



Executive Compensation

How does pay
influence decisions
and governance?

A white paper by the Sanford C. Bernstein & Co.
EMBA Student Leadership and Ethics Board

Daniel Jurow '09

Sophie Romana '08

James Deasy '09

Walter Haddick '09

Natalie Napierala '08

Tiffany Cale

Contents

EXECUTIVE SUMMARY	1
EXECUTIVE COMPENSATION AND DECISION-MAKING	2
Executive Compensation and Risk Management—Learning from Prospect Theory	2
Compensation Levels, Bankruptcy and M&A	3
Executive Compensation and Product Quality.....	3
Executive Compensation and Processes versus Outcomes	3
SUPPLY AND DEMAND OF EXECUTIVE TALENT	4
Increased Competition Fuels Demand for CEO Talent	4
Globalization and Manager Discretion Theory	5
Lone Ranger Theory—“Superstar CEOs”	5
Lone Ranger Theory Unmasked	6
REGULATORY RESPONSES AND UNINTENDED CONSEQUENCES	7
Tax Code Changes	8
Disclosure Rules.....	8
Say On Pay.....	9
Clawbacks	10
GLOBAL INNOVATIONS IN EXECUTIVE COMPENSATION POLICY	11
France: the End of the reign of “Chairman & CEO”	11
Netherlands: Assessing the Potential Exposure and Risks of Remuneration.....	12
Japan: The End of the Bureaucrat CEO?.....	13
Germany: The Birth of the Environmental CEO.....	13
CONCLUSION	15
Is There More to Compensation Than Just Money?.....	16
APPENDIX: Executive compensation limits under Treasury Guideline 15 and the Stimulus Bill	17

Executive Summary

In the wake of the extraordinary collapse of the housing market bubble and the ensuing global recession, numerous traditional assumptions—such as lax *laissez-faire* banking oversight and the primacy of shareholder value maximization—are under attack as root causes of the financial system meltdown. Another such assumption under fresh attack is the infallibility of our carefully designed remuneration systems for senior executives in publicly owned corporations, particularly in the banking sector, where performance rewards reached historical highs, resulting not in great performance but outsized risk-taking.

In the face of aggregate data showing a dramatic increase in the ratio of CEO pay to average-worker pay (from 24 times in 1965 to 262 times in 2005), particularly since the rise of stock option and restricted stock awards in the early 1990s, arguments in defense of rising executive compensation packages often rely on the following to justify the trend: efficient-market theory—a global shortage of superior executive talent causes their pay to rise, and agency theory—the best way to ensure shareholder-manager alignment is to make the managers into equity-holders. But when stunning management failures and unprecedented destruction of shareholder value are brought into the light, it becomes increasingly difficult to defend current executive remunerative policies with these economic underpinnings.

At the same time, the public debate, particularly in the media, frequently boils down to a single, difficult question of whether a firm's pay packages are "fair"—fair to the company's shareholders, fair to its other employees, or otherwise fair to the community at large and society in general. Should any one person be able to earn hundreds of millions of dollars over the course of a few years in a bull market, or at their retirement, or when fired, particularly when it seems like they are writing their own check?

The EMBA Student Leadership and Ethics Board members recognize that fairness is a limited tool for understanding and responding to the debate on executive compensation. It is, of course, a relative concept that changes depending on whose vantage point one takes when analyzing the fairness of a particular pay policy. In this, the Board's inaugural White Paper, we have deliberately chosen not to study the topic from the perspective of a single audience, and therefore we do not attempt to conclude whether trends in pay policies and regulatory responses in the United States have been fair.

Instead, we examine the issue of excessive executive compensation by first asking if it matters at all whether CEOs and senior executives of publicly owned firms are overpaid. In our analysis of the current literature, interviews with academics, executives, and compensation consultants, the Board does not attempt to determine a direct inflection point where a given level of compensation correlated directly to a diminished return to shareholders, though such research would add great value to this debate. Rather, we learn that certain human decision-making biases are exacerbated as a person reaches increasingly large absolute and relative (compared to peers) amounts of wealth. The agency model, in theory and practice, does not mitigate these decision-making

biases. For example, when excessive executive compensation occurs in economically significant amounts for a firm, it can result in suboptimal managerial decision making related to mergers and acquisitions, lower product quality, and too great an emphasis on outcomes rather than managerial processes.

Because senior executive compensation packages are settled in a negotiation between the executives and board members acting on behalf of the company's internal and external shareholders, we also examine in this White Paper whether these agreements are negotiated fairly—at arms' length—such that the clearing price for executive talent is economically efficient. Though there are aggregate data that directionally support the argument that executive pay merely reflects the going rate for scarce talent, this topic is perhaps the most hotly contested in the study of executive compensation, as a litany of potential distortions to the process are raised. Economic theory has not, thus far, fully captured the inner dynamics of director-manager power relationships and information asymmetries and the Student Leadership and Ethics Board therefore cannot conclude that current pay practices, in total, represent the optimal price shareholders should be willing to pay for senior talent.

Because the US government has already intervened since October 2008 to legislate changes to executive compensation schemes for publicly owned firms, we next examine the efficacy of the government's toolset in capping executive pay, including taxation, disclosure rules, and the restrictions embedded in TARP including "say on pay" and clawbacks. The Board concludes that US government regulation of executive pay has historically been incomplete, ill conceived, and ineffective—and thus rife with unintended consequences. We then look globally at important developments regarding compensation regulation, particularly in Europe, and a robust cataloguing of the current and proposed US regulatory changes follows as an appendix.

The aim of this White Paper is not to vilify corporate boards or the executives whose compensation is in question; nor is it to prescribe regulatory barriers to excessive remuneration. In our investigation, we have learned that, by and large, key stakeholders have tried to make the best decisions possible with a limited amount of information; nonetheless, in an increasingly complex process, misunderstanding the economic and managerial underpinnings of compensation design is the most frequent cause of egregious error. We conclude our White Paper, then, with a summary of findings and key questions for boards, compensation consultants, investors, analysts, executives, employees, and researchers to ask as they grapple with the difficulties of modern compensation design.

Executive Compensation and Decision-Making

The purpose of this section is to discuss the degree to which compensation can have an effect on executive decision-making, plus the implications of these findings. First, we review how the current agency model is undermined by executive access to hedging mechanisms as well as by sheer absolute wealth (i.e. prospect theory). Next, we discuss how executive compensation can negatively impact decisions related to mergers and acquisitions, product quality, and the actual risk management process. By establishing how compensation can inform decisions, we can begin develop an opinion on how to best structure contracts that maximize value across all economic stakeholders.

Executive Compensation and Risk Management—Learning from Prospect Theory

Modern agency theory, which is the theoretic basis for many compensation negotiations, is founded on the principle that managers are egoistic and must be given incentives to act in the best interests of the firm. This theory is based on the ideas of managers as “homo economicus,” perfectly rational people who maximize gains across all decisions. As a result of this theory, companies have developed structures to align pay with performance, on the grounds that managers need to be motivated with monetary rewards to achieve performance. The heart of this alignment has been substantially increasing equity compensation for senior executives. Holmstrom and Kaplan (2001) point out that from 1980 to 1994, the average annual CEO option grant (valued at issuance) increased almost seven-fold.¹ As a result, equity-based compensation made up almost 50 percent of total CEO compensation in 1994, compared to less than 20 percent in 1980. The amount is even higher today.

Pay for performance and the increase in executive equity awards have been discussed and analyzed in detail. In terms of decision-making, it is more important to focus on what executives are able to do with their equity awards that are vesting over time, especially in bull market periods. It is argued that if the managers have unrestricted access to financial markets, they will hedge the performance incentives in their compensation schemes, rendering the incentive justification for managerial stock ownership invalid (Bank (1995), and Easterbrook (2002)). Because of lax disclosure rules and the managers’ own incentives not to attract too much market attention, these hedging transactions have been quite private (Celen and Ozerturk).² Celen and Ozerturk further argue that unless they can be made exclusive, swap contracts lead to a complete unraveling of effort incentives when the firm specific risk/manager’s risk aversion is sufficiently high. This makes sense, as there is an inherent benefit to a senior manager who has sufficient wealth tied up in options to diversify by hedging. Their options are worth

more to an outside investor with balanced portfolio than they are to a manager with all his/her eggs in one basket. In a free market, we believe that there is true incentive to hedge, and therefore the incentives put in place to align management and shareholder interests are inherently weakened by access to hedging markets.

We believe that shareholder-manager alignment is further distorted by the widespread deployment of stock options. While in theory options are equity awards that align managers with a firm’s long-term incentives, they create some practical inefficiencies. The first has to do with actual awarding of options. A paper by Bolton, Scheinkman, and Xiong reveals “that there is evidence of poor understanding by directors and compensation committees of the true present value of the options granted to CEOs.” The second inefficiency is related to issue of re-pricing options in the event that they are underwater. For Lucian A. Bebchuk of Harvard Law School and Jesse M. Fried of the University of California at Berkeley, two of the most outspoken critics of the distortions of the free market on setting executive pay, underwater re-pricing rewards failure, while the former authors argue that re-pricing is “necessary to prevent the manager from quitting because his compensation going forward is no longer competitive.”³ Our position aligns more with Bebchuk and Fried, due to the fact that shareholders are not allowed to receive a refund on investments that have lost a substantial amount of value, but executives with re-priced options effectively do. This action is another avenue for executives to alleviate some compensation risk as well as decouple themselves from the needs of shareholders.

A critical conclusion that we should make is that through hedging mechanisms, senior executives can protect themselves from catastrophic downside risk in the event that their firm, and stock options, dramatically lose value. This is not to say that CEOs and senior executives do not stand to lose a tremendous amount of money if a company fails; rather, we argue that they are not going from the “penthouse to the poor house” overnight. CEOs are generally wealthy before they become CEO. Many CEOs and senior executives fall into the 0.01 percent of wage earners in the United States and have accumulated enough wealth to ensure a high standard of living for themselves and most likely their descendants.

We are stressing this point because it has decision-making implications, especially related to risk management. The first implication pertains to Kahneman and Tversky’s “prospect theory.” The early makings of this theory were developed by Bernoulli in 1738, whereby he “attempted to explain why people are generally averse to risk and why risk aversion decreases with increasing wealth.” (Kahneman and Tversky 1983)⁴. Further, Thaler (1999)⁵ noted that this value functions display diminishing sensitivity, where the “difference between \$10 and \$20 seems bigger than the difference between \$1,000 and \$1,010, irrespective of sign.”

1 Bengt Holmstrom and Steven N. Kaplan, “Corporate Governance and Merger Activity In the U.S.: Making Sense of the 1980s and 1990s.” Working Paper 01-11, February 2001, pp. 46.

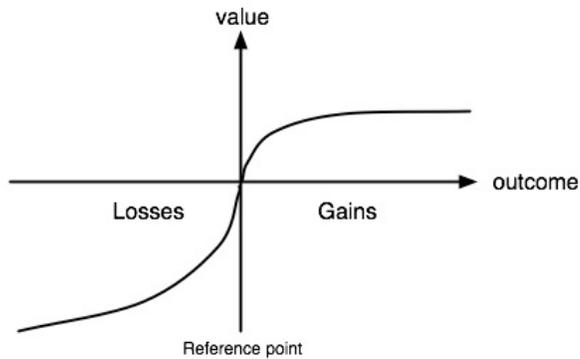
2 Boachan Celen and Saltuk Ozerturk, “Implications of Executive Hedge Markets for Firm Value Maximization.” *Journal of Economics & Management Strategy*, Vol. 16, No. 2, pp. 319-349, Summer 2007, pp. 319-339.

3 Patrick Bolton, José Scheinkman, and Wei Xiong, “Pay for Short-Term Performance: Executive Compensation in Speculative Markets.” *Journal of Corporate Law*.

4 Daniel Kahneman and Amos Tversky, “Prospect Theory: An Analysis of Decision under Risk.” *The Econometric Society*, 1979.

5 Richard H. Thaler, “Mental Accounting Matters.” *Journal of Behavioral Decision Making*, 1999, pp. 183-206.

The theory is represented by the hypothetical value function below:



Our argument is that the reference point of executives receiving top compensation packages begins more towards the far right-hand side of the concave curve. An executive's last million dollars earned is not as significant as receiving his/her first million. The problem arises: These are the leaders whom we want to have the most at stake, the most to lose, and yet excessive pay over time can have the inverse effect of insulating executives to their own decision-making detriment. We conclude that a substantial amount of absolute pay, coupled with access to hedging instruments/underwater options re-pricing to off-set equity compensation risk, can lead to an executive experiencing lower external risk aversion based on the principles of prospect theory.

This is not the whole story, as we are not arguing that a wealthy person cannot be a good CEO. That is far from the truth. However, behavioral economists have conducted many studies that establish that humans, executives and corporate directors included, are more like "homo sapiens" than the fully rational "homo economicus." "Homo sapiens" have limited processing capacity, memory, and willpower. The next three topics of this section re-confirm that when it comes to decisions, humans are not always as rational as we would like to believe.

Compensation Levels, Bankruptcy and M&A

"I would never lend money to a company where the highest-paid employee was paid more than 20 times the lowest-paid, as in my view that company is unstable." — Banker J.P. Morgan

In an eloquent argument articulated by Columbia professors Hayward and Hambrick in their paper, "Explaining the Premiums Paid for Large Acquisitions: Evidence of CEO Hubris," Hayward and Hambrick link relative pay levels between corporate officers to hubris, mismanagement, bankruptcy risk, and poor M&A decision-making:

Discussions with several prominent executive compensation consultants support the view that the ratio of the CEO's pay to that of the second-highest paid officer reflects a personal trait that the consultants variously called "ego," "megalomania," and "chutzpa." The average pay for other officers was significantly greater for bankrupt firms five years before they failed than

for a matched group of survivor companies. Usually, CEOs receive between 30 and 50 percent more compensation than the next highest-paid executive. When this differential is much larger, however, say 100 percent or more, the CEO's sense of great personal importance is revealed. Not only does such a large gap reveal the CEO's belief that executives vary widely in their contributions but also that he or she is extremely valuable (Hambrick and Cannella, 1993). Such a large gap may also indicate that the CEO has extraordinary power (Finkelstein, 1992).⁶

Hayward and Hambrick were able to provide convincing evidence to support their assertions that CEO self-importance, one measure of which was high pay relative to the second highest ranking company employee, leads to overpaying for acquisitions. Excessive pay, not even in the absolute sense but relative to peers, appears to be linked to problems for the long-run viability of firms and/or the destruction of shareholder value.

Executive Compensation and Product Quality

Douglas Cowherd and David Levine were among the first to find empirical evidence that link a firm's reward system with its product quality. Cowherd and Levine found that "egalitarian interclass reward distributions lead not just to perceptions of fairness by lower-level employees, as has been demonstrated in many studies, but may also increase product quality."⁷ This study has enormous implications for the debate on executive compensation, as it provides evidence from 102 companies that excessive pay can adversely affect employee morale and the quality of output, which is crucial to any firm's success. Rather than providing an optimal contract that motivates managers to do a great job, excessive compensation creates a situation that demoralizes the average member of a firm, and thereby destroys value that the contract was intended to create.

Executive Compensation and Processes versus Outcomes

Another difficulty with agency theory as applied to executive compensation is that it rewards outcomes (earnings, etc.) regardless of whether it is the result of a good, repeatable, sustainable process. A short research report by James Montier of Societe Generale highlights the problems that psychologist find with what is known as "outcome bias." He states that outcome bias is the "habit of judging a decision differently by its outcome. For instance, if a doctor performs an operation and the patient survives, then the decision is rated significantly better than if the operation results in the patient's death. Of course, the correctness of the doctor's decision should not be a function of the outcome, since clearly he couldn't have known the outcome before the event."⁸

⁶ Mathew L. A. Hayward and Donald C. Hannbrick, "Explaining the Premiums Paid for Large Acquisitions: Evidence of CEO Hubris."

⁷ Douglas M. Cowherd and David 1. Levine, "Product Quality and Pay Equity between Lower-level Employees and Top Management: An Investigation of Distributive Justice Theory."

⁸ Montier, James. "Mind Matters, Process Versus Outcomes in Sports, Gambling, and Investment!" Societe Generale Cross Asset Research, September 2008.

The paper goes on to discuss that a focus on outcomes is detrimental to decision-making because bad processes could still lead to good outcomes while good processes can lead to bad outcomes. An example would be the financial risks taken in the US residential housing markets from 2003–2007. That time period consisted of a series of bad processes that lead to positive outcomes for many people, but only for a period of time.

Outcome mindset was exemplified by the famous uttering of Charles Prince, former CEO of Citibank, “As long as the music is playing, you’ve got to get up and dance. We’re still dancing.” In a traditional agency theory model, senior executives are rewarded for profits and perceived risk management (i.e. the profits have held up this year). But there is no component in compensation that rewards the process of effective risk management. Therefore, excessive compensation can lead to a hyper-concern with hitting periodic outcomes (earnings targets), rather than with the long-term health of the institution.

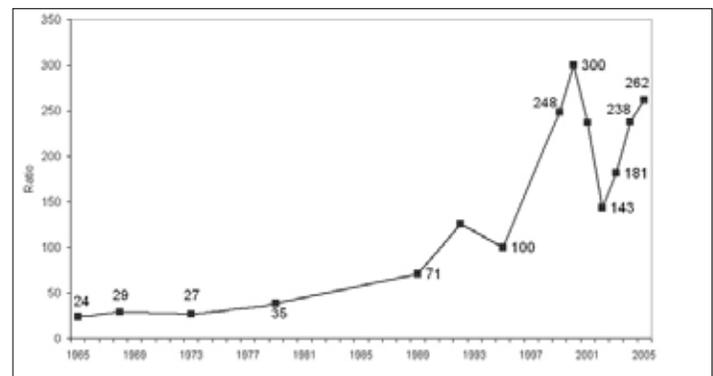
In summary, this section set out to demonstrate that executive compensation has real consequences for the decision-making abilities of senior management. However, one of the reasons it is so difficult to structure an optimal contract is that there is no direct inflection point—there is no evidence that all CEOs paid more than \$50 million overpay for acquisitions. In fact, some of them may be worth every penny. Boards must keep in mind, above all: Executive compensation contract can actually be counterproductive—more money and long-term alignment does not necessarily lead to better risk management, more strategic acquisitions, better quality products, and more effective management decision-making processes. For decision-making, the best contract might not be one that focuses on pay relative only to peers, but also benchmarks against pay relative to average internal employees and other members of the senior team, while also rewarding good processes in addition to good outcomes. Further, boards must note that any incentive effect can be muted by an executive’s absolute level of wealth, i.e. position on the value function, by clever compensation hedging, and by options re-pricing.

Supply and Demand of Executive Talent

In this section, we examine the question of whether current compensation levels are generally appropriate, in that they are negotiated fairly and represent the efficient clearing price for executive talent. Classical economists and other researchers provide us with data suggesting that most markets act efficiently when guided by Adam Smith’s “invisible hand.” As competition increases, supply of executive talent remains limited, and demand for market share increases, so the price of top talent rises. Critics of the efficient-market theory identify “deficiencies” of the market-driven outcomes of executive pay that have led to seemingly inefficient increases in the ratio of CEO pay to average-worker pay from 24 (1965) to 262 (2005).⁹

Some question the true scarcity of CEO talent, while others question the fundamental fairness of the compensation negotiation process, with owners on one side and managers on the other. We begin with the question of scarce talent.

Ratio of CEO to average worker pay increases more than 10x, 1965–2005



Increased Competition Fuels Demand for CEO Talent

The responsibilities and influence of the chief executive officer are vast. The experience and talent required are rare as compared to other entry-level employee positions. When you add to that the desire of shareholders and activists for a sustainable double-digit return per annum and increasing global competition, it is easy to see how demand of CEO talent grows quickly.

Vincente Cuñat and Maria Guadalupe¹⁰ build on the work of Schmidt (1997) and Raith (2003) by exploring the impact of increased market competition on a firm and its need for top executive leadership. The argument regarding increased competition suggests that as competition increases, the firm must pay more via incentives to drive the same level of production. The counter argument states that as competition increases, a worker will be motivated to be more productive out of fear of bankruptcy and loss of work. The findings of

⁹ Economic Policy Institute.

¹⁰ Vicente Cuñat and Maria Guadalupe, “How does product market competition shape incentive contracts?”

Cuñat and Guadalupe “suggest a causal effect from increased product market competition to increased sensitivity of pay to performance in contracts.” The findings seem to point to the willingness of firms to increase incentives to motivate more productive behavior in an environment of increased competition. As global competition has grown exponentially in everything from toys, to cars, to information technology, the work of Cuñat and Guadalupe seems to explain the desire for shareholders to develop more pay for performance compensation models in an increasingly competitive global environment.

Of course, corporate boards play a significant role in setting compensation. Still, Guadalupe argues something more fundamental has changed. Technology has changed the way we share and profit from information. While it has broadened opportunities in emerging markets, it has also created additional barriers in developing or maintaining customer captivity and competitive advantage. Companies, executives, and managers must work harder to maintain market share versus effort required 10–15 years ago. They must work even harder to gain share.

The popular business view of increased demand raising “price”—in this case demand for executive talent to do a more challenging job—seems to have some evidence of support. We now look at the impact of greater global competition on the demand for executive talent.

Globalization and Manager Discretion Theory

According to the efficient-market theory, the globalization of business leads to an increase in the demand for qualified chief executives. In their 2002 work, Lars Oxelheim and Trond Randøy⁴ look at the impact of product, capital, and corporate governance markets on a listing of Swedish firms. Specifically, they look at “the overall compensation...assumed to represent the wage that clears demand and supply factors,” and they discuss the CEO exposure to greater “performance fluctuations that lie beyond their control.”¹¹ The work suggests that CEO pay was increased in firms due to an increased demand for qualified CEOs.

CEO Tenure Shorter at Firms Listed on Anglo-American Exchanges¹²

	Firms without Anglo-American Exchange Listing	Firms with Anglo-American Exchange Listing	T-Test for Equality of Means
Average CEO Tenure (years)	7.31	4.03	5.15***
*** p < .001 (two-tailed)			

11 “The Effect of Internationalization On CEO-Compensation”; Lars Oxelheim; Trond Randøy, April 2002, page 3.

12 Ibid, page 4.

CEO Tenure Shorter at Firms with Anglo-American Board Membership¹³

	Firms without Anglo-American Exchange Listing	Firms with Anglo-American Exchange Listing	T-Test for Equality of Means
Average CEO Tenure (years)	7.21	5.51	1.71*
* p < .05 (two-tailed)			

Oxelheim and Randøy also showed that a CEO would likely demand higher compensation (risk premium) for the incremental job risk from scrutiny by Anglo-American boards and from the challenges of international competition. The argument parallels what has recently happened with the US Automakers and the banking industry. Why would a highly skilled executive already successful at another firm switch to a troubled industry? The logical response would be that in order to lure someone to take a job at an automobile manufacturer or bank a board would have to approve a more lucrative offer—whether to offset the complexity of the task at hand, intense government oversight, and low probability of success. It is true that GM found a replacement for Rick Wagoner in Fritz Henderson. Yet, Henderson was an “insider” and the jury will be out for sometime deliberating on the success of his leadership. So, generally, it appears that executive compensation can be driven higher by demand for talent and incremental risk due to the short tenure of CEOs based on business environmental factors. We now explore whether certain CEOs are “all hat and no cattle,” with respect to being lauded as superstars.

Lone Ranger Theory—“Superstar CEOs”

Those more tolerant of executive pay will talk at length of the skills required and the market value created during the tenure of a chief executive. Investors, hungry for growth, are willing to pay to find the right “hero” to deliver it in a turbulent global economy. John T. Landry, business development editor at *Harvard Business Review* had the following perspective on supply and demand of top talent: “Executive leadership has remained a scarce resource compared with capital and labor, and the most powerful investors have been willing to pay dearly for it—even when performance is poor.”¹⁶ Some argue that chief executives have a “huge influence” on organizations particularly on how they delegate and set the direction for the next level of company managers. The market for really good CEOs is small. There are “remarkably few” people available who are right for the job, the situation, or the environment.

These rare superstar CEOs ride in on a “fiery horse at the speed of light” creating value for shareholders, and via options, themselves. James B. Wade, *et al*, put it this way:

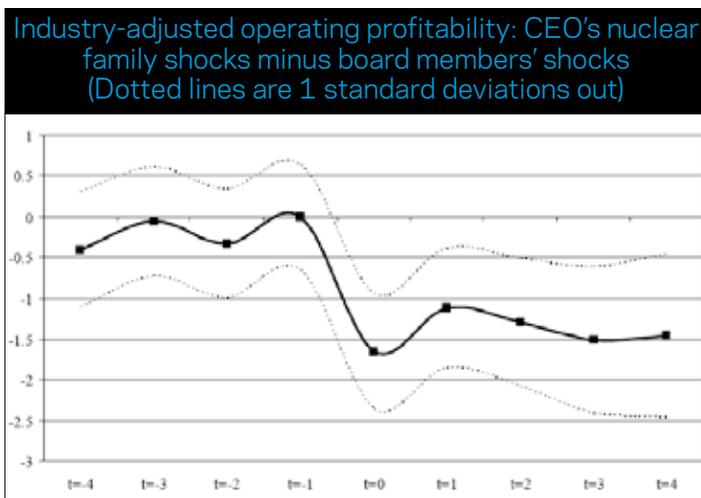
Common wisdom suggests that employing a highly celebrated CEO yields a number of tangible performance benefits for a firm. The presence of a star CEO can signal to investors and other key stakeholders that the

13 Ibid, page 4.

CEO is of high quality and likely to add economic value to the company. As a consequence, the firm may be able to attract higher quality employees, acquire capital at lower rates and transact with suppliers under more favorable terms.¹⁴

The bigger question, assuming value is manifested in a higher valuation following a new CEO hire, is whether that halo effect is sustainable. After all, the proof lies in the steady attainment of earnings among other factors. Recently, there are numerous examples where this is not the case.

In January of 2008, Morten Bennis et al tackled the question of true CEO value. In their work "Do CEOs Matter?" Bennis and his team researched the impact of adverse events, such as CEO death or close family death, on the impact of firm operating profitability (see below).¹⁵ The findings strongly suggest that a CEO is important to the performance of a firm. In addition, the work by Bennis does not show the same importance for directors of firms.



The data here support the argument that CEO pay reflects the value they deliver whether it is attracting other talent business managers, influencing the direction of the business, etc. What is interesting here is that the Board of Directors seems to have less influence on the operating profitability. It begs the question about whether the board is the best advocate for major company decisions. If they, according to the work by Bennis, have less importance, would the same hold true for their "arms' length" relationship with the CEO when deciding on fair compensation? The lack of board of director influence would seem to add weight to the problem of "arms'-length contracting," which we will address later in this section. We now look at the alternative argument to the CEO as superstar.

Lone Ranger Theory Unmasked

14 "Stat CEOs: Benefit or Burden?," James B. Wade, et al: *Organizational Dynamics*, Vol. 37, No. 2, pp. 203-210, 2008.

15 Bennis, Copenhagen Business School and CEPR; Pérez-González, University of Texas, Austin and NBER; Wolfenzon New York University and NBER, "Do CEOs Matter?" January 2008.

The evidence for CEO-as-hero does not go unchallenged. In his article, "Jack Welch and the Lone Ranger Theory," Uwe E. Reinhardt challenges the contribution the famous CEO had on the legendary value jump of G.E. from \$14 billion to nearly \$500 billion during his tenure. Reinhardt points out that the rise in G.E. value parallels the dramatic increase in the overall market. In addition, he questions whether or not Welch "managed earnings" during the lead up to a high GE stock price before Sarbanes-Oxley took effect. Bebchuk and Fried seem to agree with the "rising tide" theory of the market and executive pay:

The options [managers] received did not link pay tightly to [their] own performance, but rather enabled managers to reap windfalls from that part of the stock price increase that was due solely to market and sector trends beyond their control. As a result, managers were able to capture much larger gains than more cost-effective and efficient option plans would have provided.⁵

To further prove the point, Reinhardt contrasts the performance of Welch with his protégé and current CEO Jeffery Immelt who has resided over the dramatic drop in GE value. Can the talent of these two leaders be so dramatically unequal considering they were all but cut from the same management cloth? The danger for boards here is obvious. Over-emphasis of an executive's individual contribution to the firm, and then scarcity of executive talent can lead compensation committees to overpay, particularly if the board does not properly analyze the potential value of stock option grants when exercised. In addition, there are several other potential distortions to an efficient market for executive talent, beginning with the fair negotiation itself.

Arms'-length Contracting

The arms'-length contracting view says that the boards of directors operate and make decisions on behalf of, and to benefit, shareholders of a company. The view states that while the board is generally appointed by and friendly with a CEO they are at an "arms'-length" from her to act in the best interests of the shareholder. The arms'-length contracting view is also thought to account for the agency problem of the CEO, which notes that the incentives of the manager are not necessarily aligned with the incentives of the company owners.

Bebchuk and Fried cite a long list of issues with the process. They argue that just as it is recognized that the executives do not have the same incentives as shareholders, there is no reason to think that boards of directors do either. More to the point, Bebchuk and Fried note that collegiality, friendship, loyalty, cognitive dissonance, and ownership in the company create major conflicts of interest in honoring a true arms'-length contracting process.¹⁶

Cognitive Dissonance and Solidarity

Some may have referred to it as the "good old boys network." Others might call it the "Country Club." Whatever it is, Bebchuk and Fried comment on the familiarity of board members with the CEO who they are compensating and the situation

16 "Pay without Performance: An Overview of the Issues," *Journal of Applied Corporate Finance*, Volume 17 Number 4, A Morgan Stanley Publication, Fall 2005.

that she is facing. Many of the compensation committee members are current or former executives themselves. There is a certain solidarity that develops between the groups as board members can empathize all too well with the executive they are evaluating. Further, some compensation committee members are appointed after a new CEO is named. Bebchuk and Fried not only argue that board members will naturally look to gain favor with the new CEO they refer to the work of Main, O'Reilly, and Wade (1995) that shows executive pay rises in just such a scenario.¹⁷ Board members will treat the chief executive as they too want to be treated. One could sum up this argument by saying that the Golden Parachute is the offspring of the Golden Rule.

Ratchet Effect

Another important deficiency in fairly setting executive pay is the ratchet effect, also known as the "Lake Wobegon" effect. (Lake Wobegon is the fictitious Minnesota town in Garrison Keillor's "A Prairie Home Companion" radio show, where "all the children are above average.") The ratchet effect is the pernicious cycle where compensation committees, convinced that they have hired extraordinary managers, look widely at peer companies' compensation disclosures and, using them as norms, pay their managers above the group average, at, for example, the 75th percentile. When enough firms follow this mistaken belief, and the majority of managers are somehow above average, the net effect is to steadily ratchet up pay for all executives.¹⁸

Power and Camouflage

The power of the executive as it relates to the board of directors also plays an important role in compensation, according to Bebchuk and Fried. The argument suggests that the influence of the board on the executive depends in large part on the size, make up, and membership of the board itself. When a CEO is the chairman of the board, executive compensation was shown to be 20-40 percent higher.¹⁹ If the board of directors has more members, the executive tends to have more power and influence as consensus is much tougher to achieve with larger groups. On the other hand, if the shareholder make up has more institutional investors, there is evidence linking higher institutional ownership to lower CEO pay.²⁰

Camouflage and Stealth Compensation refers to the intent of some companies to try and "legitimize" compensation that is exorbitant or not closely tied to performance. The camouflage compensation takes the form of deferred compensations, post-retirement perks, and executive pension plans.²¹ The occurrence of these arrangements work contrary to the effectiveness of transparency, shifts more tax liability to the firm from the CEO, and contradicts the basis of the arms'-length contracting view which exists to align the incentives of shareholders with CEOs.

In sum, the research on executive compensation provides us with sound empirical data that yield very important but narrow

insights into the efficacy of CEO talent. The data seem to strongly suggest that CEO talent plays a very valuable role in driving value and influence at an organization. In addition, it would seem that the "invisible hand" is alive and well in some respects. The market had and will continue to respond to increasing competition globally making someone who can grab a point of product or service share invaluable to a struggling business. There is also good evidence to suggest that greater scrutiny over CEO performance and thus a shorter tenure will lead for some executives to demand a "risk premium" in their pay.

The research does not however account for the distortions in the decision making on executive compensation. The nature of the CEO and board of director appointments make the arms'-length contracting view problematic from the start in that there is an inherent conflict of interest. The ratcheting effect whether driven by hubris or a need to influence market perception does not seem to have a logical conclusion available, and transparency is clouded by workaround compensation arrangements and cronyism to maintain the status quo within the executive club. As we have seen as a nation, there have been times when we have thrived in a free market and times when more restraint and intervention was beneficial. We must now search to find that effective balance of Adam Smith and John Maynard Keynes for compensation that is constructed fairly, incentivizes wisely, and rewards more equally. The aggregate data seem to suggest that markets are efficient to the extent of increasing demand for talent and the valuation of the price for this talent. The gaps in efficiency surround real transparency to the executive compensation decision process, true value of the total compensation package, and the likely conflicts of interest with acting board members. Steps to improve these gaps would not only serve to increase the awareness of the market forces that drive executive pay higher, but it would help avoid unproductive practices such as ratcheting, camouflaging, and stealth compensation packages.

Regulatory Responses and Unintended Consequences

The debate on whether executive compensation in American public companies is too high or too disconnected from long-term value creation is neither new nor static. Since the SEC was created, it has grappled with the question of whether value was being properly distributed to shareholders and employees or hoarded by management. But as federal policy-makers stepped in to regulate compensation practices, generally under extraordinary public pressure, they sometimes succeeded in only moving executive pay from one pocket to another. For example, the 1942 SEC rules requiring firms to disclose compensation in a simple-to-understand table, as opposed to narrative forms, was a disclosure improvement in terms of clarity and comparability. Yet it also limited the forms of pay that were required to be disclosed, and hidden payment vehicles, such as perquisites, ballooned. This loophole was not closed until 1978 with new disclosure rules requiring inclusion of all compensation types, including perks, and new tax rules

¹⁷ Ibid, page 13.

¹⁸ Bahar, Rashid, 2005. "Executive Compensation: Is Disclosure Enough?" Available at SSRN: <http://ssrn.com/abstract=869415>

¹⁹ Ibid, page 15.

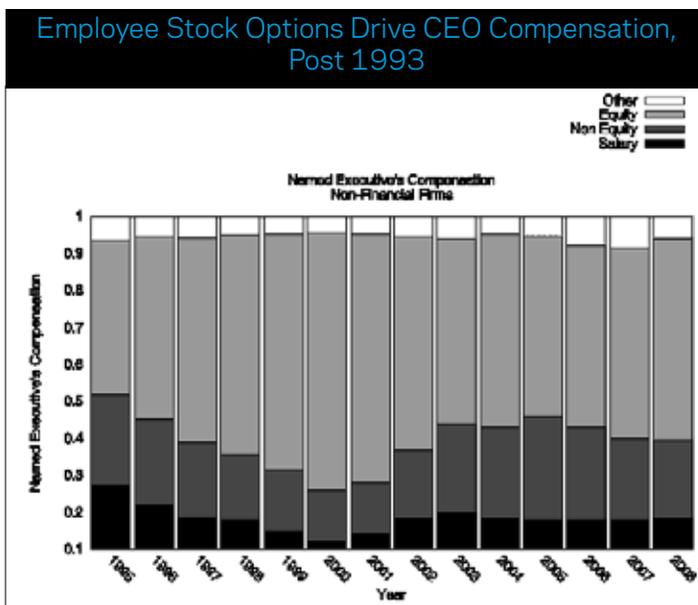
²⁰ Ibid.

²¹ Ibid, page 16.

by the IRS aimed at closer scrutiny of perks.²² According to McGahran (1988), these new rules then effectively shifted compensation towards salary again.²³

Tax Code Changes

Sometimes, with American regulatory changes, the cure has been worse than the disease. Tax law § 162(m), signed in 1993, called any pay above \$1 million that wasn't tied to performance "excessive," and made it ineligible for deduction from company income. This had the unintended effect of legitimizing \$1 million as the "standard" CEO base salary, and not only did salaries higher than this amount come down after passage of the law, but those salaries below \$1 million moved closer to this limit over time, for a net effect of increasing average CEO pay.²⁴ Further, the law's stated purpose, to more closely link pay to performance, gave rise to the widespread use of employee stock option grants after 1993. Perversely, these stock options were loaded onto executive compensation packages and executive pay skyrocketed through the 1990s, leading to an almost reckless short-term earnings focus and inevitable accounting scandals. Ferris and Wallace (2009) used data from ExecuComp to illustrate the growth of stock option compensation following the passage of § 162(m)²⁵:



Source: Sudhakar Balachandran, Bruce Kogut, and Hitesh Harnal, "The Probability of Default, Excessive Risk, and Executive Compensation: A Study of Financial Services Firms from 1995 to 2008." Columbia Business School working paper, 2010.

22 Dew-Becker, Ian, 2008. "How Much Sunlight Does it Take to Disinfect a Boardroom? A Short History of Compensation Regulation." CESifo Working Paper No. 2379.

23 McGahran, Kathleen T., 1988. "SEC Disclosure Regulation and Management Perquisites." *The Accounting Review*, 63(1), pp. 23-41.

24 Harris, D., Livingstone, J., 2002. "Federal Tax Legislation as an Implicit Contracting Cost Benchmark: The Definition of Excessive Executive Compensation." *The Accounting Review*, 77(4), pp. 997-1018.

25 Ferris, Kenneth R. and Wallace, James S., 2009. "IRC Section 162(m) and the Law of Unintended Consequences." *Advances in Accounting, incorporating Advances in International Accounting*, 25(2009), p. 148.

Fighting excessive executive compensation through the tax code like this has been notoriously ineffective. Rules § 280G and § 4999, signed in 1989 and 1984, respectively were similarly rife with unintended consequences. § 280G, which disallowed tax deductions for golden parachutes in excess of 2.99 times annual compensation, effectively standardized golden parachutes at 2.99 times annual compensation.²⁶ § 4999 forced executives to pay a 20 percent excise tax on parachute payments above this limit and caused the emergence of gross ups, or additional payments to an executive to cover the excise tax, plus the taxes on the gross ups themselves. Now profit dollars were going not only to executives themselves, but to the government in addition. Miske (2004) concludes that caps on compensation through the tax code do not work because they are specific and proscriptive, and therefore easily circumvented or abused by compensation committees.²⁷

Disclosure Rules

The SEC has focused its regulatory efforts since the Securities Acts of 1933, including the aforementioned changes of 1942 and 1978, predominantly on disclosure rules. Under the assumption that disclosure of executive compensation packages effectively shames boards into doing right by their shareholders and employees, a steady stream of decisions by the SEC over more than 70 years made disclosure of compensation policies more transparent, more comprehensive, and more comparable from firm to firm. Put more formally, transparent disclosure reduces the costs of shareholder monitoring of corporate board decision-making, and in theory, reduces agency issues between them. This culminated in the 2006 rule, where the SEC created the "Compensation Discussion and Analysis (CD&A)" filing, in which companies are expected to disclose all prior and potential payments, of any form or function. Notably, perks, severance, and retirement packages, as well as payout ranges for incentive plans, must be clearly spelled out.²⁸

Today the United States has perhaps the most comprehensive executive compensation disclosure rules of any country. Yet, as disclosure increased over time, so has executive pay, implying that disclosure rules are, in the end, ineffective. For one thing, even with a well-constructed disclosure scheme, corporate boards and their compensation consultants may seek increasingly opaque forms of compensation (such as time on the company jet), which are more costly, dollar for dollar, than simply paying the executive what it is they think he or she is worth in cash, just to avoid the public outrage that follows disclosure of seemingly exorbitant remuneration.

Second, as compensation consultant James F. Reda pointed out to *The New York Times*, compliance to the 2006 rules

26 Dolmat-Connell, 2009. "Potential Implications of the Economic Downturn for Executive Compensation." *Compensation & Benefits Review*, 41(1), pp. 33-38.

27 Miske, Ryan, 2004. "Can't Cap Corporate Greed: Unintended Consequences of Trying to Control Executive Compensation Through the Tax Code." *Minnesota Law Review*, 88(6), pp. 1673-1696.

28 Dew-Becker, Ian, 2008. "How Much Sunlight Does it Take to Disinfect a Boardroom? A Short History of Compensation Regulation." CESifo Working Paper No. 2379.

has been further limited by a large loophole that excuses companies from providing details on performance targets if publishing them would put the firm at a competitive disadvantage. Namely, if a competitor knows a firm's performance benchmark, and knows that in a bad year executive bonuses will be meager or foregone, the competitor could move in to steal away the firm's executives with better offers. Of course, many companies have claimed this loophole. Reda's firm sampled S&P MidCap 400 firms and found that only 47 percent complied with the short-term incentive pay disclosure rules in 2007.²⁹

And third, thorough disclosure of pay philosophies and specific packages may actually lead to the ratchet effect, described previously. It is unclear whether disclosure is to blame; our interviews with compensation consultants indicate that today, there is enough private survey data on executive compensation levels that the ratchet effect may no longer be attributable simply to SEC disclosure rules.

Say On Pay

Given the challenges regulating executive compensation levels through rule-based tax penalties and disclosure policies, a superior approach to combat ill-designed or inappropriately generous pay packages may be in the offing: Shift additional power to shareholders through binding or advisory votes on compensation issues so that they may effectively prod the board to refine poorly designed proposals to better represent shareholder interests.³⁰ These "say on pay" powers are increasingly common in Europe but are rarely granted by firms in the United States. In 2006, a campaign led by the American Federation of State, County, and Municipal Employees attempted to push more than 60 companies to accept advisory say on pay votes. Aflac was the only target firm to voluntarily institute the policy, while Blockbuster and Verizon were forced to accept it when a majority of their shareholders approved the proposal in an unpleasant, public battle³¹.

Aflac then held the first United States "say on pay" vote in 2008, and the compensation plan was approved by 95 percent of shareholders. RiskMetrics, H&R Block, and Littlefield also held their first compensation votes in 2008, with the support of 94 percent, 99 percent, and 97 percent of their shareholders, respectively.³² Along with Verizon and Blockbuster, Motorola, Intel, Ingersoll-Rand, MBIA, and others will hold their first say on pay votes in the 2009 proxy season.³³ The most important development in regards to United States adoption of this rule was the inclusion of a say on pay requirement into the American Recovery and Reinvestment Act of 2009. According to Section 7001 of the Act, all Troubled Asset Relief Program (TARP) recipients

must hold advisory say on pay votes in 2009 if they file their proxy statements after February 17. (See appendix 1 for a full discussion of the compensation restrictions for TARP recipients.) RiskMetrics noted that given the time constraints, many of the TARP recipients have thus far included brief, skeletal justifications of their pay practices, for up-or-down advisory vote³⁴.

With the heightened interest in executive compensation issues in the media and in Congress following large bonus payouts to Merrill Lynch and AIG employees, in the face of both companies' public collapses, SEC Chair Mary Shapiro has endorsed the TARP say on pay requirement, and it seems increasingly likely that say on pay will become mandated for all publicly-listed American firms by the SEC. But of course, the core question is: what effects do these advisory votes actually have on compensation payouts? If pay proposals are overwhelmingly approved as in the examples cited above from 2008, then are shareholders actually knowledgeable or motivated enough to cast a critical vote? In order to assess say on pay, we have to look overseas where there is more available data.

Stephen Deane (2008) provided an excellent review of results from the United Kingdom, the Netherlands, and Australia, who each adopted differing approaches to say on pay legislation. In the United Kingdom, which was the first country to legislate say on pay in 2002, Deane found that following the adoption of say on pay, most UK firms reduced severance provisions to one year's base salary, and eliminated the practice known as "performance retesting" where, if a firm fails to meet performance criteria within a mandated timeframe, the timeframe is extended to give managers another chance to achieve their goal. In all three countries, Deane found that performance hurdles have risen, and boards scrutinize pay packages more carefully, wary of shareholder backlash on poorly designed compensation schemes.³⁵ Though there is no concrete evidence that say on pay requirements lowered absolute levels of pay in these countries, Balachandran *et al* (2007) ran carefully controlled empirical analyses on British firms from 2000 to 2005, and found that say on pay policies were linked to increased pay-for-performance sensitivities in terms of CEO cash compensation as well as total compensation.

When proposals arise to increase shareholder power, in any form, critics often fret that they will result in surges of investor uprisings, particularly activists who may be bent on removing or replacing directors, or who hope to make gains on short positions on the firm. In the UK, this fear has not been realized. Between 2002 and 2007, only 64 of 596 votes resulted in dissents of more than 20 percent.³⁶ And within this time frame, there has been only one spectacular 'no' vote on a pay proposal. GlaxoSmithKline's 2003 pay proposal was defeated (50.72 percent against), when it planned to reward the CEO

29 Morgenson, Gretchen. (September 7, 2008) "If the Pay Fix Is in, Good Luck Finding It." *New York Times*, p. BU1.

30 Balachandran, Sudhakar, Ferri, Fabrizio, and Maber, David. "Solving the Executive Compensation Problem Through Shareholder Votes? Evidence from the U.K." Mimeo, November, 2007.

31 Sloan, Allan. (May 29, 2007) "Aflac Looks Smart on Pay." *Washington Post*, p. D01.

32 "Intel Adopts Advisory Vote on Executive Pay." Walden Asset Management Press Release, January 27, 2009.

33 Ibid.

34 Allen, Ted, RiskMetrics Group. "A Preview of Management Pay Vote Proposals." March 6, 2009. Risk and Governance Blog, <http://blog.riskmetrics.com/gov/2009/03/a-preview-of-management-pay-vote-proposalsubmitted-by-ted-allen-publications.html>

35 Deane, Stephen. "Say On Pay: Results From Overseas," *The Corporate Board*, 2007, 28(165), pp. 11-18.

36 Davis, Stephen, 2007. "Does 'Say On Pay' Work? Lessons on Making CEO Compensation Accountable." *Policy Briefing* No. 1, Millstein Center for Corporate Governance and Performance, p. 10.

with US-comparable pay and was poorly socialized among investors. As retold in Davis (2007), a former board member described the aftermath: "Beforehand, we paid the CEOs what we wanted to and told investors who objected 'too bad...' Now the board must base remuneration on performance and be scrupulous about it."³⁷

Whether say on pay requirements in the United States will achieve the desired goal of shaming boards into enacting responsible compensation policies depends a great deal on the particulars of American firms. On the one hand, as previously mentioned, the United States has far more comprehensive disclosure rules than European countries. So active investors are perhaps in a better position to judge the merits of compensation packages here, and to use dissenting say on pay votes to better align pay to their own aims. But on the other hand, the US market is more diverse, with more players holding small, non-controlling interests in firms, making it more difficult for them to coordinate responses during proxy season. Compensation consultants and directors we spoke with agreed that in this diverse investor market, proxy recommendation firms like ISS (owned by RiskMetrics) would therefore wield considerable undue influence on pay proposals, with proscriptive one-size-fits all recommendations. But in RiskMetrics proxy voting guidelines for 2009, the firm avoids heavy-handed approaches. It only recommends case-by-case voting for compensation proposals, depending on the particulars of the business, such as the pay proposal's alignment with long-term shareholder value, and avoidance of "pay for failure."³⁸ One point of agreement in our interviews was that say on pay is likely to be widely adopted in the United States, either voluntarily or through federal regulation.

Clawbacks

Another safeguard widely gaining prominence is the "clawback" provision, in which deferred compensation is forfeited—or previously paid compensation is recovered—on a variety of grounds. Traditional clawbacks, or "bad boy" provisions, forfeited an executive's stock options, unvested stock, or in some cases severance payments in the event of misconduct such as violating noncompete clauses or ethics codes. Following the accounting scandals earlier this decade, and in order to prevent managers from extracting undue rents through the manipulation of financial statements, Sarbanes-Oxley was written to include a tougher clawback provision, Section 304, that allowed the return of the prior year's CEO and CFO bonuses in the event of a financial accounting restatement that resulted from noncompliance with reporting requirements due to "misconduct."³⁹ The SEC announced its first individual Section 304 settlement in 2007, for a record-breaking \$468 million in bonuses, profits, and penalties, due to options backdating by William McGuire, the former chairman and CEO of UnitedHealthGroup, Inc.⁴⁰

American publicly owned firms have been introducing their own clawback provisions in increasing numbers. In a 2008 survey by The Corporate Library, 329 of the 2,100 businesses surveyed adopted clawbacks for financial misstatements, compared to just 14 of 1800 firms surveyed in 2003. Forty-four percent of the provisions are "fraud-based," triggered if the executive engaged in misconduct causing a restatement. And 39 percent are "performance-based," a stronger form in which all executives' incentive payouts are returned if they are based on incorrect financials.⁴¹ The adoption of these clawback policies comes as financial restatement rates in the United States plummet. A study from Glass, Lewis & Co. LLC found that in the first quarter of 2008, there were 21 percent fewer restatements than the same period in 2007.⁴² Though correlation has not been effectively studied, improved financial accounting and auditing systems mandated by Sarbanes-Oxley, combined with the extra security of these clawback policies, may have been effective at reducing the incentive to misstate earnings in order to maximize compensation payouts.

But today's clamor regarding excessive executive compensation is generally not in response to accounting fraud. Rather, outrage is directed at firms, particularly in the financial industry, in which gargantuan incentive bonus schemes are not, in fact, tied to long-term firm performance, or which may have only upside potential, with no downside risk. Professor Raghuram Rajan, of the University of Chicago Business School, describes Wall Street's compensation design problem in terms of huge annual bonuses that encourage the creation of "fake alpha," or excess returns that are based on huge, hidden tail risks.⁴³ True alpha, or excess investment returns without additional risk, is a rare find, often only in the hands of extremely talented individuals (such as Warren Buffet), so fake alpha is a great temptation for lesser performers. And so long as bonuses are handed out annually without any downside potential, traders and managers are incentivized to chase fake alpha, in the hope that the investment does not implode until after the bonuses have been paid out. Rajan uses the example of AAA-rated collateralized debt obligations (CDOs), which generated 50-60 bps higher return than similarly rated corporate debt. The traders who created these CDOs were remunerated for these excess returns, without regard for the fact that these excess returns came with the tail-risk of CDO default.

Rajan's approach to discourage the pursuit of fake alpha is a strict clawback for traders and managers, triggered not by financial restatements, but by poor financial performance of the assets under their control. A portion of the individual's bonus would be kept in escrow until the tail risk had passed, so that only true alpha is rewarded.⁴⁴ One well-known example of this type of individual-performance clawback was the remuneration policy at the Harvard Management Company. Portfolio managers were paid a base salary, a "neutral" bonus, and an incentive bonus. The incentive bonus could be positive

37 Ibid, p. 9.

38 "2009 US Proxy Voting Guidelines Summary." RiskMetrics Group report, December 24, 2008, p. 40.

39 Liliensfeld, Doreen, and Singh, Romica, 2008. "Designing a Successful Executive Compensation Clawback Policy." *Compensation & Benefits Review*, 40(6), pp. 30-36.

40 "SEC Litigation Release No. 20387." Washington, DC: US Securities & Exchange Commission, December 6, 2007. www.sec.gov/litigation/

litreleases/2007/lr20387.htm.

41 Paul Hodges, 2008. "Updated Analysis of Clawback Policies." Report by The Corporate Library, July 2, 2008.

42 "Restatements: Out of Sight, Out of Mind." Glass, Lewis & Co. LLC report, May 30, 2008, p. 1.

43 Rajan, Raghuram. "Bankers' Pay is Deeply Flawed." *Financial Times*, January 8, 2008.

44 Ibid.

or negative, depending on the portfolio's return, and large portions were carried forward and reinvested in the portfolio until the following year, rather than paid out immediately. If the fund performed below a certain benchmark the following year, those withheld bonuses were clawed back, and thus downside risk and upside potential were matched, both short- and long-term.⁴⁵

While the Harvard Management Company generated famously high returns, enough to fund one-third of Harvard University's operating expenses annually, the effectiveness of the firm's remuneration policy is questionable. Recent evidence indicates that even this sophisticated clawback policy could not prevent the portfolio managers from taking on excessive risk. The fund lost \$8.1 billion from July 1, 2008 to October 31, 2008, and was at that time, still pursuing shocking bubble-era investments in commodities such as oil, lumber, and land, while holding a tiny fraction of conventional investments and safer fixed-income and low-risk vehicles.⁴⁶

In sum, regulatory controls on executive compensation often follow a groundswell of public dissatisfaction, and historically in the United States, they have been largely ineffective. In the Appendix, we provide a full review of the current and proposed changes that have followed the recent subprime mortgage crisis, including the rules put in place for TARP recipients, and the SEC's proposals for all American publicly owned companies. With uneven success of these regulatory approaches, the merits of US government efforts put in place since 2008 remain in doubt.

Global Innovations in Executive Compensation Policy

In this section we take a look at the different initiatives and ideas other countries are working on to keep executive compensation in check. In many cases, Main Street has a rather important role to play: retail investors have huge power over companies' boards if they would just exercise their voting rights; in Europe, worker representation at the board level has proven an interesting source of balance in the executive compensation battle, as has the presence of unions. Beyond the call for more transparency and accountability, innovation is hard at work. This includes tying executive compensation to environmental record (Germany) and making sure that whatever remuneration scheme is adopted, it does not put the firm at risk (Netherlands). Overall, it is becoming obvious that the societal role of a firm goes well beyond generating shareholders' value. Jack Welch has recently provided the business and financial worlds with a stunning 360-degree turn around by renouncing his own "shareholder value maximization" mantra and replacing it with a much more comprehensive approach: "On the face of it, shareholder value is the dumbest idea in the world. Shareholder value is a result,

45 Hall, Brian J., and Jonathan Lim. "Incentive Pay for Portfolio Managers at Harvard Management Company," Harvard Business School Case 902-130. (2001).

46 Epstein, Edward Jay. "Losing Harvard's Billions. The world's biggest endowment may have lost more than it's previously stated." *The Big Money*, January 27, 2009. <http://tbm.thebigmoney.com/articles/diploma-mill/2009/01/27/losing-harvards-billions>

not a strategy...your main constituencies are your employees, your customers, and your products."⁴⁷

France: the End of the reign of "Chairman & CEO"

France is a country of contradictions. Embracing free market economy it has always vowed to correct its negative impacts through a very decentralized and powerful administration and regulatory system. Shaken by scandals such as Noel Forgeard's €8.55m golden parachute when he was forced out of EADS, despite poor results,⁴⁸ and the famous case of Vivendi Universal's Jean-Marie Messier⁴⁹ a few years earlier, France is now looking at curbing such excesses. In 2007, when Nicolas Sarkozy was running for President, he promised to "bring morals back into the business life of the country"⁵⁰ The first step was taken when he introduced a bill, passed into law on August 21, 2007,⁵¹ calling for the establishment of clear, publically available performance criteria to be used in awarding golden parachutes. Severance packs must be aligned not only with the executive's own performance but with the company's as well.

Moving forward in this direction and under pressure from the global economic crisis, in the Fall of 2008, France explored several ways to further reduce excess in compensation. The main take-away of France's approach is the prohibition of cumulating an employee contract with a board position.

1. **Create a new government entity:** This option was quickly abandoned as it raised concerns that civil servants monitoring executives' compensation might have led to excessive behavior sparking a massive brain drain.
2. **Encourage say on pay**
3. **Self Regulation:** The MEDEF (Movement of the French Enterprises) and the AFEP (French Association of Private-Sector Companies), which are the two largest unions of employers in the country, opted to self-regulate to avoid being regulated by law.⁵² Proposed reforms from MEDEF⁵³ included:
 - A. Terminating the employment contract of an executive as soon as he becomes a board member of the company;

47 Guerrero, Francesco. "Welch Condemns Share Price Focus." *Financial Times*, March, 12, 2009.

48 Noel Forgeard, the CEO of EADS, the European aerospace consortium, received an €8.55m severance pack, unanimously voted by the Board. Poor results lead to the loss of 10,000 jobs. Noel Forgeard was subsequently taken into custody for alleged insider trading.

49 Jean-Marie Messier, the CEO of Vivendi Universal was awarded a €20.5, once again despite disastrous results.

50 Speech in front of members of the parliament from the majority, June 20, 2007, Elysée Palace

51 La Loi TEPA. "En faveur du Travail, de l'Emploi et du Pouvoir d'Achat" (To Support Employment, Work, and Purchasing Power), August 21, 2007.

52 President Sarkozy gave the MEDEF until the end of year to come up with a corpus of rules that must be adopted by a majority of French companies, or he threatened to pass a law early in 2009 to regulate executive compensation. Conseil des Ministres, October 7, 2008.

53 Recommandations sur la Rémunération des Dirigeants Mandataires Sociaux de Sociétés dont les Titres sont Admis aux Négociation sur un Marché Réglementé—MEDEF & AFEP, October 2008.

- B. If a company is in trouble, or if the executive of a company is not performing, he can no longer pretend to receive any severance upon leaving the company; similarly, an executive leaving the company voluntarily to go work somewhere else can no longer be given any compensation, retribution, bonus, etc.... In any case, severance compensation cannot exceed two years of compensation.
- C. Options can no longer be given solely to executives without proposing that all employees participate in the capital as well, through profit-sharing schemes, offering of free stock to employees, etc... Stock given to directors must be subject to performance. Stock given with no ties to performance must be reserved for employees only.
- D. Put a cap on special annual retirement funds
- E. Prohibit the distribution of free stock untied to performance; executives should buy stock at market price;
- F. Increase compensation transparency through standard reporting and by using standard tables (see Annex 1)

As of January 14, 2009, 53 percent of French publicly traded companies had voluntarily adopted this code of conduct. Rates of adoption are higher among larger firms. In public companies with market capitalization of more than €1 billion, 94 percent of firms have adopted the code. Between €500 million and €1 billion, 56 percent of public companies have adopted, and below €500 million, only 33 percent.⁵⁴ However, according to a Hewitt Associates⁵⁵ study of the 120 publicly traded companies included in the SBF 120 index, 80 percent of these companies were found to be not complying with those rules. Seventy-nine percent of executives had golden parachutes as part of their compensation either as company executives or as directors. Furthermore, those severance packages were often larger than the 24-month total compensation cap imposed by MEDEF. Finally, the survey revealed that over a quarter of the companies (29 percent) hadn't published the performance criteria to which executive compensation should be tied.

Such behavior aggravated by the deepening of the economic crisis turned President Sarkozy's threat into a law. Ratified on March 31, 2009, the law⁵⁶ pertains to "executive compensation of both companies receiving bail out monies from the government as a consequence of the financial crisis and publicly traded companies." Interestingly, the present law will remain in application until December 31, 2010 only. The law contains a few innovative and noteworthy rules.

Article 2: executive compensation for companies receiving bail-out funds from the government:

1. Companies receiving public funding will no longer grant

⁵⁴ Les Echos—January 14, 2009.

⁵⁵ "Parachutes Dorés: Les Excès Continuent", *Le Monde*, January 13, 2009.

⁵⁶ Decret# 2009-348, dated March 30, 2009.

their CEO, chairman, deputy CEOs, directors, president of advisory boards, and any chief operating officer the following type of compensation: stock options and free stock.

2. A variable portion of total compensation may be authorized by the Board or by the Advisory Board, for a predetermined period of time which cannot exceed a year and must be based on predetermined quantitative and qualitative criteria independent from stock valuation. This authorization must be made public. If the company is massively laying off workforce, variable compensation stated in Paragraphs 1 and 2 is suspended;

Article 5: executive compensation for publicly traded companies

1. If a CEO or a chairman is also an employee of the company he has to renounce to his employment contract when his board mandate/position is up for renewal;
2. Variable part of executive compensation has to be made public and cannot be tied to stock price/market capitalization; variable portion must be designed to reward both the company performance and its progress on the mid-term horizon and according to clear and precise pre-determined criteria;
3. Severance cannot exceed two years of compensation; severance can only be paid upon forced termination/ resignation and on the condition of clear and precise performance criteria; severance cannot be paid if the company is amidst serious financial trouble;

To ensure compliance, the French government has asked the MEDEF & AFEP to create a "committee of wise men" by the end of April 2009, which will be in charge of supervising executive compensation schemes in companies which are laying off.

The set of regulations in France is unprecedented and quite innovative and goes well beyond the 2005 budget law, which made the first Euro of every golden parachute, taxable. Time will tell whether the committee of wise men provides adequate control; these men and women should have no ties whatsoever with the companies under their supervision: they can own no stock, stock option, or be on their board, or have been on their board for the past five years.

Netherlands: Assessing the Potential Exposure and Risks of Remuneration

The Netherlands adopted a New Dutch Corporate Governance Code, which came into effect on January 1, 2009.⁵⁷ Beyond the dual board structure,⁵⁸ one of the most innovative considerations pertains to assessing the

⁵⁷ Dutch Corporate Governance Code: Principles of Good Corporate Governance and Best Practice Provisions. 200.

⁵⁸ Dutch public companies are run by a Management Board under the control of a Supervisory Board.

remuneration risk to the company.

Management Board members may receive compensation composed of a fixed and a variable part. The "variable component shall be linked to predetermined, assessable and [...] targets, which are predominantly of a long-term nature. The variable component of the remuneration must be appropriate in the relation with the fixed component."

The code also states that remuneration schemes must be simple and transparent, take into account the medium and long term performance of the company, and not encourage executives to act in their sole best interests; furthermore, failing board members shall not be rewarded. The Supervisory Board is in charge of determining the compensation structure based on a proposal from the remuneration committee.

The Dutch are even stricter than the French when it comes to calculating the compensation a Management Board member may receive upon termination: not more than one year salary. Although, they do leave space for negotiations in case this amount "would be manifestly unreasonable in the circumstance" and can amount to a maximum of two-year salary.

But the most interesting proposition in the Dutch code calls for assessing "the risks to which variable remuneration may expose the enterprise." The different exposure scenarios must be run by the remuneration companies and are part of a remuneration report which is made public through the company's website. In case of extraordinary circumstances the Supervisory Board has discretionary power over the variable portion of the compensation. This is a bold move on several levels. First, such a statement acknowledges that executive compensation does pose a threat to the integrity of the firm and its public image. Second, it encourages firms to be proactive about remuneration schemes and protect themselves of scandals brought about by their own boards. And finally, it offers a series of stress tests to different compensation packages: ultimately, the Board will choose the package that offers the lowest risk while allowing it to retain talent, creating an entirely new dynamic between employees and the board governing them.

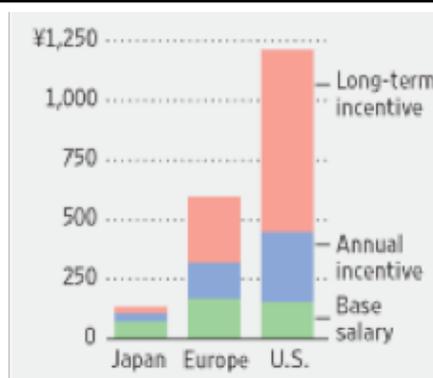
Japan: The End of the Bureaucrat CEO?

Besides individual and company performance criteria, what if executive compensation needed another comprehensive measure such as the relation to minimum wage. Japan is a very interesting example the average multiplier between a chief executive's compensation and minimum wage is 30 to 40 times (see chart above).

Seniority is the most important factor determining compensation in Japan, not performance. Furthermore, huge compensation packages are socially offensive.

"Most Japanese chief executives don't earn anywhere near the big paychecks of their Western counterparts. CEOs at Japan's top 100 companies by market capitalization earned an average of around \$1.5 million, compared with \$13.3 million for American CEOs and \$6.6 million for European chief

CEO Compensation (In millions of yen)



Notes: ¥1.25 billion = \$13.09 million; Data gathered from 2004-2006. Source: Towers Perrin.

executives at companies with revenues higher than \$10 billion, according to an analysis of 2004-06 data by Towers Perrin, a Stamford, Connecticut, human resources firm."⁵⁹

Kubo Katsuyuki of Waseda University and Takuji Saito of Kyoto Sangyo University have calculated that an improvement in stock market performance that would earn a typical US CEO \$1.8 million would bring a Japanese CEO just \$27,000.

"Japanese presidents' pay does not change, even when they achieve very good or very bad performance," Kubo said. "In sum, the financial incentives of Japanese presidents have become more like those of bureaucrats."⁶⁰

But as more Japanese companies acquire troubled American assets, the culture is slowly changing, bonuses are increasing, and individual excellence is rewarded. The major criticism of the Japanese model was that it was not encouraging CEO to take risks, assimilating them toward a bureaucratic mindset. Regardless, some researchers argue that putting the emphasis on the fixed part of the compensation enhances disclosure and transparency processes.⁶¹

Germany: The Birth of the Environmental CEO

Germany has already moved to limit executives' salaries to €500,000 for companies receiving bailout funds⁶². Germany, along with Austria, is one of the very few countries looking at tying executive compensation not only to individual performance and firm performance, but also to environmental, social, and governance indices, hence taking the responsibility of executives and their firms to another level of disclosure and transparency. Adding these criteria brings the pact among companies, customers employees and

59 "No Outcry About CEO Pay in Japan." *BusinessWeek*, February 10, 2009.

60 Jones, Del and Paul Wiseman. "In Japan, More CEOs Share the Pain of Tough Times." *USA Today*, April 6, 2009.

61 Frey, Bruno S. and Osterloh, Margit, Yes, Managers Should be Paid Like Bureaucrats (January 2005). CESifo Working Paper Series No. 1379; IEW Working Paper No. 187. <http://ssrn.com/abstract=555697>

62 www.dw-world.de/dw/article/0,2144,3735083,00.html

shareholders to a new level. It also revives the idea of firms as “responsible citizens” instead of just being a profit-oriented organization.

4. Relation between workers representation at Board level and CEO compensation:

4.1 Worker Board Level Representation

Worker board representation is common practice in Japan, Germany, Canada, and the United Kingdom. It exists to a lesser extent in the United States and only when Unions participate in broad ESOP plans (Tzioumis & Gomez).

European Employee Board Level Representation	
Bulgaria, Cyprus, Estonia, Italy, Latvia, Lithuania, Portugal, Romania, the UK	No board level representation
Belgium, Greece, Ireland, Poland, Spain	Board level representation limited to some state-owned or municipally owned companies
France and Malta	Board level representation is same as above, plus recently privatized companies; French companies can voluntarily opt to have representation at board level
Austria, Czech Republic, Denmark, Finland, Germany, Hungary, Luxembourg, the Netherlands, Slovakia, Slovenia, Sweden	Employee board level representation extends to private companies

Source: www.worker-participation.eu

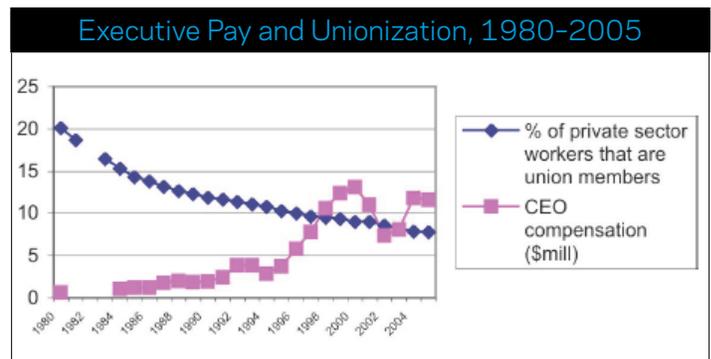
4.2 CEO Compensation: The Role of Unions

On August 25, 2008, the Institute for Policy Study and United for a Fair Economy released their 15th Annual CEO Compensation Survey.⁶³ The opening paragraph states that despite harsh economic times, “S&P 500 CEOs, last year’s [pay packages] averaged \$10.5m, 344 times the pay of typical American workers.” Pushing the comparison into the realm of the obscene, the report, then states that “Last year, the top 50 hedge and private equity fund managers averaged \$588m each, more than 19,000 times as much as typical US workers earned.”⁶⁴

Focusing in particular on tax loopholes (carried interest treated as capital gain, deferred compensation, tax deductibility of executives pay as business expenses, etc.) the report brings interesting statistics on the correlation between CEO compensation and the presence or absence of unions (see Executive Pay and Unionization, above right).

63 “Executive Excess 2008: How Taxpayers Subsidize Runaway Pay—15th Annual CEO Compensation Survey

64 Ibid.



As unionization rates have fallen, CEO pay has climbed.

Sources: Unionization: Bureau of National Affairs, Union Membership, and Earnings Data Book; CEO Compensation: Business Week and Wall Street Journal survey.

There is case for stronger unions: 50 years ago, one third of American workers were unionized, representing an important force in the bargaining process to set up pay schemes in every industry, across the United States. Today only 12.4 percent⁶⁵ of US workers are unionized. On average, CEO compensation in non-unionized public companies is 20 percent higher than their counterparts in unionized companies.⁶⁶

Comparable results were found by Tzioumis and Gomez in June 2007⁶⁷ and summarized in their abstract:

“We find that, on average, union presence: 1) is significantly associated with lower levels of total CEO compensation; 2) affects the mix of CEO compensation by providing higher levels of base pay but much lower stock option values; 3) lowers dispersion across the major components of CEO remuneration and 4) does not significantly reduce the performance sensitivity of CEO compensation as compared to non-union firms. These results are consistent with several models of union influence.”

They further explain the relationship between unions and CEO compensation through two different channels. The first one is direct: unionization puts pressure on the company and subsidiary by representing workers in the traditional bargaining game. The second channel, which is indirect, links unions to executive compensation.

- A. Direct channel: union pressure on the company and subs
- B. Indirect channel: adverse consequences that union presence can have on financial markets, which in turn determine the value of the stock-related part of executive compensation. Unions can depress stock value, and thus option values, in two ways. First, strikes can have large, negative effects on equity values.⁶⁸ Second, the presence

65 In 1983, union membership rate was 20.1 percent; Bureau of Labor Statistics.

66 “Trade-Offs in the Labor Union-CEO Compensation Relationship”, Kevin Banning & Ted Chiles, Journal of Labor Research, May 2007.

67 Tzioumis, Konstantinos and Rafael Gomez. “What Do Unions Do to CEO Compensation?” Center for Economic Performance Discussion Paper, June 2007.

68 DiNardo & Hallock. “When Unions Mattered: Assessing the Impact of

of Unions results in a greater portion of rents being redistributed to workers.

Executive compensation is no longer the sole concern of the board or of its compensation committee. As European countries are exploring different ways of designing executive compensation packages, they presently include unions, employee representatives, consumers' opinion, as well as shareholder perspectives. The evolving process also includes shaping a new place in society for companies: by adding an environmental metric to compensation (Germany), by being aware of the risk that any compensation package represents in the public eye (the Netherlands) and by putting an emphasis on leisure and family time (France), boards are indeed changing the perception of all stakeholders.⁶⁹

Conclusion

In this White Paper, rather than tackling the question of the fairness of executive compensation, we questioned whether there are objective performance reasons for a board not to remunerate a corporate executive excessively, in the absolute sense as well as relative to his or her peers and subordinates. Though we did not come across an economic formula that could predict whether a particular pay package is too high, we found sufficient evidence to indicate that higher pay doesn't necessarily guarantee better performance, and that the theoretical underpinnings of the agency model are quite often defeated from the start.

First, wealthy individuals have access to hedging mechanisms that can dissolve performance pay's effect on principal-agent alignment; in other words, the manager's wealth is safe whether the company does well or does not do well. Also, the track record of firms repricing underwater options in order to retain executive talent also weakens the incentive power of performance pay. Further, Tversky and Kahneman's Prospect Theory tells us that the wealthier an individual is, the less emotional attachment they show towards a marginal dollar they gain or lose. And the further to the right they lie on the value function, the less risk averse they tend to be when it comes to their own money.

The lesson here for designers of pay packages is that building in a looming risk of lost income is no guarantee that it will influence a manager's decisions—they may have privately hedged away that risk, or otherwise are buffered from the loss by their own total wealth and risk profile. We also found compelling arguments, particularly those of Hayward and Hambrick, and Cowherd and Levine that linked excessive pay to poor performance—from overpaying for acquisitions, to eventual bankruptcy, and even to low employee morale and poor product quality. Our conclusion is that public and political resistance need not be the only downward pressure on executive pay; compensation consultants and corporate boards must remain skeptical that lavish rewards are any guarantee of incentive alignment, good process, or great results.

We also looked at the compensation negotiations themselves, and though there is evidence that companies face real pressure to attract and retain top management talent in the global marketplace, they should not be overly reliant on compensation survey data—i.e. what the next guy is getting paid—when creating pay packages, because any assumptions that going pay rates represent efficient markets can be incorrect for several reasons. First, some companies more than others believe wholeheartedly in their superstar CEOs, namely that these individuals are solely responsible for a great deal of wealth created by the firms they manage. The over-emphasis on their contributions to the firm, combined with a belief that there are too few such superstars available, leads to, in some cases, enormous pay packages that dramatically push up the mean. This is exacerbated by evidence that some compensation packages, particularly those that emphasize stock options, are designed without a clear understanding of how large the payouts can become in long bull-market runs.

There are other reasons to be skeptical of the efficient-market

Strikes on Financial Markets: 1925-1937." *Industrial and Labor Relations Review*, 2002.

69 Compensation Disclosure Tables—Recommandations sur la Remuneration des Dirigeants Mandataires Sociaux de Societes dont les Titres Sont Admis aux Negociations sur un Marche Reglemente—MEDEF, October 2008—C

Worker Board-Level Participation in the EU-27, Norbert Kluge & Michael Stollt—European Trade Union Institute (ETUI-REHS. 05/01/2007)

assumptions regarding executive pay levels. Bebchuk and Fried and others have made numerous compelling arguments that many compensation agreements do not represent honest arms-length negotiations, nor, therefore, the true market-clearing price for executive talent. The cognitive dissonance of negotiating against a friend, a fellow CEO, or in some cases, a board member's champion, can lead to higher negotiated outcomes for the executive, as can having the CEO also serve as chairman. Further, the ratchet effect, where more than 50 percent of executives are paid as if they are better than the median talent, exaggerates pay.

Beyond keeping a critical eye towards the theoretical underpinnings of common performance pay mechanisms, shareholders, boards, and hiring managers must also operate within a dynamic regulatory environment, one that often creates as many unintended consequences as expected outcomes. In the past, most corporate responses to regulatory changes (particularly rules-based regulation) have been to discover ways to bypass them. The current crop of proposed changes, beyond the restrictions for TARP recipients, however, emphasize neither caps nor transparency alone; rather they emphasize the importance of direct shareholder voice ("Say On Pay") and fail-safe mechanisms (i.e. "clawbacks").

As firms grapple with the practicalities of these restrictions, we recommend that they consult with counsel and compensation consultants and debate the larger issues surrounding their compensation programs as well: what are the goals of the firm—do they extend beyond creating shareholder value? Do our compensation programs truly incentivize the behaviors we want? What kind of leaders should we attract, and do our compensation programs overly emphasize risk taking, selfish pursuits, or egoism? And what effects do our compensation programs have on the morale of our employees and the quality of their work?

Investors and analysts need to ask the same questions as well, even when a firm is healthy and providing strong returns. As stockholders are given a larger voice in compensation decisions, they will need a greater understanding of the inherent complexities, from the true economic cost of pay packages, to the intended and unintended incentives that are created. They also must scrutinize the sources of a company's returns and be extremely wary of Star-CEO theories of the firm's success. Surprisingly good returns that cannot be attributed to the company's fundamentals often point to accounting fraud, not CEO-power.

In our review of the literature, what appears to be wanting is a strong evaluative framework to measure the quality of a compensation program against the particular needs of a firm and its stakeholders. The comprehensive compensation risk analysis required for firms in the Netherlands appears to be a logical step that compensation committees here in the United States can adopt as part of their own thorough planning. More quantitative research is needed in this area, particularly to uncover the true long-term incentive power of performance pay, within the context of multiple dimensions (e.g. short-term return versus long-term return, environmental and social considerations) as well as within the context of an individual's total wealth and hedging capability.

Is There More to Compensation Than Just Money?

As countries around the world are trying to tie executive compensation to different measures, be they social or financial, now might be a good time to look beyond the purely financial incentives. France has clearly made a choice to reward workers with more free time outside of the office. Indeed, in 2000, the length of the legal work week was reduced from 39 to 35 hours. The idea behind the 35-hour work week was that by working fewer hours, every worker would create the opportunity for another worker to become employed. Overall 700,000 jobs should have been created⁷⁰. The number of jobs created by the 35 hour work week remained widely debated. However, the social change it brought is undisputed. Overall, French workers have eight weeks of paid vacation per year (five-week standard package plus reduced work week) while they maintain one of the highest productivity levels in the world.

As the days of the "gold watch" retirement are long gone, with more seniors wanting to remain active in the workforce, many different types of compensation will probably be brought to market: they will include more leisure time, more time devoted to education, more time to volunteer within community organizations and non-governmental organizations, and more time to reshape a career. The Sanford C. Bernstein & Co. EMBA Student Leadership and Ethics Board's final recommendation regarding executive compensation is to consider these non-financial forms of compensation and to actively avoid recruits for whom the success of their negotiation is measured solely by the size (relative or absolute) of the check.

⁷⁰ French Socialist Party, 1997 Parliamentary Elections Program "Changeons la politique économique et sociale." Results of the policy vary according to who measures it; 200,000 to 500,000 jobs may have been created.

Appendix: Executive Compensation Limits Under Treasury Guideline 15 and the Stimulus Bill

1. Recent Executive Compensation Legislation

Executive compensation rules applicable to those companies that received funds under the Troubled Asset Relief Program (TARP) have been a shifting landscape since the October 2008 enactment of the Emergency Economic Stabilization Act of 2008 (EESA). The executive compensation provisions contained in the EESA were subsequently amended and restated in the February 2009 American Recovery and Reinvestment Act of 2009 (ARRA). Most recently, the Treasury issued a June 10, 2009 interim final rule implementing Section 111 of the EESA, as amended by the ARRA (the Interim Rule).⁷¹ This Interim Rule supersedes all prior guidance (including interim rules released in October 2008 and January 2009) and consolidates guidance on executive compensation applicable to TARP recipients.

2. Applicability

The Interim Rule's executive compensation requirements apply during the time that TARP obligations remain outstanding (the "TARP Period").⁷² These requirements do not apply, however, while the Treasury only holds warrants to purchase a TARP recipient's common stock.

3. Salary Restrictions and the Special Master

Although the original executive compensation guidance included salary restrictions, the Interim Rule does not include such restrictions. The Interim Rule does, however, establish the "Office of the Special Master for TARP Executive Compensation," more familiarly known as the "Pay Czar." Kenneth Feinberg, who oversaw the September 11 victim compensation fund, has been appointed to serve in this position.⁷³

Companies that received "exceptional assistance" (i.e., more than \$500 million) are required to submit their compensation packages for their top 25 executives to Mr. Feinberg.⁷⁴ He will review these packages in light of various factors, including: the relevant company's profitability; the general marketplace for compensation; the ability of the company to

⁷¹ The Interim Rule became effective immediately upon its publication in the Federal Register. After a 60-day comment period expired, the Treasury Department published the final rule in the Federal Register.

⁷² Several TARP recipients, including American Express, Goldman Sachs, JPMorgan Chase, Morgan Stanley, Bank of New York Mellon, BB&T Corporation, Capital One Financial, Northern Trust, the State Street Corporation, and US Bancorp, have received authorization to repay TARP funds, and some have already done so. Once the TARP funds are repaid, the EESA's executive compensation provisions no longer apply to them.

⁷³ The administration is taking a hands-off approach, deferring to Mr. Feinberg's assessment of specific executive compensation packages. Julianna Goldman, "Obama Taking Hands-off Stance on Citi, AIG Pay," *Bloomberg News* (September 2009).

⁷⁴ There are seven companies that received "exceptional assistance": A.I.G., Citigroup, Bank of America, Chrysler, Chrysler Financial, General Motors, and GMAC Financial Services.

repay its TARP money; and whether the relevant compensation packages encourage excessive risk taking.⁷⁵ If he finds the compensation packages to be unacceptable, he may require restructuring of these packages. Thus, with respect to companies that received "exceptional assistance," Mr. Feinberg effectively has veto power over their executive compensation packages.⁷⁶

In addition, Mr. Feinberg may issue advisory opinions, either independently or in response to a TARP recipient's request, as to whether relevant compensation packages are inconsistent with the purposes of the EESA or the TARP, or otherwise contrary to the public interest.⁷⁷

4. Bonus Restrictions

While the Interim Rule does not include *per se* salary restrictions, it does include bonus restrictions that are based upon the amount of TARP funds received by the relevant TARP recipient. Thus, during the TARP Period, a TARP recipient may not pay or accrue for bonuses, retention awards, or other incentive compensation, except as follows:

- If the institution received less than \$25 million in assistance, it may not pay a bonus, retention award, or incentive compensation to its most highly compensated employee;
- If the institution received \$25 million to less than \$250 million in assistance, it may not pay a bonus, retention award, or incentive compensation to its five most highly compensated employees;
- If the institution received \$250 million to less than \$500 million in assistance, it may not pay a bonus, retention award, or incentive compensation to its senior executive officers (SEOs) and the next 10 most highly compensated employees;⁷⁸ and
- If the institution received \$500 million or more in assistance, it may not pay a bonus, retention award, or incentive compensation to its CEOs and the next 20 most highly compensated employees.

There are two exceptions to these bonus restrictions:

- A TARP recipient may compensate executives with long-term restricted stock provided that the stock does not fully vest during the TARP Period, and that the value of the stock does not exceed one third of the employee's

⁷⁵ While there is no *per se* upper limit on the amount that companies receiving "exceptional assistance" are permitted to pay as executive compensation, those compensation packages that total \$500,000 or less (including long-term restricted stock grants) qualify for automatic approval.

⁷⁶ Mr. Feinberg also has authority to review the compensation packages of any other executives not included in the initial 25, and the compensation packages of the next 100 most highly paid employees.

⁷⁷ Mr. Feinberg will need to balance the free market's critique of government's role in reviewing executive compensation, the public's outrage over excessive executive compensation, and the companies' goals of attracting, retaining and incentivizing executives. Thomas, "Obama 'Pay Czar' to Review Executive Compensation Plans," *www.law.com* (Aug. 17, 2009).

⁷⁸ The Interim Rule incorporates the concept of CEO, as provided for in the federal securities laws: the Chief Executive Officer, the Chief Financial Officer, and the three next most highly compensated executive officers are CEOs.

annual compensation; and

- A TARP recipient may pay bonuses required to be paid pursuant to written employment agreements executed on or before the ARRA's enactment (i.e., February 11, 2009).⁷⁹

5. Mandatory Clawback

A TARP recipient is required to institute a policy for recovering any bonus, retention award, or incentive compensation paid to a CEO or the next 20 most highly compensated employees if the compensation was based upon materially inaccurate statements of earnings, revenues, gains or other criteria. A TARP recipient is required to exercise this right unless it can show that it would be unreasonable to do so (i.e., the cost of doing so would exceed the benefit).⁸⁰

6. Golden Parachutes

A TARP recipient is prohibited from making payments during the TARP Period to CEO's or the next five most highly compensated employees in connection with their departure for any reason (including a change in control). Such payments are treated as having been "paid" at the time of the departure or change-in-control event, thereby eliminating the possibility of such amounts becoming payable after the TARP Period.⁸¹

7. Tax Gross Ups

A TARP recipient may not provide its CEO's or the next 20 most highly compensated employees with a tax "gross up" (i.e., reimbursement for taxes paid on salaries, bonuses or perquisites) during the TARP Period.

8. Perquisites over \$25,000

During the TARP Period, a TARP recipient must, within 120 days of the end of its fiscal year, disclose to the Treasury Department and the TARP recipient's primary federal regulator perquisites given to any employee who is subject to a TARP bonus restriction, when the total value of such perquisites exceeds \$25,000. In this disclosure, the TARP recipient must provide a narrative description of the amount and nature of such perquisites, identify the recipient of such perquisites, and articulate a justification for providing such perquisites.

9. Limit on Tax Deduction

A TARP recipient must agree to limit to \$500,000 its federal

income tax deduction for annual compensation (including performance-based compensation, such as bonuses and gains on stock options) paid to each CEO.

10. Disclosure of Compensation Consultants

During the TARP Period, a TARP recipient must, within 120 days of the end of its fiscal year, disclose to the Treasury Department and the TARP recipient's primary federal regulator whether it, its board of directors, or its compensation committee has engaged a compensation consultant, and must describe, in narrative form, all types of services the compensation consultant has provided.

11. Unnecessary and Excessive Risks and Manipulation of Reported Earnings

A TARP recipient's compensation committee must meet at least every six months to discuss, evaluate and review features of executive and employee compensation plans that could lead to unnecessary and excessive risk taking. At least once a year, a TARP recipient's compensation committee must provide a narrative explanation of its analysis so that the TARP recipient's shareholders may evaluate its analysis and reasoning related to such risks. In addition, when the TARP recipient is a publicly-traded company, its compensation committee is required to provide such narrative disclosures in the Compensation Committee Report included in its annual Form 10-K.

12. The Securities and Exchange Commission

Prior to implementation of the TARP, on July 26, 2006, the SEC adopted new executive compensation disclosure requirements. These requirements significantly changed the manner in which public companies are required to disclose information about the compensation of their most highly paid executive officers.⁸²

Later the same year, the SEC further amended disclosure requirements pertaining to executive and director compensation, requiring, among other things, disclosure of stock and option award compensation and related person transactions.⁸³ These rules were intended to clarify and augment existing disclosure requirements.⁸⁴

In 2007, the SEC's Division of Corporation Finance conducted a targeted review, evaluating how a diverse range of 350 public companies disclosed executive compensation and related items under the new and revised disclosure rules.⁸⁵

⁷⁹ The Interim Rule contains detailed guidance pertaining to these exceptions.

⁸⁰ Mr. Feinberg has stated that he is reluctant to seek to recover executive pay, since it has likely already been taxed and possibly spent. Whitney McFerron, "Feinberg States Clawbacks are 'Not a Great Idea,'" *Bloomberg News* (October 2009).

⁸¹ There are various exceptions to the golden-parachute prohibition, including: (1) payments for services performed or benefits accrued; (2) payments under tax-qualified retirement plans; (3) payments made due to an employee's death or disability; and (4) severance or similar payments required to be made pursuant to law.

⁸² David T. Mittelman, "Staff Observations in Review of Executive Compensation Disclosure," PLI Order No. 18393 (Oct. 9, 2007).

⁸³ *Id.* In Item 402 of Regulation S-K, the SEC requires that companies provide "clear, concise, and understandable disclosure of all plan and non-plan compensation awarded to, earned by, or paid to the name executives officers... and directors... by any person for all services, rendered in all capacities." 17 C.F.R. 229.402(a)(2).

⁸⁴ Kathryn Yeaton, "The SEC's New Rules on Executive Compensation, Illuminating the Disclosure Requirements," (July 2007) (outlining the specific rules and amendments).

⁸⁵ Mittelman, *supra*. That year, the SEC also issued comment letters to companies that may have failed to comply with the foregoing disclosure

The SEC concluded that public companies' Compensation Disclosure & Analysis ("CD&A") should be focused on how and why companies make specific executive compensation decisions and policies.⁸⁶ The SEC also concluded that public companies should consider the manner in which they present such information, recommending that companies include summaries, tables or charts to make their disclosures as understandable and as useful as possible to readers.⁸⁷

In 2008, in accordance with its selective review program, the SEC analyzed certain public companies' executive compensation disclosures.⁸⁸ Its main observation following this review was that the subject companies failed to include sufficient analysis in the CD&A's. The SEC reminded companies that disclosure requirements applicable to performance targets are principles based,⁸⁹ and recommended that filers provide an explanation of the material elements of compensation, how levels of compensation are determined, and why particular compensation practices and decisions align with the companies' overall objectives.⁹⁰ Lastly, the SEC stated that filers who benchmark a material element of compensation must identify and analyze the companies that comprise the peer group upon which the benchmark is based.⁹¹

13. Pending Legal and Regulatory Matters

The coming year will likely see significant judicial decisions and regulatory actions with broad implications for executive compensation.

For example, in July 2009, the SEC proposed changes in the proxy statement disclosure rules; these rules, which might become effective for the 2010 proxy season, would improve disclosure of executive compensation and corporate governance by companies subject to rules and regulations enacted in conjunction with the Securities Exchange Act.⁹²

requirements, yet the SEC noted that its comment letters should only provide guidance for future filings. Christopher Keller and Michael Stocker, "Executive Compensation's Role in the Financial Crisis," *The National Law Journal* (November 18, 2008). Notably, 62 percent of companies disclosed long-term compensation-related performance goals, yet only 47 percent of companies revealed the nature of their top management's short-term performance goals. *Id.*

86 *Id.* The new proxy disclosure rules require public companies that are not small business issuers to include a CD&A section in their proxy statements. See generally, SEC Release Nos. 33-8732, 34-54302 and IC-27444.

87 *Id.* (noting that the purpose of the CD&A is to provide clear and concise material information on companies' compensation objectives and policies for named executive officers and advising that companies should not resort to boilerplate disclosure language).

88 John W. White, "Executive Compensation Disclosure: Observations on Year Two and a Look Forward to the Changing Landscape for 2009" (Oct. 21, 2008). Section 408 of Sarbanes-Oxley requires that the SEC engage in a regular and systematic review of all public companies, particularly companies that experience significant volatility in their stock price, companies with the largest market capitalizations, and companies whose operations affect any material sector of the economy. *Id.*

89 *Id.* Companies are required to determine whether performance targets are a material element of their compensation policies and decisions, and, if so, they must make necessary disclosures pursuant to Item 402 of Regulation S-K.

90 *Id.*

91 *Id.*

92 For a discussion on the SEC's proposed rules as well as pending bills on executive compensation, see Joseph E. Bachelder III, "Proposed Pay Reform Raises Questions," *The Harvard Law School Forum on Corporate Governance and Financial Regulation* (Sept. 12, 2009). See also, "SEC Proposed Proxy Rule Amendments Requiring Additional Disclosures Regarding Executive

The SEC also recently proposed measures to improve corporate governance and augment investor confidence.⁹³

In addition, the SEC recently released a draft of its strategic plan for the next five years. This plan is designed to address a number of issues highlighted by the global financial crisis and includes 70 initiatives. One initiative is balancing the goal of achieving a favorable outcome in most of its cases, with the goal of filing large, difficult or precedent-setting cases, even when there is no assurance that the SEC will prevail.⁹⁴ Indeed, this past July, the SEC recently initiated its very first (and controversial!) enforcement action under Sarbanes-Oxley's "clawback" provision, seeking to recoup compensation from a CEO who was not otherwise charged with violating a federal securities law.⁹⁵

And, on November 2, 2009, the Supreme Court of the United States heard *Jones v. Harris Associates L.P.*, the first executive compensation case to be heard by the Court since the current financial crisis began.⁹⁶

In addition, the House of Representatives recently passed the Corporate and Financial Institution Compensation Fairness Act of 2009. If enacted, the Act would require public companies to permit non-binding shareholder "Say on Pay" votes, establish standards for determining the "independence" of compensation committees, and would prohibit compensation that encourages excessive risk taking.⁹⁷

The Federal Reserve also plans to regulate, among others, compensation at approximately 28 of the largest bank holding companies, including JP Morgan Chase & Co. and Goldman Sachs Group, Inc.: its Board of Governors would review and approve pay practices of such bank holding companies.⁹⁸

The following table sets forth pending federal legislation related to the TARP, corporate accountability, transparency and governance, and regulation of executive compensation:⁹⁹

Compensation May Be Effective for the 2010 Proxy Season," *Bloomberg Law Reports, Executive Compensation*, Vol. 2, No. 10 (Oct. 2009).

93 SEC Press Release No. 2009-147 (July 1, 2009); Proposed Rule Release No. 34-60218 (July 1, 2009).

94 Jenna Greene, "New SEC Goals Emphasize Enforcement—and Winning," *www.law.com* (Oct. 9, 2009). The SEC's plan is open for public comment until November 16, 2009.

95 Scheer, Westbrook and Gallu, "SEC Demands Ex-CSK Chief Forfeit Pay in Landmark Case," *Bloomberg News* (July 2009). Generally, the SEC enforcement action seeks to compel a former CEO of a company accused of accounting fraud to reimburse his bonuses and stock-sale profits to the company. The SEC has not accused the former CEO himself of fraud.

96 Case No. 08-586. 527 F.3d 627, *rehearing and rehearing en banc denied*, 537 F.3d 728 (7th Cir. 2008), *cert. granted*, 129 S.Ct. 1579 (March 9, 2009). Judge Richard A. Posner—an authority on law and economic issues—opined that "executive compensation in large publicly traded firms often is excessive because of the feeble incentives of boards of directors to police compensation." 537 F.3d at 730. See also, Adam Liptak, "Supreme Court to Hear Case on Executive Pay," *The New York Times* (Aug 17, 2009).

97 See Bachelder, *supra*.

98 Scott Lanman, "Federal Reserve's Compensation Plan Would Focus on Largest Firms," *Bloomberg News* (October 2009).

99 *Bloomberg Law Reports, Executive Compensation*, Vol.2, No. 8 (August 2009). This list was current as of August 2009.

Federal Legislative Activity

Legislation	Short Title	Purpose
S. 521 Sen. Inhofe (R-OK)	TARP Oversight Enhancement Act	To enhance the oversight authority of the Comptroller General of the United States with respect to certain expenditures by financial institutions participating in the Troubled Asset Relief Program.
S. 463 Sen. Kerry (D-MA)	TARP Taxpayer Protection and Corporate Responsibility Act of 2009	To impose limitations on certain expenditures by participants in the Troubled Asset Relief Program.
S. 431 Sen. Whitehouse (D-RI)	Economic Recovery Adjustment Act of 2009	To establish the Temporary Economic Recovery Adjustment Panel to curb excessive executive compensation at firms receiving economic assistance.
S. 400 Sen. Sanders (I-VT)	Financial Crisis Investigation Act of 2009	To expand the authority and responsibilities of the Oversight Panel of the Troubled Asset Relief Program, and for other purposes.
H.R. 1095 Rep. Maloney (D-NY)	Troubled Asset Relief Program Transparency Reporting Act.	To prohibit any recipient of emergency federal economic assistance from using such funds for lobbying expenditures or political contributions, to improve transparency, enhance accountability, encourage responsible corporate governance, and for other purposes.
H.R. 857 Rep. Moore (D-AZ)	Limit Executive Compensation Abuse Act	To limit compensation to officer and director of entities receiving emergency economic assistance from the government, and for other purposes.
H.R. 851 Rep. Giffords (D-AZ)	Executive Compensation and Corporate Governance Act of 2009	To establish executive compensation and corporate governance requirements for institutions receiving assistance under the Troubled Assets Relief Program.
H.R. 846 Rep. Cummings (D-MD)	Accountability from Corporations for Outlays Under TARP Act	To require institutions receiving assistance under the Emergency Economic Stabilization Act of 2008 to report certain corporate data, and for other purposes.
S. 360 Sen. McCaskill (D-MO)	Cap Executive Officer Pay Act of 2009	To limit compensation to officers and directors of entities receiving emergency economic assistance from the government.
H.R. 807 Rep. Bilirakis (R-FL)	(No short title)	To amend the Emergency Economic Stabilization Act of 2008 to require a public database of the executive compensation of the institutions receiving assistance under the Troubled Assets Relief Program.
H.R. 384 Rep. Frank (D-MA)	TARP Reform and Accountability Act of 2009	To reform the Troubled Assets Relief Program of the Secretary of the Treasury and ensure accountability under such Program.

<p>S. 195 Sen. Dorgan (D-ND)</p>	<p>Taxpayer Protection Act</p>	<p>To extend oversight, accountability, and transparency provisions of the Emergency Economic Assistance Act of 2008 to all federal emergency economic assistance to private entities, to impose tough conditions for all recipients of such emergency economic assistance, to set up a federal task force to investigate and prosecute criminal activities that contributed to our economic crisis, and to establish a bipartisan financial market investigation and reform commission, and for other purposes.</p>
<p>S. 133 Sen. Feinstein (D-CA)</p>	<p>Troubled Asset Relief Program Transparency Reporting Act</p>	<p>To prohibit any recipient of emergency federal economic assistance from using such funds for lobbying expenditures or political contributions, to improve transparency, enhance accountability, encourage responsible corporate governance, and for other purposes.</p>
<p>S. 3217 Sen. Dodd (D-CT)</p>	<p>Restoring American Financial Stability Act of 2010</p>	<p>To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end “too big to fail,” to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.</p>

 **Columbia Business School**

The Sanford C. Bernstein & Co. Center
for Leadership and Ethics

Columbia Business School

Uris Hall

3022 Broadway, Room 203

New York, NY 10027-6902

Phone: 212-854-1060

Fax: 212-854-0016

www.gsb.columbia.edu/leadership

leadershipethics@gsb.columbia.edu

 **COLUMBIA UNIVERSITY**
IN THE CITY OF NEW YORK