Executive Compensation

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BUSINESS

The Disney Executive Who Made $119,505 a Day

Even by show business standards, former Walt Disney executive Geoff Morrell netted a massive payday from his brief time in Hollywood.

By Erich Schwartzel January 18, 2023 10:00 am ET

Investors Protest JPMorgan, Intel, Coca-Cola Top Pay

Nonbinding "say on pay" votes against compensation packages for chief executives are aimed at influencing board decisions.

By Theo Francis May 19, 2022 10:56 am ET

CEO Pay Heads for Record as Pandemic Recedes

Annual compensation reaches $14.2 million for CEOs as companies grapple with worker shortages and inflation.

By Theo Francis April 3, 2022 01:48 pm ET

The CEOs Taking Pay Cuts: Here's the List

The leaders of Apple, Intel, Morgan Stanley and Goldman Sachs are earning lower compensation than in prior years.

By Alyssa Lukpat February 2, 2023 08:15 am ET

Is There a Relationship Between High CEO Pay and Corporate Effectiveness?

We ran the numbers for the Management 250 rankings, and were surprised by the results.

By Rick Wartzman and Kelly Tang July 30, 2022 12:00 pm ET

Companies Swallow $2.1 Billion in Taxes as Executive Pay Climbs

Tesla, Howmet and others racked up bigger tax bills after Congress ended deductions for any executive pay over $1 million a year for top officers of publicly traded companies, as well as some others.

By Theo Francis July 21, 2022 11:50 am ET

BUSINESS

How Elon Musk Helped Lift the Ceiling on C.E.O. Pay

The gap with workers widened even further as public companies granted top executives rich pay packages partly inspired by Tesla.

By Peter Eavis

PRINT EDITION Elon Musk Shattered the Ceiling on Corporate Pay | June 26, 2022, Page BU1

Two views on executive pay

"Efficient Contracting"

- Compensation contract is designed to address the principal-agent problem
- CEO works in the shareholders' best interests

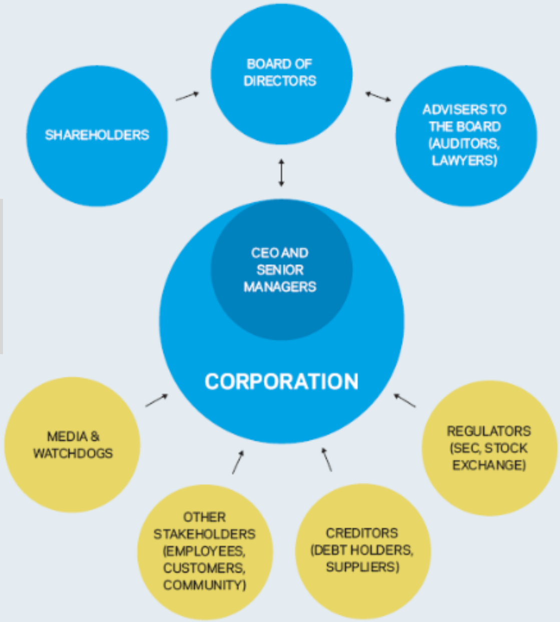
"Rent Extraction"

- Board is captive to the CEO and writes a contract that enriches executives
- Comes at the expense of shareholders

The Full Governance Structure

PARTICIPANTS IN THE CORPORATE GOVERNANCE PROCESS

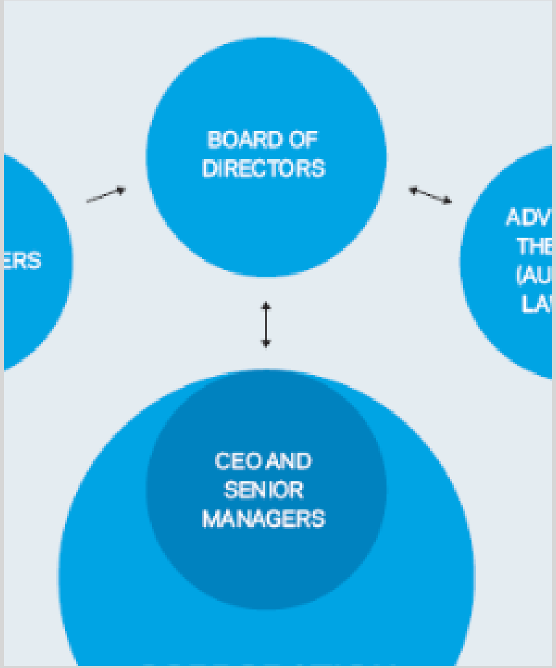
How do these forces influence compensation?



Columbia Business School
AT THE VERY CENTER OF BUSINESS

Source: Wei Jiang’s December 2021 lecture

Caveat #1



- Board sets the compensation contract
  - Contract itself is a governance mechanism
  - Addresses the “Principal Agent” problem
  - (also meeting a retention need!)
- Lots of research that characteristics of the board have influenced resulting contracts sub-optimally
  - Independent
  - Co-opted
  - Busy
- Carve that out of this presentation!

Caveat #2

- There is a vast literature and continues to grow. Lots of good papers – some I'm consciously not mentioning and others that I unintentionally missed over. Apologies to those authors in advance.

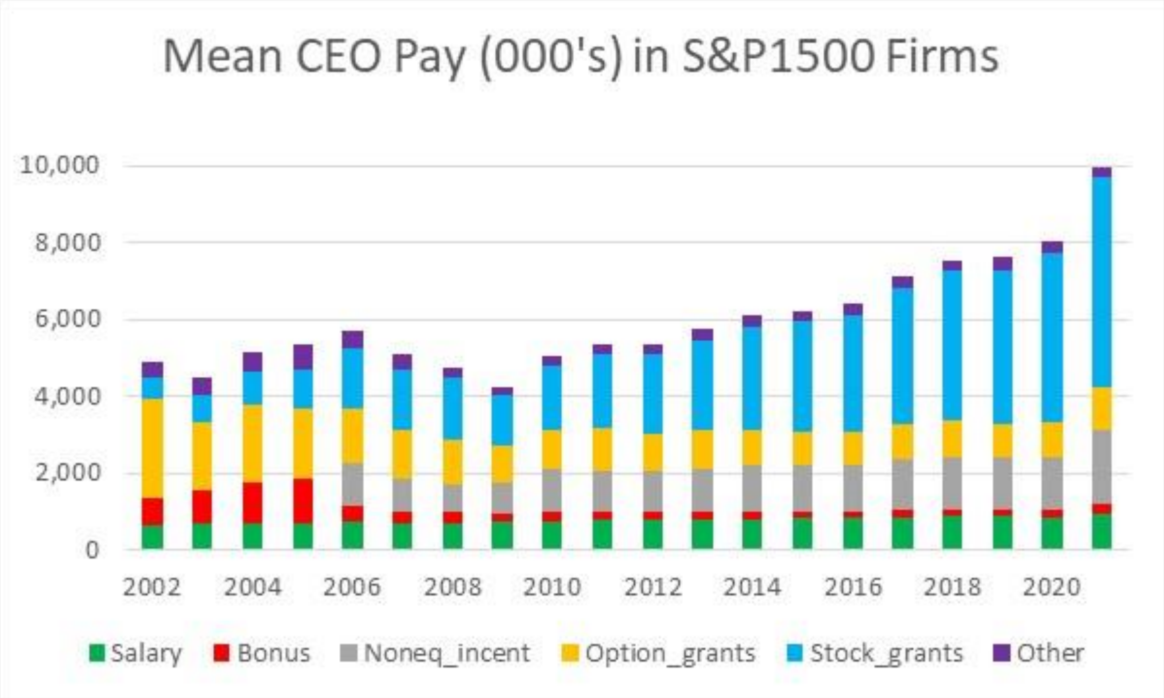
- Some very nice literature reviews:
  - Friedman and Jenter, 2010
  - Murphy 2012
  - Edmans, Gabaix and Jenter, 2017

Presentation in Four Parts

- Descriptive information about CEO compensation
- What are some forces that influence compensation?
  - Regulation
  - Disclosure
  - Labor market
- What is implications for contracts?
- What is happening now?

Part 1: Descriptive Information

S&P 1500 CEOs 2002-2021



Source: ExecuComp

Part 2: Forces Influencing Compensation

What are some forces influencing pay?

- Regulation
  - Taxes
  - Financial reporting / Accounting
  - Disclosure
- Stewardship
  - SOP
  - Proxy advisor
- Labor Markets
  - Benchmarking
  - Consultants

Two regulations that explain a lot about the graph

- Taxes
- SFAS 123R (now ASC 718)

Regulation - Taxes

- Section 162(m)
- Deductibility of nonperformance-based compensation limited to $1m
  - Intent was to curb pay and strengthen link between pay and performance
- Effect: Salaries hover around $1m and performance-based pay increased
  - Perry and Zenner (2001, JFE)
  - Rose and Wolfram (2002, JLE)
  - Balsam, Evans, Yurko (2019, JATA)

Regulation - Taxes

- Tax Cuts and Jobs Act of 2017
- No deduction for ANY compensation greater than $1 million
    - Intent was to reverse course: shift away from performance-based pay
- Effect: Not much ….
    - Luna, Schuchard, Stanley (WP)
    - Simone, McClure, Stomberg (2022, CAR)

Regulation – Financial Reporting

- SFAS 123 vs. SFAS 123R (ASC 718)
- Provided companies choice to recognize income statement expense of share-based payments using intrinsic value or fair value
- Fixed options granted with exercise price at market price = $0 intrinsic expense
    - Most companies opted for intrinsic value
- Enter SFAS 123R in 2005 with fair value recognition required

What happened after SFAS 123R?

- Shift from stock options to restricted stock
  - Carter, Lynch, Tuna (2007, TAR)
  - Brown and Lee (2011, JBFA)
  - Hayes, Lemmon, Qui (2012, JFE)
- Shift to performance shares (vesting function of meeting performance target)
  - Hayes, Lemmon, Qui (2012, JFE)
  - Li and Wang (2016, RFS)
  - Bettis Bizjak Coles Kalpathy (2018, JAE)
  - Core and Packard (2022, TAR)

Regulation – Disclosures

- SEC 33-8732a – Executive Compensation and Related Person Disclosure
- Increased pay disclosure beginning in 2006
  - Intended to “provide investors with a clearer and more complete picture of compensation earned by [executive officers]”
- Compensation Disclosure and Analysis (CD&A) section of proxy statement
  - More detail about compensation contracts and how pay was determined

Regulation – Disclosures

- How did the CD&A disclosure affect CEO pay?
- Three year period (2006 – 2009) when the income statement expense, not fair value, was reported. Firms had longer vesting terms (lower expense!) in this period.
    - Cadman, Carrizosa, Peng (2020, JMAR)
- Dollar value of perquisite pay lower after disclosure
    - Grinstein, Weinbaum, Yehuda (2017, CAR)
- Higher level of pay and more formula based
    - Gipper (2021, JAE)

Regulation – Disclosures

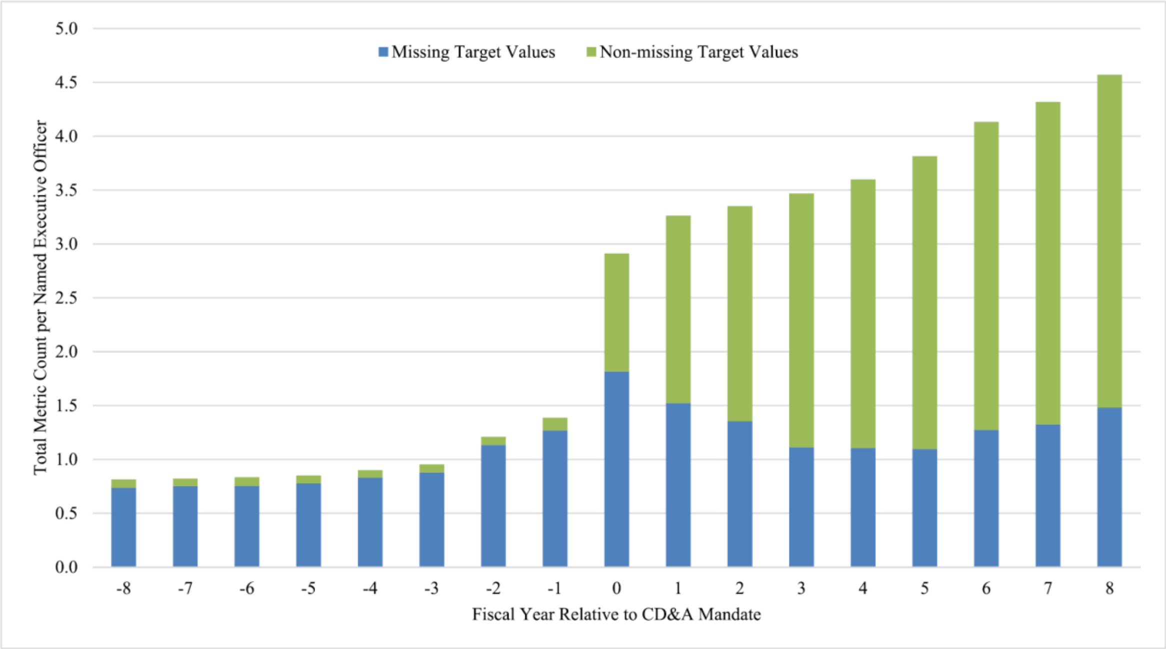


Fig. 1. Accounting Performance Measures. Fig. 1 shows the time-series counts of accounting performance metrics database scaled by the number of named executive officers that are in the ISS Incentive Lab. Accounting performance metrics are defined by a financial target level or growth rate (not necessarily disclosed) as part of the vesting conditions for the manager's pay grant, i.e., Incentive Lab variable “metricType” equal to “Accounting”.

Gipper 2021

Regulation – Another disclosure

- CEO pay ratio
  - Annual CEO total compensation / median annual employee total compensation
- Part of Dodd Frank Act
  - Origins just after financial crisis; populist criticism of CEO pay
  - Beginning in 2018 proxy seasons

As companies reveal gigantic CEO-to-worker pay ratios, some worry how low-paid workers might take the news

CEOs made 287 times more money last year than their workers did

Companies have finally started reporting CEO-worker pay ratios. Now we know why they fought so hard to avoid it.

Regulation – Another disclosure

- CEO pay ratio

What happened?

- Firms with higher ratios got a lot of negative media attention
- Some shifting among forms of pay
- … but not much change in overall CEO compensation
  - Chang, Dambra, Schonberger, Suk (JAR, 2023)

Stewardship – Say on Pay

- Dodd-Frank Act
- Majority of firms had first vote beginning in 2011
- Advisory (not binding) vote in the U.S.

<u>Effects:</u>

- Pay levels and proportion of performance based pay increases
  - Iliev and Vitanova (2019 MS)
- Added performance vesting conditions
  - Ertimur, Ferri, Oesch (2013 JAR)

Stewardship – Proxy Advisors

- Provide recommendations on how to vote on proxy ballot items
- Institutions rely on proxy advisor recommendations
  - Iliev, Kalodimos, Lowry (2021 RFS) not withstanding

Effects:

- Proxy advisor recommendations influence the outcome
  - Malenko and Shen (2016 RFS)

- Firms alter compensation to gain proxy advisor approval
  - Ertimur, Ferri, Oesch (2013 JAR)

Labor Markets – Benchmarking

- Determining the CEO's reservation wage through peer groups
- Lake Wobegon effect – "Our CEO is awesome"
  - Hayes and Schaefer (2009, JFE)
- Selection of peers reflects labor market motives

And rent extraction!

  - Albquerque, De Franco, Verdi (2013, JFE)
  - Cadman and Carter (2014, JMAR)
- Firms benchmark the <u>form</u> of pay in addition to the <u>level</u> of pay
  - Cadman, Carter and Peng (2021 TAR)

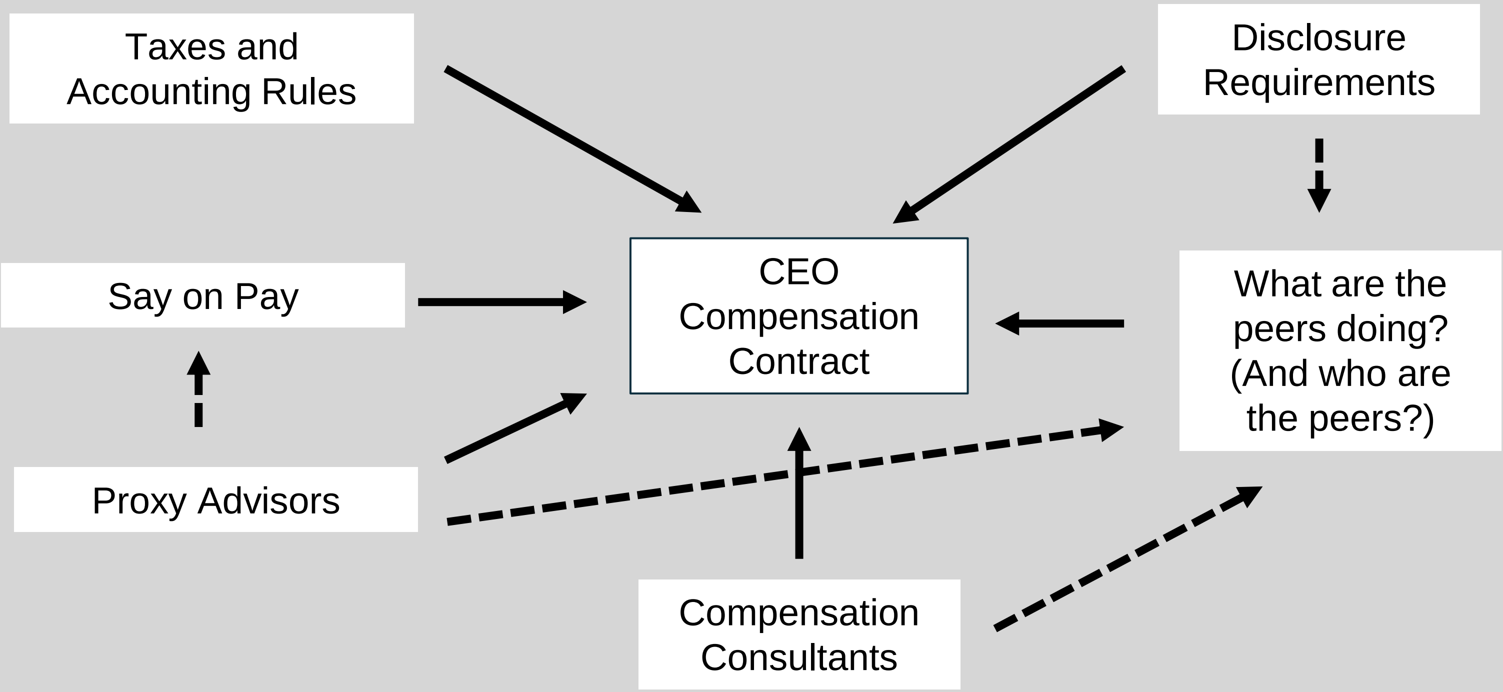
Quick Aside .....

- Edmans, Gosling, Jenter (WP) survey of UK directors and investors
- Very interesting insights!
- A few of which are:
    - Directors are willing to sacrifice value to avoid controversies
    - Pay “fairness” matters a lot to CEOs
    - Directors and investors have some divergent opinions

Labor Markets – Consultants

- Hired by board of directors to help design contracts and benchmark pay.
- Consultants aren’t causing higher pay levels
    - Armstrong, Ittner and Larcker (2012, RAST)
    - Cadman, Carter and Hillegeist (2010, JAE)
- Consultants are causing higher pay levels
    - Murphy and Sandino (2010, JAE)
- Firms using consultants have higher pay (more incentive pay) and more complex plans (number of pay components)
    - Murphy and Sandino (2020, TAR)

What does all this mean?



Part 3: Implications for Contracts

Performance vested equity is more popular!

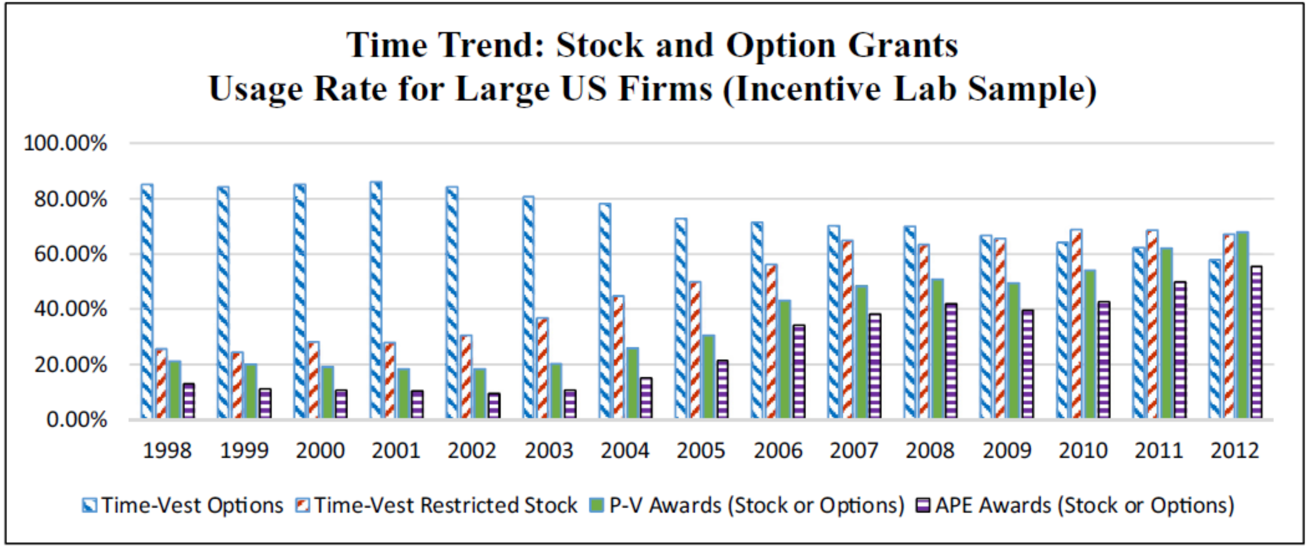


Fig. 3. Usage rates for large US firms of time-vesting and performance-vesting grants of stock and options to executives (one or more award of p-v stock or options to one or more named executive officer(s) in that year; APE = absolute performance evaluation).

Bettis Bizjak Coles Kalpathy (2018 JAE)

….. And more complex!

- What performance measures? Price, accounting, non-financial?
  - Within accounting, non-GAAP earnings?
- Absolute vs relative?
- Earned ratably vs hurdles?
- Multiple measures, either or both?

"First, early U.S. versions of p-v grants were quite simple, all-or-none in nature, with zero vesting of shares or options up to some threshold level of performance and full vesting of the shares or options if that threshold were met or surpassed. In stark contrast, among large U.S. firms over the last decade, p-v awards of stock, options, and cash to executives have become considerably more complex." – Bettis, et al 2018 JAE

"…. in salary negotiations executives discount the value of uncertain future awards they barely understand…..In general, however, the fad for stock awards with complex performance triggers has gone far too far.

"How to solve problems of misaligned executive pay" by Wilmot,
Wall Street Journal 7/5/2017

"(T)he way executives are paid has become overly complex, with too many cash and share-based awards, long and short-term targets and a profusion of measures of success, ranging from earnings per share to total shareholder return to return on equity."

"Executive pay: The battle to align risks and rewards" by Skapinkler,
Financial Times 4/30/2015

Multiple dimensions of compensation contracts

- Form of pay
  - Salary + Bonuses + LTIP + Stock options + Shares + Other
- Performance measures
  - Number of measures
  - Type (financial vs. non-financial)
  - Separable or not (i.e. either or must have both)
- Performance measurement periods
  - One year
  - Multi-period
- Performance measurement target
  - Absolute target (i.e. pre-specified goal)
  - Relative target (i.e. compared to the outcome of a reference group)

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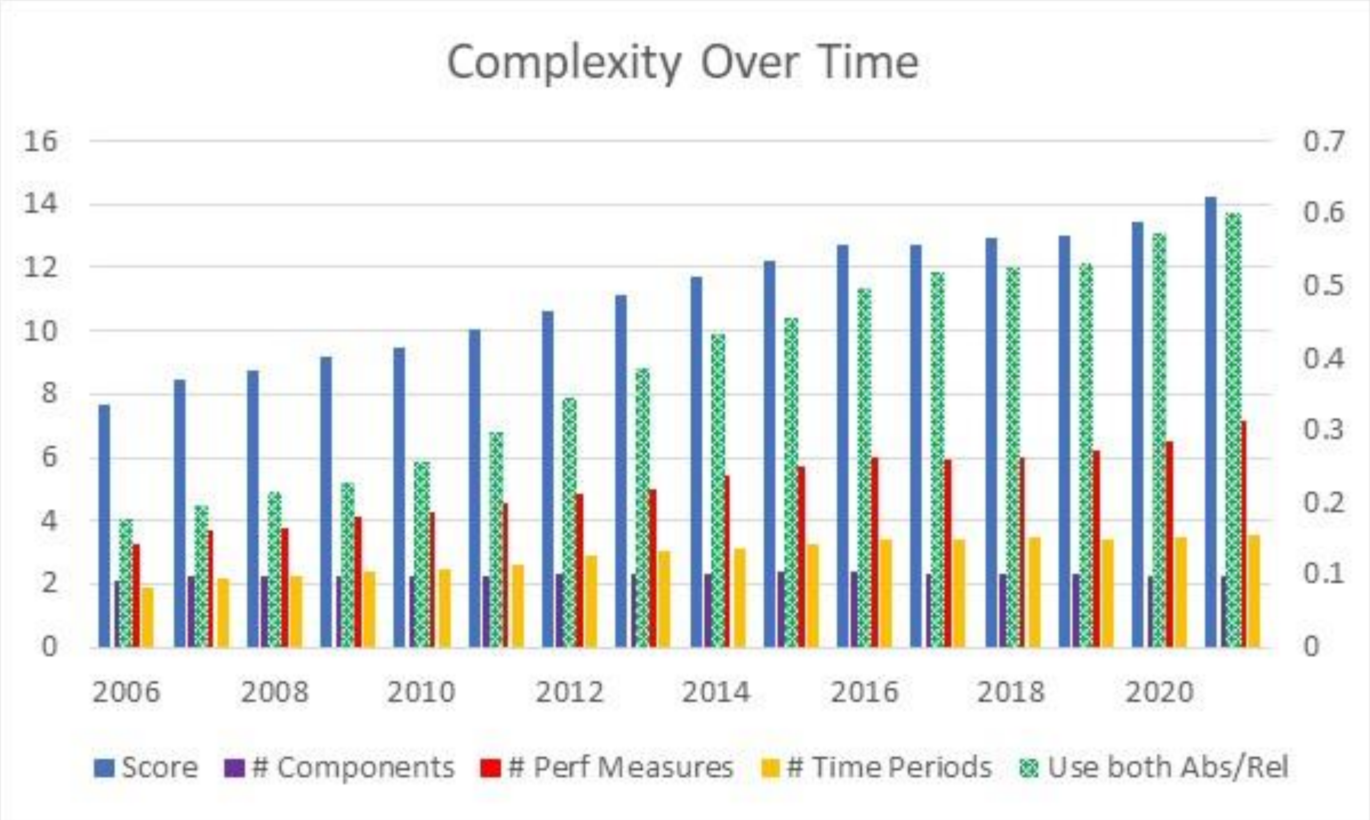
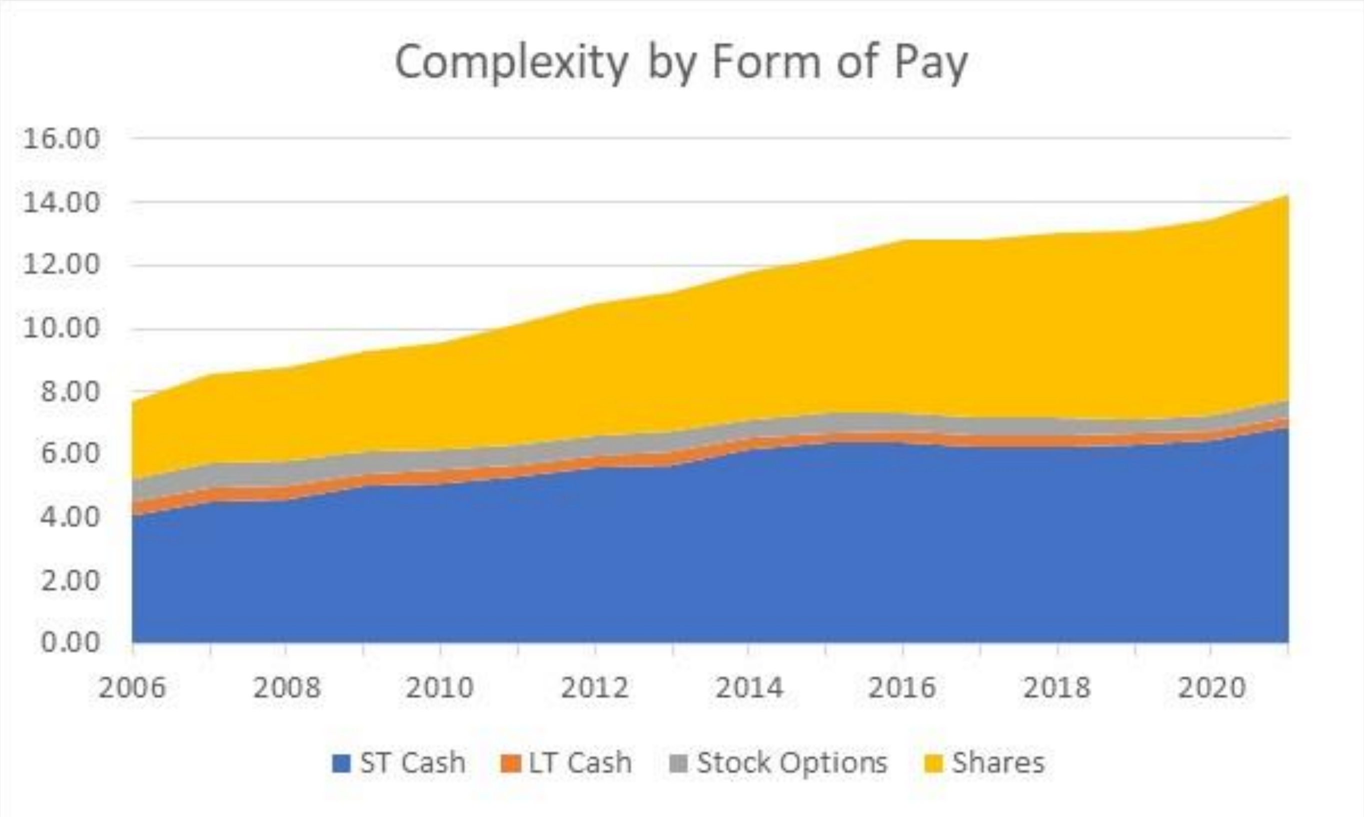


Albuquerque, Carter, Guo, Lynch (WP)



Albuquerque, Carter, Guo, Lynch (2022)

What explains contract complexity?

- Firm characteristics
  - More complex firms require more complex contracts
- CEO characteristics
  - Different degrees of principal-agent problem
- Provision for renegotiation
  - If renegotiate, the contract can be less complete
- Other factors
  - Consultants
  - Proxy advisor (ISS) guidelines
  - Peers
  - Institutional investors
  - Poor governance

Size (+), Market to Book (-), R&D (+), Prior M&A (-)

Founder (-), Ownership (-)

Yep!

Consultants (+)
Guidelines (+ when no year FE)
Peers (+ when no ind FE)
Mixed governance

Contracts are complex. So what?

- Multiple performance measures could conflict with each other
  - ROA vs ESG metrics
- Executives discount incentives or selects the achievable ones
- Information overload affect decision-making
  - Lots of studies in psychology research
  - Documented in managerial accounting studies

Does complexity impact performance?

VARIABLES	(5) ROA$_{t+1}$	(6) RET$_{t+1}$	(7) AvgROA$_{t+1,t+2}$	(8) AvgRET$_{t+1,t+2}$
COMPLEXITY $_t$	-0.050***	-0.217***	-0.050***	-0.088
	(-2.87)	(-2.64)	(-2.96)	(-1.40)
ROA $_t$	0.285***		0.174***	
	(13.07)		(8.10)	
lnSTDROA $_{t-1}$	0.033		0.004	
	(1.48)		(0.15)	
lnSALE $_t$	0.002		0.001	
	(0.53)		(0.28)	
lnMV $_{t-1}$	-0.005*	-0.107***	-0.011***	-0.086***
	(-1.83)	(-9.63)	(-3.86)	(-10.60)
MTBA $_{t-1}$	0.017***	0.001	0.018***	-0.001
	(8.69)	(0.18)	(8.88)	(-0.26)
lnSTDRET $_{t-1}$	-0.005	-0.191	-0.025	-0.134
	(-0.16)	(-1.41)	(-0.89)	(-1.24)
Controls for all but "other" factors	YES	YES	YES	YES
Firm FE	YES	YES	YES	YES
Year FE	YES	YES	YES	YES
Observations	10,624	10,629	9,958	9,929
Adjusted R-squared	0.52	0.35	0.59	0.43
Cluster	Firm	Firm	Firm	Firm

Table 6

Does it impact when CEO attention is important?

	(1) ROA_{t+1}	(2) RET_{t+1}	(3) $AvgROA_{t+1,\,t+2}$	(4) $AvgRET_{t+1,\,t+2}$
$COMPLEXITY_t$	-0.037**	-0.101	-0.039**	-0.060
	(-2.08)	(-1.12)	(-2.30)	(-0.91)
$Large\_Chng_{t+1}$ * $COMPLEXITY_t$	-0.253***	-1.096***	-0.224**	-0.949***
	(-2.78)	(-2.62)	(-2.49)	(-3.33)
$Large\_Chng_{t+1}$	0.040***	0.106*	0.043***	0.215***
	(4.00)	(1.79)	(3.91)	(5.56)
Observations	8,312	8,329	8,196	8,535
Adjusted R-squared	0.55	0.36	0.61	0.44
Control for performance included	YES	YES	YES	YES
Determinants of $COMPLEXITY_t$ included	YES	YES	YES	YES
Firm/Year FE	YES	YES	YES	YES
Cluster	Firm	Firm	Firm	Firm

Table 7

NORGES BANK
INVESTMENT MANAGEMENT

01 2017
REMUNERATION OF THE CEO
ASSET MANAGER PERSPECTIVE

Complexity

Current remuneration practices have tended to become overly complex. This complexity is due to a number of design features of incentive plans:

- LTIPs typically rely on a set of metrics, not a single target.
- Metrics are often defined relative to an index or group of peer companies.
- LTIPs are often subject to annual changes in targets, choice of metrics, conditions, matching schemes, vesting schedules and holding requirements. Hence, in any given year a CEO may be exposed to multiple LTIP vintages with a complex, and at times divergent, set of performance criteria.
- Annual bonuses have their own criteria sets, adding further complexity.

Towards a Simpler and More Robust Remuneration Model

Council of Institutional Investors®
The voice of corporate governance

Leading Investor Group Urges Companies to Commit to Long-Term Executive Compensation

Minneapolis, Sept. 18, 2019 —The Council of Institutional Investors September 17 overhauled its policy on executive compensation, urging public companies to dial back the complexity of their executive compensation plans and set longer periods for measuring performance for incentive pay.

While acknowledging that boards of directors need to tailor pay packages to company-specific circumstances, the new policy suggests firms explore adopting simpler plans comprised of salary and restricted shares that vest over five years or more. The policy also recommends that companies consider barring the CEO and CFO from selling stock awarded to them until after they depart to ensure management prioritizes the company's long-term success.

"The policy revision reflects concerns on excessive complexity in U.S. executive pay plans, and questions on the effectiveness of some approaches to pay-for performance," said CII Executive Director Ken Bertsch. "Steadily rising average pay, even when market performance is mediocre, suggests that pay-for-performance can be a mirage."

Part 4: What's Happening Now?

Regulatory Changes

- New Pay for Performance Disclosures
  - Evidence that this is needed -- Pawliczek (2021 TAR) Appendix B
  - Effects on SOP voting outcomes?

- Mandated Policy on Clawbacks
  - Prior research focused voluntary provisions
  - Heterogenous policies – Erkens et al. (2018 JAE)
  - Various effects on managerial behavior (financial reporting quality, risk taking, etc.)
  - Different outcomes if mandatory?

- Non Compete Agreements
  - NCA result in higher level and incentive pay – Kini et al (2021 RFS)
  - If prohibited?

Regulatory Changes

- Greater disclosure around human capital
  - SEC Human Capital Disclosures
  - UK Gender Pay disclosures
  - State-level disclosures in job posting
- Largely affects non-executive pay?

Including ESG metrics in contracts

- Pressure from institutional engagement
  - Cohen, Kadach, Ormazabal, Reichelstein (WP)
- Pressure from shareholders amplified with SOP
  - Carter, Pawliczek, Zhong (WP)
- In the US, SEC coming out with ESG disclosure rules this spring
  - Will that increase pressure to include in contracts?
- What does this mean for contracts:
  - More complexity?
  - Non financial measures (or part of individual goals)
  - Managing different investors preferences?

New SOP Pressure – “Pass-Through” Voting

- Alter how SOP voting is done?
  - Too much incentive on short-term with annual votes?
  - Will firms switch to triennial voting?
- What if retail investors have “populist” views on CEO pay?
  - How will boards handle differing views?
- Lecture next season by Nadya Malenko on shareholder voting

Wrapping up .....

- Lots of forces influencing executive compensation

- Forces continue to change / evolve
    - New research opportunities!

- Significantly impact the resulting contracts, which in turn influence overall governance

Thank you!