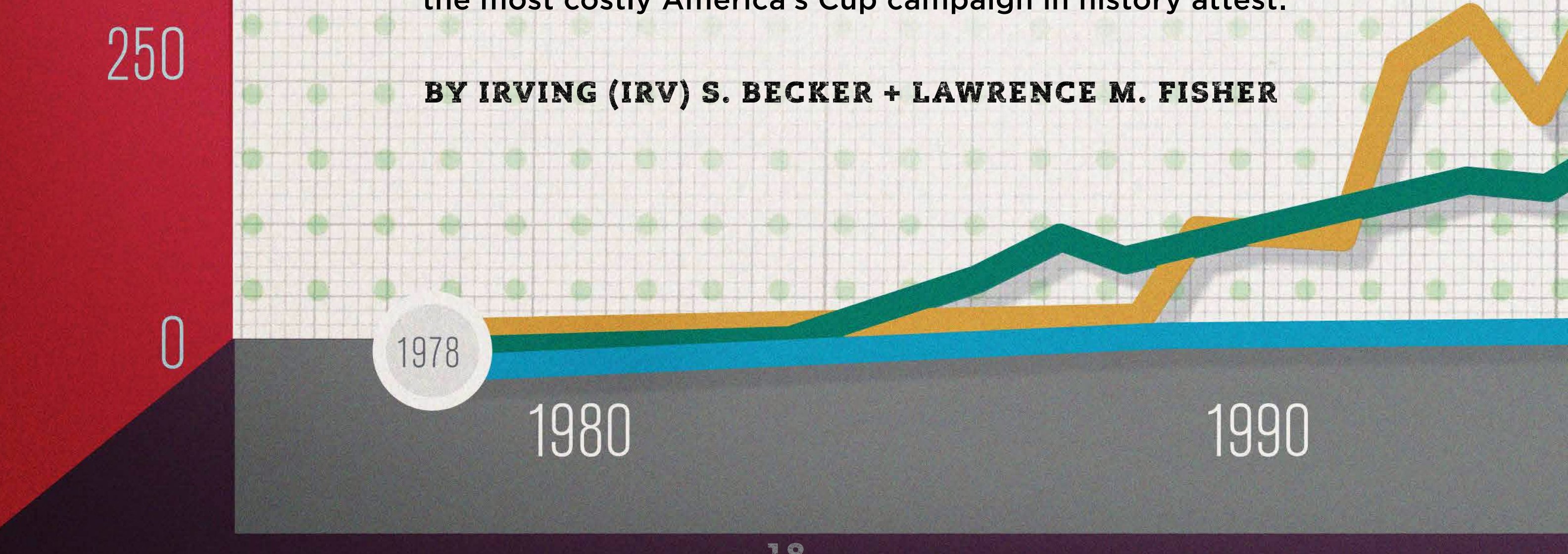
Getting the Right Measure on CEO Comp

If you Google “how much are CEOs paid?” you will get about 6.3 million results. Clearly somebody has been giving this question some thought. But perhaps a better question would be, “compared with what?”

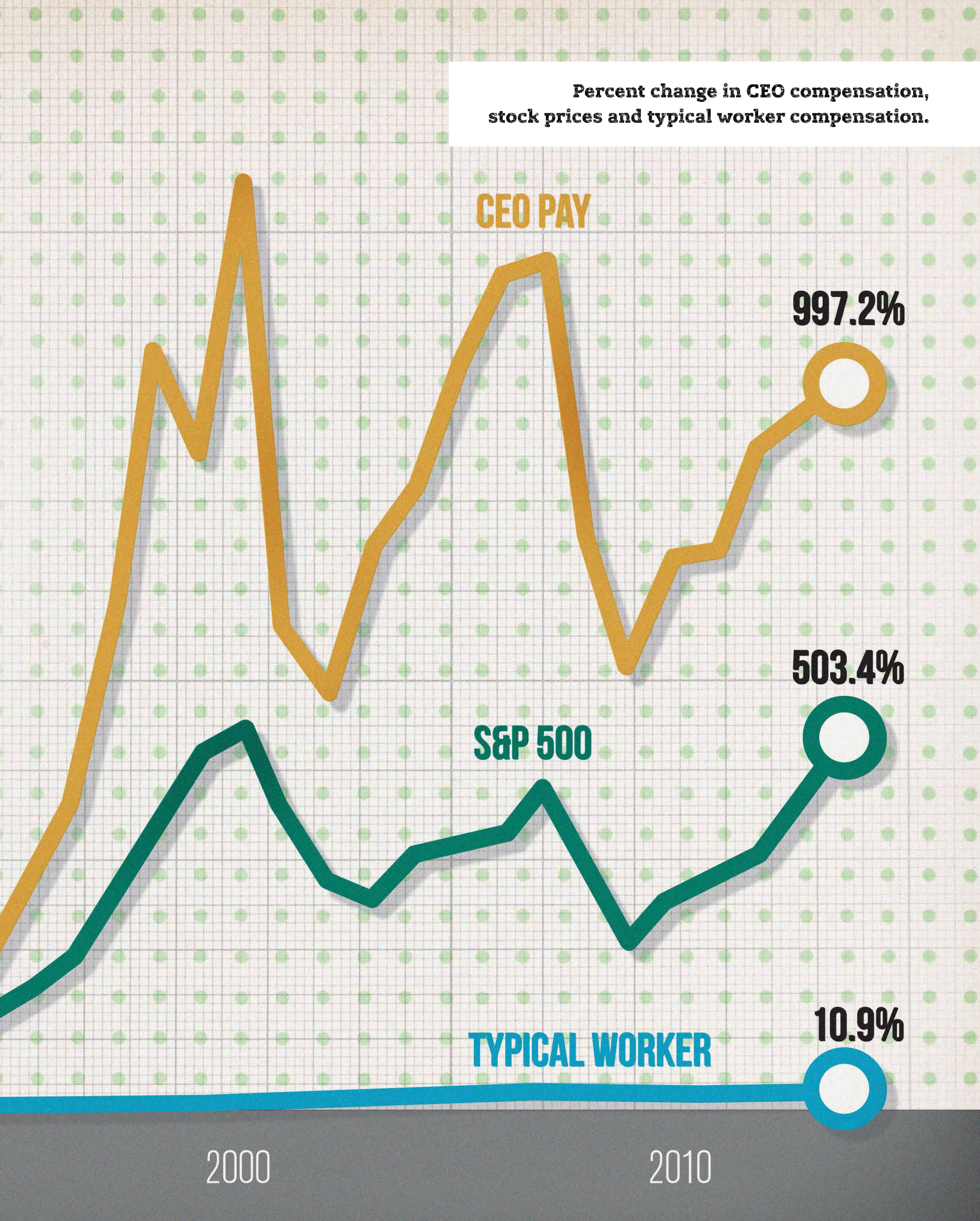
The press, and some politicians, tend to compare the compensation of corporate chief executives with the pay received by the average worker. Corporate boards and compensation committees typically benchmark “peer group” pay; they compare their CEO’s package with that offered to his or her peers at competing companies. These are easy comparisons to make, and depending on your point of view, satisfying ones as well, but neither provides a meaningful guide to setting CEO pay in a way that is equitable, credible and fair.

CEO pay gets a lot of attention because of the truly enormous packages awarded to some company leaders. Oracle Corporation paid Larry Ellison, who vacated the chief executive post in 2014, $67.3 million for his final full year in the job. Keep in mind that nearly all of Ellison’s compensation consisted of stock options; for the fiscal year 2014, his salary remained $1. But Oracle has done well, and so has Larry Ellison, as his purchase of a Hawaiian island and sponsoring of the most costly America’s Cup campaign in history attest.

BY IRVING (IRV) S. BECKER + LAWRENCE M. FISHER



Percent change in CEO compensation, stock prices and typical worker compensation.



More irksome are big pay packages for the chief executives of companies that underperform. Marissa Mayer of Yahoo is the highest-paid female CEO at $42.1 million, but the company has continued its decline since she came on board in 2012. Forbes magazine described Ms. Mayer's tenure as "A Case Study in Poor Leadership." So how does the Yahoo board justify $42.1 million?

And while such huge packages are unusual, compensation of CEOs has continued to grow across all indices. According to Equilar, median 2014 compensation in the S&P 500 was $10.3 million, up 2 percent year over year. Median pay in the S&P 1500 increased 7.8 percent in 2014, reaching $5.3 million. When The Wall Street Journal reports that the pay of top CEOs is 373 times that of the average worker's salary, it gets attention.

But the problem with comparing CEO pay with that of the average or median employee is that the ratio can be distorted by many factors. A multibillion-dollar global corporation may have many employees in developing countries who are paid a competitive wage for that environment, yet very little in absolute terms, driving down the average. The CEO of that company makes decisions that can have nine-figure consequences, dwarfing the size of even the most generous pay package. Nevertheless, the Securities and Exchange Commission issued rules last August requiring most public companies to regularly report the ratio of the chief executive's pay to that of the median employee, beginning in 2018.

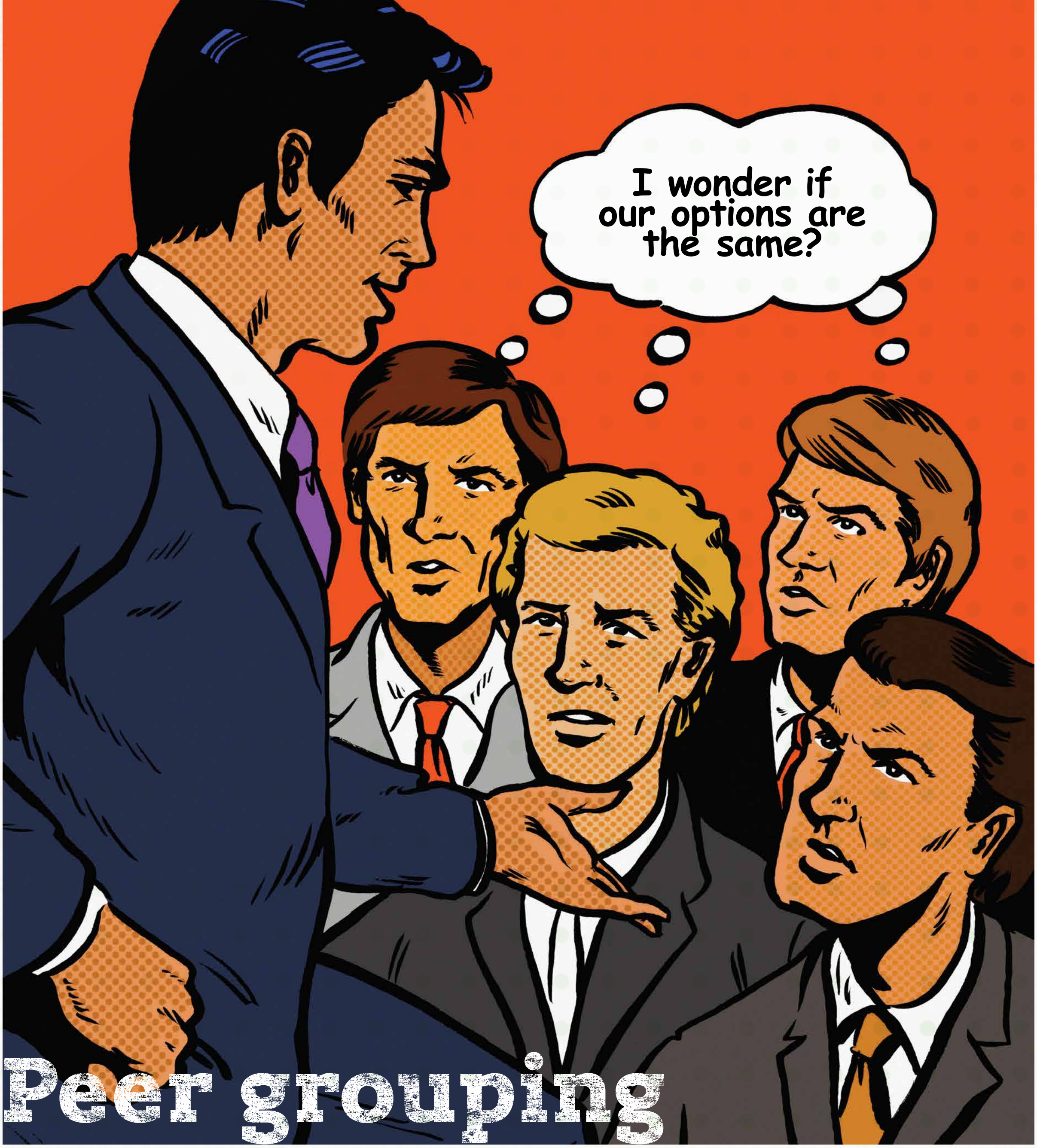
Do CEO's make much more in the United States than elsewhere? The A.F.L.-C.I.O., the federation of trade unions, says they do. But a 2013 study by Pedro Matos, an associate professor of business administration at the University of Virginia's Darden School of Business, says that once you control for firm size, ownership structure and the greater use of equity-based awards in the United States, the world of CEO pay is essentially flat. "Our study finds that there is no huge difference in CEO pay among companies, regardless of their locations, if they compete in international markets," Matos wrote.

Benchmarking CEO pay against peers is problematic. It assumes that CEO pay must be competitive or the chief executive will depart for another company, but research shows that CEOs rarely do this. A better comparison would be against the CEO's direct reports, who are often paid far less, and who are often poached by competitors offering fatter pay packages. Is the chief executive's contribution to the bottom line twice that of the chief operating officer? Four times? Ten? These are questions board members should ask.

Boards are under pressure to make informed CEO pay decisions that are seen as "fair" by an expanding pool of stakeholders—from investors and employees to the CEO and affected communities and the general public. Korn Ferry Hay Group recommends that board members go beyond benchmarking, and instead use multiple lenses to evaluate compensation via a more complex and rigorous assessment of both internal and external factors. The goal is to establish "internal equity," or the perception that the organization is paying people according to the relative size and impact of their roles.

The board must determine the goals it has for the CEO and how it will measure and reward that person for achieving those objectives and milestones. It must also factor in any challenges associated with the role and evaluate the differences and expectations of the CEO relative to the market, such as needing to turn around a struggling business. Mapping these answers against the CEO job requirements and expectations will foster a holistic view of pay that is both fair and effective.

Boards must also look inward to evaluate CEO pay. Consider the CEO's experience, skill set, leadership style, motivators and appetite for risk. Will the chief executive thrive on a low-base salary, with high potential payouts from incentives, or would a more balanced pay program be more compelling? His or her pay should reflect the company's overall compensation philosophy and corporate culture. Also consider succession planning; are CEO successors standing in the wings? Internal candidates will generally not require a marketplace premium to assume the role for which they have been groomed, and they also reduce the risks associated with bringing on a leader from outside.



Peer grouping

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Boards often justify paying their CEO an immense compensation package through competitive benchmarking, in which compensation levels are generally targeted to the 50th, 75th or even 90th percentile, referenced to the pay of the executives at other enterprises in similar industries and of similar size and complexity. As noted, the assumption is that the executive can easily depart for a similar position. But a much-cited paper by Charles M. Elson and Craig K. Ferrere, both professors with the John L. Weinberg Center for Corporate Governance at the University of Delaware, argues that this notion is simply not true.

CEO pay is "out of whack because it's based on peer-group pay," Elson said in an interview. "Benchmarking against other CEOs is problematic. Their pay is compared to somebody in another organization, and boards always pay the median and more. It's based on the assumption that CEO talent is transferable, and it's not. It's much more homegrown. We discovered that it's quite rare that CEOs move between peer companies."

Thus "the process of peer-group benchmarking creates a model of a competitive market for executives where it otherwise does not exist," Elson and Ferrere wrote in their paper, "Executive Superstars, Peer Groups and Over-compensation: Cause, Effect and Solution." "Instead, the independent and shareholder-conscious compensation committee must develop internally consistent standards of pay based on the individual nature of the organization concerned, its particular competitive environment and its internal dynamics." This won't be easy, they concede, but the shareholder value movement has empowered directors to do the right thing as never before.

"Compensation has to be related to the productivity that the executive provides the company; pay for performance is critical," Elson said. "Secondly, I think their pay package needs to be created in the context of how others in the organization are paid. You need neutral metrics, designed by boards that have long-term interests in the health of the company themselves, because anything can be gamed. That's why I'm a big believer in restricted stock," he said. "Let the market itself figure out the value you've created."

Pay for performance

About 10 years ago, Wayne Guay of the University of Pennsylvania's Wharton School co-authored a paper with John Core of the MIT Sloan School of Management and Randall Thomas of Vanderbilt with the succinct title: "Is U.S. CEO Compensation Broken?" Their answer was surprising to some.

"Certainly the takeaway from that paper, is it broken, was more or less no, in contrast with popular conceptions," Guay said in an interview. "That was one of the reasons we wrote that paper, to debunk the common criticisms. A lot of the things people go on and on about are not the ones I'm concerned about."

The article, published in the Journal of Applied Corporate Finance, concluded that most, if not all, concerns are exaggerated by the popular tendency to focus on the annual income of CEO's, consisting of salary, bonus and stock and option grants, while ignoring their existing holdings of company equity.

Guay said the pay-for-performance relationship is strong and has grown in recent years.

A second conclusion, closely related, is that what may appear as above-normal growth in annual pay levels may be necessary to compensate CEOs for the increased risk associated with their growing level of equity-based incentives. Third, conventional, unindexed stock and options may provide an optimal solution to two conflicting demands: shareholders' insistence on tying executive rewards to company performance and executives' preference to diversify their wealth. CEO equity ownership in the United States remains high.

"If I was trying to monitor exec compensation I would focus on the equity part," Guay said. "If a CEO gets 10 percent too much salary, that's small potatoes compared with a CEO who doesn't have proper incentives. Pay for performance to my mind is about giving executives incentives to look after shareholders' interests. It's often mischaracterized as about the fairness of the CEO's pay, but it's really not about that. Many now hold many millions of dollars in stock, and that is what I would monitor. Is that a significant chunk of their wealth? If I've got a CEO with a net worth of $100 million, making them hold $10 million in company stock might not be enough; for a net worth of $12 million, it's probably plenty."

"Say on pay" politics

Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, shareholders have had a "say on pay," or the right to vote on the compensation of CEO and other "named executive officers," beginning with the first annual shareholders' meeting taking place on or after January 21, 2011. Pay has not gone down.

"The problem with CEO pay is it's a political football," said Kevin Murphy, a professor at the University of Southern California's Marshall School of Business. "Since Dodd-Frank, we've had say on pay and most of these pay

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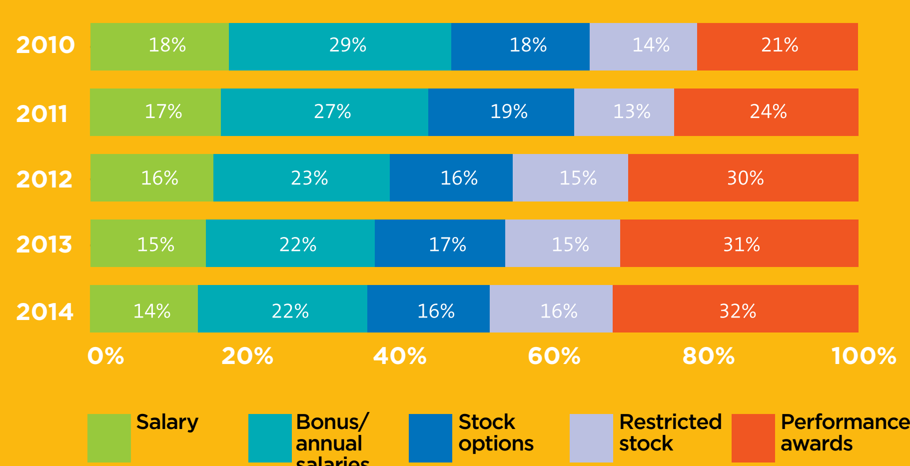
The Growing Emphasis on Performance in CEO Compensation



SOURCE: THE WALL STREET JOURNAL/HAY GROUP
2014 CEO COMPENSATION STUDY, BASED ON A SAMPLE OF 300 LARGE COMPANIES

packages are passing with overwhelming shareholder approval, at the same time the headlines are saying CEOs are being paid too much. The politics of CEO approval are laser-focused on pay, and inequality, but shareholders are focused on whether CEOs are incented to create value. That tension has, if anything, gotten worse."

In a chapter he contributed to the "Handbook of the Economics of Finance," Murphy wrote that government intervention has been both a response to and a major driver of trends in executive compensation over the past century, and that any explanation for pay that ignores political factors is critically incomplete. In an interview, he put the case more bluntly: "If you asked me how to fix compensation, the best thing to do is get rid of all regulations and start from scratch. So many of the problems we see are the result of prior attempts to regulate pay."

Murphy is at his most scathing describing the role of proxy advisory firms, which are hired by shareholders of public companies (usually an institutional investor of some type) to recommend proxy statement votes to the shareholders. Government regulations have increased the reliance on such firms, the most prominent of which are Institutional Shareholder Services Inc., known as ISS, and Glass, Lewis & Company.

"One of the culprits here is everyone hates ISS and Glass Lewis, who have played this increasingly controversial role," Murphy said. "They've got this business model where on the one hand they are providing recommendations to people holding proxies and on the other are providing advice to companies looking to get good recommendations. There's this inherent conflict of interest and they can talk about Chinese walls and no one believes them."

Balancing act

Not surprisingly, Carol Bowie, ISS's head of Americas Research, takes exception to the suggestion that the firm is conflicted. "There is a unit of ISS that does supply advisory services," she said. "We have a very thick firewall between that business and my part, which is supplying research to institutional investors. What they are trying to do is educate companies that feel they will benefit from that sort of advice. My guess is they're not advising companies on the specifics of their program."

ISS is powerful. When the firm recommended a "no" vote on Jeffrey Immelt's award of 2 million stock options in April 2011, G.E.'s compensation committee amended its chief executive's pay package accordingly. The company had shifted his compensation from so-called performance shares, which are granted contingent upon achievement of previously defined performance objectives over a multiyear period, to stock options, which simply vest over time.

"We use some quantitative methodologies to identify what we consider pay-for-performance outliers," Bowie said. An especially large award, such as one of 2 million stock options, she said, is known as a mega-grant. "By anyone's measure," she added, "this was an exceptional award. In the case of G.E., the board came back and modified those option grants. They did what we felt investors deserved."

Not everyone agrees. "What is lost in this conversation is that stock options have a built-in performance basis, because only if you raise the share price are they worth anything," said V.G. Narayanan, a professor at the Harvard Business School. "By and large, ISS gets many things right, but this isn't one of them."

Bowie said share prices often go up for reasons that do not reflect long-term performance, and that large option grants increase the pressure on CEOs to take short-term actions that may be harmful. "There's a lot of risk with these extreme rewards," she said. "They could incentivize the wrong behavior. We see that over and over again. There are so many variables. Giving someone these extreme rewards can raise the risk that they will do something with catastrophic consequences for the company. The other risk is that shareholders are simply overpaying."

Paying enough, but not too much

Boards should also keep in mind the law of unintended consequences when setting CEO pay. Consider this article, in the Harvard Business Review, "Executive Compensation: The More Leaders Make, the Meaner They Get." Mean CEOs tend to push their employees into the state psychologists call "frazzle," and frazzled employees are less productive.

Outsize CEO pay is also a major contributing factor to the income inequality roiling society. Thomas Piketty of the Paris School of Economics, author of the surprise best seller "Capital in the Twenty-First Century," shows that two-thirds of the increase in American income inequality over the last four decades can be attributed to a steep rise in wages among the highest earners in society. This, of course, means people like CEOs. "The system is pretty much out of control in many ways," Piketty told The New York Times.

Those with outsize income also include the singer Taylor Swift, who earned $80 million in 2015, considerably more than G.E.'s Immelt, according to Forbes's annual list. But entertainers and sports stars are less subject to scrutiny than the leaders of publicly held companies. There's a reason for that. When you shell out big bucks for Taylor Swift tickets, the pay-for-performance equation is pretty clear.