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HOLDING CEOS ACCOUNTABLE: IMPROVING COMPENSATION STRUCTURE

HUNG W CHU
School of Business
Manhattan College, Bronx, New York

Abstract

This paper presents three different hypotheses that attempt to explain the CEO compensation structure and the optimal contract, managerial power, and tournament system hypotheses. Using knowledge gained from these three hypotheses, a brief analysis of the reasons the government needs to be involved in regulating the CEO compensation structure follows. The paper ends with a proposal to regulate the compensation structure and addresses various potential objections to government regulation.

Keywords*: Executive compensation; optimal contracting; managerial power; tournament system.*

Introduction

Recent events surrounding the meltdown in the financial industry, which occurred while senior management executives were still drawing large compensation, have sparked a public debate regarding the possible need to change the senior executive compensation system, especially the compensation of chief executive officers (CEO). While some scholars have argued that the CEOs' compensation is appropriate (Kaplan, 2008), many other scholars believe something is wrong when one individual earns a salary that is hundreds of times larger than that of the average employee (Bogle, 2008; Walsh, 2008). Scholarly journals and news reports are suggesting that, while senior executives receive hundreds of times the salary of average workers, they lose very little in compensation when the company under-performs. For example, the public was outraged when Merrill Lynch awarded billions of dollars in bonuses to its management executives after it requested and received government assistance. The US government now faces a question: What is the fairest way to install a compensation structure for US companies seeking government assistance in these tough economic conditions?

This exploratory analysis addresses three questions:

1. What caused the compensation structure for CEOs to be hundreds of times that of average workers?

2. Is there a need for the government to intervene, or will the market correct itself?

3. If the government needs to intervene, what would be considered a fair and just compensation structure for CEOs?

The next section presents the various hypotheses used to construct the compensation structure for CEOs and the ways in which each hypothesis answers question 1. Next, a short discussion of whether the government needs to intervene addresses question 2. The paper ends with recommended changes to the way in which CEOs are compensated, along with various assumptions and requirements of such a compensation structure, in order to address question 3.

Hypotheses on Existing Compensation Structure

The majority of the discussion of the executive compensation system has focused on compensation for CEOs because the CEO is usually the highest paid executive of the company. One can argue that if the total compensation for CEOs can be "corrected," then their lieutenants' compensation will be "corrected" as well. There are at least three competing hypotheses regarding how CEO compensation is structured: (a) optimal contract, (b) managerial power, and (c) tournament system. The discussion below provides the basic framework for each hypothesis' explanation of the CEO compensation structure and discusses available studies that have tested these three hypotheses.

Optimal Contract

Description. The optimal contract hypothesis is an extension of agency theory. Agency theory has two main conjectures:

1. If the interests between the principal (the owners or the shareholders) and the hired help (the agent or management executives) are not aligned, the agent can act to promote its own interests at the expense of the principals' interests.

2. The principals must spend resources to align the interests of their agents with their own interests.

Agency theory further suggests that as long as the goals of the shareholders and the management executives differ, however slightly, the management executives will misbehave. The focus of this analysis centres on the CEO because the CEO is often the highest paid employee of the company, and if the highest paid employee is correctly compensated, the rest of the employees will be correctly compensated.

Further examination of the interests of the CEO and shareholders revealed a slight difference. In the case of executive compensation, stockholders want a CEO who will maximise long-term profitability for the company because only with higher profits can the shareholders realise higher dividends and stock appreciation. Conversely, the CEO is interested in the highest possible compensation that he or she can obtain from the company. Since the two parties' interests are not exactly the same, agency theory posits that the shareholders must spend some resources to align the interests of the CEO with those of the shareholders. Shareholders can either monitor or correct behavior that is harmful to their interests, or they can make the CEO's interests contingent on achieving the interests of the shareholders, that is, aligning the CEO's interests with their own.

From agency theory's conjectures, proponents of optimal contract make the following arguments: (a) the cost to monitor the behavior of the CEO will reduce shareholders' value, and (b) providing incentives is a better way to align the interests of the CEO with those of the shareholders than punishing bad behavior. Optimal contract holds that it is impossible to design a contract that directly shapes all the behaviors of the CEO because different environmental conditions may force the CEO to act in ways that can reduce the shareholders' value in the short term; however, these actions may be necessary to protect or increase the shareholders' value in the long run. Hence, optimal contract would not design a contract with the CEO that specifies behavior; instead, the contract would specify results that the shareholders want.

Since both the shareholders and the CEO want to increase some value, aligning the interests of these two parties can be as simple as tying the increased value of the shareholder to the compensation of the CEO. Optimal contract suggests that compensation for performance would align the interests of the CEO with those of the shareholders. That is,

the CEO would receive a higher compensation if the company is more profitable. Shareholders can use several techniques to align the CEO's interests with their own, such as providing any or all of the following to the CEO: (a) stocks options, (b) granting some stocks, or (c) bonuses tied to how well the company performs. The board of directors, who represent the shareholders in corporate governance, are supposed to help make sure that the contract with the CEO is designed with the best interests of the shareholders in mind.

When using these tools to negotiate with the CEO, the board of directors needs to decide how much wealth the shareholders are willing to share with the CEO. This is often measured by comparing the change in the wealth of the shareholders with the change in total compensation of the CEO or the pay sensitivity of the compensation (Jensen & Murphy, 1990). Ideally, pay sensitivity should be larger if there is a drop in shareholders' wealth when compared to an increase in shareholders' wealth. This would discourage the CEO from pursuing interests that would be detrimental to shareholders' interests. For example, suppose the CEO wishes to engage in an acquisition that would enhance his or her reputation. The CEO might value the acquisition at $500,000, but such action might cost the company $50 million in shareholders' value. If the pay sensitivity for the CEO is greater than 0.01, then it is less likely that the CEO would engage in such an acquisition because the CEO's total value of the acquisition would be lower. Once the two sides agree to a compensation structure, the contract should not be changed.

Proponents of optimal contract argued that the board of directors will create an efficient contract that specifies the compensation structure with the CEO and other executives. An efficient contract is one that balances the value retained by the shareholders and the increased pay that the executives demanded from a better performing firm. The board of directors is expected to design a compensation structure that maximises the shareholders' value (Demb & Neubauer, 1992).

Business Practices and Empirical Evidence. If the CEO's compensation has a none zero pay sensitivity value, it would imply that his or her take home pay is variable. Of the four potential components of management executives' compensation–base salary, annual bonus, long-term incentives, and granting of stocks options-base salary is the only component that will not be affected by the company's performance and be a drag on pay sensitivity. Annual bonuses may result from achieving some financial or accounting measures, such

as number of new customers or revenue/profitability target. Annual bonuses exist to motivate the CEO to deliver short-term results and perhaps punish bad behavior quickly. Long-term incentives can include bonuses tied to multi-year financial objectives, restricted stock plans, and a retirement plan. This portion of the compensation structure is used to align the CEO with the long-term interests of shareholders by providing incentives to the CEO to set a positive long-term direction for the company. Finally, the granting of stock options is a way to compensate the CEO through stock appreciation, which is what the stockholders ultimately want to happen (Murphy, 1999). Designing a contract that has a high pay sensitivity, thereby aligning the interests of the CEO with those of the shareholders, should allocate a higher percentage of total compensation in annual bonuses, long-term incentives, and stocks options.

However, aligning the interests of the CEO with those of the shareholders by providing incentives to increase the performance of the company only partially resolves the interests of the CEO. Anabtawi (2005) suggested that one of the CEO's interests is reducing potential volatility in compensation. The CEO will argue that uncontrollable variables, such as general economic trend or changes in regulations, can affect his or her compensation. While shareholders may mitigate such volatility by investing in many companies, thereby reducing their systemic risk, CEOs are not able to diversify because they can only be the CEO of one company during a short period. When CEOs negotiate their compensation packages, they demand a premium that is higher than the financial market because they must assume such risk.

Base salary and annual bonuses are portions of the compensation package that can be corrected quickly if the business environment experiences a drastic change. While these two parts of the package can represent a significant portion of a CEO's yearly compensation, they are not the portions most contested by stockholders. Instead, the long-term incentives and the granting of stock options often generate the most heated debates. In particular, two actions generate a significant amount of discussion regarding the long-term incentive portion of the CEO contract: (a) when the options are re-priced and (b) when the CEO exercises his or her options. As noted earlier, optimal contract suggests that options should not be re-priced, but many companies re-price anyway. A re-priced option means that if the original contract offers management the ability to purchase company stock at last year's 1 January price but the current stock price is

below that price, the compensation board changes the purchase price to, say, 10% below the current price. Companies that re-price stock options often argue that if these stock options are not re-priced, the recipients of these options will experience lower morale and be less useful to the company. One can argue, however, that if the options are re-priced, the shareholders of the firm cannot complain that there is a lack of linkage between compensation and performance because shareholders are allowing such an outcome.

Two potentially "enraging" actions can result from CEOs exercising their stock options: (a) when the CEO claims sizable compensation relative to the company's performance and (b) what may happen subsequently to the stock price after the CEO receives the reward. If the stock price is much higher than the strike price of the option when a CEO exercises his or her stock options, it is possible that the CEO will be able to obtain a payout that is comparable with the yearly net income of the company.

This begs the question of reasonableness from at least two stakeholders. One stakeholder that may view this as unreasonable is the employees, especially other management executives, because the company's profit is a result of the entire organisation's effort. The CEO may have set the right plan and designed the correct motivation, but corporate profit is the result of all employees' efforts. For one individual of the company to be compensated for the efforts of thousands may result in the demoralisation of others in the firm because of the perception that they are not compensated equally. Lower employee morale leads to lower performance in the future. The other stakeholder that may complain is the shareholders because, as a result of the CEO exercising the stock option, they will have less retained earnings in their company, lower stock prices, or possibly less dividend payout because resources are used to pay one individual.

A well known example of this scenario involves Michael Eisner, CEO of Disney. While Eisner generated much heated discussion when he exercised more than $200 million in 1992 and more than $500 million in 1997, Disney's board of directors argued that Eisner is worth every dollar from those two exercises of stock options since his efforts increased the stock price substantially during the 1990s. Furthermore, the Disney board argued that the granting of stock options was contractual and is legally binding. The Disney board did recognise that they were overly generous with the incentive plan for Eisner, and subsequent incentives for Eisner were viewed as more appropriate than earlier ones (Hodgson, 2004).

When the CEO receives compensation based on stock price, whether it is in the form of stock options or a bonus triggered by the performance of the stock price, optimal contract may argue that the system worked. Observers of executive compensation, however, have noted that, at times, the company will announce "correction" news that substantially reduces its stock price, earnings outlook, or both. For example, the top three executives at Computer Associates–Chairman and CEO Charles Wang, chief operating officer Sanjay Kumar, and chief technology officer Russell Artzt–were given a special incentive stock award when Computer Associates' stock price stayed above $53.13 for 60 consecutive days (Hill & Jones, 2008). As soon as all of the conditions for the special award were met in May 1998, Wang, Kumar, and Artzt were given the special award, totaling $1.1 billion. Then, in June 1998, Kumar announced a deteriorating revenue forecast, and stocks promptly fell to less than $40 per share. These events raised the question of whether the optimal contract actually works when those who design the compensation, implement the strategy, and receive the awards are the same group of people.

Since pay sensitivity is the measure that determines the correlation between total compensation and firm performance, many optimal contract researchers had focused their efforts on identifying pay sensitivity. Pay sensitivity can be measured by determining the changes in shareholders' wealth and in the CEO's total compensation. Researchers have argued that if the contract is designed correctly, pay sensitivity should be relatively high. Jensen and Murphy's (1990) study indicated that the CEO's pay sensitivity is only 0.3% for publicly held companies. Ten years later, Himmelberg and Hubbard (2000) found pay sensitivity to be at 1.87%. This change probably correlates with an increased use of stock options as the incentive for senior management executives. However, during the 10 years between 1990 and 2000, there was a general rise in the stock market. Hence, whether the CEO is well compensated or not, the stock price of the firm will increase regardless. Once this anomaly is controlled, Himmelberg and Hubbard found that pay sensitivity is about 0.4%, which is of similar magnitude as was found in the Jensen and Murphy study done 10 years earlier.

The optimal contracts theory suggests that the CEO's compensation structure would have various incentives payments to the CEO that would trigger only when the CEO helps to achieve the shareholders' interests. The CEO should only receive these payments when they reach the performance target specified in the contract. However, research studies (Himmelberg & Hubbard, 2000; Jensen & Murphy,

1990) have indicated that pay sensitivity contributes insignificantly to the large size of CEO compensation when compared to the average compensation of the employees. Specifically, the existing contracts seem to be rewarding good luck and do not penalise poor performance (Anabtawi, 2005). Furthermore, existing contracts contain clauses, such as deferred compensation and retirement benefits, that have nothing to do with the performance of the company (Bebchuk, Fried & Walker, 2002; Rosen, 2007).

Managerial Power

Description. Since the empirical evidence suggests that the current contracts for CEOs have low pay sensitivity, many scholars have theorised various alternatives to explain how the CEO's compensation is structured. The leading alternative hypothesis is managerial power. Managerial power suggests that the process of designing the contract may have favoured the CEO instead of the shareholders because the CEO can control the negotiation of the compensation structure with the board of directors to reduce or eliminate the need for him or her to show superior performance.

Proponents of managerial power have argued that while the market for corporate control, an external force, could hamper CEOs' ability to obtain a self-serving compensation structure, these forces are usually not strong enough to influence the executive compensation structure (Bebchuk et al., 2002). The market for corporate control may be from the shareholders or hostile takeovers. Shareholders have a limited number of alternatives for restricting executives' pay, and the granting of options is often ineffective. Furthermore, it is doubtful that shareholders will be successful during a proxy fight against executive compensation. While hostile takeovers can result in a company losing its autonomy, they often have no bearing on the compensation at the very top because, as proponents of this hypothesis argue, the CEO has the ability to structure his or her own compensation.

Managerial power argues that CEOs have an advantage over boards in negotiating their compensation (Bebchuk & Fried, 2004). Suppose the CEO is facing two possible compensation packages from the board, one with a fixed compensation of $5 million and another that is also $5 million but only if certain performance measures are met. To get those performance measures, the CEO will have to work hard to set the right strategic plan and make tough calls on a wide variety of decisions, such as letting employees go or eliminating less profitable businesses. Even though the total compensation for both

packages is the same, the CEO will most likely use his or her position and knowledge of the company to negotiate for a fixed compensation package. Taking this one step further, the CEO may try to obtain more compensation through complicated schemes that obscure the actual compensation with no real effort on the part of the CEO, such as asking for stock options with a relatively low strike price (purchase price) when the general market condition indicates that the stock price can only increase.

The CEO can influence the board with his or her position and knowledge of the company in numerous ways, including (a) the ability to nominate board members, (b) the ability to direct compensation to the board members, (c) the use of social forces to encourage directors to cooperate with management, (d) little personal outlays to the directors to side with management, and (e) limited time and effort for most directors of a board (Anabtawi, 2005; Bebchuk et al., 2002). Once the CEO controls the board of directors, de-coupling the compensation structure with the performance of the firm would be easy for the CEO.

Theoretical Problem and Empirical Evidence. While the managerial power hypothesis tries to address the problem of pay sensitivity in optimal contract, a closer analysis of this hypothesis reveals a slight flaw in its reasoning. Extending Bebchuk and Fried's (2004) example, suppose the board is considering a compensation structure that has a base salary of $1 million with a bonus of $4 million if the net income of the company grows by 5%, while assuming the firm's prior year's net income is $100 million. The CEO is only willing to have the performance measure in the contract if the total compensation is worth 20% more—a total of $6 million. If the board comes to the conclusion that the firm is still ahead with the additional 20% compensation expense, or $1 million, then there is no reason why the board and the CEO will not be able to agree to have a performance measure in the compensation structure. Extending this analysis further, the CEO may argue that with a 5% increase in net income, stockholders will experience an appreciation in the firm's stock price, so the CEO should retain more of the increased net income. Hence, the CEO would argue for a $5 million base salary and perhaps half of the increase in net income as the bonus. One can extend the logic further and arrive at the conclusion that as managerial power increases, the link between compensation and firm performance would be tighter, even if the members of the board are only trying to increase the value of their stock in the firm.

There are several possibilities for measuring managerial power. Some have argued that if an investor or large shareholder holds a substantial portion of the company's equity, such an investor or shareholder would have more incentive to monitor the behavior of the senior management executives (Bertrand & Mullainathan, 2001; Hambrick & Finkelstein, 1995; Hartzell & Starks, 2003). Another way to measure managerial power is to compare an inside board of directors with a so-called "independent" board of directors, where the CEO has less influence. Finally, one might use the length of the CEO's tenure as a possible measure of managerial power.

The issue with using the existence of large shareholders to measure managerial power is that these shareholders have only an indirect influence on the CEO (Anabtawi, 2005). The large shareholders can vote on the board of directors, so the board should control or monitor the behaviour of the CEO on behalf of the shareholders. According to the managerial power hypothesis, however, once nominees become board members, they will be more influenced by the CEO instead of the shareholders. It becomes difficult to determine who is more influential on new members.

The second test of managerial power assumes that the greater the number of board members who cannot be influenced by the CEO (e.g., so-called independent directors), the more likely it is that CEO will have to accept a compensation structure that includes some performance measure. Under this scheme, managerial power can be determined in two ways: (a) the portion of the inside director and (b) the portion of the independent director. Inside directors are those board members who also hold managerial positions in the firm; the CEO has more ways to influence such members. Independent directors are those board members who have no other relationship with the CEO except their status as a board member.

The limited number of published studies (Bhagat & Black, 2002; Daily, Johnson, Elstrand & Dalton, 1998; Wan, 2003) did not provide support for an increase between performance and compensation in the composition of board of directors. Bhagat and Black found an inverse correlation between board independence and firm performance, which they attributed to changes in board members as the firm's performance deteriorated. Daily et al. found no relationship between an increased ratio of inside directors in the compensation committee and CEO compensation. Finally, Wan found no support for the notion that an increase in independent directors leads to increased pay sensitivity of the CEO.

The last test for the managerial power proposition was based on the assumption that time has an impact on the degree of influence the CEO can exert on the board of directors. The expectation is that a new CEO will not have time to establish relationships with a large portion of the board members; hence, a new CEO will have less ability to dictate the compensation structure. However, once a CEO has been in position longer than a year, he or she will be able to use the CEO position to influence compensation for the director and may even nominate people he or she trusts to the board. So far, however, there are no published studies that examine this proxy for managerial power.

Managerial power hypotheses would suggest that the compensation for the CEO would grow ever larger because CEOs have a significant influence over their compensation structure and can direct an ever increasing amount of payment to themselves. The managerial power hypothesis seems to fit with the trend in corporate board room decisions regarding CEO compensation structure. The empirical studies thus far, however, have not provided support for this hypothesis. Inconclusive results from various tests of the managerial power hypothesis (Bhagat & Black, 2002; Daily et al., 1998; Wan, 2003) suggest a need to search elsewhere to explain CEO's compensation.

Tournament System

Description. Since the optimal contract and managerial power hypotheses both have problems explaining existing executives' compensation structure, researchers have turned to ask why the board is willing to compensate employees with larger than usual rewards. Analysing the ways in which many firms set up the compensation structure leads to an interesting observation: there is often a sizable gap in compensation between levels of the organization, with the CEO as the highest paid individual in the firm. This structure is a way to motivate employees to become more productive for the firm so that the firm will promote them to the next level of the organization as a reward for increased productivity.

This reward system or incentive system is often referred to as the *tournament system* in peer reviewed journals (Ehrenberg & Bognanno, 1990; Lazear & Rosen, 1981; van Dijk, Sonnemans & van Winden, 2001). As long as there is a career ladder or promotion possibility within the firm, the compensation structure will provide incentives for all employees to be more productive so that they can be promoted. The tournament system has been used to explain differences in

compensation between upper level managers and middle level managers and between US managers and foreign managers. Anabtawi (2005) argued that the tournament system can be extended to examine CEOs' compensation structure as well.

The tournament system is an elaborate way to set up a compensation system within an organization, as the system must consider all parts of the organization and must make sure the pay differences exist between different levels of the organization. Once the tournament system is set up in the firm, the employees can be motivated to increase their productivity because the potential reward for being more productive is a potentially higher salary in the future. The employees are compared to their peers at the same level, which reduces problems with uncontrollable factors, such as general economic conditions or changes in government regulations, which can impact employees' job performance. Using relative performance at the time of promotion, however, effectively de-couples absolute performance measure with compensation. Additionally, while it is time consuming to develop the compensation scheme for all levels of the organization, implementation of such a system often involves minimal cost and can be viewed as fair for the employees if the firm chooses an objective measure of performance evaluation. As long as the employee performs better than his or her peers at the same level, the likelihood that the employee will be promoted to the next level remains positive. The pay difference is often a compromise between the need for higher shareholders' wealth and enough incentive for the employee to want to be promoted (Lazear & Rosen, 1981). Since the tournament system is a relative standing system, compensation for performance is often ignored.

The question for the tournament system is how to compensate the CEO, as no more promotions are available within the firm once a person becomes CEO. One may argue that those who become CEOs have won the contest set up by the firm and are high-achievers who must be compensated handsomely so that they are not tapped by other firms. As a result, compensation for the CEO is often much higher than the next lieutenant in the organization because the firm wants to retain valuable talent. However, compensation cannot be excessive, as the shareholders of the firm want to keep some of the wealth. Often, the firm will find the average compensation of CEOs of other companies of similar size and in similar industries and compensate its CEO a little higher in order to diminish the likelihood of the CEO finding a better position. Since the CEO's compensation now depends on the size of the company, the CEO will be motivated

to grow the company because that is one way for the CEO to increase his or her compensation. The consequence of this setup, however, is that compensation for the executives is increasingly de-coupled from the actual performance of the firm (Anabtawi, 2005). Additionally, each time the CEO negotiates his or her compensation contract, the average is increased because firms want to make sure their CEO is compensated at an above average rate to deter them from moving to another firm.

Criticism of the Tournament System. There are at least three criticisms of the tournament system: (a) increased hiring of CEOs from outside the firm, (b) lack of means for motivating the CEO to maintain his or her performance, and (c) potentially uncooperative behavior between employees (Anabtawi, 2005).

If the firm uses the tournament system and hires the CEO from outside the firm, then the employees who are competing for that top position will be less motivated to compete for it. Recent data suggested that the rate of hiring the CEO from outside the firm increased from about 15% in the 1970s to about 26% in the 1990s (Murphy & Zabojnik, 2004). The increased reliance on hiring CEOs from the outside implies that the possibility of promotion within the firm has decreased. The question then becomes, how can the firm put the incentive back into the system to motivate its employees to seek the CEO position? One assumes that lower/junior level employees compete for the next higher level position because of higher compensation. They judge their chances of getting that promotion as a probability. One can express the minimum incentive to motivate the employee to compete for the higher position as the probability of the employee winning the position and the new compensation of that position. Since the practice of hiring the CEO from outside of the company decreases the probability of the company employee winning the higher position, the easiest way to rekindle competition for the top position is to increase the top prize or increase the total compensation for the CEO, which is exactly what has happened as the rate of hiring the CEO from the outside has increased.

Another criticism of the tournament system is that once an employee becomes the CEO, there are no more incentives within the firm to motive him or her to perform well. One can address this concern in several ways. Firstly, the CEO may find another tournament arena; that is, instead of intra-firm competition, the CEO may look for inter-firm competition. As mentioned earlier, similar-sized firms will have similar compensation for their CEOs. For the CEO to receive a higher

compensation level, he or she will have to increase the size of the firm, which means growth and is what shareholders want. Secondly, for an employee to become the CEO, he or she must have won many times within this tournament. One can argue that the employee is used to winning, and it would not be in his or her nature to relax and allow the company to underperform. Thirdly, the possibility of losing the CEO title still exists. If the CEO cannot deliver the expected performance, he or she will be forced to resign or lose the position. The loss of the CEO title will be enormous because the individual will have to leave the company, and this loss is accompanied by a loss of financial income (Anabtawi, 2005).

The third criticism of the tournament system is that the contest between employees may create uncooperative behaviour among employees that can be detrimental to the overall performance of the firm. This uncooperative behavior stems from the use of relative performance between employees. While the use of relative performance can help the firm reduce monitoring costs, employees can affect the chance of promotion for their peers, which can lead to poor overall performance of the firm. Proponents of the tournament system (Baker, Choi & Gulati, 2005) argued that the firm can design the organization to minimise employees' ability to interfere with their peers' efforts by using geographic separation or separation via independent business units. Another technique to limit the effect of uncooperative behavior is to re-locate individuals who have disrupted the overall performance of the firm. The firm can then find ways to deal with these employees, such as retraining them, sending a warning memo, or removing them from the firm.

As discussed earlier, the tournament system was derived from observations of the ways firms set up their compensation structure to provide incentives to their employees to become more productive. However, this system relies on relative performances of the peers which de-couple compensation from performance. To properly compensate their CEO, firms analyse how firms of comparable size compensate their CEOs and pay their CEO competitively, usually higher than the average. However, this would imply that the CEO's compensation will only increase unless there is some mechanism that will put a drag on the rate of increase.

Government Involvement

While the debate regarding how a CEO's compensation comes about will probably continue, one should recognise that without some

rules or procedures, compensation for CEOs, and executives in general, will only increase. The expected link between compensation and performance in the optimal contract hypothesis does not exist (Himmelberg & Hubbard, 2000; Jensen & Murphy, 1990). A deeper examination of the managerial power hypothesis demonstrated that the link between compensation and company performance should be stronger. The tournament system hypothesis offered an explanation of the de-coupling between compensation and performance, and explained why the CEO's compensation will increase when firms rely on external candidates to fill their CEO positions. One can thus infer that market forces, if left unchecked, will continue in this trend of rewarding CEOs without a clear link with the firm's performance.

When the US government bailed out the banks in the last quarter of 2008, there were some strings or regulations attached for receiving the money from the government, such as a salary cap for company employees and rules regarding bonuses. The companies that received these funds tried to return government aid as soon as possible because they did not want to limit their executive compensation. Senior management executives at these companies argued if their employee pay is lower than that of their competition then their employees will leave the company, creating a worse situation for them (Andrews & Baker, 2009).

The appropriate question may not be should the government be involved in structuring executives' compensation but, instead, how will the government be able to provide a justifiable compensation system for the CEO that satisfies all of the important stakeholders? The results of the 2008 bailout may not mean that companies do not want direction from the government, as salary limits or the elimination of bonuses may have been major motivators for executives to return government assistance. It is questionable that the board of directors and shareholders in general agree with the executives' decision.

Proposal to Regulate Executive Compensation

Assumptions

Before suggesting ways to regulate executive compensation, one must determine the various stakeholders and the most important attributes that each stakeholder wants. There are at least three important stakeholders: (a) shareholders, (b) employees, and (c) the CEO. Shareholders want to maximise the long-term profits of the

firm, which can usually be measured by the changes in the stock price of the firm. Employees probably want to share some of the compensation that the executives receive. The CEO wants to receive as much compensation as possible, without any limit on how large that compensation might be. One must realise that changes to the CEO's compensation will affect the compensation of all executives because if the CEO's compensation is lower, the other executives' compensation will be lowered as well. Therefore, the recommendation should include all the executives who may be influenced by the change. The challenge for the US federal government is providing an arrangement that satisfies all three stakeholders.

The Proposal

The government should address the major concerns of each of the stakeholders separately and try to integrate the policy at the end. Addressing the concerns of the shareholders requires that compensation depend on the firm's performance. While performance may use relative indicators, the compensation to the executives should remain below the firm's means to pay them. Although the firm's performance may be affected by forces beyond the control of the executives in the short-term, given enough time, the executives should and must be able to address these forces. Additionally, since shareholders would like to maximise the long-term profits of the firm, compensation should depend on an aggregate of three to five years of performance similar to the economic value added system proposed by Stern, Stewart, and Chew (1995) or the more recent practices by Goldman and Sachs where the restricted stock cannot be sold for five years (Katz & Harper, 2009).

Employees and shareholders may feel slighted when the top management receives a far greater share of the firm's profits than they do. However, if the tournament system hypothesis is correct, the market may not be able to monitor itself because the prize must keep on increasing to provide a challenge for the CEO. Therefore, the government will need to create a level playing field. The recommendation is to provide a fixed percentage of the average profits for the executives. Since the market might not be able to keep the compensation percentage constant, the federal government should provide some incentives either to the firm or to the executives. Additionally, since different industries have different rates of profitability, each firm should have the option to select the percentage of profit that it is willing to share with its executives.

The concern of the executives is simple: they do not want their maximum potential compensation limited. That is, if the firm is willing to compensate the executives with large bonuses beyond their salaries, then the firms should be able to do so. The main issue here may not be the bonuses because bonuses are often tied directly to the performance of the firm. The problematic compensation is the granting of stock options. As discussed earlier, executives can increase their total compensation in various ways. Granting stock options aligns the interests of executives with the interests of shareholders. However, when executives exercise the option and then sell the stock, the alignment disappears. The question then becomes how to provide an incentive for executives to keep the stocks that they just received. Since the stocks are only paper money and may go up or down in value, depending on the performance of the firm, the government should distinguish this from actual take-home pay. That is, if the executive has a salary of $100,000, a bonus of $400,000, and a stock option worth $5 million, the take-home pay would be $500,000 and any profit generated from the sale of the stock. If the executive sold $2 million worth of stocks while spending $1.5 million to purchase the stock, the total compensation for the executive would be $1 million. If after five years the executive sold the remaining shares for a profit of $2 million, the $2 million should be counted as compensation in year five. This arrangement would not limit the potential compensation of executives, as the firm may award the executives as much as they feel comfortable awarding, but the profit draw from the company would be spread out over a number of years.

In assessing the needs and concerns of the three stakeholders, the federal government may require publicly traded companies to decide on three variables: (a) the percentage of executives, (b) the number of years to use when averaging the firm's profit, and (c) the percentage of profit the firm is willing to share with these executives. The percentage of executives may be the top 1% to top 20%. The number of years may be from 3 to 10. The percentage of profits probably should be less than 50%. The firm may change the mix, perhaps after five years. Hence, one firm may decide to award the top 2% of its executives with no more than 15% of the average net income from the past five years, while another firm may decide to include the top 1% of its executives with no more than 10% of the average net income from the past three years. This type of statement should be made known to the shareholders.

There is a need, however, to have some incentive for the firm to follow through with the above statement or to create a penalty for failure to

implement it. One can argue that once the firms set their preferences, the shareholders and employees should be satisfied with the correct implementation of them. If they are unhappy with the statement, they can change it every five years. The issue is what the penalty should be for lack of implementation. There is probably a need to have a series of warnings and consequences to the firm, and undesirable outcomes for the executives in question. The first warning from the federal government may be an announcement of the firm's inability to implement the statement for the first year. If the firm is unable to implement for the second year, the list of executives who received more than the suggested amount may become public knowledge. If the firm continues to have difficulties implementing the statement, the amount that each executive draws could be made known, in addition to the list of executives who draw more compensation from the firm. Making these facts public may cause the stock price to fall because shareholders may start selling their stock. Once the stock price falls, the firm may become a takeover target, and the top managers may not be able to draw the same kind of compensation they could draw if the firm remains independent (Haspeslagh & Jemison, 1991). Additional incentives or penalties that can be imposed by the federal government are perhaps some reduction in corporate tax if the firm follows through with the statement and additional tax rate if the firms are unable to execute it.

Potential Criticisms

There are some obvious criticisms of the recommendation that the government intervene in executive compensation. First and foremost, government intervention effectively puts a limit on executive compensation. However, if the executives' actual take-home pay is within the limits of the statement, the firm can reward the executives as much as it wants, but the executives may only draw more pay if the firm performs well. If the executives are forced to keep the stocks received from stock options, they are more aligned with the interests of the shareholders.

The second possible criticism may be what to do with executives who have excess stocks when they retire. These executives should have the ability to sell their stocks once they leave the company because they can no longer control its performance. The issue becomes the length of time that must pass before these executives may sell all of their shares. A suggestion would be anywhere from 9 to 18 months because if retired executives have been deceptive in any way, it should be revealed in about a year and be reflected in the stock price.

An exception to the 9 to 18 months rule would be those executives who retire from a management position in the firm but still hold a seat on the board or become a consultant of the firm.

A third possible criticism is that firms may not want to declare a statement and, hence, may avoid a decision regarding violation. The government could start off with a default statement, such as the top 3% of the executives will not draw more than 3% of the average compensation from the past three years. The government may allow the default statement to be changed after only one year. Once the statement is changed, the firm must not change it for another five years.

Another criticism may be that there are no data to back the various claims of the relationship or that the government has no right to implement the various activities in this recommendation. For example, will the stock price fall if the firm is on the list of firms unable to make good on their statements? Does the government have the right to broadcast potentially negative publicity for the firm or the individual? These questions, of course, require further study and public debate.

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