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SCHIFF'S

INSURANCE OBSERVER

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Money Doesn't Talk—It Swears

CEO Overcompensation

Dick Grasso, who by most accounts did a good job of running the NYSE, was forced from his position because he was paid so much that it became an embarrassment to his organization and to the board of directors that paid him so much money.

David D'Alessandro, the chief honcho at John Hancock, has done a terrible job. Actions he played a major role in have cost his company's owners $1.8 billion. Nonetheless, not only is his compensation of Grasso-esque proportions, some of it appears to be a flagrant violation of the law. Why Grasso is gone and D'Alessandro remains is one of those things that can't be explained by facts or figures.

In this issue, we'll revisit one of our favorite issues: compensation. On July 18 we published "John Hancock's CEO Should be Fired," which laid bare the sleazy maneuvers D'Alessandro & Cohorts used to garner unconscionable compensation. Our article has not yet led to a shareholders' revolt—just a lawsuit. Perhaps we were early, or perhaps late July is not the best time to publish a lengthy exposé. In any event, we're republishing the article on page four.

On the following pages you'll find an article about CEO compensation by Ralph S. Saul. Ralph, who spoke at our conference last Spring, knows a thing or two about CEOs, boards, markets, and regulation. He practiced law in the 1950s, then worked at the SEC, where, in the early 1960s, he was the head of the Division of Trading and Markets, which was responsible for market regulation and enforcement. He was subsequently president of the American Stock Exchange, co-CEO of First Boston, and CEO of INA (where he oversaw the merger with Connecticut General that formed CIGNA, of which he was co-CEO). He later served as chairman of Drexel Burnham during its Chapter 11 reorganization and, until recently, was chairman of Horace Mann Educators.

"Your shareholders have suffered but you've made a pile. How do you feel?"

One rationale some use to justify CEOs' lavish compensation is that CEOs are like star athletes—baseball players, for example. We've heard this often, but don't think it makes much sense. Although one must be an excellent player to make it to the big leagues, it's obvious to everyone that only a small percentage of Major League baseball players are future members of the Hall of Fame. In Major League Business—the Fortune 500—it's equally obvious that most CEOs are not hall-of-famers, and most will not deliver exceptional financial results over 10 or 20 years. Yet the average CEO is paid as if he's an All-Star. One would be hard pressed to find a correlation between outsized CEO compensation and outsized corporate results.

Compensation isn't the secret to winning ballgames, either. The Oakland A's have one of the lowest payrolls in baseball—about one-third of what the Yankees spend—but they have one of the best records over the last five years. Michael Lewis's wonderful new book, *Moneyball*, explains how the A's general manager, Billy Beane, accomplished this through the analysis and interpretation of statistics ignored by others, using a cadre of players who had been rejected by most as unfit for baseball. *continued*

CEO Compensation: A System Out of Control

by Ralph S. Saul

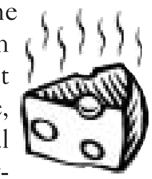
As long as average CEOs are paid as if they were superior CEOs, the issue of executive overcompensation won't go away. Where CEO pay is out of alignment with long-term corporate results, shareholders will not remain complacent.

How, during the past two decades, did CEO compensation at mature companies and organizations become so disconnected from average employees' compensation?

Not too long ago, established companies developed or hired executives who were viewed as professional managers. Before 1980, CEOs received compensation packages that bore a reasonable relationship to the pay of the average worker. (According to *Business Week*, in 1980 the average CEO of a large company was paid 42 times what the average hourly worker was paid. That figure escalated to 85 times in 1990 and 531 times in 2000.) Many of these professional managers were veterans of World War II or the Korean War who had acquired a set of values that connected them to the companies they managed. Their primary motivation was to do a good job, and they took pride in developing new products and services, increasing market share, and creating a strong management team and motivated work force. Increased shareholder value wasn't an end in itself; it was the result of getting these fundamentals right. Great companies and their CEOs demonstrated concern for their employees by engendering loyalty and abiding by a value system. Managers sought to follow the old-fashioned precept of leadership by example. There was an implicit understanding between management and employees that both would participate in the ups and downs of the business.

During the stock market boom that began in 1982, companies began emphasizing "stock-based compensation," which stimulated a major change in the expectations and values of American executives. (IRS limits on the deductibility of cash compensation for executives subsequently provided an additional rationale for stock-related pay-for-performance plans.) Stock options were lottery tickets that were likely to pay off—the biggest unknown was the size of the payoff—and the rising market created rewards beyond all earlier expectations. Executives who received huge options packages bore none of the risks of stock ownership; they profited if their company's stock went up but lost nothing if it went down. In fact, a decline in their company's stock price usually meant that options they would receive the following year would carry a lower strike price.

Part of the shift in executive compensation arose out of envy. CEOs resented *and* desired the compensation earned by corporate raiders, LBO executives, and investment bankers. (Who can forget the $550 million that Drexel Burnham paid Michael Milken in 1987?) But unlike entrepreneurs, CEOs of large, mature companies had few financial risks. They received pensions, severance agreements, loans, private jets, club memberships, and an ever increasing array of perks—regardless of how their companies' did.



Somewhere along the line the tenuous theory that there was a scarcity of executive talent provided some sort of justification for raising CEOs' pay. Corporate directors—many of whom were also CEOs—embraced this theory, and compliant compensation consultants quickly endorsed the notion that it was necessary to compensate CEOs at levels that appeared excessive because that's what it took to hire the best. For compensation purposes, CEOs were compared to star baseball players (rather than to the managers of the best teams).

Many companies felt compelled to search outside their organizations for talent, and began to compare themselves with groups of so-called "peer companies" to determine whether their pay levels were in the *top quartile* (the theory being that if you didn't pay in the top quartile you couldn't get a good CEO). Compensation reports in proxy statements contained a rote recitation of the need to attract, incentivize, reward, and retain executives of superior quality, and that companies had to compete with peer companies for these executives. (The peer companies chosen often included those with high compensation.)

In addition to higher compensation, CEOs received guarantees, pension add-ons, extraordinary benefits, and change-in-control agreements—all largely unheard of before the 1980s. Consultants, lawyers, and others devoted considerable intellectual efforts to devise new ways to bolster executive compensation, often by stealth. Compensation became an iceberg in which the salary and bonus were the only parts above the water. No matter how a company fared, CEOs had the additional protection of the new safety nets—without the risks of ownership.

Decoupling the pay of CEOs from that of rank-and-file employees changed the implicit understanding between CEOs and workers, damaging America's corporate cultures. CEOs and management suffered a loss of respect as employees began to view senior executives as mercenaries concerned primarily with their own interests rather than those of the company or employees. Unlike the ordinary worker, who was subjected to "downsizing" and "outsourcing," CEOs had lucrative contracts to protect them in the event that they were made "redundant." This created a "me first" mentality throughout companies. (It is probably no coincidence that two of America's most respected CEOs—Bill Gates and Warren Buffett—did not taken stock options or large salaries.)

Buffett recently wrote that "the acid test for [corporate-governance] reform is CEO compensation." It will not be easy to reform the runaway executive pay system because serious reform will occur only if shareholders assert their ownership rights and pressure boards to change their behavior.

Although government cannot fix the problem, it can help create solutions by mandating better disclosure. Something is very wrong when a shareholder can't tell how much a CEO is being paid without hiring a compensation consultant to examine the CEO's employment contracts. CEOs' total compensation should be disclosed *in plain English and in plain sight*, to paraphrase the Conference Board's report on executive compensation. Last year President Bush said that CEOs should disclose their total compensation in their letter to shareholders. That good idea has been heeded by few.

In addition, annual reports and proxy statements should clearly explain the amount and percentage of future stockholder value that will be diverted to executives and employees under equity-based compensation plans. Proxy statements should also clearly explain what executives will receive upon retirement, termination, resignation, and change in control.

A bigger step is the liberalization of the SEC's proxy rules so that shareholders won't have to resort to expensive proxy fights in order to nominate a candidate for the board and get him elected. Proxy statements should be required to include nominations for the company's board of directors from a shareholder, or group of shareholders, that owns some reasonable amount of a company's voting stock.

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Corporate directors must behave like the independent stewards they're supposed to be. The unhealthy interlock of executive expectations, peer compensation, and amenable consultants must be broken. Respected directors and institutional shareholders must keep saying "Enough!" until their message gets through.

Finally, independent compensation committees made up of directors who are truly independent—not merely "independent" according to the inadequate rules and regulations currently in place—must take control of the compensation process. When setting compensation, they must be, as the Conference Board report has recommended, "unconstrained by median compensation statistics or by the company's past practices."

We have entered a new era of how CEOs' vast rewards are viewed. Greater emphasis will be placed on how CEOs connect with the companies and employees they manage. Connection means an abiding interest in creating value over the long term, building morale, and fostering loyalty and respect.

Most CEOs do not achieve superior long-term results for their companies. They should not be paid as if they do.

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Continue to the next page.

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INSURANCE OBSERVER

John Hancock's CEO Should Be Fired

Illegal Compensation?

Editor's Note: We recommend that you print this article before reading it.

Although David D'Alessandro, chairman, president, and CEO of John Hancock Financial Services, was paid $21.7 million last year, he's more than just the overpaid honcho of a recently demutualized life-insurance company; he's also the author of the "national bestseller" *Brand Warfare®: 10 Rules for Building the Killer Brand.* This slim canon (ghostwritten by Michele Owens) can be purchased in hardcover for 50¢ at Amazon.com. and read in about an hour.

Those who follow John Hancock may wonder whether D'Alessandro has read his own book. That's because Hancock appears to be ignoring one of D'Alessandro's ten dictums: "Rule 7: Do Not Allow Scandal to Destroy a Brand." As brand-warrior D'Alessandro has written, "If you're a high-flying brand and something negative comes at you, it's dangerous not to handle it. If the charge is crazy, prove it—but don't think that its craziness alone will make it powerless to hurt you."

Well, something negative *has* happened to Hancock—its lavish executive-compensation practices have finally attracted attention (and will be laid bare in the following pages). These practices, depending upon your point of view, are: (a) customary, (b) outrageous, or (c) illegal.

If there were a gold medal for excessive executive compensation, Hancock—the official worldwide life-insurance sponsor of the Olympics—would win it. D'Alessandro's paycheck is so disproportionate to the company's size and results that even Wall Street analysts have objected. (When was the last time that happened?) The company has been the subject of numerous unfavorable articles (including the essential "How John Hancock Overpays its CEO," *Schiff's*, May 20, 2003).

On May 28, the company's directors and CEO were sued for breach of fiduciary duty, unjust enrichment, and waste of corporate assets due to excessive and illegal compensation to D'Alessandro and other insiders. Hancock declined to discuss the lawsuit or its executive compensation, but sent us a short press release calling the lawsuit "frivolous" and a "nui-

sance." It said that its actions were "permissible and appropriate." If Hancock hasn't done anything wrong, why isn't the company following D'Alessandro's Rule 7: "*If the charge is crazy, prove it*"?

Schiff's has conducted an investigation into Hancock's executive-compensation practices and the circumstances surrounding them and has uncovered a complex history of duplicitous conduct.

The Set-up

In January 2000 John Hancock converted from a mutual insurance company to a stock insurance company. During the conversion process, Hancock repeatedly misled and deceived its policyholders, ultimately costing them $1.8 billion. The conversion has been lucrative for Hancock's officers and directors—especially D'Alessandro—who played a key role in the demutualization.

On the following pages we'll reveal how Hancock and its officers played the demutualization game: how they sent misleading "information guides" and "information statements" to policyholders; how their sworn testimony at a public hearing was deceptive; and how they took a system that was supposed to ensure that mutual policyholders are treated fairly and turned it upside down.

Perhaps it's no coincidence that D'Alessandro isn't an actuary, underwriter, CLU, CPA, or attorney. He may be the only public-relations man to become CEO of a major life-insurance company.

D'Alessandro, brand warrior and PR impresario, told policyholders that Hancock wanted to demutualize to benefit them and the company when, in reality, those who would benefit the most—and without justification—were the insiders who masterminded the process.

Although Hancock began the demutualization process several years before its January 26, 2000 IPO, most policyholders didn't have details of Hancock's plans until September 1999, when they received an 8-page brochure labeled "Information Guide," a 79-page "Policyholder Information Statement, Part 1," and a 242-page "Policyholder Information Statement, Part 2."

The length and complexity of these documents—and the absence of key information and disclosures—assured that few policyholders would understand key aspects of the plan, and accordingly, few would be able to make informed decisions about its merits.

continued

The Information Guide included a letter from D'Alessandro and then-chairman Stephen Brown urging policyholders to vote in favor of the conversion. They told policyholders that Hancock wanted to demutualize so that it would have "sufficient capital" to invest in "new technology and customer-service improvements"—that a demutualization would make Hancock "even stronger and better equipped to support your policies and benefits." (Two months later, Brown testified under oath that Hancock was already in "strong financial condition" and "did not have the need to raise...capital.")

In the process of securing policyholders' confidence and votes, D'Alessandro and Brown withheld important information: that a demutualization would enable D'Alessandro to make a fortune without creating value for policyholders (his annual pay subsequently increased 600%), and that paying Hancock's executives *much* more than they were then getting was one of the *purposes* of the demutualization.

These facts were not included in the documents Hancock sent to policyholders. They were, however, alluded to in voluminous SEC filings never seen by most policyholders: "Our primary reason for converting to a stock company through demutualization is to improve our access to the capital markets," stated one Hancock filing. "Access to the capital markets will allow us to...better attract, retain, and provide incentives to management in a fashion consistent with *other stock life insurance companies*." [Emphasis added; note that Hancock was a *mutual* insurance company.]

D'Alessandro and Brown didn't provide policyholders with material information—that the full value of Hancock's stock was much greater than the IPO price at which most policyholders would be *cashed out*. If policyholders had known this, they would have voted against the company's conversion plan or insisted upon receiving stock. (For more on Hancock's conversion, see "John Hancock's Unfair Demutualization Plan," *Schiff's*, November 15, 1999.)

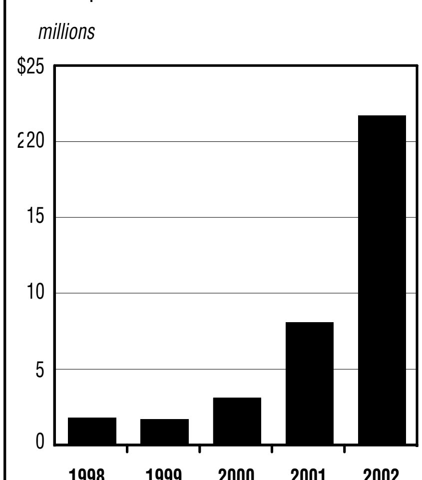
Hancock's Opposition

Hancock's plan of demutualization was not without its opponents. There was Jason Adkins (an attorney with Adkins, Kelston & Zavez), Joseph Belth (editor of *The Insurance Forum*), James Hunt (former Vermont Insurance Commissioner and a life-insurance actuary), David Schiff (an insurance observer), Thomas Tierney (a life-insurance actuary), Paul Weeks (an attorney), and The Center for Insurance Research. Although each was concerned with the inequities in Hancock's plan, they had no effective way to communicate with Hancock's millions of policyholders.

The inequities in Hancock's demutualization—which were complex and best understood by disinterested parties who had considerable experience with mutual insurance and finance—included the following: (1) Hancock's share-allocation formula for policyholders, (2) Hancock's failure to provide adequate disclosure to policyholders, (3) Hancock's conflict-of-interest-laden relationship with Morgan Stanley, which served as its investment bank, financial advisor, underwriter, and fairness-opinion purveyor, (4) The cashing out of policyholders without their informed consent, (5) The cashing out of policyholders for inadequate consideration, (6) Anti-takeover provisions that would entrench management and depress Hancock's stock price, (7) The dilution of policyholders' value through an unnecessary IPO in which stock was sold to institutional investors at $17 per share—far below the company's intrinsic value of $30 to $40 per share—which set in motion the conditions that allowed the company's senior officers to receive excessive compensation, (8) The failure to provide policyholders with subscription rights so that they could buy shares in the IPO, and (9) The hundreds of millions of dollars of compensation that Hancock's officers and directors would make for pulling off this mountebankery.

D'Alessandro's Compensation Soars

After John Hancock demutualized in January 2000, D'Alessandro's compensation rose 600%. The figures below do not include stock options he received in 2001 and 2002.



Source: *The Insurance Forum*

The Smoking Gun

On November 17 and 18, 1999, a public hearing regarding Hancock's proposed plan of demutualization was held before Massachusetts' insurance commissioner, Linda Ruthardt, who seemed more concerned with getting the hearing over quickly than getting the truth, and did not allow Hancock's witnesses to be cross-examined.

Two Hancock officers testified at the hearing. Senior vice president John DeCiccio claimed that Hancock's plan contained "safeguards" that would "restrict the amount of executive compensation." (Massachusetts law prohibits a mutual's employees from receiving fees from a demutualization, and management is prohibited from gaining "any unfair advantage.")

"Our plan [of conversion]," DeCiccio asserted, "provides that no director, officer, agent, or employee of John Hancock may receive any fee, commission, or compensation for participating or assisting in the demutualization process." DeCiccio also claimed that Hancock had "implemented restrictions on the ability of senior management to acquire, receive, or sell stock." (One can only imagine how much D'Alessandro—who was paid $21.7 million excluding options last year—might have reaped without these "safeguards" and "restrictions.")

Sharon Kamowitz, one of the presiding officers at the hearing, asked chairman Stephen Brown why Hancock's executives would be prohibited from getting stock options *for only one year*. Brown replied that Hancock had wanted a six-month prohibition, but the insurance department insisted on a year. "I think that the reasoning behind having some period of time is appropriate," he said. "It's hard to say whether it should be six months or one year."

Kamowitz then asked Brown why the conversion plan contained a three-year anti-takeover provision.

"We felt that...when you are a demutualizing company you do not have the degree of profitability that a stock company has," he said, "and that it takes a substantial period of transition to reach that level of profitability. And our board felt that we should focus our entire attention on reaching levels of profitability that are similar to successful stock companies, rather than fending off any possible takeover bids."

Brown didn't explain why *fending off* a takeover—which would have occurred at a much higher price than that at which Hancock was issuing shares—was in the interest of shareholders (most of whom were mutual policyholders). Nor did he mention a memorandum regarding anti-takeover provisions that Hancock had requested from Morgan Stanley five months earlier. In that memorandum, Morgan Stanley estimated that Hancock's "stock-market valuation" was $26.66 to $33.33 per share, and that this was significantly less than "full value." The memorandum said that since Hancock, with its desirable businesses and low valuation, "would be particularly vulnerable in its early years to an unsolicited offer...the importance of [anti-takeover] protection...may be particularly acute." Morgan Stanley said that Hancock's low valuation and growth potential implied that its stock might increase "more rapidly post-demutualization than some other companies." [The "other companies" were MetLife and Prudential.]

Brown, under oath, responded to Kamowitz by saying that he favored a three-year anti-takeover provision because *no one knew what Hancock was worth*. He said that since Hancock didn't have a history as a public company, "it is very, very difficult for the board or anyone else to determine the appropriate long-term value of the company until it is seasoned to some degree."

Jason Adkins, who was representing several policyholders, called David Schiff as a witness. Schiff, testifying *pro bono*, did not find it very difficult to determine an appropriate valuation for Hancock; one simply had to be familiar with the price of life-insurance companies. "The private market value of John Hancock is somewhere between $30 and $40 a share today," he testified. "It could be higher if there's a bidding war." (Schiff had not seen the Morgan Stanley memorandum at that time. Hancock's stock is now $31.60.)

The Massachusetts insurance department spent a considerable amount of time, money, and effort gathering papers, documents, exhibits, and opinions from investment banks, actuaries, attorneys, and John Hancock. The alleged purpose of this effort was to determine that Hancock's plan conformed with the law and was "not prejudicial to the policyholders." One didn't have to be astute to recognize that Hancock's plan was "prejudicial" in dozens of ways. The insurance department, which is supposed to protect policyholders, could have required Hancock to modify its plan or disclose material information to policyholders, but it didn't. Instead, insurance commissioner Linda Ruthardt approved the plan a few weeks after the hearing.

D'Alessandro's compensation appears to be a flagrant violation of the law.

The Big Sting

Ten weeks after the hearing, on January 26, 2000, Hancock conducted its IPO, issuing 102 million shares at $17 per share. (The net proceeds approximated the company's per-share book value—an absurdly low valuation for a life-insurance business with extremely high ratings and an excellent brand.)

Brown had testified under oath that it was "very, very difficult to determine [Hancock's] long-term value" without years of seasoning. The credibility of this statement was strained by events that followed. Shortly after the IPO, D'Alessandro and CFO Thomas Moloney apparently determined that Hancock's stock was so undervalued that it was sensible for them to borrow a significant amount of money from John Hancock to buy shares.

Hancock's plan prohibited directors and executive officers from buying stock until the twenty-first day of trading. Immediately after the 21-day ban ended, D'Alessandro, Brown, and Moloney began buying shares. By March 16 they had purchased 126,950 shares, 63,810 shares, and 44,600 shares, respectively, at prices ranging from $13.63 to $16.50. Others bought, too. Edward Linde, a member of the board, acquired 20,000 shares, and vice president Kathleen Graveline acquired 31,417 shares.

These insiders were able to buy shares so cheaply because Hancock's stock was depressed, for obvious reasons: the company had flooded the market with 102 million shares in an *unnecessary* IPO at a time when insurance stocks were cheap in general (but whole insurance companies weren't), and Hancock's conversion plan prohibited anyone from acquiring more than 10% of the company for two years and acquiring the entire company for three years—even though an acquirer was likely to pay at least $30 to $40 per share.

It appears that Hancock's board of directors did not find it very difficult to determine that Hancock was worth far more than the IPO price. Eight months after the IPO, when Hancock's shares were *already* up 60%, the company announced that its board had approved a $500-million share-repurchase program. By year end Hancock had spent $91.8 million to buy back stock at an average price of $30.60 per share.

One year after the IPO—February 28, 2001—Hancock's stock was $34.40—more than twice its IPO price. D'Alessandro, writing in his annual letter to shareholders, said that "John Hancock's stock price does not fully reflect the company's prospects," that Hancock's repurchase program was "effective capital management," and that "an investment in JHF [the ticker symbol] is an attractive way to deploy excess

D'Alessandro's Golden Parachute

David D'Alessandro's employment contract calls for him to receive a huge payment if there is a "change of control" at John Hancock (i.e. a takeover). An estimate of the value he would receive is presented below. It does not include any pension-plan enhancements he would get.

Provision	Value ($ millions)
3x base salary and bonus	$ 6.3
3x 2002 Long-term incentive plan	13.1
Restricted stock vests	23.2
Underwater options vest	10.4
Tax payments vested stock and options	11.8
TOTAL	**$64.8**

Source: Deutsche Bank Securities, Inc.

capital and enhance shareholder value." In short, D'Alessandro had, once again, made a *determination* about the company's value. (Remember, Brown testified that Hancock needed three-year anti-takeover provisions because it was supposedly "very, very difficult for the board or anyone else to determine the long-term value of the company until it is seasoned to some degree.")

Bait and Switch

Did Hancock's officers and directors know all along that Hancock was worth much more than the IPO price? (If they didn't know, why did D'Alessandro and others immediately *borrow* money to buy stock for their own accounts, and why, less than a year after the IPO, did the board approve the repurchase of shares at prices twice that of the IPO?)

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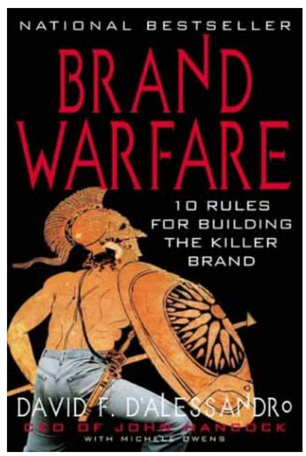
By December 31, 2002, Hancock had spent more than $1 billion to repurchase 29.5 million shares at an average price of $35.80 per share. (In its IPO, Hancock sold 102 million shares for a net price of $16.25 per share.) This large outflow of capital—$1.4 billion to cash out policyholders and $1 billion to buy back stock—hardly jibes with what D'Alessandro told policyholders when he was seeking their vote—that Hancock wanted to demutualize so that it would have "sufficient capital" to invest in "new technology and customer-service improvements."

Morgan Stanley's memorandum about Hancock's anti-takeover provisions and valuation—written on June 21, 1999, five months before the hearing and seven months before the IPO—tells us what John Hancock knew and when it knew it. Morgan Stanley wrote that "John Hancock has consistently held a strong concern about an unwanted takeover at a price that does not fully reflect the fundamental values [sic] of the company."



If Hancock's concern about an unwanted takeover at a price that didn't reflect the company's fundamental value had *anything* to do with a concern for its policyholder-owners, then it would have been logical for Hancock to be just as concerned about selling 30% of the company (102 million shares) to institutional investors in an IPO at a price far below its fundamental value. Yet Hancock demonstrated no such concern, cashing out 75% of its policyholders at the $17 per share—about $18 less than what they might have got in a takeover. Thus, the IPO and concomitant cash-out cost Hancock's policyholders about $1.8 billion in lost value.

If D'Alessandro's and Brown's concern about a takeover at less than full value was *really* the result of concern for its policyholder-owners' financial well-being, then Hancock could have adopted anti-takeover provisions pegged to a price, rather than to time. Instead of prohibiting a takeover for three years, Hancock could have, for example, prohibited a takeover for less than $30 per share for three years. Doing that, however, would have conflicted with D'Alessandro's financial interests, as well as with the interests of the other insiders. (If Hancock had been taken over for fair value right away, D'Alessandro wouldn't have had time to pile up compensation, long-term incentives, stock grants, options, incentive compensation, and other emoluments worth more than $100 million.)

A mutual insurance company is owned by its policyholders. A mutual's officers and directors have no ownership interests in the mutual aside from those they have if they own policies. Over the years, however, state laws have been rigged by the mutuals so that policyholders have no real say in the affairs of their companies (see "The Big Fix," *Schiff's*, February 1998). Although a mutual's directors and officers exercise almost absolute control over a mutual, they do so as fiduciaries rather than owners. Perhaps that's why state laws prohibit a mutual's directors and officers from receiving compensation for their company's conversion from a mutual to stock company. Massachusetts' demutualization statute, for example, states the following:

> No director, officer, agent or employee of the insurer, or any other person, shall receive any fee, commission, or other valuable consideration whatsoever, other than their usual regular salaries and compensation, for in any manner aiding, promoting or assisting in such conversion, except as set forth in the plan approved by the commissioner.

The statute also prohibits an "insurer's management" from "secur[ing] for the individuals comprising management any unfair advantage through such plan [of demutualization]." Other states have similar laws.

To prevent management from securing "any unfair advantage," officers and directors are usually prohibited from being given stock options and stock grants for a certain period. (The sooner they can be *given* options or stock, the greater their incentive to underprice the IPO, or undervalue the company—both of which are contrary to policyholders' interests.) Article 9.2 of Hancock's Plan of Reorganization complies with Massachusetts' law, decreeing that "until one year after the comple-

News

John Hancock Financial Services

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No executive officer was compensated for the IPO,

Our board's Compensation Committee did exactly what the demutualization plan required. No executive officer was compensated for the IPO, nor did they receive any stock options or stock grants during our first year as a publicly traded company. The Compensation Committee made its decisions independently and all of those decisions were permissible and appropriate under the plan of demutualization

John Hancock Financial Services, Inc. (**NYSE: JHF**) and its affiliated companies provide a broad array of insurance and investment products and services to retail and institutional customers. As of March 31, 2003, John Hancock and its subsidiaries had total assets under management of $130.4 billion.

\# \# \#

Hancock's May 28 press release

In 2000, the Committee implemented a loan program whereby the Company made loans available to members of the Policy Committee to facilitate their purchase of Common Stock pursuant to the stock ownership program. The maximum amount a member of the Policy Committee was entitled to borrow under the loan program was two times base salary. The principal amount of such loans, plus any accrued but unpaid interest, is required to be repaid prior to the earlier of (i) the 180th day after termination of employment or death of such Policy Committee member or (ii) the fifth anniversary of the first date any Policy Committee member is eligible to purchase Common Stock. Interest on the principal amount of such loans is equal to the London Interbank Offer Rate plus 1.25%, reset every 30 days.

Compensation of Messrs. Brown and D'Alessandro

In determining the 2000 annual incentive awards for Messrs. Brown and D'Alessandro, the Committee evaluated...Messrs. Brown's and D'Alessandro's individual performance against the goals established by the Committee. During 2000, [they] met or exceeded several important objectives established by the Committee, including:

• The Company successfully converted to a publicly-traded stock company.

profitability.

In view of these accomplishments, the Committee recommended annual incentive awards for Messrs. Brown and D'Alessandro for 2000 of $1,960,000 each.

Messrs. Brown and D'Alessandro are participants in the LTIP. Growth in earnings per share and return on equity were significantly above targeted levels during the three-year performance cycle ended December 31, 2000. Based on this performance under the plan, Messrs. Brown and D'Alessandro received long-term incentive payments of $1,495,200 and $1,013,148, respectively, relating to this cycle. Taking into account strong Company and individual performance, in 2000 Messrs. Brown and D'Alessandro were each granted 35,000 equity rights for the three-year performance cycle ending December 31, 2002.

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Hancock's 2001 proxy statement

tion of the IPO, neither the Holding Company [John Hancock Financial Services] nor the Company [John Hancock Life Insurance Company] shall award any stock options or stock grants to an Executive Officer or Director."

John Hancock has many programs to enrich its senior executives, including an "Annual Incentive Compensation Plan," a "Long-term Incentive Plan," a "Long-term Stock Incentive Plan," an "Employment Continuation Agreement," a "Retirement Plan," a "Stock Ownership and Loan Program," and a "Retention Arrangement" (for D'Alessandro)."

In order to receive "incentive awards" under Hancock's plan, D'Alessandro and Brown had to achieve "corporate performance objectives established by the [board of directors'] Compensation Committee." One "objective" the Committee used was how Hancock's stock performed in the year it went public. (Because the IPO was priced at a huge discount to Hancock's intrinsic value, the stock was likely to rise sharply—which it did, and, as a result, D'Alessandro and Brown were paid "incentive awards.")

Since D'Alessandro and Brown were prohibited from receiving stock grants or stock options during the first year after the IPO, the payment of "incentive awards" based on Hancock's stock performance during this period clearly violated the intent of the law, which is to prevent directors and officers from making money from the stock's rise without putting up their own money. (Hancock's officers and directors could buy stock 21 days after the IPO.)

Disregard for the Law

As noted above, Massachusetts' law prohibits a mutual's directors, officers, and employees from receiving compensation "for in any manner aiding, promoting, or assisting" in an insurance company's conversion from a mutual to stock company. Despite this absolute prohibition, D'Alessandro and Brown were paid *because* Hancock converted from a mutual to a stock company.

Hancock's Compensation Committee had established "several important objectives" upon which it based the "incentive awards" that D'Alessandro and Brown received for the year 2000. The Committee concluded that the two men "met or exceeded" these objectives. In a 2001 report, the very first "objective" cited by the Compensation Committee was that Hancock "successfully converted to a public company." As a result, D'Alessandro and Brown were paid incentive awards because they "met or exceeded" this absurd "objective."

That Hancock's Compensation Committee actually used Hancock's conversion from a mutual to a stock company as an "objective," and paid D'Alessandro and Brown based on that, is shocking because it appears to be a *flagrant* violation of the law, which prohibits the payment of "any fee, commission, or other valuable consideration whatsoever, other than their usual regular salaries and compensation, for in any manner aiding, promoting or assisting" in the "conversion."

By using the conversion from a mutual to stock as an "objective" upon which it gave extra money to its two top officers, Hancock demonstrated remarkable audacity. At the public hearing, senior vice president DeCiccio had testified under oath that "no director, officer, agent, or employee of John Hancock" would "receive any fee, commission, or compensation for participating or assisting in the demutualization process." Massachusetts law and Article 9.3 of Hancock's plan of reorganization use similar language. Nonetheless, John Hancock paid D'Alessandro and Brown "incentive awards" because Hancock "successfully converted to a public company."

On a May 2, 2003 conference call with investors, D'Alessandro displayed absolutely no shame or remorse. "Another fallacy," he said, "is that we could not be rewarded for our IPO success and for year-one valuation. That's simply not true. We could not be rewarded within that year, nor could we have a program within that year that rewarded it. Going back, we could do—and indeed the Comp Committee felt it was important—to look at the IPO success. And the last three years we've been in a program to give—to the top three executives here that participated in the IPO—compensation for that success."

In case you think that was just a slip of the tongue, here's what D'Alessandro had to say a moment later. We have italicized the highlights:

> I thought maybe the best way to answer this kind of question is to pose a few questions that are considered by the [Compensation] Committee.
>
> The first one I mentioned before, which is: *How are we going to compensate senior management for the IPO* and subsequent value that was created?
>
> They felt it was important to award executives working in the best interest of our two owners, first our policyholders that owned us prior to the demutualization...and then, of course, the shareholders.
>
> So what did we do? *The Comp Committee's plan was to reward the executives for value created at the IPO*, as I said, and value sustained for three years.

How many hundreds of millions can one siphon from a mutual insurance company before the Massachusetts insurance

"...and then John Hancock's CEO got a zillion dollars."

department does something about it? Must an insurance company take out a full-page ad in *The Boston Globe* announcing a violation of the law before Massachusetts' insurance commissioner Linda Ruthardt awakens from her somnambulism?

A Special Loan

Hancock's scheme to enrich D'Alessandro and his confederates did not stop here. Immediately after the IPO, Hancock created a "stock ownership and loan program." (Remember, Hancock's Plan of Reorganization prohibited D'Alessandro and executive officers and directors from receiving stock options and stock grants for one year after the IPO.) Four to five weeks after the IPO, Hancock lent D'Alessandro $1,999,909 to "facilitate [the] purchase of common stock of John Hancock Financial Services, Inc. pursuant to the stock ownership program." (As mentioned earlier, other executives got loans as well.)

The terms of the loans were better than those offered by anyone in the business of lending money. D'Alessandro was not required to post collateral or make principal payments for five years. The interest rate was LIBOR plus 1.25%. The loan itself—regardless of the terms—violated the intent of the law. D'Alessandro and others were prohibited from receiving stock grants and stock options, yet four to five weeks after D'Alessandro oversaw Hancock's demutualization and IPO at a price that Morgan Stanley opined was far below the company's "full value," he received a $1,999,909 loan from Hancock to buy stock at prices that were dirt cheap *because* he had masterminded a conversion and IPO in a manner that was almost guaranteed to produce a dirt-cheap stock price. (In Mel Brooks' *The Producers*, the protagonists try to make a bundle by producing a Broadway flop—but fail and end up in jail. David D'Alessandro produced an IPO flop and ended up getting a package worth more than $100 million.)

Before the conversion, Hancock could not have made the same loan to D'Alessandro. Massachusetts' law governing *life-insurance companies* states that "no loan...shall be made to an individual unless it is secured by collateral security; and provided further, that such funds shall not be invested in the purchase of stock..." John Hancock Financial Services, however, is not a life-insurance company (it's a holding company), and therefore could make an uncollateralized loan to D'Alessandro so that he could buy stock.

The stock loans weren't a violation of Massachusetts law *per se*, but they were a breach of Hancock's fiduciary responsibility to its policyholders. Hancock should have told policyholders about any loans that might be made to officers and directors before the policyholders had to vote on the conversion plan and *before* they would be cashed out at the IPO price. When D'Alessandro and Brown had written to policyholders several months earlier, they hadn't told them that Hancock would lend D'Alessandro $1,999,909 to buy stock—stock that Morgan Stanley had previously opined was worth much more than the offering price).

If Hancock's policyholders had understood that D'Alessandro would load up on Hancock's undervalued stock with money borrowed from Hancock, they would, in all likelihood, have wanted to receive stock rather than be cashed out at $17 per share. (Approximately 75% of policyholders were cashed out at the IPO price.)

Although Morgan Stanley had written a memorandum opining that Hancock was worth far more than the IPO price, D'Alessandro didn't tell policyholders about it. Instead, Hancock, through the use of off-putting language, persuaded many policyholders to accept a cash-out even though it was in their interest to receive stock. "It is highly likely that there will not be enough cash to distribute to all policyholders who prefer cash," stated Hancock's Information Guide. (As noted earlier, Hancock had no economic need to cash out policyholders who were eligible to receive stock.)

Hancock's Policyholder Information Statement devoted four pages to a reasonably positive summary of Hancock's business, followed by *ten pages* about the "risks" of owning Hancock's stock. It is proper to disclose risks; it is not proper to make an unbalanced presentation. By emphasizing the risks of Hancock's stock (which were not significant considering the bargain-basement IPO price), and omitting key facts—in particular, Morgan Stanley's opinion of Hancock's "full value"—Hancock duped policyholders into taking cash instead of stock. (It appears that the majority of policyholders didn't understand the material they received from Hancock: only 30% of policyholders voted on the conversion.)

Hancock made it especially difficult for policyholders who were to receive only a small number of shares (even though they weren't necessarily small policyholders). If a policyholder *didn't* want to be cashed out, he had to complete and return a "Cash/Stock Compensation" card. As former Vermont insurance commissioner James Hunt testified, that was a form of "negative sign-up," and "negative sign-ups for insurance have always been frowned upon, if not prohibited."

At the November 17 hearing, Brown testified why, as part of the complex restructuring, it was fair to cash out most of the policyholders rather than give them stock: "The demographics of our policyholder base...are very heavily weighted towards smaller policyholders, older policyholders—people who we felt should not have stock forced upon them, because we feel that...any individual stock is subject to risk. And I think the people who have commented on this in the past have simply ignored the risk..."

It was sensitive of Brown to be so concerned about his policyholders that he spared them the risk of receiving shares in John Hancock at a dirt-cheap price. According to Brown, the small, old policyholders were better off being cashed out at the ridiculously low offering price, thereby incurring a tax and eliminating the likelihood of future capital gains. (Brown, not surprisingly, *bought* plenty of stock for his own account.)

Six months later, on May 5, when Hancock's stock was trading in the $20 range, Brown told a conference-call audience—primarily institutional investors and analysts—that Hancock was considering a share repurchase. "We believe our stock is significantly undervalued," he said.

Insider Trading

Hancock's management was prohibited by law from securing "any unfair advantage" through the plan of demutualization. Hancock's management, however, was in possession of a crucial piece of information—the Morgan Stanley memorandum that opined on Hancock's "full value." Because this memo—or its contents—was not disclosed to policyholders in the documents they received from Hancock, policyholders were at a material disadvantage to management and others who were aware of the memo. Whether Hancock's failure to tell policyholders about this memo provided management with an "unfair advantage" in violation of the laws governing a Massachusetts' demutualization is a matter that may have to be settled in court.

Although insurance is regulated by the states, the sale and purchase of securities is a federal matter and is regulated by the SEC. Although Hancock didn't tell its policyholders about the Morgan Stanley memo, the memo was, in fact, a public document. It was among perhaps 100,000 pages of documents and exhibits in the Massachusetts insurance department's Public Document Room, and it is available from the department by making a freedom of information law request.

The existence of this document—buried in public files—does not mean that its existence was adequately disclosed to policyholders or to *shareholders*. When Hancock's insiders began buying stock twenty-one days after the IPO, some—or many of them—were doing so with the benefit of having seen the Morgan Stanley memo. There is no question that DeCiccio and Brown saw it, and, presumably, other senior officers and members of the board (including D'Alessandro) should have been aware of it due to its importance.

This raises the question of whether Hancock's insiders who purchased stock did so in violation of securities laws against illegal insider trading. Rule 10b-5 (Employment of Manipulative and Deceptive Devices), promulgated under the Securities Exchange Act of 1934, states that it is unlawful for any person "to make any untrue statement of a material fact *or to omit to state a material fact necessary* in order to make the statements made, in the light of the circumstances under which they were made, not misleading...in connection with the purchase or sale of any security."

The SEC's website notes that "illegal insider trading refers generally to buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, *while in possession of material, nonpublic information about the security*." [Emphasis added.]

It seems highly likely that broad public disclosure of the Morgan Stanley memorandum would have had a significant positive effect on the price of Hancock's stock. Yet no broad disclosure was made, and, as a result, Hancock's senior officers and directors were able to buy stock at cheaper prices than they would have been able to otherwise.

We believe that the SEC should investigate this matter.

"The John Hancock brand stands for integrity," writes D'Alessandro in Brand Warfare. "The safekeeping of the brand is the CEO's responsibility. The buck stops there." David D'Alessandro has besmirched Hancock's reputation. He is arrogant and greedy, has overstepped the bounds of decency and fairness, and can't be trusted. He should be fired, and should not receive golden-parachute payments. In addition, Hancock should seek to recover the excess compensation paid to him.

Hancock's Compensation Committee should be replaced by new directors. Finally, Hancock should make restitution to the policyholders who were cashed out without receiving proper disclosure.