

Managerial Remuneration

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Outline of Lecture

- Introduction—theory
- Pay for performance sensitivity
- CEO Compensation
- Trends in compensation
- UK and EU regulation
- US Shareholder Alignment
- Problems of Options
- Alternatives

Key Points in this Lecture

- Pay-for-performance sensitivity in market-based and blockholder-based systems
- Types of CEO compensation, types of options
- US contracts, decision-making on CEO pay, managerial power
- EU compensation pattern

Executive compensation: aim

- Agency costs and dispersed ownership structure of publicly held firms
 - Free-riding problems of shareholders
 - CEO compensation to reduce agency costs—optimal contracting
 - Bebchuk—managerial power approach
 - Stock (options): incentives are important part of CEO compensation in US & Europe

Pay-for-Performance sensitivity

- Expected to be higher in market-based governance system (US & UK)
 - Higher agency costs
 - Capital markets better developed
 - Corporate goal—maximize shareholder value
- Blockholder System (e.g., Ger, Fr, NL, It, Spain)
 - Lower agency costs due to monitoring by shareholders

Empirical Studies

- Shareholder monitoring as a substitute for price performance based remuneration policies?
 - Empirical studies show that pay is higher: when (1) CEO is powerful vis a vis board; (2) Anti-takeover provisions protect incumbents; (3) smaller institutional investor presence; (4) no large outside shareholder

CEO Compensation: types of remuneration

- Salary and other compensation—not performance related
- Bonuses, restricted stock, managerial stock options, and long-term incentive plans—performance-based pay
- Deferred compensation and pension plans
- Severance payments (golden parachute)

Stock compensation v. stock options

- Stock options expire:
 - Risk of short termism
 - Manipulation of accounting information (U.S.: Enron, Worldcom, etc)

Performance measures

- **Accounting criteria: annual earnings**
- Based on historical accounts/no direct relationship between executive action and firm performance/potential for abuse by management
- **Share price: easy to calculate and verify**
- Risk of managerial decisions aimed at increasing share price/prompts management to take on riskier investments/exogenous factors: industry and general stock market developments

Options

- Exercised price fixed
 - At-the-money options
 - In-the-money options
 - Out-of-the-money options
 - No reward for good performance/no penalty for underperformance

Reloaded Options: firms grant new options to executives who exercise their options

- Reloaded options (allows executives to benefit from share price volatility to capture short term gains even if long term share price is flat)
 - Exercise before expiration
 - Exercise price paid with stock already owned
 - CEO receives underlying share optioned + new option for shares tendered in exercising the option
 - New reload option carries the expiration date as the original options, but exercise price is set at market price

Reloaded continued

- Example:
 - 10 reloaded options, strike price 20 per share
 - Market price at exercise 40 per share
 - Pay: 200, thus tender 5 shares
 - In return: 10 shares + 5 new options with strike price 40
 - Motivation: captures upside, can still capture increase in share price for new option until original expiration date

Indexing

- Indexing exercise price (having rise or fall) either with the sector of market or broader market movements (in order to tighten pay-for-performance link)
 - Exercise price = grant date market price x % rise/fall in market price
 - Index: narrow (basket of peer firms) or broad
 - Exercise price could be lower than grant date price—only indexing on the upside

Benchmarking

- Benchmarking: performance-conditioned vesting of options—only exercisable if certain targets are met
 - Earnings per share, net asset value, return on capital
 - Index as performance target: difference w/index options is that managers profit from absolute price increases

Most common option contracts in US

- At-the-money when granted
- Vesting over time
- Vesting date + cash out date often the same time
- Contracts usually do not prohibit hedging of options and selling of shares already owned by managers
- Virtually no use of out-of-the-money options and reduced windfall options
- Exercise price: grant date market price regardless of vesting period
- Repricing in case of downward market movement
- Use of reload options

Decision-making on CEO pay

- Board of directors (US) has power to formulate stock option plan (Del Gen Corp Law §157 and Model Business Corporation Act §6.24)
- Remuneration committee: 3-4 independent directors
- If shareholder vote: shareholders typically approve

The Optimal Contracting Perspective

- No contract can perfectly align interests of managers and shareholders
 - Optimal contract: minimizes agency costs (sum of contracting, monitoring & other costs);
 - Executive compensation contract (if well-designed) creates optimal incentives for executives
 - Problem: firm must locate incentives that both induce effort and motive managers to take shareholder-regarding decisions

Questions:

- What is the right level of compensation?
 - Is there a fixed price or variable?
 - What is the right level of fixed compensation?
 - Should we use a strict pay-for-performance link so that we reward managers in terms of their marginal revenue product?
 - If so, then high levels of fixed income are suspect.

Tournament

- CEO compensation can be viewed as part of a prize for winning a tournament (for CEO)
 - Compensation is prize, including reward for prior effort
 - Tournaments arise in situations where its difficult to measure individual performance
 - Optimal performance could be viewed in terms of large fixed payout (prior performance) & incentive-based compensation (curent performance)
 - Retirement and other deferred income are justified under this view

Stock Options Critique: Managerial Power Explanation

- Passive boards or boards captured by management
 - CEOs, CFOs, members of board, etc.
 - Influence of CEO over (re)appointment of outside directors
 - Board dynamics (deference and politeness to CEOs, outside directors focussed on performance CEO, social group dynamics and justification of own CEO pay)
 - Cost of curbing excessive CEO pay higher than benefits
 - Management employs consultants that provides data to committee
 - Deference by outside directors to consultant

Managerial Power & the evidence

- 1, Inverse relationship between corporate governance improvement and higher managerial payout (decent board throughout 90s)
- 2. Increased rate of CEO turnover (3 fold increase over 90s)—termination threat that is an implicit contract provision which adds to pay-for-performance element
- 3. Conventional options used widely outside top management (81% of lower tier options granted to lower tier employees)

Stock Options: theory

- Range of performance based possibilities using conventional options (contingent elements introduced, eg., number of options granted this year, next year, etc.)
 - Pragmatic use for conventional option plans (tax and accounting treatment is favorable): drafting non-conventional options is costly;
 - Use of indexing to option price may reward uncertainty & some sectors;
 - Tailoring to reward only firm-specific performance may increase Enron problem (eg., earnings manipulation by managers to increase gain)

US taxation of options

- Tax deductibility—fixed salary, bonuses: deductible by corporation as part of business expenses I.R.C. §162(a)(1)
- Stock options: (1) employee is taxed on capital gains at the time the option is exercised; (2) deductible as business expense, but for I.R.C. §162(m)

Trends in Executive Compensation

- US—90s compensation doubled from 92-98
- S&P 500 firms (250% increase); medium pay is \$1.35 (medium base pay--\$340,000)
- UK—US firms made ten times UK counterparts; average pay for top firms \$550,000 (medium base pay--\$260,000)
- US—paid better, have higher incentives;
- No tax difference—granting of options in UK & US not a taxable event; approved options—manager pays nothing upon exercise but pays capital gains (40% UK; 20% US)

Difference in US/UK

- Besides capital gains, no appreciable differences in tax regime;
- Two differences in terms of corporate taxation
 - 1. Unapproved share options—exercise date spread between market and exercise price is treated as deductible compensation expense; gains realized through option exercise are not deductible by company;
 - 2. Limits on non-performance based compensation—US: performance & non-performance based pay; non-performance based pay in excess of \$1M is not deductible from corporate profits as business expense; Rule: has played no effect on compensation in US

Explosion of Share Options

- US—size of share options related to prevalence and magnitude of share options in US;
 - Recent trend in US (counter trend in UK—rejected share option plans and adopted performance share plans);
 - Incentive regime enhanced in order to overcome problems of 80s (create superior performance)
 - Threat of Financial Accounting Standards Board—to institute grant-date accounting charge (in mid-1990s) and SOA (2002)—rejected under pressure from Silicon Valley sector
 - Stock market performance—was used to show that stock options provide incentives to increase shareholder wealth (3 years post NASDAQ top—poor argument)

UK Factors shaping Executive Compensation

- UK—political factors against executive compensation
 - Political fallout from large utilities payout in 1995;
 - Greenbury Report (highly critical of use of share option schemes as a means of aligning shareholder and executive interests);
 - Recommended avoidance of benchmark based solely on share price (lottery); target could be figure—such as earning rise at the rate of inflation plus 2 % or annual earnings as basis for reward (avoids some pitfalls)
 - Government—responded by tightening restrictions on approved option schemes; reducing amount deducted from \$120,000 to \$45,000

UK Legal Regime

- Annual director's remuneration report details information set forth in Sch 7A to CA 1985;
- Directors' Remuneration Approved by board (member) and must include audited report; remuneration report by committee, remuneration policy, financial performance, each director's remuneration terms and conditions, expired, unexpired options, pay out on termination, pension, long term incentive plan
- Report must be approved by AGM (Sec 241)

Disclosure in annual accounts in EU

- Law reform across EU focus on enhanced disclosure of executive pay
 - Disclosure of both aggregate and individual compensation in annual report (UK, Ire, It, NL, Swe, Fin)
 - Only aggregate data in annual reports in Ger (but Cromme Code 2002 recommends disclosure of individual compensation), Aus (Corporate Governance Code 2002 also recommends on individual basis), Sp, B, L, Den, Gr, P.

Remuneration Committee

- Recommendation of remuneration committees w/in board of directors or supervisory boards
 - UK & Ire: Combined Code, ‘comply or explain’, committees composed of at least 3 independent non-executive directors
 - Corporate codes in Fr, It, Sp, B and NL recommend remuneration committees w/ a majority of independent, non-executive directors

Shareholder Approval

- Shareholder Approval
 - UK Companies Act 1985 shareholders' approval of Directors' Remuneration Report + Ire Listing Rules subject employees' share schemes and long term incentive schemes to shareholder approval
 - Continental Europe: shareholders' resolutions required if plan involves the issuance of new shares if options are exercised
 - Fr: shareholder resolution required for all share option schemes

NL

- Tabakslat Code 2003 ‘comply or explain’
- Remuneration committees composed of independent supervisory directors
- Supervisory directors may not receive variable compensation
- Vesting of stock options if executive directors have met certain performance based targets three years after grant
- Shares granted for free may not be sold during the first five years after the grant or until service has terminated
- Exercise price –greater or equal to grant date share price

NL (2)

- Directors' Remuneration Report has to be submitted to general meeting of shareholders for prior approval
- Stock (option) incentive plans as well as important changes need to be subject to general meeting for approval
- Code—is self-regulation, but a bill pending in Parliament proposes to require by law that listed companies adhere to code on 'comply or explain' basis

US Shareholder Alignment— political issue

- US: Response to large payouts—greater disclosure of compensation and performance
 - Sec 162 (m) IRS Code—disallows deductions of non-performance-related pay over \$1M for CEO & 4 top execs
 - Compensation is performance if: (1) performance goals are determined by committee of outside, non-exec directors; (2) performance goals disclosed to shareholders and approved by majority vote; (3) before any payment, compensation committee certifies the performance goals and other material terms were satisfied

Improved Governance Environment

- Sec. 162 (m) IRS—stock option plans to vote;
- Increase of non-executive directors on compensation committees;
- Shareholder approval of compensation plans (New York Business Corporation Law, sec 505(d)); but cf. Model Business Corporation Act & Del. Gen. Corp. Law (do not require approval);
- NYSE & NASDAQ: shareholder approval required before introducing a stock option plan;
- While no need to obtain approval, boards may be are subject to potentially subject to suit—fiduciary duties of good faith to shareholders

Shareholder Proposals

- Executive compensation awards are subject to substantial number of shareholder proposals (Rule 14a-8)
- Higher threshold in UK (5% or more) ensures a smaller number of proposals—restricted to small number of institutional investors--under 376 of Company Act 1985
- Upshot—shareholder proposals in UK are not common; whereas US experience suggests that there will be a continuing stream of proposals

Voting on Stock Option Plans in the US

- US shareholders typically approve stock option plans (no opposition from shareholders);
- Value of shares typically rise after announcement of stock option plan;
- Institutional Investors urge shareholders to introduce stock option plans;
- Stock option plans—are now pivotal type of managerial remuneration in the US

Opposition to Stock Option Plans

- Institutional investors (CALPERS) have adopted guidelines against under-water options (stock market price is below the price options can be exercised)
- Change in voting patterns of investors—average level of shareholder opposition (20% & increasing);
- Increased opposition to re-price options (lower the strike price)

Sarbanes-Oxley (SOXA)

- Section 304: CEO and CFO must reimburse any incentive or equity-based compensation or profits from stock sales during a year following the issuance of a financial document that has to be restated due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities law
- Section 402: unlawful for any public company to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit in the form of a personal loan to or for any director or executive officer

Payout

- 1992-1998
- Salary compensation—45% to 28%;
- Option-based compensation—16% for all firms in 92 to 35% for all firms in 98 (38% for S&P 500 firms);
- Pay-performance relationship—do firms just pay larger salaries and bonuses unrelated to benchmarks?
 - Bonus payments are positively related to accounting profitability & stock returns & increasingly related to stock performance since 93

CEO wealth & firm performance

- Hall & Liebman (2001) statistically significant relationship between CEO wealth & firm value
 - CEOs in lowest performance decile lost \$435,00 (94)
 - CEOs in highest performance decile gained about \$8.6M (94)
 - Jensen & Murphy; Hall & Liebman—most of gains & losses came from CEO exposure to company stock & options
 - CEO ownership—increase is driven by options; overall equity (& options) is slightly higher (2000), suggesting alignment between shareholders & managers;
 - Alternative view—CEOs expect strong performance & thus held more stock and are granted more options

CEO compensation

- If options included in calculations & stock excluded, median CEO gains \$2.15 for every \$1000 increase in shareholder wealth;
- Thus, CEO pay is sensitive to changes in shareholder welfare
- Real change over time: from 80 to 94, median pay for performance elasticity tripled from 1.2 to 3.9
- However, increase may not be sufficient—pay for performance elasticity was insufficient in 1980s (Jensen & Murphy)
- While sharing rate has doubled since 1980s study, the late 1990s sharing rate is still insufficient (Murphy 1996; 1998)

Executive Compensation—Not too high (Jensen & Murphy)

- One-to-one ratio between firm value and executive pay is not realistic measure;
- Firm size is constraint on this type of relation (managers can not obtain 1% of firm shares; Hall & Liebman, 2001);
- Low sharing rates may be optimal—particularly for risk averse CEOs;
- Higher sharing rates may require greater pay-outs & lead to more dubious conduct (Enron; Worldcom; Tyco—cooking the books) or increase in takeover activity,

Criticism of Options

- Managerial rent seeking—evidenced by use of non-performance based options (Bebchuk 2001)
- Relative performance problem—tie performance to index, sector, etc. (may not be best index);
- Index options would be best means to align incentives
- But, they are not a realistic alternative (although they would create higher incentives) because they must be expensed; hence a bias toward in the money options
- Repricing of options—when options are underwater, board can reprice options
 - Problem: not done to correct exogenous market event
 - Boards: under pressure not to reprice options

Alternatives

- Increase number of independent directors on remuneration committee
 - Evidence however indicates that presence of CEO on remuneration is single most important factor reducing payouts to executives

Increase disclosure level of non-executives ties to CEO, board

Increased disclosure: can increase pressure on board to limit increases

But, since options that are agreed to with pre-exercise price are not expenses, boards can hide large pay awards & board has few incentives to employ higher premium incentives

When management is paid based on share options, there are high power incentives to manipulate disclosure