CEO Compensation that Benefits Shareholders

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ABSTRACT

This paper is developed around the set of design principles for executive compensation contracts as outlined in the study of Shan and Walter (2014). We propose guidance for determining an appropriate CEO starting compensation level based on past performance and the market for managerial talent. We also outline factors to be considered in determining annual changes to CEO compensation. This paper argues that stock options and restricted stock grants should become exercisable only upon meeting both time and performance criteria against an appropriate benchmark peer group. We agree with Shan and Walter's (2014) recommendations regarding termination payments and make suggestions on how to apply these recommendations in practice.

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1. *Introduction*

This paper discusses recent developments in executive compensation literature and presents a number of recommendations regarding the structure of CEO contracts that we believe can maximise firm value and benefit shareholders. Shan and Walter (2014) identify the need to reconsider the design principles of CEO contracts in public firms after the recent controversies surrounding executive compensation. This controversy frequently stems from complaints about excessive CEO compensation that cannot be justified by company performance and a perceived inability of boards to provide effective monitoring (Kaplan, 2013).

Competition among firms for hiring talented outside managers has substantially increased in recent years. Murphy and Zabojnik (2007) show that the competition among firms is particularly intense for CEOs with relative prior experience and transferable skills. They suggest that the increased importance in general managerial skills can explain the documented increase in executive compensation. Moreover, they find that a higher number of CEO vacancies are filled with external hires and that the compensation of internally promoted CEOs is lower than that of CEOs hired from outside their firm. Along the same lines, Frydman (2005) argues that the shift in importance from firm-specific skills to more general managerial skills has resulted in higher CEO compensation and increased inequality among top managers within a firm. Since excessive executive compensation and inequalities within a firm can have an adverse impact on shareholder value, a set of principles is needed for optimal executive compensation contract design.

Against this backdrop, the focus of our analysis is to start with the appointment of a new CEO and determine how pay should initially be designed. We then move through the CEO tenure cycle as base pay grows with experience but incentive compensation is set to match the firm's risk profile and investment opportunity set. We end with a discussion of optimal termination pay terms for departing CEOs.

The paper is organised as follows. Section 2 presents our proposal for the estimation of appropriate CEO compensation; Section 3 discusses those factors that drive changes in executive pay; and Section 4 provides recommendations about equity-related compensation. Section 5 discusses termination payments to outgoing CEOs and Section 6 concludes.

2. *Setting the Level of Total Compensation*

A crucial question with respect to the design of executive compensation is how to define its optimal *level*. Only then, can the appropriate *structure* of the compensation elements (cash, performance-bonus, equity-related compensation etc.) be considered. Although long term incentives should result in future value creation, research has shown that there is a positive ex-post relationship

between the level of CEO compensation and firm size, but little link between CEO compensation and firm performance, no matter how the latter is measured (Izan et al., 1998; O'Neil and Iob, 1999; Merhebi et al., 2006). These findings can collectively be interpreted as evidence of suboptimal contracting decisions that destroy shareholder value.

Building on Shan and Walter's (2014) second principle that base pay should take into account the market for managerial talent, we offer suggestions on how this can be operationalized in practice. We offer proposals for both internally promoted CEOs and externally hired appointments. Our base position is that an arbitrary upper limit in CEO compensation will likely result in a competitive disadvantage since the most skilful CEOs will eventually be hired by competitors who are willing to compensate talented CEOs more generously.

We identify two key benchmarks for setting the base pay of an internally promoted CEO. First, the new CEO can be offered the same remuneration package paid to his predecessor. Alternatively, the new CEO's remuneration package can be set in line with the median CEO pay of the appropriate risk-adjusted benchmark group. The first approach is problematic if the departing CEO had a long-tenure and exercised soft power over the remuneration committee. It also assumes no major restructuring of the firm such that the skill set demanded of the incoming executive is comparable to that of the outgoing manager. The second approach better identifies a fair market rate for incoming CEOs, but creates a potential ratcheting effect when using the benchmark median and raises concern over how to identify the appropriate risk-adjusted benchmark (see Bizjak et al., 2008; Bizjak et al., 2011).

For externally hired CEOs, the level of compensation account for the executive's previous performance. If the newly appointed CEO has been hired from more junior positions elsewhere (CFO, COO, etc) an appropriate starting point for base pay would again consider the departing CEO's base pay and the median CEO pay for the peer benchmark group. However, firms should retain flexibility for higher pay to induce managers to leave secure jobs and compensate for unvested equity based compensation that the executive must surrender on leaving their current employer. This is especially likely to be the case where new CEOs are to be hired from larger firms, and where junior executive positions offer salaries comparable to the CEO position at the current firm. If the newly appointed CEO was a CEO at another firm, a starting point for base pay would be previous salary plus a premium to attract the candidate to the firm. This premium should be increasing with corporate size and risk (stock price volatility, financial distress, threat of takeover).

In both cases, and on the assumption that new CEOs are appointed from publicly traded companies, past performance of the newly appointed CEO is an observable variable. Abnormal stock price performance (in relation to set peers) during the executive's tenure should be used to

determine the contribution of the new CEO to firm value. As is the case with any statistical model, the larger the available sample (years of CEO working experience) the more accurate the outcome will be. The discounted contribution of the CEO to firm value will then be used to calculate a premium or discount on CEO compensation relative to the appropriate risk-adjusted benchmark.

Clearly, these proposals are subject to two important limitations. First, it is not easy to attribute changes in a firms' market value to the decisions and actions of one individual, even if it is the CEO. This is particularly relevant where the newly appointed CEO was a junior executive at their previous firm. Second, the underlying factors that affect company performance may be quite different compared to the firm the CEO comes from. Both issues highlight the need for newly hired CEO pay to be set with reference to an appropriate risk adjusted benchmark group.

3. Annual Changes in Executive Compensation

Even if an agreement is reached with regard to the level of CEO compensation, an equally important task is to determine the rate at which CEO compensation should change. Bebchuk and Grinstein (2005) show that executive compensation in US firms during the period 1993-2003 has increased more than can be justified by factors such as growth in firm size and other performance measures. In this section, we build upon principles 2, 4, and 8 of Shan and Walter (2014) to discuss annual changes in executive compensation. However, rather than focus on bonus payments, we centre our discussion on annual revisions to CEO base pay. In doing so, we identify two non-mutually exclusive reasons for revision to CEO base salary. First, executives should be awarded for strong performance through annual increases in base salary. Second, executives should receive increases in base salary in light of annual pay reviews against their appropriate benchmark peer group of CEOs. We identify these areas as related given the findings of Bizjak et al. (2008) that CEOs who receive annual pay increases above the benchmark median have performed better than their peers.

The work of Bizjak et al. (2008) and Bizjak et al. (2011) highlights the importance of Shan and Walter's (2014) eighth principle surrounding the use of an independently selected group of peer firms against which benchmark pay is set. In line with extant literature, this benchmark can be a portfolio of matched firms with similar characteristics (e.g. industry, size, book-to-market, risk etc.). The need for independent identification of peer firms is highlighted in Bizjak et al. (2011), who show that firms can be opportunistic in the selection of peer firms in order to boost CEO compensation. The severity of this issue is most pronounced amongst non-S&P 500 firms who selectively benchmark against larger firms to boost CEO compensation given the known size bias in CEO compensation packages (see e.g. Merhebi et al., 2006).

Unfortunately, independence in the selection of peer firms is problematic and responsibility is typically designated to the independent directors in a remuneration committee, and in consultation with outside consultants. Given the potential for conflict of interest in these transactions, we add to Shan and Walter's eighth principle with a requirement that peer groups should be disclosed in the annual report. Bizjak et al. (2011) find that disclosure of peer group firms reduces the bias of remuneration committees in the selection of peer group firms.

Following the identification of an appropriate benchmark group, we suggest that CEO pay should not increase annually or over a rolling three-year period by more than the percentage increase in share price. The rationale is that director compensation should not increase proportionally by more than their contribution to firm value. We propose a three-year rolling period so as to avoid concerns over introducing convexity to executive payoff functions. Convexity in executive remuneration rewards managers for sub-optimally risky investments decisions that have the potential to generate large gains and losses from one year to the next. Executive base pay is unlikely to be cut from year to year, and so short-term incentives that offer little or no cost for failure should be limited. Thus, if the stock price has increased but failed to outperform the benchmark, an executive should not be rewarded with an increase in compensation. If a skilful CEO can consistently make positive (above benchmark) contributions to firm value, wealth should rise substantially along with that of the shareholders.

4. Equity-Related Compensation

A key purpose of incentive compensation should be to link changes in CEO wealth to changes in shareholder wealth, both in the short- and long-run. When a firm is expected to make investment decisions that affect its cash flows in the longer term, CEO remuneration should be based on more long-term incentives with higher pay-performance sensitivity. In this way, CEO wealth will be more closely related to the future impact of strategic investment decisions, and aligns their interests with those of the shareholders. This argument is consistent with Smith and Watts (1992) who note that when a large proportion of the future value of a firm depends on investment opportunities, executive remuneration packages are expected to include a higher percentage of incentive compensation.

The effectiveness of incentive compensation as a mechanism to mitigate agency costs has been the subject of extensive research in the US, where equity-related pay is a fundamental component of executive compensation. Datta et al. (2001) find that firms that award a high proportion of equity-based compensation to their managers experience superior long-term stock-price performance. Similar evidence is presented by Murphy (1999), Core et al. (2003), and Zhao

(2013). Empirical findings regarding the relation between firm performance and incentive compensation in non-US firms are more limited and less conclusive. Coulton and Taylor (2002) show that CEOs are awarded with a higher percentage of stock options relative to their total compensation following a year of superior stock price performance. Matolcsy et al. (2009) argue that when stock options are used as a reward for past performance, a negative relation is expected between stock-based compensation and firm market value. However, their results do not provide support for this hypothesis. In contrast, they find a statistically positive relation between stock-based compensation and firm market value when stock options are used as incentives for future performance.

The value of stock-based compensation in a CEO's portfolio should also depend on firm risk characteristics in the context of the wider investment opportunity set. There is extensive evidence that equity-linked compensation is positively related to risk-taking activity via the increased convexity of payoffs stemming from executive stock options (Hagendorff and Vallascas, 2011; Cohen et al., 2013; Anantharaman and Lee, 2014). Inducing managers to take risk can have a substantial positive impact on firm value, since risk-averse managers who are not sufficiently incentivized via their compensation may forgo profitable risky investments (Smith and Stulz, 1985). However, excessive exposure to risk can also have the opposite impact on firm value. Therefore, the volume and value of equity-related incentives should be determined by the optimal level of risk exposure.

Whether incentive compensation can mitigate agency costs in the long-run depends upon the conditions under which equity-related grants become exercisable. Following Shan and Walter's (2014) seventh principle that performance bonuses should be higher for statistically superior performance, we propose that stock options and restricted stock grants should become exercisable not only by time but also under the condition of abnormal performance relative to the peer group benchmark. Doing so ensures that the size of award is contingent on firm level benchmark-adjusted performance than can be directly attributed to the executive's tenure as CEO.

In line with our discussion in section 3 on changes to executive base pay, Morse et al. (2011) show that powerful managers can manipulate the choice of performance measures towards those criteria they perform best against, thereby rigging the incentive contract. In firms with powerful CEOs and low board independence, earnings-based performance measures that can be manipulated through changes in accounting policies should be avoided. We augment our contribution to principle eight in Shan and Walters (2014) to suggest that the performance criteria should be independently set and disclosed in the remuneration committee report to minimise selection bias concerns in Bizjak et al. (2011).

These performance measures should also be independent from prior year performance. If prior year performance is used as a benchmark for the following year compensation, executives may deliberately follow a course of action that would reduce earnings to avoid a large increase in their performance target next year. This is in line with the fourth recommendation of Murphy and Jensen (2011) in their study of bonus plans design.

5. Termination Packages

Principle 9 of Shan and Walter (2014) states that termination payments should be a function of benchmark-adjusted performance during the tenure of the executive and that a CEO who is dismissed for poor performance or inappropriate/illegal conduct should receive no termination bonus. This assessment of termination pay is consistent with Fama's (1980) view that termination pay is a mechanism for ex-post settling up.

However, companies do not pay termination simply to reward outgoing managers for failure and it would be difficult to limit these contractual payments to departing CEOs in practice. For example, Stanley O'Neal received a reported $161.5 million termination package following his departure from Merrill Lynch in 2007 following significant losses on sub-prime investments, as well as allegations that he attempted to sell the company to Bank of America without previously consulting the firm's board. While Mark Hurd's reputed $34.5million payoff from Hewlett-Packard is smaller in absolute terms, media coverage suggested the firm should have withheld the contractual payment following allegations of inappropriate conduct by the outgoing CEO that led to dismissal in the first place. The figures involved in these cases are exceptionally high but they highlight that companies award termination pay because the type of gross misconduct that equates to inappropriate or illegal conduct is often difficult to prove.

Yermack (2006) shows that CEOs receive high termination packages upon exit, the majority of which are discretionally awarded by the board of directors. He also reports a negative price reaction to the announcement of termination agreements in the case of voluntary CEO termination. Rau and Xu (2013) show that ex-ante severance agreements are more frequently used when the executive has weaker job security, and that firms largely base ex-post severance payments on ex-ante contractual terms. Goldman and Huang (2012) find that one third of departing CEOs receive severance pay in excess of the contractual entitlement, with an average value of $8million. The authors conclude that for normal CEO retirements, severance pay represents a failure of corporate governance. However, with involuntary CEO departures, excess termination pay increases the likelihood of a smooth transition from a poorly performing departing CEO to a more capable replacement. Against this backdrop, we propose that failing to award severance pay following poor

performance could disrupt the CEO succession process and make an alternative proposal to limit the size of these payoffs.

Under the UK Corporate Governance Code, firms are advised to limit director service contracts to a one year rolling period. This limits the base component of severance pay to one year of salary and benefits. This reform was a direct response to severance payments of between three and five year's salary under long-term notice periods. The recent departure of Philip Clarke from Tesco highlights the benefit of these limitations. Mr Clarke was dismissed following a period of poor accounting and stock price performance. Following his departure, the company subsequently aimed to withhold payment during his contractual notice period following allegations of misstatement of accounting earnings. Despite these allegations, Tesco were unable to prove the gross misconduct required to withhold the contractual entitlement. However, because of the one-year notice period Mr Clarke's payoff was limited to £1.2 million plus the value of unvested long-term incentive plans. As such, we recommend an addition to Shan and Walter's (2014) ninth principle and suggest that director service contracts should be limited to one-year rolling periods and that base severance pay be capped at salary and benefits during the contractual notice period. We also propose that such payments should be adjusted should the executive find new employment during the notice period.

We also propose that any discretionary awards and retirement settlements, as well as acceleration equity based compensation vesting terms should be subject to shareholder approval at a general meeting. These payments should be disclosed on an itemised basis in the remuneration committee report, rather than as a single line item for severance pay. Boards should retain the existing vesting period for equity-based pay so as to ensure that outgoing executive remuneration remains tied to performance following their departure. This contrasts with Shan and Walter's (2014) view that incentive payments that have been earned but not yet vested should vest on resignation. Maintaining the existing vesting period of these incentives would limit the scope for managers to engage in short-term decision making to boost profits at the point of departure at the expense of long-term investment. This would also prevent boards from camouflaging large amounts of compensation that public firms pay to executives in the form of retirement benefits (Bebchuk and Fried, 2004).

6. Summary and Conclusion

We believe that the general design principles for executive compensation contracts outlined in Shan and Walter (2014) are in the correct direction. However, we make a number of additional recommendations to supplement and operationalize these principles to optimise their impact. We

also identify distinct issues and time periods in the CEO life cycle and apply the pay principles of Shan and Walter (2014) to these circumstances.

In this paper, we present some basic principles for the estimation of CEO compensation level upon appointment that take into consideration competition in the market for managerial talent and prior experience. These are consistent with the design principle outlined in Shan and Walter (2014).

Regarding changes in CEO compensation, we suggest that these should not be higher than the CEO's contribution to firm value on a rolling basis, after controlling for the performance of a risk-adjusted benchmark group. This supports Shan and Walter (2014) and we make some suggestions surrounding the selection and disclosure of the appropriate benchmark group to restrict ratcheting effects and selection bias in the choice of peer group.

We propose that stock options and restricted stock grants should become exercisable upon meeting both time and performance related criteria and that these criteria should be demonstrably in excess of the performance benchmark. Additionally, we offer suggestions to ensure performance criteria should be carefully selected and the level of firm's risk be taken into consideration. This follows recent research on selection bias and choice of performance criteria in executive compensation.

We propose some practical guidance to limit the perceived rewards for CEO failure. While we agree with the sentiment of Shan and Walter (2014), we expect that identifying the type of gross misconduct that would allow firms to refuse to pay contractual severance in cases of poor performance or inappropriate conduct will be difficult to implement in practice. Given this, we make recommendations to limit the term of director service contracts and conditions under which equity based compensation can vest in order to minimize severance pay surrounding involuntary CEO succession.

We accept though that optimal levels and structure of executive compensation are not easy to be achieved at first attempt. It is quite likely to take some time and as stated by Matolcsy et al. (2012), can be part of a learning process which may entail errors and omissions by the firm. However, we are convinced that by following the general principles presented by Shan and Walter (2014) and in this paper, this process can be smoother and lead to stronger incentives for skilful managers to act in the best interests of shareholders.

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