort of insurance to "hedge" against a much greater loss. This higher price may still pencil out for his company. His expenses are just higher and his profits lower. But as long as he's making a profit, all's well.

So you can see why this process can be a useful tool. Now, if the market value of a Widget is $2 when it comes time to deliver, Party A will lose his shirt, assuming he can deliver to a smiling Party B, who, at this point, is convinced he's a financial wizard.

But if Party A cannot deliver, because he has bet more than he can cover, a nasty chain reaction can be set into place.

The Financial Policy Forum's 2002 study on derivatives helps explain the domino effect, when things go wrong with these high-risk bets:

> Taking on these greater risks raises the likelihood that an investor, even a major financial institution, suffers large losses. If they suffer large losses, then they are threatened with bankruptcy. If they go bankrupt, then the people, banks and other institutions that invested in them or lent money to them will face losses and in turn might face bankruptcy themselves. This spreading of the losses and failures gives rise to *systemic risk*, and it is an economy-wide problem that is made worse by leverage and leveraging instruments such as derivatives.

> When people suffer damages, even though they were not counterparties or did any business with a failed investor or financial institution, then individual incentives and rules of *caveat emptor* are not sufficient to protect the public good. In this case, prudent regulation is needed—not to protect fools from themselves, but to protect others from the fools.

Because of the heavy use of leverage, which is essentially a pile of credit, these hedge funds' influence extends far beyond their estimated $2 trillion size. If the market takes a sudden nasty turn, hedge funds can lose far more than the value of the funds themselves.

Even in Las Vegas, most gamblers' losses are generally limited to what they have in their pockets, but on Wall Street, because of the heavy leveraging that occurs, when someone loses big, the implications can extend deep into our economy.

The Financial Policy Forum study illustrates some recent examples:

> Long-Term Capital Management collapsed with $1.4 trillion in derivatives on their books [and it nearly caused a major collapse in our economy]. Sumitomo Bank in Japan used derivatives in their manipulation of the global copper market for years prior to 1996. Barings Bank, one of the oldest in Europe, was quickly brought to bankruptcy by over a billion dollars in losses from derivatives trading. Both the Mexican financial crisis in 1994 and the East Asian financial crisis of 1997 were exacerbated by the use of derivatives to take large positions on the exchange rate. Most recently, the collapse of a major commodity derivatives dealer Enron Corporation has led to the largest bankruptcy in U.S. history.

Not all hedge funds place large risky bets on stocks, currencies, bonds, commodities, and gold while using lots of leverage. The modern version of hedge funds has been around since 1949. Some

employ conservative strategies. Others live on a high wire of high risk and high return.

Warren Buffett once called derivatives "financial weapons of mass destruction" because of the damage they could do to Wall Street in an instant. For nearly a quarter of a century, until 2004, nothing was done by federal authorities against hedge fund fraud or manipulation affecting others. When action was finally taken, it was an Attorney General of New York who moved against a hedge fund that had cheated mutual fund account holders.

In 1998, after the collapse of the hedge fund Long-Term Capital Management, which nearly brought on a global financial collapse, it took the Federal Reserve Board and a coalition of banks working together feverishly to provide a safety net that rescued the financial system. That experience with hedge funds and the risky credit derivatives should have convinced policy makers to move to provide even modest regulations.

President Clinton formed an oversight group, which included the SEC as a member. But efforts were stymied when an SEC rule designed to oversee hedge funds was invalidated by the U.S. Court of Appeals. It limited but did not end SEC oversight. However, the court decision means hedge funds do not have to register or submit to investigations.

You certainly won't see the fund managers themselves putting on the brakes. The reason is that hedge funds have a fee structure (the 2 and 20 formula) that nearly guarantees success for those who are managing them. The managers typically charge a 2 percent management fee. That means that they will earn 2 cents on every dollar they manage, and that has nothing to do with their success or failure in turning a profit for the investors. But there's more. Managers also typically take a large percentage of the profits that exceed their benchmarks—some are around 20 percent, some even higher. So, the way it works is they make staggering amounts of money if they are successful and some have earned a massive income even when they failed.

Some of that changed in 2008 when some hedge funds experi-

enced major losses as the house of cards collapsed. But, up until that point, a good number of the hedge fund managers made massive amounts of income.

HE'LL EQUAL YOUR SALARY IN SIX MINUTES

James Simons ranks in the top three hundred of the world's wealthiest people. He was king of the hill in hedge fund pay in 2006 with a $1.7 billion income in that one year, according to an article by Jenny Anderson and Julie Creswell in *The New York Times*. If you're on a monthly salary and want to compare yours to his, Simons's salary was $141 million a month, or about $4.5 million a day. For a ten-hour day, that's about $450,000 an hour. That means he makes in a matter of minutes the salary an average American worker makes in an entire year. I hope he tips well.

But in 2007 the top hedge fund manager made a much higher income: $3.7 billion. That's over $300 million a month. Neil Weinberg and Bernard Condon noted in a 2004 article titled "The Sleaziest Show on Earth" that hedge fund managers are paid "fees that would be outlandish or even illegal if extracted from a plain old mutual fund."

Simons is a mathematician and former military code breaker, who, according to Alistair Barr, "employs roughly 80 Ph.D.s who develop computer programs to seek out price anomalies in a wide range of markets, including equities, commodities, futures and options." Translated, it means Simons is always looking for an angle. And he's finding them.

Published reports said one of his company's funds—the Medallion Fund—gained 44 percent in 2006, with an average return of 36 percent since 1988. And, after a 5 percent management fee and a 44 percent performance fee, Mr. Simons went home with $1.7 billion for himself in 2006. Such is the rarified air of success.

Of an estimated eighty-eight hundred hedge funds in 2006, only

twenty-five hundred were registered with the SEC, said SEC chairman Christopher Cox. He told the U.S. Senate Committee on Banking, Housing, and Urban Affairs on July 26, 2006, "Given the general lack of public disclosure about the way hedge funds operate, the lack of standards for measuring a fund's valuation and its performance, the possibilities for undisclosed conflicts of interest, the unusually high fees, and the higher risk that accompanies a hedge fund's expected higher returns, these are not investments for Mom and Pop."

HOW TO MANIPULATE THE MARKET

Some have called the boom of hedge funds a kind of gold rush, with the usual mix of honest prospectors and plain cheats. The opportunity for manipulation by the big players stands to bury some investors. Nixon could have learned a few dirty tricks from these guys.

On June 17, 2007, Barbara T. Dreyfuss reported in *The American Prospect*:

> Jim Cramer, who ran a major hedge fund, Cramer, Berkowitz & Co., for more than a dozen years, recently boasted publicly that market manipulation is indeed how the system works. . . . Cramer detailed how easy it is to manipulate stock prices. Suppose, said Cramer, his investments were tied to Apple's stock tanking, and suppose that stock began to rise. In such a case, he said, he would "pick up the phone and call six trading desks" at brokerage houses and tell them people at Verizon were panning Apple. "That's a very effective way to keep a stock down," he chuckled. "I might also buy January puts"—stock options that anticipate a stock going down. This, said Cramer, creates an image that bad news is coming. And, he added, you then call investors and reinforce that image. "The way the market really works is you hit the nexus of the brokerage houses with a series of orders that can be leaked to the

press, and you get it on CNBC, and then you have a vicious cycle down."

It's disappointing if we turn these kinds of people into heroes. If this is the way Jim Cramer talks about doing business, why are we idolizing such behavior? He is the host of CNBC's *Mad Money*, a show in which he offers financial advice while, at times, sounding and looking a bit like a lunatic. I guess that sells in some quarters. He did, however, redeem himself somewhat with me when, during the late 2008 stock market collapse, he advised people that if they needed their money within the next five years, they should be taking it out of the stock market. That was sage advice.

In today's instant media, a blip of bad news can snowball into a panic. Pros can always react faster than casual investors, who can be financially wounded by the type of shenanigans Cramer describes. It is market manipulation, and it is wrong.

The answer to lessening the risk of an economic meltdown driven by hedge funds is obvious. More oversight and regulation! Instead of putting out the fire, President Bush signed legislation designed to put gas on the fire, making it *easier* for pension funds, school endowments, and charities to invest in these high-risk ventures.

A Bank of New York study predicts such investments will account for about *one-third* of new money to hedge funds by the end of this decade. Why does this matter? Because in the beginning the high ante to play the hedge fund game was limited to those with enough chips so that if a few high rollers lost a bundle, it wasn't a big deal, with one exception—if it had a snowball effect on others. Yes, it sounds exclusionary, but the fat cats could afford the loss. But when *pensions* are on the line, it affects people who can't afford to lose.

Iowa Senator Charles E. Grassley, a Republican, has sought more oversight of hedge funds. "We recently enacted pension reforms to increase transparency for pension-holders about how their money is invested," Grassley said in October 2006. "Now we're learning

hedge funds pose huge risks to pension-holders. It's disturbing that we can't even come close to understanding the extent of the risks because hedge funds operate in such a secretive way. We need to get a handle on this situation before more hedge funds go belly-up and leave rank-and-file investors in the ditch."

Laudably, the Connecticut Department of Banking set up a hedge fund oversight department in 2006. (Many hedge funds and corporations are located in the state.) They're on the right track. Hedge funds need to be registered. The evidence of market manipulation by these fast-trading hedge funds is so strong that the idea that the status quo is just fine is laughable. The marketplace should be safe for all investors, not just those in the know or those powerful enough to manipulate markets.

But alas, we discovered in late 2008, the market isn't really safe for anyone as long as the gamblers are out there creating the undertow that pulls innocent people out to sea when things go sour.

ONE HEDGE FUND TRADER SEIZES CONTROL OF THE NATURAL GAS MARKET

The danger of unregulated hedge fund trading was demonstrated in 2006 when some smart investigation by a congressional committee disclosed that a thirty-two-year-old trader named Brian Hunter had found a way to virtually control the market for natural gas. He did it by conducting an excessive number of trades on unregulated markets from his hedge fund in order to obscure what he was doing. The trader controlled up to 70 percent of the natural gas market on the New York Mercantile Exchange (NYMEX) at one point, and he allegedly manipulated prices in a manner that finally led to the collapse of a hedge fund called Amaranth. Federal regulators say his positions in the natural gas market were so big that he could cause prices to move as he wanted by buying or selling giant holdings in the last thirty minutes of trading on NYMEX (a move known as "smashing the close").

PIMCO bond fund, as saying, "There's nothing wrong with it. . . . It's not illegal. But it's ugly."

I second that last part. Invariably, massive concentrations of power and wealth subvert the economy and, ultimately, democracy itself.

The same *Times* story reported that the top twenty-five hedge fund managers had to make $360 million in order to make the list last year. That is eighteen times higher than the amount that was required to make the list just five years before. Not double, triple, or even quadruple. Eighteen times! That's what I call moving the bar in a hurry.

The *Alpha* magazine survey reported that the top twenty-five hedge fund managers each earned an average of over $800 million in 2007. That compares to $570 million each in 2006 and only $362 million in 2005. All of this at a time when the average working family was losing ground each year.

While hedge funds have been around for a good many years, they have taken on new life in recent years and have been central to the creation and trading of sophisticated new securities and derivatives. The trading in derivatives has become big business with new and complex trades of securities that derive their value from other prices of products. The private equity firms have also been having an income field day. The hedge funds, derivative trading, and private equity firms have created a type of worldwide economic casino with more and more wealthy participants interested in placing their bets.

Most of the activity in hedge funds, derivatives, and private equity firms involves increasingly complicated financial transactions that are out of public view and largely unregulated. Many of these transactions are so complicated, even the participants have difficulty explaining them. The players in this speculation are limited to a relative few who have built massive wealth. And as the data shows, the income being collected at the top of these mountains of speculative investment is piling on top of already large fortunes for those who participate.

Private equity firms are also a relatively new entry in the financial sweepstakes. The people involved in this business accumulate their wealth by buying public companies, taking them private, and

making bundles of money by breaking them up and reselling. In some cases, the private equity firms are doing investors a service. Big corporations can become large, bloated organizations that are inefficient and waste money. And the threat of being bought by a private equity firm and taken private has forced companies to shape up.

But there are many other cases where the motive of the private equity firm has to do only with their own self-interest, which sometimes runs opposite to the interest of a business investing for the long term or opposite to the public interest. But, whatever the motives, it is creating another class of the superwealthy in America.

BIG INCOME, SMALL TAX BILL

Notable among the new wealthy investors is Steve Schwartzman, the man who, with another billionaire, Pete Peterson, founded the Blackstone private equity firm. Schwartzman drew some attention a while back by throwing himself a sixtieth birthday party.

Schwartzman, with an estimated net worth of $7.3 billion, was reported by *The New York Times* to have spent over $5 million on his birthday party. It was held in his large Park Avenue apartment (reported to be a thirty-five-room, $40 million dwelling) and included performances by Rod Stewart and Patti LaBelle.

The interesting thing about all of this wealth is that Mr. Schwartzman's income (and the income of many others doing what he does for a living) is taxed at only a 15 percent income tax rate. The reason for that is our old friend "carried income," which gives him the ability to pay the same tax rate as the capital gains rate. But it is not just Mr. Schwartzman who enjoys paying a low, 15 percent income tax rate. Many of his colleagues in both hedge funds and private equity firms are privileged to pay some of the lowest tax rates in the country. I've described that in greater detail in the chapter about the tax system and how the big interests avoid paying their share.

Henry Kravis is one of the most successful at buying companies and taking them apart. Kravis once said, "Once you buy a company,

you are married. You are married to that company." If that is the case, why does he always end up with most of the assets when the marriage is over? Apparently there is no community property in that industry.

Let me be quick to make the obligatory disclaimer that there are many people in the hedge fund industry and the private equity firms who earn salaries that are not huge and whose work contributes in a positive way to our economy. But still, the money at the top gets and deserves attention in describing what is happening in this economy to the people at the top and the people at the bottom.

It's worth noting while describing the stratospheric incomes for some in 2007, that according to Jared Bernstein at the Economic Policy Institute, "Since 1913, the United States witnessed only one other year of such unequal wealth distribution—1928, the year before the stock market crashed" (as quoted by Jenny Anderson in *The New York Times*).

It's no coincidence that we have experienced the economic trials we have. When incomes get so out of balance, it is a sign that ambition has been sublimated by greed. In our capitalistic free-market system, we encourage and want each person to be able to do what is in his own best interest. We celebrate success, and we should. But we also should want to see that a fair reward for work goes to the working families, the small businesses, and others who make up the middle class. Expanding opportunities for the middle class is what has distinguished our country from many others. It has made us stronger and more prosperous.

CORPORATE GENEROSITY

Salaries at the top of major corporations in America are also turning heads. I know some outstanding CEOs who are worth every penny. But in recent years the staggering amount of money paid to some CEOs seems almost completely disconnected with performance. In the past, in our market system, there was always expected to be a

relationship between performance and reward with corporate executives. The harder you work, the better you perform and the more income you make. It is a pretty simple calculation.

But that is changing.

CEO pay in the past five years has grown at an unprecedented rate. In 1980 the average CEO was making about forty times the earnings of the average worker. CEO income has grown tenfold in the past several decades. Read this slowly: *the CEOs are now making over four hundred times the income of the average worker in the corporation.* That's unbelievable. Had the minimum wage advanced at the same rate, it would be somewhere north of $22 an hour. The average CEO is making in one day what the average worker earns in an entire year.

According to *Forbes* magazine's annual report on CEO compensation, in 2006 the CEOs of the five hundred biggest corporations averaged $15.2 million in total annual earnings. That was up nearly 10 percent from the year before. Again according to *Forbes*, the top eight CEOs each received more than $100 million.

The CEOs were not only being paid well, but their severance packages when they left their jobs were skyrocketing, too. According to the Executive PayWatch Database, the average severance pay for CEOs with employment contracts was 170 weeks of severance pay for each year on the job. Compare that with two weeks of pay for each year worked, which is the average severance pay received by workers—if they are lucky enough to get severance pay at all. Sometimes it's just a pink slip and a boot out the door.

Growing up, we are taught that there is, or at least there should be, a logical connection between effort and reward. Work hard in school and get good grades. Work hard on your job and earn a promotion and a pay raise. But in recent years, we've seen that the rule of thumb about effort and reward might not apply to people in corporate executive suites.

Even as most folks are now trying to make ends meet and stretch their paychecks from month to month, the CEOs of some of America's major corporations are padding theirs. And as workers are

learning that their pension programs are being reduced or eliminated, they read about nearly unbelievable pension arrangements for the people at the top of the corporate pyramid.

In 2005 Exxon gave Lee Raymond one of the shiniest golden parachutes ever—nearly $400 million, including pension, stock options, a consulting deal, and other perks such as use of a corporate jet.

Consider the disclosure of the executive perks given Jack Welch, the former CEO of General Electric. It's true that he led what had been an appliance company to become a worldwide corporate powerhouse. But when he retired he was more than handsomely rewarded for those accomplishments. When his lavish retirement perks were disclosed in a divorce proceeding, it caused him so much embarrassment that he would surrender most of the perks because they could be "misportrayed."

You think? How could one "misportray" a life of free flowers, free use of an $11 million Manhattan apartment, a wine budget, a cook, sports and opera tickets, free dry cleaning, twenty-four-hour jet airplane and helicopter service, and a car and driver? What? No masseuse?

So Welch and GE negotiated a new deal. And according to published reports, he will end up with a $9 million annual pension and he will pay to clean his own suits and pay for his own flowers and he will still have the use of the corporate jet and the apartment, but he will have to pay for it out of his $9 million pension.

The real owners of General Electric (the stockholders) were unaware of how their money was being spent. If it hadn't been for his divorce proceeding in which Mr. Welch's ex-wife disclosed these lavish perks, we would never have known. Nor would the Securities and Exchange Commission. But it was an instructive window into the retirement packages offered to some of those who run major American corporations.

The SEC took some action against GE for failing to disclose the perks, but even the SEC likely wouldn't have known except by chance. According to an article written for the Minneapolis Fed by Ronald Wirtz, "such pay is 'stealth compensation,' because it is

rarely disclosed, or obscurely so when required, and so flies under the radar of investors, the public, even boards themselves."

IF IT'S ALL LEGIT, WHY ARE THEY TRYING TO HIDE THEIR ACTIONS?

So don't misunderstand my position, here. What I am saying is simply that all of this needs to be aboveboard. The fact that some of these companies are trying to hide ostentatious compensation packages tells you it's wrong and they know it's wrong.

When executives succeed and the business grows and the stockholders benefit, I understand the need and justification for generous compensation. I know some CEOs who do an outstanding job and deserve substantial compensation. But even those CEOs will tell you in private that executive compensation has gotten out of hand.

To its credit, the SEC finally took some steps in 2006 to keep stockholders better informed. According to Equilar, an independent provider of executive and board compensation information, "The SEC indicated that its new disclosure requirements would significantly alter the format of executive and director compensation disclosure in annual proxy filings, and that the goal of the new regulations will be improved and comprehensive disclosure of executive compensation, related party transactions, director independence and corporate governance information in 'plain-English.'" The SEC also promised improved disclosure of severance packages.

That's all well and good. I hope it translates into more than lip service.

BEING PAID WELL FOR FAILING

These days you don't have to be a successful or a retired CEO to rake in the big bucks. You can actually be paid some big money for failing. Take the case of Richard Grasso. He was fired by the New

York Stock Exchange. It turns out he had a pay package that allowed him to earn $193 million for eight years of work. When he was fired he claimed another $140 million in contract severance pay. You have to admit, America is the land of opportunity. Where else other than Wall Street can a man make millions by getting fired? As it turns out, it happens all the time.

Hewlett-Packard decided to get rid of CEO Carly Fiorina and it was reported that she walked out with $46 million. You may remember Fiorina—she provided some comic relief during the 2008 presidential campaign when, speaking as a supporter of John McCain, she declared he wasn't competent to run Hewlett-Packard. Then, stuffing her Manolo Blahniks deeper down her throat, she added that neither was Sarah Palin, Barack Obama, or Joe Biden—her premise being that it's tougher leading Hewlett-Packard than being the leader of the free world. This from a fired CEO! Well, never mind.

Home Depot's Robert Nardelli was booted out of that company and left with a parting compensation of $210 million. Despite the fact that he was pushed out by the Board of Directors, Nardelli was to receive a reported settlement of cash and stock worth $210 million, coupled with a $20 million severance payment and retirement benefits of $32 million. All of that for *not* doing the job that the Board of Directors evidently expected of him.

After Pfizer dumped Hank McKinnell, he got a send-off worth a reported $200 million. In his and Nardelli's case, they were fired because the Boards of Directors were concerned about the companies' poor performances but the CEOs still were handsomely rewarded. Let's hope that the business school students in college aren't looking at these rewards and aspiring to become failed CEOs.

Ford Motor Company lost $12.6 billion in 2006 and then hired a new CEO, Alan Mulally, for a pay package of $39 million. But, so that there were no hard feelings, Ford paid $10.5 million to the former CEO, Bill Ford. That will soothe the hurt in the executive suite. But should the stockholders really be pleased with that?

In 2006, according to an analysis performed by the Associated

Press after culling through annual reports of publicly traded companies, compensation for CEOs was continuing to skyrocket, with some 386 of the 500 CEOs of the Standard & Poor's 500 receiving a combined $4.16 billion and more than half of the executives earning more than $8.3 million for the year. Some of them had incomes that rang the bell for excess according to the study.

Terry Semel, Yahoo CEO: $71 million
Bob Simpson, XTO Energy: $59 million
Ray R. Irani, Occidental Petroleum: $52 million
E. Stanley O'Neal, Merrill Lynch: $46 million
H. Lawrence Culp, Danaher Corporation: $46 million
Angelo Mozilo, Countrywide Financial: $43 million
Alan Mulally, Ford Motor: $39 million
Edward Whitacre, AT&T: $31 million

"About half of American industry has grossly unfair compensation systems where the top executives are paid too much," said Charlie Munger, Warren Buffett's partner at Berkshire Hathaway, according to Rik Kirkland writing for *Fortune* magazine.

I'm sure you could make a case that some of those salaries are justified. But there will be other cases where there seems to be no relationship between actual performance and pay. In the case of our well-heeled friend from the oil business, Lee Raymond, his supporters justified his golden parachute because Exxon had done extraordinarily well. But then, all oil companies did when oil prices started their run-up.

According to the previously quoted *Fedgazette* article, Harvard economist Lucian Bebchuk suggests an alternate reality when measuring performance—"that performance benchmarks use indexed options that compare a company's stock price appreciation to a basket of competitors, and offer compensation to the degree that the company beats the competition in stock price appreciation and is the result of firm-specific performance. . . . The idea has reportedly been slowly winning some board converts."

The lowest-paid major CEO was Costco's James Sinegal, who earned $411,000. But he owns an estimated 2.4 million shares of Costco, which would be worth over a billion dollars, so don't pass the hat just yet; he's doing just fine. Unlike some other corporate leaders, however, Sinegal spends a lot of his time working on ways to make sure his employees benefit from the company's success. He's a leader.

While there are rising concerns in Europe about CEO pay, European CEOs still lag behind American captains of industry. According to Jeanne Sahadi's 2007 CNNMoney.com story, "The top 20 CEOs of U.S. companies made an average of $36.4 million in 2006. That's 204 times that of the 20 highest-paid U.S. military generals, and 38 times that of the 20 highest-paid nonprofit leaders. They also made three times more than the top 20 CEOs of European companies who had booked higher sales numbers than their U.S. counterparts."

HOW SHOULD CEOS BE PAID?

I know some outstanding corporate CEOs. They commit themselves to their company, work hard, long hours, and are worth a great deal to the corporations that employ them. I don't suggest that these CEOs shouldn't be compensated very well. They are integral to the success of some very large corporations, and they are worth a great deal to the companies they lead. But when we hear of these stratospheric salaries, it is reasonable to expect that there would be some connection to performance. Unfortunately, that is not always the case these days.

Common sense and old-fashioned business ethics tell us a CEO salary should reflect performance not only for stockholders but for employees, too.

Stockholders have a hard time reconciling a CEO pay raise while the stock is in the toilet. In a perfect world, company boards would begin reining in these salaries based on a formula with some sem-

blance to reality. Failing to do so, because these are publicly traded companies, they run the real risk of intervention from Washington.

Certainly, outrageous salaries adversely affect stockholders and employees, so new rules governing salaries should not be off the table. I am specifically speaking about publicly traded entities and not private companies. If corporations want the advantages of being publicly traded, responsible, commonsense behavior shouldn't be too much to ask. Honesty and ethics are not too high a price to pay to be granted admittance to the greatest market on earth. Any company with government contracts should also have to abide by fair rules of compensation.

A rather remarkable result of the recent financial crisis was watching governments buy stock in financial institutions to increase liquidity. The logic was that it was the quickest way to stabilize these institutions and buck up confidence and get them lending to one another. However, governments also became stockholders in these businesses with a voice that could have been capable of addressing things like CEO compensation. But it turns out the proposal was for nonvoting preferred stock. So no dice!

It is ironic that lack of oversight in the interest of less regulation has led to actual government *intervention*. No one wants that. The best option is honest oversight and regulation.

So, what's the magic number for a CEO in a given company? There's no one-size-fits-all answer. But I believe it should be performance based. There should be some reasonable multiple of the salaries of the average worker in the corporation as a starting point for a base salary. (And four hundred times is not a starting point. . . . It is absurd.) And beyond that base salary, there should be some form of performance-based pay.

There is significant concern about stock or stock options being offered as part of the compensation package. As it relates to the company's success, I don't have a problem with that, but when stocks become the dominant financial factor in CEO compensation, it can lead to trouble. The CEO becomes an insider trader, and too much stock equals too much power and too much temptation. A

reasonable base salary combined with stocks ought to motivate a CEO to perform.

And when a CEO starts dumping shares, it should be reported immediately—within the hour. The SEC now allows a two-day lag. Great. That's just what the pros need, a two-day head start on the average investor. If a CEO has lost confidence in his company or thinks the stock has peaked, everyone ought to know immediately.

If the private sector won't take action to correct this area, Congress should.

The Institute for Policy Studies (*Executive Excess 2007* report by Sarah Anderson et al.) suggests the following remedies should be considered:

ELIMINATE THE TAX REPORTING LOOPHOLE ON CEO STOCK OPTIONS. Corporations are currently allowed to report one set of executive stock option compensation figures as expenses on their financial statements and a completely different set of figures—often a much larger amount—on their tax returns. Proposed legislation in Congress would require corporations to disclose the same information about executive stock options to the IRS as they do to their shareholders.

LINK GOVERNMENT PROCUREMENT TO EXECUTIVE PAY. Federal law already limits the amount of pay that a company with a government contract can bill the government for executive compensation. But corporations whose stock soars after gaining a federal contract can pay executives whatever they please. The federal government could limit these windfalls.

MAKE SURE HEDGE FUND AND INVESTMENT FUND EXECUTIVES PAY THEIR FAIR SHARE OF TAXES. Top partners in America's private equity and hedge fund industry currently pay taxes on most of their multi-million-dollar incomes at less than half the 35 percent tax rate in effect on ordinary income. President Obama has now proposed eliminating the carried-interest loophole, and I think chances of finally getting this done are much improved.

Any economy depends greatly on emotion—confidence. If average American investors do not have confidence in the companies on Wall Street, their CEOs, and the fairness of the system, they will pull out.

As Rik Kirkland wrote in a probusiness *Fortune* article, "What's at stake, in short, is nothing less than the public trust essential to a thriving free-market economy."

When people of power yield to the temptation of greed and abuse their positions to consolidate and accumulate more wealth, the result is an economic aristocracy. Remember, we are a young country. One need only look across the pond to Great Britain to see that social stratification is very real even today, having had centuries to grab a foothold.

I am not against generously rewarding performance. But I firmly believe that when it comes to publicly traded companies and those funds that invest in them, it is entirely fitting to have oversight over executive compensation, because what goes into their pockets comes out of the pockets of shareholders. If a company wants to take advantage of the capitalization and opportunity for growth that come with being publicly traded, we should not be shy about making sure the owners of the company (the investors) are treated honestly. And making sure that fund managers don't have their hand too deep in the cookie jar is just common sense. Our economy will do much better if there is a sense of trust that the game isn't rigged.

The reason so many people want to come to America is because they see our country as the best opportunity for a fair shot at success. That tells us that despite our flaws, we remain the best hope for individual and economic fairness and freedom. People still see America as a meritocracy, where advancement though merit is still possible.

Expanding inequality eats at the foundation of what our country is about. Our country has been seen as the place where everyone has an opportunity to do well. It is supposed to be a place where effort is connected to reward.

This means an eternal struggle for the proper balance. So the

pendulum will probably always be swinging in one direction or another. It is clear that the pendulum has swung too far to the right and the rush to privatization and deregulation and oversized salaries and compensation with no oversight stands to create such great inequities that it will, if left unchecked, change our country in a manner that undermines much of what we have aspired to achieve.

It's akin to the credo of the old wagon trains that crossed the Plains on their journey westward. These pioneers believed that you can't move ahead by leaving some behind. It's a reasonable credo for our country as well.

It is also understood that we live in an ever more competitive world and as our corporations compete internationally, we would be well advised to put the fundamentals in order. And yes, that includes dealing with the issues of compensation at the top, which has become disconnected from reality.

As a final note, I prefer that the private sector deal with this issue. But if it will not, the public sector has a role in setting fair rules for publicly traded companies.

And one more thing! I admire success and salute those at the top of our large institutions. Most of them sacrifice much and work hard, long hours. But even most of them will admit the compensation programs are out of balance and need to be brought back to some reality.

It is likely that the economic crisis of 2008 will increase the pressure for these changes to occur.