

CEO Pay

How Much is Enough?

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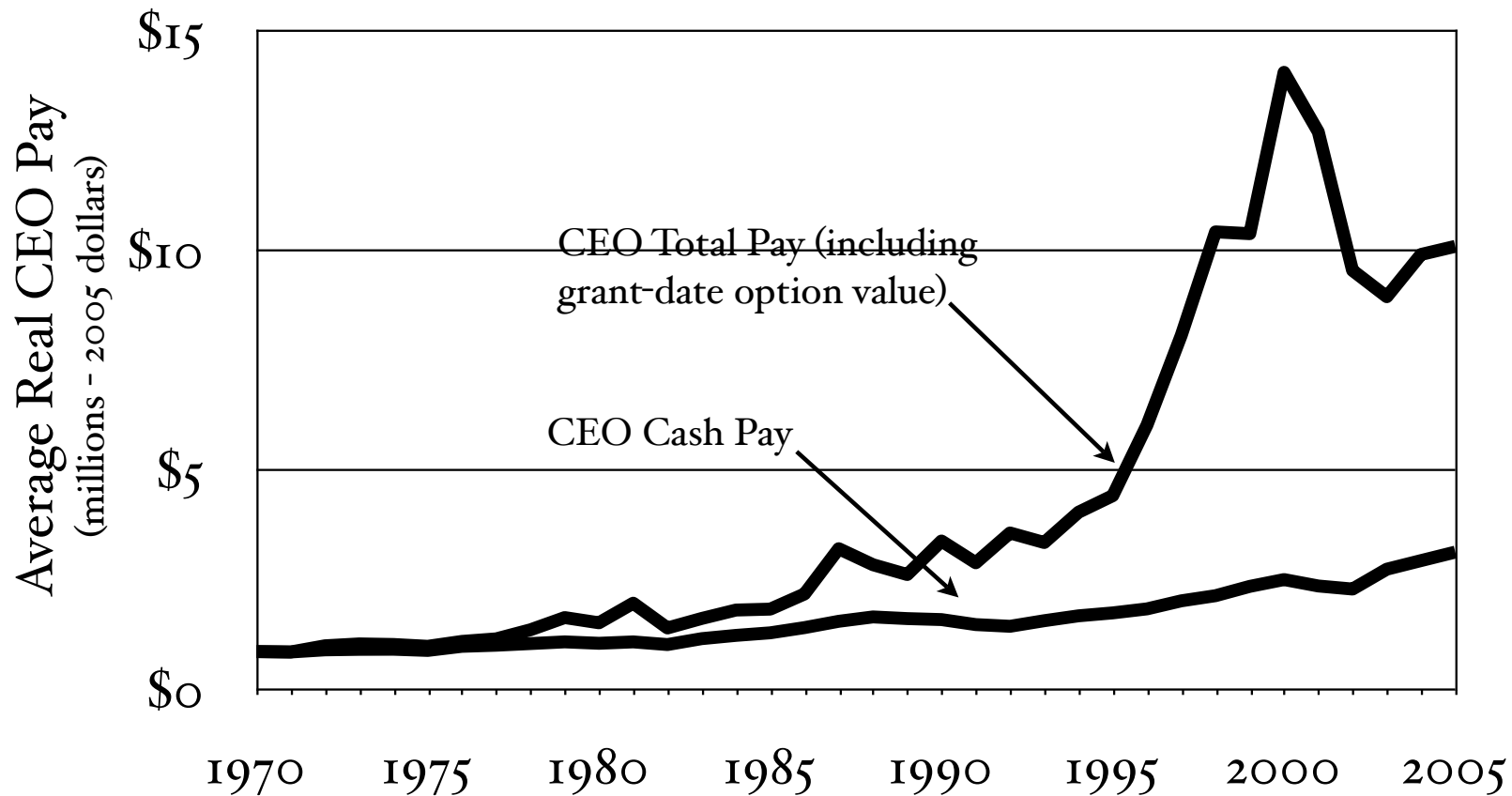
The outrage over CEO pay

- CEO pay has always generated scrutiny, controversy, and government action
 - Pre-Depression
 - Railroad executives in WWI
 - exposed when gov't took over
 - Banking execs in the 1920s

The outrage over CEO pay

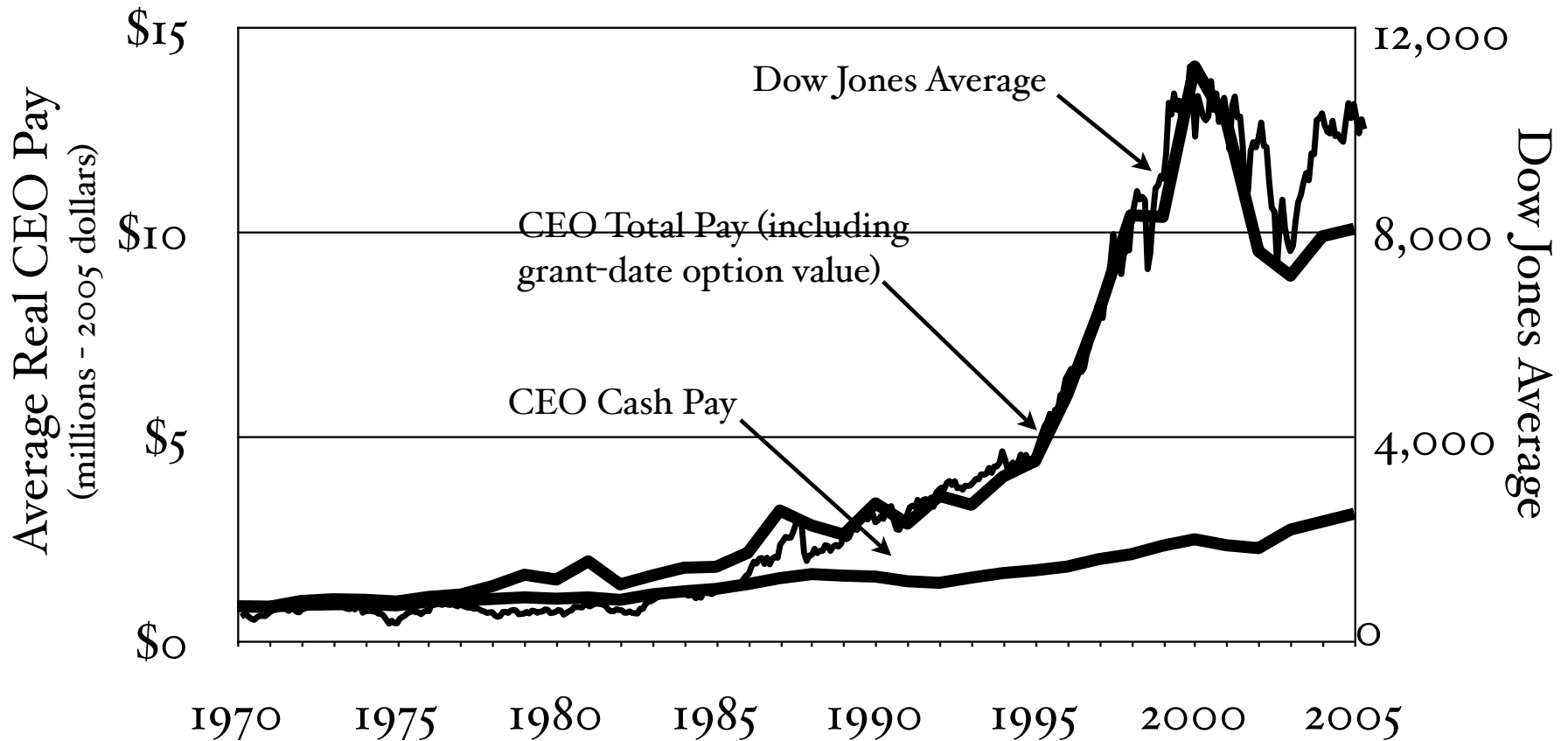
- By the Depression in the 1930s:
 - Reconstruction Finance Corp, Federal Trade Commission, and others demanded information for firms in their jurisdictions
 - Led to establishment of SEC to centralize the monitoring of compensation
 - First disclosure requirements
- In real terms, CEO pay stayed fairly constant from WWII through the early 1970s

The outrage over CEO pay



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The outrage over CEO pay

- Outrage over CEO pay spiked in early 1990s
 - Companies downsizing, CEO pay upsizing
 - Shareholders demanded more incentives; public demanded lower pay
 - Major issue in 1992 elections
- Resulted in:
 - Sweeping changes in disclosure
 - Section 162(m)
 - Failed attempt at option expensing

The outrage over CEO pay

- Outrage subsided during the Internet Boom years, but came roaring back in the mid 2000s
 - Shareholders suffering, CEOs still OK
 - Resulted in:
 - Sweeping changes in disclosure
 - Successful move to expense options
 - Sarbanes-Oxley
 - Amended Section 162(m)?

The outrage over CEO pay

- CEO pay has always generated scrutiny, controversy, and government action
- Much of this reflects jealousy, sensationalism, and a lack of understanding of the role of compensation and incentives in organizations
- At the end of the day, the scrutiny doesn't matter much, and CEO pay keeps going up

The outrage over CEO pay

- So . . . here we are again
 - CEOs are overpaid, not worth it, blah, blah, blah.

- Or, is there something different this time?
 - “Good” CEOs criticized for high pay
 - “Bad” CEOs prosecuted and jailed
 - What about those option backdating scandals?

Restoring integrity in CEO pay

- **Definition:** *Webster's New World Dictionary.*
- **1. the quality or state of being complete; unbroken condition; wholeness; entirety**
- **2. the quality or state of being unimpaired; perfect condition; soundness**
- 3. the quality or state of being of sound moral principle; uprightness, honesty, and sincerity
- I use the word in this work according to Definitions 1 and 2.
 - I do not use it to refer to a moral or ethical code or to denote right vs. wrong, or good vs. bad
 - The way I use integrity it is not religion, it is not ethics, and is defined without reference to values

Restoring integrity in CEO pay

- By this definition: CEO pay is broken; it is out of integrity
- Our system has led to:
 - CEOs winning the bargaining game
 - Bonus systems that pay people to lie
 - Earnings management that destroys value
 - Too much focus on short-term stock prices
- All this in spite of “better” governance, more disclosure and more scrutiny

Restoring integrity in CEO pay

- In 1990, Mike Jensen and I proclaimed:
“It’s not how much, but *how* that matters”
 - Focus not on levels, but incentives
 - More stock-based pay to solve
“short-termism”
- New focus: *restoring integrity*
 - No simple answers, but it can be fixed

Is CEO Pay too high?

- How do we define “too much”?
 - Not based on public sensibilities

- Ask instead: are we paying in a way that maximizes the value of the firm?
 - If so, we can sell it
 - If not, we have worse problems

The Bid-Ask Spread for CEOs

- Think about the “Bid-Ask” spread for CEOs
 - The “Bid” is the lowest amount the CEOs would be willing to accept
 - The “Ask” is the highest amount the CEOs would be willing to pay
 - The spread is huge, and CEOs have been getting a bigger share
- Why? And, how do we reverse it?

Fixing the pay-setting process

- Problem #1:

- Ignoring the governing objective**

- Companies must embrace “creating firm value” as the firm’s sole objective
 - Compensation committees should develop a “compensation philosophy” that is consistently faithful to this objective

Fixing the pay-setting process

- Problem #2:

- Letting management set the pay agenda**

- Plans and levels usually emanate from HR, and approved by top execs before going to the compensation committee to be blessed
 - Compensation committees must take full control of the compensation process, policies, and practices

Fixing the pay-setting process

- Problem #3:

- Misusing outside pay consultants**

- Inherent conflict of interest with integrated HR firms
 - Be wary of executive pay consultants who are used by the firm for actuarial or pay for lower-level employees
 - Analogy: auditing rules under SOX
 - Mis-use of surveys and the ratchet effect

Fixing the pay-setting process

- Problem #4:

- Overuse and abuse of employment and COC agreements**

- Do we really need them? When and why?
 - COC agreements must be paid only to top execs and must be double-trigger
 - Employment agreements should be discouraged and not provide benefits when managers are incompetent

Fixing the pay-setting process

- Problem #5:

- Paying too much to new CEOs**

- Current process is a recipe for over-paying; “Joe Bachelder effect”
 - Broad parameters should be negotiated before the candidate is offered the job
 - Compensation committees should employ their own contracting agents, and should *never* pay for the candidate’s agent

Fixing the pay-setting process

- Problem #6:

- Letting judgment calls go to the CEO**

- Judgment calls favor the CEO even in the most well-intentioned boardroom
 - Solving this problem involves more than changing the mix towards outside directors, but rather involves fundamentally changing the role of the board and how it relates to the CEO

Fixing the pay-setting process

- Directors must no longer see themselves as (effectively) the employees of the CEO
 - The board should be chaired by someone who is not the CEO, was not the CEO, and will not be the CEO
 - Firms should limit the number of outside CEOs on the board
 - The CEO should be the only member of the management team on the board

Will this get pay under control?

- Let's not kid ourselves . . . but it's a start
 - Key source of the recent pay explosion was options, not bad boards
 - Increased disclosure is good, but will not curtail pay
 - Much of the problem with pay lies in the details of equity plans, bonus plans, and the way executives interact with capital markets
- So, there is still a lot of work to do . . .