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Letter from the Editors

In this issue, we examine the influential people, companies and industries that represent the inherent and growing talent and innovation that defines San Diego. The Rady School of Management, with its wealth of talented students and faculty, provided us with a plethora of talented authors. We feel that this issue will not only give readers a peek into San Diego’s relevance today, but also its impact on the global economy in the future.

In this edition, we present topics at the frontiers of innovation such as emerging technologies in wireless health care and cloud computing. We also address the competitive arena and the effects of technology innovation on the operations of the television industry. Stepping away from the technology space, we are proud to deliver insights into the world of finance and economics. We discuss with a Nobel Laureate his ideas of Modern Portfolio Theory. The authors also explore the philosophies of value investing, financial regulation and employee ownership. In addition, our Rady School faculty provide a unique and innovative analysis into pricing and incentive experimentation in firms.

The articles in this issue represent the cutting-edge innovations in San Diego and broad networking opportunities the Rady School of Management offers our students.

Karen Boyd and Juan Mier
Co Editors-in-Chief
For many U.S. households, it is difficult to imagine a world without television. In fact, 115.9 million homes have at least one television, with an average of two-and-a-half per home. Broadcasters, content producers and distributors seek to satisfy Americans’ 35.6 hours per week consumption habit with an ever-growing array of channels and increasing diversity of programming.

In 2009, TV industry analysts and advertising pundits noted signs of volatility as traditional advertising revenues began to detour to a variety of Internet video providers, including YouTube and Hulu. Prime time TV viewership had dropped and improved online program quality compelled viewers to watch longer content on the Web. The ubiquity of broadband Internet and adaptive streaming technology, a disruptive technology that overcame periodic slowness in broadband, posed a new threat for Multichannel Video Programming Distributors (MVPD) — the FCC’s name for cable, satellite and IPTV providers. With adaptive streaming technology, an Internet video provider could reach quality levels suitable for viewing on high definition TVs and computer screens.

Enter Netflix, a fast growing DVD rental-by-mail house and early adopter of adaptive streaming technology. Netflix prepared their recently licensed Starz movies for Internet distribution and executed a strategy to reach as many TVs as possible, engaging in head-to-head competition with MVPDs in the video-on-demand market. They partnered with Blu-ray players, game console manufacturers and Roku, a startup focused on placing inexpensive set-top-boxes in viewers’ living rooms. This strategy provided easy access to homes where high-definition content was a must-have and broadband Internet connections were readily available.

In 2010, Hulu and AppleTV, also adopting varieties of adaptive streaming, combined standard broadcast content with clean, powerful user interfaces. It appeared that “cord-cutting,” or the act of replacing your MVPD with Internet content, was going to shake the foundation of the TV industry, leaving a wake of broken business models and apprehensive content producers, advertisers and distributors.
The Business of Television

TV is available through several mainstream modes. Traditional broadcast TV, known as over-the-air (OTA), is the least expensive and most widely available. With a small antenna and modern TV, most Americans have access to the major broadcast networks: ABC, CBS, NBC and FOX. The large broadcast networks rely on Nielsen ratings to determine program value, which in turn enables them to value advertising time slots. Often a broadcaster’s top program commands an audience in excess of 14 million viewers, while a championship football or baseball game may attract nearly 60 million viewers. In addition to advertising revenue, broadcasters receive a small retransmission fee from MVPDs who place these signals on their own networks.

Few people are satisfied by the limited channel lineup or aesthetically unappealing antenna that accompanies the OTA TV model. Many opt for a broader range of content by way of MVPD such as AT&T U-Verse, DirecTV or Time Warner. The combined market share of the top 25 MVPDs is nearly 100 million TV households. These distribution networks offer nearly 500 channels (including the OTA channels) and with the exception of Dish and DirecTV, offer phone and Internet service directly through unified infrastructures.

The business model for these MVPDs is different from that of the OTA. MVPDs rely on cable programming networks, such as ESPN, Discovery Channel and CNN, who often require a significant per-subscriber fee for their content. In turn, all MVPDs charge subscribers for large channel bundles; though many subscribers spend the majority of viewing hours on just a few channels. Satellite and IPTV providers offer telephony, Internet and TV services for less than $100 per month. Many cable operators offer similar “triple play” packages, where average revenue per user is nearly $135 per month. MVPDs also provide large video-on-demand libraries, which are accessible to subscribers on a per-view basis of approximately five dollars for most new releases.

Finally, the newest and latest models of TV consumption come from online video providers: Apple, Hulu and Netflix. Apple maintains a closed eco-system, allowing viewers to purchase or rent movies and TV shows through its tightly controlled iTunes store, which delivers content to computers, phones, tablets and most recently, an Internet-enabled set-top box. Netflix rents DVDs by mail and streams content to a wide variety of computers, phones, set-top-boxes and smart TVs.

Infrastructure Differentiates Competitors

The MVPD competitive landscape is shaped by infrastructure advancements and government policy. Cable companies have franchise agreements that ensure their fiber and coaxial cable infrastructures are not shared by other cable companies. For example, Cox cannot compete with Time Warner. Satellite TV providers, Dish and DirecTV, have an FCC-licensed spectrum that allows them to provide vast signals that blanket the U.S. without interference. IPTV providers, leveraging new fiber and DSL technology, fight to shed their telephone company designation as their primary revenue-generating services become television and broadband Internet.

IPTV, satellite and cable compete to offer subscription TV. Broadcasters and cable programming networks behave as arms dealers and offer their content to most MVPDs, regardless of network type. With all providers, churn, an industry metric for periodic subscriber loss, is the enemy.

The Cord Cutter Alternatives

In 2010 the phrase “cord cutter” dominated the TV technology media, as cable lost 710,000 TV subscribers by the third quarter. Many predict the fourth quarter numbers, yet to be announced, will reveal one million lost. However, the loss has often been misinterpreted since competitors to cable like DirecTV, DISH, Verizon and AT&T (satellite and IPTV), added nearly 500,000 subscribers. Despite this shift there was an overall loss of nearly 250,000 subscribers to the industry. Analysts agree: this is unprecedented. Many agree that this loss represents an exodus to the Web for content.

Three main positive growth indicators are cited: Netflix subscribers, Hulu revenue and the AppleTV re-launch.

Netflix charges subscribers between $8 and $14 per month and provides a streaming and DVD-by-mail service for a full library of movies and TV shows. But how did Netflix, a direct video-on-demand competitor of the MVPDs, add 7.7 million subscribers in 2010 to reach a staggering 20 million total? Netflix avoids sports and live content and focuses on monetizing content that MVPDs have been unable to market. Moreover, they take advantage of the latest adaptive streaming technology to reach out over broadband Internet connections to nearly all Blu-ray players, game consoles and inexpensive consumer set-top-boxes, such as AppleTV.

At a recent UBS Media Conference, Time Warner Cable CEO Glenn Britt blamed the cable set-top-box, which Charter Cable’s CEO later referred to as the “Achilles heel of the industry.” More to the point, SlingBox (now DishTV) Founder Blake Krikorian said, “The reason other services have started to crack in, is because they (MVPDs) have not provided a great user experience. Netflix should not exist if the cable guys actually did VOD really well.”

Netflix is nearly a $10 billion company; if the National Cable & Telecommunications Association ranked it among MVPDs, it would be ranked second in terms of subscribers, between Comcast (23 million) and DirecTV (19 million).

If Netflix is a cord cutter’s video-on-demand, then Hulu is their version of traditional TV. Hulu is a corporate conglomerate with founders such as NBC Universal, Newscorp and The Walt Disney Company. Hulu operates with two business models: a free, or ad-supported model, similar to that of the aforementioned FTA/broadcast model; and a subscription model, similar to Netflix. Hulu commands a large viewership of 30 million viewers per month. Like Netflix, Hulu maintains a brilliant user interface and leverages the adaptive streaming
technologies that allow its quality to rival that of competitive MVPDs.

Finally, AppleTV (version 2) was announced with great fanfare in the middle of 2010. While GoogleTV has pulled back, AppleTV continues to sell strong (over 1 million units). A $99 set-top-box allows users to view Netflix or connect to their iTunes accounts to rent movies and TV shows. Apple uses its own version of adaptive streaming to ensure a quality picture. Unlike Netflix and Hulu, Apple has created some apprehension among content owners and producers. Some have been openly critical of Apple’s demand to rent shows for $0.99, including NBC Universal. At launch time, Steve Jobs stated that ABC and FOX were online and he thought “the rest will see the light and get on board with us.”

The Active Role of the FCC

Despite decades of regular negotiations, 2010 was perhaps the most tumultuous period in TV history. Broadcasters and other content producers became concerned over the significant loss of advertising revenues in 2009, the lowest since 1995. Negotiations resulted in full-page negative advertising, with each side accusing the other of damaging consumer value.

In one failed deal between FOX and Cablevision, nearly 5 million subscribers lost access to the FOX network for two weeks, causing the FCC to revisit its role in protecting consumers’ rights. Though the FCC hopes to draft regulations to prevent this, TV Analyst Ryan Lawler states, “By the time the process is finished, consumers can expect to see several more contentious negotiations end in blackouts.”

The Past is the Future

MVPDs have 100 million subscribers and remain profitable. IPTV and Cable operators possess the infrastructure that connects Netflix, Hulu and AppleTV with subscribers. Should IPTV and satellite, continue their growth as a middle tier, above the low price leaders: Netflix, Hulu and Apple? Should cable worry about a loss of subscribers to these services? Many companies have tried to break the TV model and only succeeded in chiseling a corner away, even Netflix is at the mercy of apprehensive content owners who dare not jeopardize their lucrative cable revenues.

Perhaps the new state of TV is change. Disruptive technologies and models will come and go at an unprecedented rate. In the words of billionaire businessman, HDNet Owner and TV evangelist Mark Cuban, “The number of DVRs, HDTVs and VODs users will continue to expand every year. Every year for the next 10 years we will be discussing the future of Internet video and all the great things that could possibly happen. Remember this. The potential for video over the Internet is huge…and always will be.”

Jarrod Hammes (Rady Full-Time MBA ‘08) is a marketer with more than 10 years of experience developing television transmission technology. He is the vice president of marketing for IP Video Networks, a company that specializes in global IP media delivery and quality analytics.
Intuition Can’t Beat Experimentation

by Professors Ayelet Gneezy and Uri Gneezy

In the summer of 2009, we received a call from Joe, a winery owner in Temecula. Joe asked for our help with pricing his wines — clearly one of the most important decisions he needs to make. We were happy to go visit Joe, taste some wines and possibly help him in the process.

When we asked him how he’d chosen prices in the past, we encountered the usual suspects: looking at how other wineries price similar wines, intuition, inertia, etc. Joe expected the business professors to come over, look around, do some quick calculations — and come up with the magic number that would make him rich. You can imagine then how disappointed he was when, having spent some time with him (and his wine), we told him we had no idea what the “right” price was and that the magic number didn’t exist. He almost took away the wine he’d already poured for us.

In an attempt to save our drinks, we did offer him help. The help was a method—no magic, equations, or superior knowledge — just a simple experimental design. This article provides a brief introduction to a new and exciting field in behavioral economics: experimentation in firms. The new part of this method is the use of economic techniques in the process of designing and running experiments and then analyzing the results. The main takeaway is that in many market instances, experimenting (rather than guessing) is the most accurate, simple and often the cheapest way to know how to approach a challenge, be it the pricing, presentation or promotion of a product.

Why Do We Need Experiments in Firms?

Business experiments are research investigations that present companies with an opportunity to get fast and accurate data regarding important decisions. Manipulating various factors in the environment could be used to better understand the causal relationship between a change in strategy and a response in consumers’, employees’ or other stakeholders’ behavior. Typical examples of business experiments are the use of a promotion on a test population, with the goal of determining the optimal conditions (discount depth, discount type, framing, etc.) for maximizing a promotion’s success. This test is different from commonly used focus groups, because participants make real life decisions without even knowing that they are part of a study. When designed properly, business experiments can provide invaluable insights and reveal surprising results, which the company can then implement on a larger scale.
Numerous challenges are associated with predicting market reaction to changes. Research has shown that imagining consumers’ thought processes and reactions is difficult. Product, service and market information is typically more readily available to the manager, but this availability does not necessarily make the prediction easier or more accurate. Even the most educated guesses remain imprecise at best. With this difficulty in mind, an important tool for predicting how the market will receive your efforts is experimentation. A well-controlled experiment provides an unbiased snapshot of how consumers may react to changes.

To understand the spirit of things, imagine going to your doctor, who prescribes a new treatment for you. When you ask her what she bases this treatment on, she gives you the same answer Joe gave us: “By looking at what others have done, intuition, inertia.” This answer would be suspicious at best and not very reassuring. You would prefer your doctor base her decision on empirical research!

**Examples: Pricing Wines, Pricing Photos**

Let’s go back to Joe, the winery owner. Pricing wines is a particularly tricky task since quality is objective. Intuition asserts that price and quality will be positively correlated. Often, when product attributes are objective and measurable (e.g., the weight of a laptop when lighter is better), finding evidence basic to this basic intuition is difficult. Consequently, substantive literature provides evidence that when the quality of a product is hard to evaluate, increasing its price (without changing actual quality) increases its attractiveness to consumers. Is this also the case with wines?

Visitors to Joe’s winery, as with others in this region, can taste different wines and subsequently choose to buy from the available selection. Consumers typically come to this region for wine trips, going from one winery to another, sampling and buying wine. The wine we experimented with was a 2005 Cabernet Sauvignon. The price Joe had previously chosen for it was $10, and it sold well.

For our experiment, we manipulated the price of the Cabernet to be $10, $20 or $40 on different days during two weeks. Each experiment day, Joe greeted the visitors and told them about the tasting. Then visitors went to the counter, where they met the person who administered the tasting and gave them a single printed page containing the names and prices of the nine included wines, ranging from $8 to $60, of which visitors could try six of their choice. As in most wineries, the list was constructed from light to heavy, starting with white wines, moving to red wines and concluding with dessert wines. Visitors typically choose wines going down the list, and the Cabernet Sauvignon was always number 7. Tastings take between 15 and 30 minutes, after which visitors decide whether to buy any of the wines.

The results shocked Joe. Visitors were almost 50 percent more likely to buy the Cabernet when he priced it at $20 than when he priced it under $10. Using an almost costless experiment and adopting prices accordingly, Joe increased the winery’s total profits by 11 percent.

Interestingly, following this experiment, Joe happily adopted the results and changed the price of this wine to $20. However, he did not adopt the experimental method and didn’t plan to in the future.

On a larger-scale experiment, we (together with Leif Nelson and Amber Brown) tested a new pricing strategy in one of Disney’s amusement parks. We suggested Disney test a new model of corporate social responsibility that allows customers to take greater ownership in their donations. In the field experiment with over 100,000 participants, we manipulated two factors in the sale of souvenir photos. First, customers saw either a traditional fixed price or could choose their price (including $0). Second, half of those customers saw a variation in which half of the revenue went to charity.

We found that at a standard fixed price, the charitable component only slightly increased demand. However, when participants could choose their price, the same charitable component created a substantially more profitable treatment. Switching from corporate social responsibility to what we termed shared social responsibility works in part because customized contributions allow customers to directly express social welfare concerns through the purchase of material goods.

From a business perspective, Disney’s profit from this change will amount to over $600,000 a year, just in this one location in the park. More generally, this change also increased the benefit to the charity and presumably to the customers who felt they were doing something good.

**Our Message**

So why don’t businesses experiment more? A number of barriers make implementing experimentation in firms difficult. For example, the students who helped us write this article were recruited in order to help with a field experiment on incentives in a large company. This was back at the end of the summer, over half a year ago. We naively believed that by now we’d have the data that they could analyze. In reality, the study is still buried somewhere in the big organization, waiting for management approval.

At existing companies with standard procedures, instilling a culture of experimentation is hard, especially if past success has occurred independent of experimentation. Some of the typical barriers are managers that are intimidated by the uncertainty involved in a change and the unknown. Going the traditional way without introducing new methods is familiar and as long as it works, it seems safer (“if it ain’t broke, don’t fix it”). Another barrier is that managers feel they’ve been hired to provide solutions and make tough decisions to enhance the firm’s performance. In other words, they feel they are expected to have ready answers for the challenges the firm faces. Opting for experimentation may appear to imply they don’t and could compromise their level of expertise – as if they have failed to do their job.
One could overcome these barriers in two distinct ways: top-down and bottom-up. Under top-down, the company’s managing team would need to overcome the typical “short-term earnings first” mindset and encourage (and even reward) experimentation that can improve the firm’s performance. This approach would require some level of training that would provide the relevant employees with the skill set to design and run experiments, analyze the data and draw conclusions. Under a bottom-up approach, lower-level managers could conduct smaller-scale field studies and then present the results to the management, providing them with the costs and benefits associated with expanding the experimentation and potentially defining new practices (prices, promotions, etc.).

Changing a tried – if not so true – mindset is no small feat. We suggest starting with future leaders by providing them with the concepts and basic skill sets associated with experimentation via the curriculum of MBA students. Education, combined with hands-on experience, would help decrease suspicion and skepticism and provide tomorrow’s leaders with some tools that would allow them to make a difference in the way companies make decisions.

Uri Gneezy is the Arthur Brody Endowed Chair in Behavioral Economics and professor of economics & strategy at the Rady School. Before joining the Rady School, Gneezy was a faculty member at the University of Chicago, Technion and Haifa. He received his Ph.D. from the CentER for Economic Research in Tilburg.

Ayelet Gneezy is an assistant professor of marketing at the Rady School. Prior to graduate school, she worked as a consultant in marketing services to companies in various industry areas including consumer goods, banking services and the nonprofit sector. Gneezy received her Ph.D. in marketing from the University of Chicago Booth School of Business.

Research assistance was provided by Eric Dorflinger, Joshua Rutenberg, Ning Ge, Poornima Suresh, Sam Chi and Toshi Nakamura.
More than 100 million Americans are living with at least one chronic disease and if current trends continue, as many as one in three U.S. adults will have diabetes by 2050. In 2009, the U.S. spent more than $1.7 trillion on chronic disease care and by 2010 health care accounted for 17 percent of the U.S. GDP, rising at a rate 2 percent above the overall economy’s growth rate.

Faced with these numbers, it is clear that the public health burden of chronic disease will cripple the health care system unless drastic changes are made. According to Dr. Eric Topol, chief academic officer for the Scripps Translational Science Institute and co-founder of the West Wireless Health Institute, “If there ever was a perfect storm — in a good way — for medicine, this is it, because we’re desperately needing innovation and cost-saving approaches.”

What is the answer to this health care crisis? One solution is wireless or mobile health devices — and San Diego is virtually at the epicenter of the wireless health revolution. Home to 600 life science companies, 1,900 wireless/IT companies and 75 research institutes, San Diego is becoming the preeminent location for wireless and mobile health.

Cementing this reputation was the establishment of the West Wireless Health Institute (WWHI) in La Jolla, one of only a handful of nonprofit institutes around the world specifically created to advance wireless health. The mission of the WWHI is clear: lower health care costs by accelerating the availability of wireless health solutions. Although the public appears poised and ready for these solutions — it is estimated that the market for wireless health devices and services in the U.S. will reach almost $10 billion by 2012 — there is reticence on the part of some physicians, patients and the government that must be addressed before mass adoption of mobile health becomes a reality.

**What is mHealth?**

Wireless or mobile health (mHealth) is broadly defined as the use of mobile devices for health or wellness purposes. It encompasses the physical devices used to collect or manage health data, the wireless technology used to transmit the data (e.g., Bluetooth, WiFi or 3G) and the associated software applications that support health care. Ranging from large coordinated health care systems such as Kaiser Permanente down to health-conscious consumers, mHealth solutions are present at every level.

While 2009 was considered the breakout year for mHealth, 2010 saw an explosive growth of mHealth technologies and companies, many of which are located in San Diego. From this, it is appears the technological hurdles associated with the collection and transmission of mHealth data are being cleared. However, before the mHealth revolution can get underway, there remain a significant number of social and regulatory barriers.

Within mHealth, there are two principal divisions, those devices prescribed or used by doctors in the care of patients and those marketed directly to consumers. Clinical mHealth encompasses the lion’s share of wireless health and includes devices and applications to monitor or treat chronic conditions, such as diabetes, and devices used in hospitals to monitor patients and equipment. These devices must pass federal Food and Drug Administration (FDA) safety standards and demonstrate clinical utility though large clinical trials...
before being used routinely in medical practice. Currently, there are only a handful of FDA approved wireless medical devices, such as the CardioNet continuous ECG monitor and the myGlucoHealth blood glucose monitor, but many more are positioned to seek approval in the near future.

The other division is consumer mHealth, which is primarily focused on preventative wellness monitoring and not subject to FDA review. Compared to the small number of FDA approved wireless medical devices, there are more than 200 million mHealth applications currently in use and that number is expected to top 600 million by 2012. In addition to smartphone applications, there are stand-alone devices that consumers can buy directly. Examples include the BodyMedia FIT or FitBit — devices worn on the body to track caloric burn during the day — and such products as the Wii-fit and Nike+, a running shoe that wirelessly shares exercise data.

**Regulatory Hurdles**

If wireless health technology is here, why is there the sense we are still awaiting the full revolution? To begin, the nascent industry faces a number of uncertainties that make entrepreneurs, developers and investors wary of committing the necessary capital to spur significant growth. One of the most important factors driving uncertainty is the degree to which mHealth devices, transmissions and applications will be regulated by the federal government.

Last year, in a bold and forward-thinking move, the FDA and Federal Communications Commission (FCC) announced a partnership and subsequent public meeting to streamline regulatory processes and clarify the agencies’ jurisdiction over wireless devices. “The joint FCC-FDA public meeting is a vital first step in providing the regulatory clarity that is needed to spur investment and innovation in health care delivery,” said Dr. Joseph Smith, WWHI’s chief medical and science officer. “The relationship between FDA approval and FCC certification of wireless-enabled medical devices must be further delineated and expedited to overcome hurdles to innovation identified both by both agencies.”

To accelerate this process and provide a policy perspective, a private sector short-term industry coalition was formed in May 2010. The mHealth regulatory coalition (MRC) includes members ranging from device manufacturers to clinicians and researchers. In August 2010, the MRC submitted a guidance letter to the FDA and FCC outlining three primary considerations to reduce the regulatory burden facing mHealth.

First, the MRC called for clarification in defining the regulatory boundary between medical and wellness uses of mHealth technology. It is clear that the FDA must approve high-risk and medically critical technologies, however it is less clear for devices that are low risk and could be used in medical treatment or for general wellness (e.g., wireless scales for post-bariatric surgery monitoring versus general fitness use).

Second, the MRC urged a review of the medical device accessory rule, arguing that current regulations may “unnecessarily limit the advancements in health care delivery offered by mHealth technologies.” The strict interpretation of this rule requires FDA approval across the myriad of connections necessary for functioning mHealth solutions — from the Bluetooth or cellular network used to initially transmit the data to the broadband Internet connection used to access and manage the data. The MRC argues that these connections are precisely what makes mobile health possible and drives much of the value. Requiring individual FDA clearance for each of the multitude of connections would likely inhibit the growth of mHealth.

Finally, the MRC highlights the importance of separating physical mHealth medical devices from supporting software systems that are frequently used by physicians to help diagnose or treat a patient, with the aim of leaving software systems relatively unregulated. They argue that the current rules for regulating software are inadequate because they “cannot cover the complexity of the software architectures and the variety of mHealth systems” and the resulting regulatory uncertainty impedes innovation and development.

In another series of recommendations to the FCC and FDA, the Wireless Life Science Alliance offered a solution to these hurdles, recommending post-market surveillance of some products rather than full pre-market approval.

**The Tipping Point**

According to a recent report from Pyramid Research, as many as 70 percent of people worldwide are interested in having access to mHealth applications. Notably, countries with large populations and limited health care options, such as South African nations and India, are the most interested in mHealth solutions given the ubiquity of mobile phones even in the most remote regions of these countries. However, even given the significant market size, much of the resistance to adoption of mHealth centers around cost. It is unclear who will pay for these solutions — insurance reimbursements or consumers — and how the development costs will be recouped. Compounding this hesitation is the fact that the health care industry is traditionally a slow adopter of change.

How then will mHealth become the new norm? Many are now looking to the end users, the consumers, to drive the market. As seen in genomic medicine with the popularity of direct-to-consumer genotyping driving genomic education for physicians, if patients begin to demand wireless health solutions, providers will have to listen. “It’s a consumer-driven revolution,” said Topol. “It’s using the smartphone as a mediator of this information.”

Recent research by the Deloitte Center for Health Solutions supports this sentiment. They found that the younger generation will likely drive clinical mHealth, with as many as twice the number of Generation X and Y patients wanting access to their personal health records via a mobile device than baby boomers or seniors.
Paul Sonnier, wireless health industry catalyst and vice president of partner development for the WLSA, envisions a process analogous to the consumer demand for organic foods. "The parallel model demonstrated by the organic movement is that availability of products was not immediate," said Sonnier. "Of course, neither was demand. There's a feedback loop that we need to initiate, wherein consumers become aware, products are available, demand increases, solutions evolve and so on in a mutually reinforcing way."

Although organic foods began as a small niche market, producers were attracted by the demand for organic products and now quality organic produce and meats are everyday items in large supermarket chains. Perhaps one day soon you will find an equal variety of mHealth options at your local drugstore.

Ashley A. Van Zeeland, Ph.D. (Rady FlexMBA ’13) received her doctorate in Neuroscience from UCLA, specializing in the neurobiology and genetics of autism spectrum disorders. She has been published in Science Translational Medicine, Autism Research and Biological Psychiatry. Dr. Van Zeeland is currently the Dickinson Research Fellow in Genomic Medicine at the Scripps Translational Science Institute. She has an interest in combining genomic medicine with wireless health technologies, especially in early interventions for neurodevelopmental disorders like autism.
Executive Compensation in an Era of Fiscal Irresponsibility

The origins of the Dodd-Frank Reform Act

by Berna Kamyar

As the financial crisis of the late 2000s proceeded through its worst stages, numerous accounts emerged detailing the reluctance of executives to moderate their lavish pay-packages. Despite hard times, boards of directors continued to approve highly lucrative payments for executives while paying little regard to the plights of rank-and-file workers.

Professor Shivaram Rajgopal, a professor at the Goizueta Business School of Emory University whose research activities center on executive compensation, put the situation this way: “Look at Larry Ellison (CEO of Oracle). He earns so much money, does he need another billion dollar option grant to keep him motivated? I find it hard to believe.”

As public outrage reached its height in 2009, Congressman Barney Frank and Senator Chris Dodd proposed a law, the Dodd-Frank Reform Act, seeking to achieve widespread reform in the financial sector.
Legislators included provisions within the act directed at encouraging firms to incorporate greater shareholder input prior to approving pay packages. However, the non-binding nature of shareholder votes and the lack of adequate enforcement mechanisms guarantee that astronomical levels of executive compensation will continue to be approved by some public companies, even amid widespread shareholder disapproval.

Despite this, the law had high profile proponents, such as Joseph Bechelder III, member of the advisory board of the Program on Corporate Governance at Harvard Law School. In a Law.com article titled “Dodd-Frank: Selected Provisions Applicable to Executive Pay,” Bechelder argued that the “provisions in Dodd-Frank that affect the executive pay process quite arguably will have the broadest and most significant impact on that pay process of any set of new rules ever contained in one law.”

No supporter was more high profile than President Obama, who signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law on July 21, 2010.

The Resulting Shift to Performance-Based Compensation

The act requires that public companies disclose the relationship between the amount of executive compensation paid and financial performance. The rationale for mandating such disclosures is that issuers may be more inclined to moderate the level of compensation they provide to executives if it appears unwarranted by the firm’s performance. These requirements are sensible insofar as stockholders should be provided with more information to judge whether a CEO’s pay is reasonable in light of whether his or her direction increased the company’s competitive position.

One drawback of associating pay with performance is that some companies undertake long-term strategies in which payoffs, shown by financial indicators, are observable. It is reasonable to conclude that shareholders who are sufficiently motivated to examine CEOs’ pay in light of financial performance will also take into account whether chief executives are adopting short-term or long-term strategies.

However, there may be other issues. For instance, in his Reuters article titled “U.S. Firms Prepare Pay Plans for Dodd-Frank,” Erik Krusch points out that the legislation merely requires “information that shows the relationship between executive compensation actually paid and the financial performance of the issuer.” The law provides little guidance concerning how extensive the disclosures must be or what form the disclosures must take.

Comparing Executive Compensation to Other Employees

For clarity, public companies are now required to disclose the total annual compensation of CEOs, the median total annual compensation of all other employees and the ratio of the median employee compensation to the compensation of the CEO. Some speculate that Congress mandated these disclosures in order to appeal to labor unions that have historically cited widening disparities between compensation of CEOs and that of other employees as evidence that pay practices are unfair. Irrespective of the motivations underlying these provisions’ inclusion, it is likely that this set of disclosure requirements may induce moderation of CEO compensation.

Critics of the relative payment disclosures argue that compiling compensation data on all employees will prove excessively burdensome and result in significant administrative costs. Yet, given the array of disclosures already required of public companies and the lack of empirical data supporting the view that widespread compensation disclosure is excessively costly, these criticisms are unpersuasive.

A weakness associated with the relative payment disclosure requirements is that the payment of CEOs is to be compared to all other employees, including other named executive officers. Since these non-CEO executive officers are likely to be considerably better compensated than rank-and-file employees, firms’ figures for median employee compensation may be skewed.

Who Has Say-on-Pay?

A central feature of the legislation as it relates to executive compensation is the “say-on-pay” voting requirement. Say-on-pay mandates public companies to permit their shareholders to place a non-binding vote on the compensation of their executives and on “golden parachute” packages triggered upon mergers.

The act requires that shareholders be given two votes at the company’s first shareholder meeting following the six-month anniversary of the act’s enactment into law. First, shareholders must be granted the right to approve the compensation of executive officers as disclosed in the proxy statement in a non-binding vote. Second, shareholders can vote on whether future votes on executive compensation should take place annually, biannually or triennially. The act further requires that companies hold shareholder votes concerning the frequency of say-on-pay votes at least once every six years. Companies will be permitted to state their preferences with respect to how often say-on-pay votes should take place. Firms with multiple-year incentive compensation plans will likely lobby shareholders to hold votes every two or three years.

Say-on-pay as mandated by the act seeks to provide shareholders with a voice without substantially infringing upon the power of the board. Should a firm proceed with a compensation package without shareholder approval, negative publicity would likely follow? There is a chance that if dismissal of say-on-pay votes becomes widespread, then the only “teeth” that such measures have — namely, public embarrassment of companies ignoring their shareholders — would be lost. The non-binding nature of this vote ensures ultimate board
discretion. Nonetheless, directors will have reason to create reasonable executive compensation packages that are increasingly related to performance, especially when the chief executive’s pay is considerably greater than that of the median worker.

Shareholders Vote on Golden Parachutes

As a result of this legislation, shareholders will now also be permitted to place non-binding votes on payments in connection with acquisitions, mergers, consolidations or the disposition of firm assets. Companies are required to disclose agreements made regarding compensation stemming from the transaction. This set of requirements is aimed at preventing situations in which executive officers provide themselves with lavish severance payments, despite shareholder disapproval. While this measure increases transparency associated with major transactions and potentially reveals incentives underlying lobbying efforts by executives, it is ultimately an advisory vote that directors will be free to ignore.

In a hearing before the House Financial Services Committee, Brookings Institution Senior Economic Fellow Martin Neil Baily asserted that, although shareholders are now required to have non-binding votes on executive compensation and golden parachutes, “this may further align shareholder and management interests, but…this is not the same as alignment with taxpayer interests.”

What is a Claw back?

Companies are required to adopt policies to recover compensation when it is shown that the compensation was based on erroneous financial results. The “claw back” policy mandates that if the company has to restate its financials due to noncompliance, the company will recover incentive-based compensation from any current or former executive officer during the three-year period preceding the date of the restatement.

This set of requirements imposed by the act is notable insofar as its reach is broader than clawback provisions included in the Sarbanes-Oxley Act of 2002. The act’s more stringent stance induces companies to police themselves and decreases the likelihood that executives will develop lavish “golden parachutes” that permit them to disproportionately benefit from transactions dramatically altering the nature of the firm.

There are commentators, such as Professor Raigopal, who suggest that more drastic departures from previous compensation practices are necessary to achieve any meaningful change. For example, he cites proposals holding that “incentive compensation should be put away in a bank so that if things went wrong you actually take that money back,” yet they have not received enough support from the legislature or business community to be implemented.

How Do Companies Move Forward?

Firms must assess the practical implications of these new regulations and take steps to prepare for their implementation. For example, firms may include a review of executive compensation disclosures in the proxy statement, actively engage with institutional investors and proxy advisory services in anticipation of the say-on-pay vote and revise incentive-based compensation and severance plans.

Public outrage stemming from accounts detailing the exorbitant pay of some executives is particularly understandable during this period in which the financial sector is only beginning to recover. Shareholder criticism of director-approved pay packages is similarly comprehensible when multi-million dollar executive payments are not matched by firms’ financial performance.

The Dodd-Frank Act initiated needed reform in this politically difficult arena. However, unless increased enforcement mechanisms are available to shareholders, little will substantially change from the status quo.

The ultimate effect of the provisions discussed in this article is well assessed by Rossen Valkanov, professor of finance at the Rady School of Management of the University of California, San Diego. “While the new disclosure rules are of definite benefit to shareholders, it is unlikely that top CEO compensations will decrease significantly. Rather, we are likely to see the compensations of under-performing CEOs shrink.”

Berna Kamyar, J.D. (Rady Full-Time MBA ’12), a San Diego native, attended UCLA as an undergraduate, during which time he studied at the University of Barcelona for a year. He then studied law at the University of Minnesota, where he served as a member of the Law Review and interned in the chambers of Chief Judge Michael Davis of the U.S. District Court of Minnesota. He intends to practice law in Southern California upon graduation from Rady in 2012.