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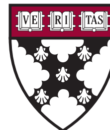
EXECUTIVE COMPENSATION: A BROADER VIEW



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INTRODUCTION

Professors Brian Hall, Rakesh Khurana, and Jay Lorsch hosted the Conference on Executive Compensation: A Broader View at Harvard Business School, held on campus September 14–16, 2009. The participants included thirty HBS faculty members and a group of fifteen outside experts (see lists). The conference gave faculty members a chance to discuss the "Top Management Compensation Problem" with each other and with a group of experienced experts.

The purpose of the conference was to understand more completely the nature and causes of the "Top Management Compensation Problem" in the United States. The issues discussed were divided between those that were company-specific and broader societal issues. At the company level, the discussion brought three themes to the forefront: a push to simplify compensation plans, the need to focus on long-term performance, and the need to improve alignment between pay and performance. In regard to alignment, three sub-themes emerged. Compensation must be aligned with the company's long-term strategy. Compensation must also be consistent with the firm's organization and culture. Finally, the executives must see a connection between their own efforts, results achieved, and rewards received. In the broader societal context, the debate was centered on "fairness" because of the increasingly skewed income distribution in the United States and the public's disapproval of excessively large executive paychecks, especially in light of the recent financial crisis. The HBS faculty and guests also concluded that the severity and nature of America's compensation problem was determined to some extent in the eyes of the beholder. A participant's position in the debate depended upon his or her background and previous experiences. Some participants believed that the problem was mostly one of perception while others thought that the problem was real and eroded the public's trust in the business community.

The conference was organized into the following four sessions: The Nature of the Compensation Problem, Compensation as a Motivator, The Nature of Compensation Plans, and Ideas for Change. What follows describes each discussion.

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1. WHAT IS THE NATURE OF THE COMPENSATION PROBLEM?

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OVERVIEW

The current debate over executive compensation has been generated by a variety of factors, from media scrutiny to misaligned and perverse incentives within organizations. Panelists differed on whether executive compensation practices were currently problematic, often invoking their own experiences as board members, journalists, compensation consultants, institutional shareholders, lawyers, and regulators.

CONTEXT

This session offered a broad introduction to the conversation about executive compensation. It highlighted participants' diverse backgrounds and perspectives, and set up multiple points of discussion for subsequent conference sessions.

Panelists disagreed on the extent to which current executive pay practices are problematic.

Although there was a consensus among participants that executive pay has been depicted as a major problem in many large American corporations today, the question of whether that depiction is rooted in perception or reality was a point of disagreement. Panelists invoked their individual experiences when discussing their views.

The discussion highlighted and questioned the assumption that companies employ fundamentally flawed practices when developing executive compensation packages. Some participants identified numerous ineffective and detrimental elements of many companies' compensation practices. By contrast, other participants argued that while some egregious cases of misguided pay exist on the margins, the vast majority of companies use sound judgment in designing pay plans, and that the media plays a significant role in painting a deceptively broad and serious picture of an "executive compensation problem."

Boards face several challenges when designing pay plans.

The panelists agreed that it is desirable to align incentives in compensation plans with the company's long-term strategy, but some questioned how well companies achieve this alignment. One panelist pointed out that many companies use data from their group of peer companies to guide their decisions on compensation, which can decouple incentives from long-term value creation. Misaligned incentives can also lead to "short-termism," creating plans that reward quick gains while failing to penalize bets that do not pay off.

Some panelists also argued that boards are at a disadvantage in negotiations over executive compensation. Board members necessarily have limited time and resources to fully understand compensation details, the relevant performance measures, tax laws, and strategic goals of the company that are relevant to compensation. By comparison, CEOs can and do engage compensation lawyers that allow them to gain leverage during negotiations. Further, if a candidate, especially from outside the company, is highly desirable, boards will likely take whatever measures necessary in order to secure him or her.

Some panelists believe that executive pay practices are justified, and pointed out that the media plays a significant role in shaping the debate.

Some panelists and participants defended current pay practices, arguing that they are necessary to retain effective CEOs. In the words of one panelist, "You can't pay a good CEO enough." Executive compensation should be attractive to the CEO while also being tailored to the company's needs.

These same individuals also argued that there is a perception of a widespread problem with pay practices among the general public, while in reality there are only a few extreme cases on the margins. The media has played a role in spreading news of these "outliers," which has contributed to the current outrage over executive compensation. Members of the media on the panel and in the audience agreed that the most reporting is done on the most egregious examples because these stories hold the highest interest for readers.

The complexity of pay packages contributes to the debate.

Various panelists and participants expressed the strong view that in executive compensation, "one size does not fit all." Compensation should, above all, be designed with the company's strengths, weaknesses, culture, and needs in mind. Instituting broad regulations that apply to all companies increases the complexity of pay decisions by putting external pressures on the boards that are unrelated to the company's context.

Similarly, most panelists agreed that using a particular performance metric to determine incentive compensation almost always results in attention to that metric. Opponents of complexity in pay plans argued that once companies decide on how they measure performance, it should be relatively simple to create incentives to guide behavior.

Executive compensation affects the ways in which companies measure and improve performance.

The majority of panelists agreed that executive compensation practices are closely related to—and, often, affect—the rest of the organization, including the organization's culture, the relationship between the board and management, and signals that are sent to the financial markets. This session explored how companies choose appropriate performance measures, and how they incorporate these measures into their short-term goals and long-term strategies, and compensation plans. It was concluded that while no one action or regulation will itself alter the system of setting pay, discussing the nature of the executive compensation problem is a crucial step in better understanding how compensation can drive performance.

Panelists suggested several potential courses of action to improve current pay practices.

In their comments on the state of executive pay practices, several panelists identified potential solutions to some of the problems that were outlined in the session. One suggestion—discussed further in subsequent sessions—was for companies to adopt a "Say on Pay" advisory vote for shareholders, in order to hold boards accountable for their pay decisions.

Panelists also suggested that more attention should be paid to succession planning. Compensation was being blamed, in one panelist's view, for problems that are more related to recruitment and retention. When boards need to look outside of the company to replace a CEO or other senior managers, this will likely increase the level of compensation they need to pay. Instead, companies should plan for a top manager's replacement early on by developing talent within the company.

Other potential solutions discussed were changing the makeup of compensation committees, and increasing boards' transparency on their decision making.

Thinking Outside the Box

- The discussion also touched on whether compensation committees should include a compensation expert or simply a member who is deeply familiar with the company's strategy, who will help the committee create a tailored compensation package. What is the role of compensation committees, and how can the membership of the committee best reflect that role?
- Do CEOs have the right or the obligation to receive a high level of pay? One participant pointed out that many practices that boards use to determine executive compensation—including comparisons with peer companies—could perpetuate a cycle of very high compensation.
- One participant pointed out that the discussion of executive compensation included various untested assumptions. First, there was a commonly held view that boards are too collegial with management, which has little, if any, concrete evidence. The participant also challenged the argument that boards are "outmatched" in negotiations because it relies on the assumption that boards have few resources and limited time.

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OVERVIEW

Most panelists and participants believe that a firm's compensation plan can and does motivate CEOs and other executives. However, compensation plans often motivate short-term behavior and excessive risk taking. At times, compensation plans are so complex that they are not well understood and don't motivate executives to take the actions that are desired.

Often in great companies, the motivators of the leaders extend beyond compensation and economic rewards. In these situations, leaders are motivated by creating a sustainable enterprise that delivers long-term value for customers and benefits society. They identify with these purposes and create an environment where people want to work.

CONTEXT

In this session, the panelists and participants debated whether compensation serves as a motivator and the group examined compensation plans, expressing a variety of opinions on when plans work and when they don't.

Most panelists and participants are of the view that compensation intends to motivate future performance.

What is important to affect performance is that the compensation plan pays out when executives achieve goals that are clear, understood, and within a person's control. The challenge for directors and compensation committees is to understand the business well enough to know which goals to establish.

While most participants believe that compensation does motivate executives, in many instances, compensation motivates behavior in undesirable ways. Some specific problems associated with compensation plans include:

- *Complexity*. Compensation plans, often dreamed up by compensation consultants and those in HR, can be so complex that they aren't understood by directors or management. If a compensation plan isn't understood, it won't motivate behavior.

  One participant said:

  > *"I have read hundreds of compensation plans and I can tell you, I usually don't have a clue [what the compensation plan is motivating] and I don't think the boards and the people that are being compensated have any idea as well."*

- *Short-termism*. Compensation plans tend to motivate CEOs and executives to hit short-term goals in order to achieve bonuses and equity grants. To correct this problem, one participant suggested that bonuses should be paid out over three to five years rather than immediately. The participant also favored mandatory equity ownership and holding requirements so that top management would be required to hold a portion of equity through his or her tenure. Otherwise, the motivation to achieve short-term rewards can be counter-productive to long-term value creation.

  One participant said:

  > *"Everyone talks about the long term but they want to see short-term results."*

- *Asymmetric risk*. Executives are likely to take large risks if there is a large upside and no downside. Under some compensation plans, an individual receives significant rewards if the bet succeeds, but the company bears the exposure if the bet turns out unsuccessful.

  One participant said:

  > *"Big risk equals a big bonus, but a big loss equals no personal cost."*

- *Actions should not be taken outside of the stated compensation philosophy or plan*. Compensation will fail to motivate CEOs and executives if their payouts veer from stated plans. For example, this occurs when boards continue to pay bonuses after a bad year in order to send a positive signal to the market.

- *Guaranteed compensation*. Compensation fails to motivate CEOs when contracts are established as they walk in the door. Their departure packages are "written into stone" before they begin the job. Therefore, CEOs may receive large severance packages even after they failed as leaders. Pay and performance are not aligned when contracts are created on the way in.

- *Strategy first, tax laws second*. When designing compensation plans, their relationship to long-term strategy must be the first consideration, not accounting and tax laws.

- *One size doesn't fit all*. Different jobs require different pay schemes. Compensation plans should be designed so that individuals are motivated to reach job-specific goals.

Compensation can be viewed as a trailing indicator.

One participant said that there are two theories of executive compensation: 1) It rewards past performance; and 2) It is used to try to shape future performance.

A fellow participant believed that the first theory dominates. Compensation rewards past performance, and according to this view, compensation is a trailing indicator rather than a motivator. In addition, SEC disclosure requirements allow CEOs and other executives to compare their pay to others in the industry so that executives' pay becomes a scorecard for the executives involved.

Thinking Outside the Box

- Too high to matter? One participant said that executive compensation levels are so high that achieving various goals to earn more doesn't even matter. A fellow participant responded: "The opportunity to earn a significant upside is motivating, even when executives are already earning a great deal."
- Compensation plans can become too narrow and limit executives to only the behaviors that enable them to reach the goals outlined in the plan. How do compensation committees and compensation consultants know which behaviors to encourage when they have limited knowledge about the CEO's day-to-day responsibilities?

  One participant said:

  "We are trying to move the CEO's arms and legs."
- One panelist said that executive compensation and the current financial crisis are unrelated but executive compensation is mostly widely discussed when the public's own situation is bad.

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OVERVIEW

Some of the problems associated with executive compensation result from the way in which compensation plans have been designed and structured. Current structures encourage a short-term focus and provide rewards that are often unrelated to long-term performance. But there are actions that can be taken to remedy these problems.

CONTEXT

Professor Narayanan and Ms. Ferracone shared data about the current level and structures of compensation plans. The panelists and participants then discussed the design of executive compensation plans, the problems related to plans, and potential solutions for these problems. All participants did not agree that problems existed or that the potential solutions would solve these problems.

In recent years, the level and structure of executive compensative has changed significantly.

The median salary of CEOs of large companies, which is currently about 1.1 million per year, hasn't changed much in the past decade. This is largely due to the tax law of 1993 which capped the tax deductibility of non-performance based salary at 1 million dollars. However, what has changed during that time is the amount of equity-based pay. In 1990, equity-based pay was 8% of total compensation; in 2008 it represented 70% of total CEO compensation.

CEOs typically receive 4 to 5 times the compensation of the next highest-ranking person in the organization and CEO pay is about 500 times more than the compensation of the average worker. CEOs also tend to receive perks such as gross-ups, rich severance packages, and various compensation guarantees.

Ms. Ferracone presented data with implications contrary to Professor Narayanan's presentation. Ms. Ferracone said that from 2001 to 2008, corporate profits were up about 100% while CEO compensation grew about 300%. Her research shows that CEO pay has increased, but when adjusting for inflation and the size of the company, it hasn't increased by a level to merit the current public outrage.

Current compensation structures present multiple issues.

While many issues and problems were mentioned in previous sessions, the conversation focused on a narrower set of issues, specifically:

- *Rewards are often unrelated to performance.* Research shows that there is about a 20% correlation between performance and compensation. In today's compensation plans, there is a reward for size of enterprise, some reward for performance—and a lot of noise. Also, compensation paid on the way out for severance and various perks is unrelated to performance.
- *The timing of rewards is problematic.* Equity is often used to reward short-term performance and is not connected with long-term performance.
- *The Lake Wobegon effect.* Directors always want to believe that their CEO and executives are better than average, and so they pay them better than average. No one wants to say, "Our CEO performed in the 25th percentile." This leads to compensation escalation.

Participants identified potential solutions for the problems associated with compensation structures.

The potential solutions included:

- *Longer equity holding periods.* To address the problems of timing and short-termism, several individuals called for longer equity holding periods before an executive could cash out. One suggestion was a set period of three to five years after equity vested. Another suggestion was to require that executives hold all (or most) of their equity until they retired, or possibly for a period post-retirement to ensure a focus on succession planning. The argument against this suggestion is that it would incent early retirement in order to cash out.
- *Shareholder Engagement.* "Say on Pay" represents a vehicle to give shareholders a greater voice. While participants seemed to generally support "Say on Pay," some expectations for it were low. An argument was made that proxy access would heighten the short-term focus of boards and management and that shareholders do not have the expertise to weigh in on compensation decisions.
- *Greater government involvement.* This was not supported by many participants. They feared that government intervention would lead to unintended consequences. Golden parachutes and tax law 162(m) are examples of unintended consequences previously created by the government.

Thinking Outside the Box:

- While participants outlined several potential actions to address these concerns, a few participants were skeptical about the ultimate results of such actions. One participant said, "We can't change the world through pay. Pay is merely price setting and we shouldn't expect too much. What other price decisions get equal scrutiny?"
- One participant suggested that compensation plans should use performance-based vesting as an alternative to time-based vesting of stock.
- According to one participant, compensation committees do not compensate for changes in the whole value of the firm, but for changes in equity value. Does this capture long-term value creation? How do we define long-term value creation?
- Do companies that place a great emphasis on compensation plans attract people who place great emphasis on compensation? Are there other approaches that companies might take to attract people who are less focused on compensation? One participant suggested that unique compensation plans could attract a "certain type" of person.

4. WHAT SHOULD CHANGE?

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OVERVIEW

The final session encouraged all participants to take a big-picture view in suggesting what needs to be changed in order to fix the "Top Management Compensation Problem." Participants believe that business leaders must come together to take collective action to enact changes or the government will force changes, which is undesirable and will most likely have problematic unintended consequences.

CONTEXT

Panelists and participants focused on addressing the question: "What Should Change?" Numerous suggestions were offered and attendees broke into small groups to brainstorm the actions that could be taken to drive change.

Almost all participants agreed that compensation plans must align with a company's strategy and long-term performance.

The following ideas are ways to achieve alignment. They were not supported by all conference participants but they underscore the varying suggestions that resulted from the discussion.

- *Eliminate peer comparison data.* Boards should stop relying on benchmarking data.

One participant said:

> *"I would abolish surveys; they are a crutch … use of surveys is an excuse for not carefully thinking through the value of the people being hired."*

- *"Simplify, simplify, simplify."* Compensation plans should be simpler and clearer.
- *Change the stated purpose of the corporation.* The purpose of the corporation is often articulated as "to maximize shareholder value." But, this definition frames the mission of the corporation and measures a corporation's performance solely in terms of stock prices. Investors demand share price appreciation which drives the directors and executives to focus on the short term. A redefined purpose would be "to create long-term value for shareholders." For example, if a firm that produced 4 billion in net income grew in a reasonable period of time to a level of 8 billion in net income, this firm would have created long-term value, regardless of the stock price during that period. Therefore, the company executives deserve to be rewarded for this creation of long-term value. This restructured mission and corporate purpose would encourage boards to sort through their performance measures and define long-term value, as well as change how boards operate, how compensation plans are structured, and how executives behave.
- *Create incentives for investors to invest long term.* Directors and executives focus on the short term because this is the focus of many investors. In 1960, the average holding period for a stock was more than eight years; in 2008, it was less than three months. Some shares are traded 100 times in a year, as mutual funds, hedge funds, and other short-term investors act as short-term traders in flipping stocks. Getting executives to focus on the long term starts with getting investors to focus on the long term; therefore, some suggestions to change investors' time horizons included:
  - Eliminate quarterly earnings guidance in order to change the focus from hitting a quarterly earnings number to creating long-term value.
  - Change the tax laws. Changes can be made to reward long-term investors who hold their shares.
  - Require a holding period before shares can be voted. Only allow long-term shareholders (holding the shares for at least six to twelve months) to vote their shares.
- *Proceed with Say on Pay.* Providing shareholders with an advisory vote on pay will send a message to a board and will hold the board more accountable. Transparency will also ensue because boards will have to articulate their compensation philosophy and plans to shareholders.

  One participant said:

  > *"Say on Pay leads to engagement and consultation [between shareholders and directors]."*

Government action is likely if the private sector fails to address public concern.

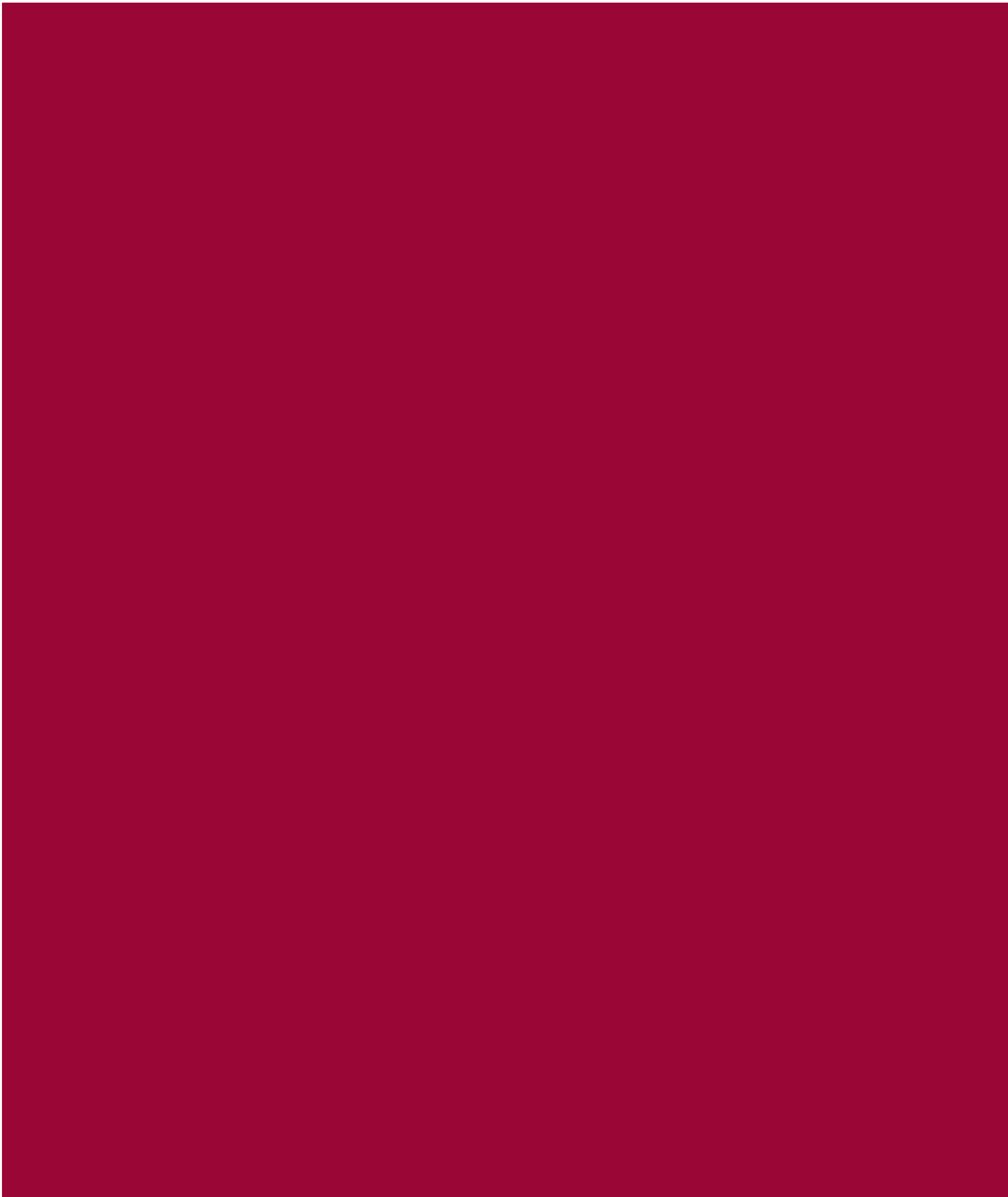
Directors and executives who often contend that "executive compensation is not a problem" need to recognize that optics matter. The public and therefore politicians are outraged, and trust of business leaders is extremely low. While the outrage may be based on outliers, failing to take this outrage seriously and to bring about change will undoubtedly lead to government action.

Government action is undesirable, a point on which almost all participants agreed. Government action brings about unintended consequences so the private sector must act to prevent the government from intervening. The reality is that despite much talk in the private sector over the past years, little has changed in terms of governance of compensation.

A problem that is preventing private sector action is a concern about being the first mover in changing pay practices. Major investors and corporations must come together.

Thinking Outside the Box

- Some participants believed that problems associated with executive compensation are related to problems in the larger system of corporate governance. One participant said that board members cannot be independent once they enter the boardroom. They must be aware of their emotional ties as a result of serving on the board. Therefore, boards of directors must rethink their behavior, group dynamics, processes, and principles when determining the level and structure of their executive pay plans.
- Another participant believed that directors should become familiar with the "Key Agreed Principles to Strengthen Corporate Governance for U.S. Publicly Traded Companies" developed by the National Association of Corporate Directors (NACD). As a result, directors would assess their board's current practices and make better decisions about both governance and strategy.
- Can we learn from global differences? One participant suggested that we look at alignment between pay and performance in other capitalist countries.



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