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**Insights on Chief Executive Officer Pay: Excessive or Earned?**

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Presented Monday March 7<sup>th</sup>, 2016

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## **Chapter I: Introduction**

The controversy surrounding executive compensation is not necessarily a new topic; in recent years, shareholders have adopted a more critical eye over how executives are compensated.<sup>1</sup> According to the executive compensation research firm, Equilar, the median pay for the 200 highest earning CEOs in 2014 was \$17.6 million, up 1.9% from 2013.<sup>2</sup> While these CEOs are making a lot of money on an annual basis, the high earnings are a reflection on the nature of the position.

To begin with, it is important to understand the purpose behind CEO pay. According to former Princeton University President and author of *The Board Book*, William G. Bowen, the most important function of the board of directors is to recruit and hire an effective CEO.<sup>3</sup> That said, in his book, *Too Much Is Not Enough: Incentives in Executive Compensation*, Robert Kolb articulates, “the talent to be an excellent CEO is extremely valuable and quite rare.”<sup>4</sup> With the supply and demand for a CEO, Kolb notes, “it might be costly to secure the services of a good one [CEO].”<sup>5</sup> However, despite the cost, Kolb notes, “an excellent CEO will be able to create many millions or even billions of shareholder value, over and above that which could be achieved by a merely adequate manager.”<sup>6</sup> Kolb’s assertion is consistent with the ideas behind American business journalist and *New York Times* bestselling author, George Anders, “five-to-

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1. Thomas Lee, “Target’s Narrow Vote on Executive Pay Suggests Shareholder Discontent,” *Minneapolis Star Tribune (Online)*, June 18, 2013.

2. “Equilar 200 Highest-Paid CEO Rankings,” *The New York Times*, May 16, 2015.

3. William G. Bowen, *The Board Book: An Insider’s Guide for Directors and Trustees* (New York: W.W. Norton & Company, Inc., 1994), 21.

4. Robert W. Kolb, *Too Much Is Not Enough: Incentives in Executive Compensation* (New York: Oxford University Press, 2012), 13.

5. Ibid.

6. Ibid.

one-test.” The “five-to-one-test” is the idea that the best performers are not just a little bit better, but better by a factor of five.<sup>7</sup> If a company *wants* a great CEO, it has to *pay* for a great CEO.

Equally as important to *what* the CEO makes is *how* the CEO makes it, making the structure of the compensation package very important. The board of directors’ compensation committee is usually responsible for designing the CEO’s pay package.<sup>8</sup> The package is structured to provide incentives for the CEO and the rest of the executive team, as they have a significant impact on strategy, decision-making and value creation for the company.<sup>9</sup> Though the CEO and common shareholder alike want to see an increase in the value of the company’s stock, different forms of compensation create different incentives for the CEO and upper level management.

The purpose of this paper is to assess whether or not there should be a limit on CEO compensation in addition to examining the different forms of pay used to compensate the CEO to determine if there is an optimal structure. The paper will begin by looking at how the landscape surrounding executive compensation has changed since 2010 with the passage of the Dodd-Frank Act. Following that, the paper will explore the arguments for and against limiting CEO pay to ultimately conclude if a limit on CEO compensation is appropriate. After this, the paper will look into the structure of current CEO pay packages and evaluate the use of different forms of compensation to determine if an optimal structure for a pay package exists. Finally, the paper will examine the results of a survey taken by 75 accounting, business and financial economics majors at the University of Redlands regarding what and how CEOs feel they should be paid versus what and how shareholders in the same company feel the CEO should be paid.

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7. Phillip Delves Broughton, “The Rare Find: How Companies Can Hire Exceptional Talent,” *Los Angeles Times (Online)*, December 4, 2011.

8. “Basics of Executive Compensation,” *Center on Executive Compensation*, 2016.

9. *Ibid.*

## **Chapter II: Impact of Dodd-Frank on Executive Pay**

On July 21<sup>st</sup>, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act—from here on referred to as the “Dodd-Frank Act.” The Dodd-Frank Act quickly proved to be a comprehensive overhaul of the United States financial regulatory environment. The voluminous document created a plethora of new agencies, bureaus and councils, imposed more stringent regulatory capital requirements, reformed the regulation of credit rating agencies and enacted significant changes in the securities market. More notably to the purposes of this paper, the Dodd-Frank Act also called for the implementation of changes to corporate governance and executive compensation practices. Subtitle E under Title IX of the Dodd-Frank Act addresses “Accountability and Executive Compensation.” Though each title and ensuing subtitles contained within the Dodd-Frank Act are of importance to the financial services sector and the economy as a whole, many do not directly pertain to concerns regarding executive compensation. On the other hand, Subtitle E addresses numerous mandates that play a role in determining how a CEO is compensated.

### ***Compensation Committee and Adviser Independence***

The first of several mandates affecting executive compensation under Subtitle E pertains to updated listing standards for the compensation committee and adviser independence. Section 952 of the Dodd-Frank Act added Section 10C to the Securities Exchange Act of 1934. Under Section 10C, the U.S. Securities and Exchange Commission (SEC) is required to direct the national stock exchanges to prohibit the listing of any company issuing equity securities unless specific criteria are satisfied with regard to “the authority of the compensation committee, the independence of the members of the compensation committee, and the consideration by the compensation committee of specific factors relating to the independence of compensation

advisers.”<sup>10</sup> Subsequently, the SEC adopted Rule 10C-1 implementing provisions of the Dodd-Frank Act that affect “the composition of compensation committees, the use of compensation advisers by companies listed on national securities exchanges, and disclosure provided by companies regarding their use of compensation consultants.”<sup>11</sup>

On January 11, 2013, both the New York Stock Exchange (NYSE) and the NASDAQ had their updated listing standards relating to the compensation committee and adviser independence approved by the SEC.<sup>12</sup> These new listing standards mandated that a compensation committee can only select “compensation consultants, legal counsel, or other advisers after taking into consideration independence standards established by the SEC.”<sup>13</sup> Furthermore, the new listing standards require enhanced disclosure regarding the use of compensation consultants to identify any potential conflicts of interest.<sup>14</sup> The purpose of the updated listing standards is to ensure a director does not receive compensation from another person or entity that would impair his or her independent judgment about the listed company’s executive compensation. The updated listing standards are not so much a check on the executive him or herself, rather, they are meant to add an additional layer of precaution when it comes to preserving the compensation committee’s ability to act independently.

### ***Pay Versus Performance***

The second section under Subtitle E of Title IX concerns enhanced compensation disclosures.

Unlike most other sections of Dodd-Frank, the “Pay Versus Performance Disclosure” was not

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10. David M. Lynn, Lawrence R. Bard and Daniel Kahan, “SEC Approves New Compensation Committee and Adviser Independence Listing Standards,” *Morrison Foerster*, January 18, 2013.

11. Listing Standards for Compensation Committees, Securities Act Release No. 33-9330, Exchange Act Release No. 34-67220, *Securities and Exchange Commission*, June 20, 2012.

12. Exchange Act Release No. 34-68639, Exchange Act Release No. 34-68640, *Securities and Exchange Commission*, January 11, 2013.

13. “The Dodd-Frank Act: A Cheat Sheet,” *Morrison Foerster*, 2010.

14. *Ibid.*

proposed until April 2015 and was not finalized until August 2015. Section 953(a) of the disclosure adds yet another section to the Securities Exchange Act of 1934.<sup>15</sup> This amendment requires disclosure “of the relationship of the compensation actually paid to executives versus the company’s financial performance.”<sup>16</sup> Though it seems relatively simple in nature, the disclosure is actually quite complex when considering changes in the value of stocks and dividends throughout the year must be taken into account. Furthermore, Section 953(b) introduces the pay ratio disclosure. This states that a company is required to disclose the median annual compensation of all employees *excluding* the CEO, the annual compensation of the CEO and the ratio of the median employee total compensation to CEO total compensation.<sup>17</sup> The pay ratio disclosure is geared toward providing “investors with information regarding the compensation of a company’s CEO as compared to the median compensation of that company’s employees.”<sup>18</sup> The pay ratio disclosure will be required for all SEC registrants with limited exceptions beginning with the commencement of a registrant’s first fiscal year on or after January 1, 2017.<sup>19</sup>

### ***Say On Pay***

Effective January 25, 2011, the SEC adopted final rules required under Dodd-Frank concerning shareholder approval of executive compensation. The rule has come to be popularly known as Say on Pay. The SEC’s final rules implemented Section 951 of the Dodd-Frank Act, which

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15. Joseph E. Bachelder III, “Executive Compensation Under Dodd-Frank: an Update,” *New York Law Journal*, March 21, 2014.

16. OpCit., “The Dodd-Frank Act: A Cheat Sheet,” *Morrison Foerster*, 2010.

17. OpCit. Joseph E. Bachelder III, “Executive Compensation Under Dodd-Frank: an Update,” *New York Law Journal*, March 21, 2014.

15. M. John Burgess, Jake R. Downing, Michael T. Dunn, Jennifer Neilsson and Kelly R. Rourke, “Dodd-Frank and Executive Compensation—Where Are We Now?” *Seyfarth Shaw*, August 28, 2015.

19. Ibid.



added section 14A to the Securities Exchange Act of 1934. This statute, which is required by all public companies subject to federal proxy rules, provides shareholders with an advisory vote on executive compensation. More specifically, the SEC stipulated that these Say on Pay votes “are required at least once every three years beginning with the first annual shareholders' meeting taking place on or after January 21, 2011.”<sup>20</sup> Furthermore, the rule requires companies to disclose the results of the Say on Pay vote in the annual meeting proxy statements in addition to further disclosure in the Compensation Discussion and Analysis section regarding “whether, and if so how, companies have considered the results of the most recent say-on-pay vote.”<sup>21</sup>

In addition to the shareholder approval of executive compensation, the shareholders are also granted the right to approve the frequency of the Say on Pay votes. Companies are required to allow the shareholders to vote on how often they want the Say on Pay vote to happen: every year, every other year or every three years.<sup>22</sup> This vote is required to take place at least once every six years and must also be disclosed in the annual meeting proxy statements.<sup>23</sup> Like the Say on Pay vote, this frequency vote is non-binding.

### ***Pros for Say On Pay***

Advocates argue that Say on Pay votes have helped curb excessive CEO compensation. In 2012, 84% of Target shareholders supported then-CEO Gregg Steinhafel’s pay package.<sup>24</sup> Even though the company received well above the majority, the compensation committee reacted by eliminating a discretionary cash bonus worth \$1.25 million.<sup>25</sup> The following year, Target

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20. “SEC Adopts Rules for Say-on-Pay and Golden Parachute Compensation as Required Under Dodd-Frank Act,” *U.S. Securities and Exchange Commission*, January 25, 2011.

21. *Ibid.*

22. *Ibid.*

23. *Ibid.*

24. Paul Hodgson, “Target Misses The Target For Executive Pay,” *Forbes*, June 18, 2013.

25. *Ibid.*

suffered a massive hack of its customer accounts before the onset of the holiday retail season in addition to trouble with expansion efforts in Canada. Target shareholders voiced their discontent in 2013 as the company narrowly obtained a majority with only 52.1% of shareholders voting to approve compensation at the company.<sup>26</sup> Once again, the compensation committee acted. Following Steinhafel's resignation, Target's proxy statement reported, "a 41 percent decrease from \$9.5 million to \$6.6 million in CEO total direct compensation."<sup>27</sup>

Other advocates such as governance expert, Paul Hodgson argue that Say on Pay has completely changed the way the board approaches executive compensation. A study conducted via the joint efforts of the *Wall Street Journal* and Philadelphia-based management consulting firm, Hay Group, revealed that across the board, CEO perks have been cut. These perks include: club memberships, supplemental life and disability insurance, "tax gross-ups"—where a company pays a CEO's tax bill—and personal travel on the corporate jet. Hodgson asserts the reason for such action is simple: "knowing that shareholders are going to vote on a CEO's pay package every year is forcing boards to improve matters."<sup>28</sup> Supplementing the position of advocates, the U.S. leader of the board of solutions for Hay Group, Irv Becker, claims "seven or eight years ago they [compensation committees] weren't as focused on the reaction of their shareholders. Now when we work with clients to implement changes to pay, one of the most important questions is: How will that look in the proxy?"<sup>29</sup>

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26. Paul Hodgson, "Target Misses The Target For Executive Pay," *Forbes*, June 18, 2013.

27. Meghan Drake, "Shareholders Rise Up in Annual Meetings to Oppose Mega-Salaries for CEOs," *The Washington Times (Online)*, May 27, 2014.

28. Paul Hodgson, "Surprise Surprise: Say on Pay Appears to be Working," *Fortune*, July 8, 2015.

29. Ibid.

### *Cons of Say on Pay*

Critics of Say on Pay counter with a valid point: *the Say on Pay votes are nonbinding*. Even in a case where a company may have failed its Say on Pay vote, it is not legally obligated to take any action. However, it may choose to do so for a variety of reasons.

A corporate governance study conducted at Stanford University revealed what it evaluated to be ten myths about Say on Pay. The most compelling of the ten is myth number three: that Say on Pay reduces executive compensation. The study highlights that prior to its passage, advocates thought shareholders would take advantage of the right to vote with Say on Pay and express their widespread dissatisfaction, forcing the board of directors to cut executive compensation. However, as the results of the study found, the dissatisfaction was anything but widespread. Of approximately 2,700 public companies that put their compensation plans up to a shareholder vote in 2011, only 41—roughly 1.5%—failed to receive majority approval.<sup>30</sup> However, just because a company received majority approval does not automatically mean there is no cause for concern. The board and management may pay very close attention to a 30% “no” vote depending on the shareholders reasoning for casting that vote.

On the whole, support levels for Say on Pay across all companies averaged about 90.1% in 2011.<sup>31</sup> Even though this study is a few years old, the aforementioned study conducted by the *Wall Street Journal* and Hay Group confirms that the trend has held true. According to the Hay Group’s study, in 2014, only a handful of Fortune 500 companies failed their Say on Pay votes

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30. David Larcker, Allan McCall, Gaizka Ormazabal and Brian Tayan, “Ten Myths of Say on Pay,” *Stanford Closer Look Series*, June 28, 2012.

31. “Say on Pay 2011: A Season in Review,” *Glass, Lewis & Co.*, In: David Larcker, Allan McCall, Gaizka Ormazabal and Brian Tayan, “Ten Myths of Say on Pay,” *Stanford Closer Look Series*, June 28, 2012.

and average approval still totaled 90%.<sup>32</sup> In certain cases such as at Target, Say on Pay has achieved palpable results in curbing executive compensation. However, critics use the 90% company approval data to claim that instances as such are anomalies and not the norm.

Whether or not Say on Pay has been completely effective depends on the views of the individual. Even though a company may be passing its Say on Pay votes with flying colors in the current fiscal year, to an extent, that 90% approval rating comes at a cost. That cost includes heightened awareness of how shareholders may perceive a CEO's compensation and pay structure. Say on Pay has added an entirely new dimension to executive compensation.

### ***Clawbacks***

Expansions on clawback provisions under the Dodd-Frank Act also have an effect on executive compensation. Following the Enron and WorldCom scandals, the Sarbanes-Oxley Act (SOX) was passed in 2002. Under Section 304 of SOX, the first clawback provision was introduced. The provision allowed for the recoupment of incentive or equity-based compensation from the CFO and CEO if an accounting restatement became necessary because of material noncompliance due to misconduct under federal securities laws.<sup>33</sup> However, the SOX clawback provision had a number of limitations.

To begin with, it only called for the recoupment of pay from the CEO and CFO, making no mention of other senior officers such as the controller, COO or CIO. Furthermore, the term "misconduct" was never defined, making it very unclear as to exactly what defined "misconduct" and warranted the recoupment of incentive-based pay. Lastly, Section 304 is only enforceable

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32. OpCit., Paul Hodgson, "Surprise Surprise: Say on Pay Appears to be Working," *Fortune*, July 8, 2015.

33. Gibson, Dunn & Crutcher's Securities Regulation and Corporate Governance Practice Group, "Clawbacks of Executive Compensation," *Gibson & Dunn Publications*, July 9, 2008.

by the SEC and does not provide shareholders standing against the CEO or CFO. However, despite the limitations, the clawback provisions have still proved effective in several instances.

For example, in 2014, an SEC investigation found that the former vice presidents at Saba Software Inc. were the masterminds behind a scheme that included the falsifying of time sheets to hit quarterly revenue and margin targets. The SEC required the CEO, Bobby Yazdani to pay back \$2.5 million in stock options and bonuses he received because of the fraud.<sup>34</sup> Although Yazdani was never charged with misconduct, the Director of the SEC's Division of Enforcement, Andrew J. Ceresney, asserted "CEOs and CFOs can be deprived of bonuses and stock profits if there is misconduct on their watch that requires a restatement by their employer," adding "we will not hesitate to pursue clawbacks in appropriate cases."<sup>35</sup>

In 2010, Section 954 of the Dodd-Frank Act added Section 10D to the Securities and Exchange Act of 1934, building upon clawback provisions already outlined under SOX. On July 1, 2015, by a 3-2 vote, the SEC proposed implementing Section 954, Rule 10D-1. The proposed rule directs the stock exchanges to adopt listing standards that require all listed issuers to adopt and comply with a written clawback policy to recover any excess incentive-based compensation erroneously paid to any current or former executive officer because of material noncompliance resulting in a financial restatement.<sup>36</sup> Section 10D also calls for disclosure of the policy the company listed on the exchange uses to determine incentive-based compensation.<sup>37</sup>

The SEC's proposed rule goes beyond the requirements mandated by Dodd-Frank, however. Most notably, the issuer is required to collect *all* incentive-based compensation from

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34. "SEC Charges Software Company in Silicon Valley and Two Former Executives Behind Fraudulent Accounting Scheme," *U.S. Securities and Exchange Commission*, September 24, 2014.

35. *Ibid.*

36. "SEC Proposes Dodd-Frank Clawback Rule," *Davis Polk*, July 8, 2015.

37. *Ibid.*

*all* executive officers as defined under Section 16 *on a no-fault basis*.<sup>38</sup> Section 16's list of executive officers include: the principal accounting officer, any vice-president in charge of a principal business unit or any other person who performs policy-making functions for the company.<sup>39</sup> Furthermore, each listed company must file its written clawback policy in its annual report and in the event of a restatement, disclose how much incentive-based pay was subject to recovery.<sup>40</sup> Though according to a study conducted by PricewaterhouseCoopers, about 90% of Fortune 100 companies have clawback policies in place, Rule 10D-1 is determined to ensure no executive keeps a bonus attained by ill-gotten means.<sup>41</sup>

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38. "SEC Proposes Dodd-Frank Clawback Rule," *Davis Polk*, July 8, 2015.

39. "SEC Proposes Rules Requiring Companies to Adopt Clawback Policies on Executive Compensation," *U.S. Securities and Exchange Commission*, July 1, 2015.

40. *Ibid.*

41. Andrew Ackerman, "SEC Proposes Broadened Corporate 'Clawback' Rules," *The Wall Street Journal (Online)*, July 1, 2015.

### **Chapter III: The Impact of Limits on CEO Compensation**

According to a 2015 study conducted by The Rock Center for Corporate Governance at Stanford University, “nearly two-thirds (62 percent) of Americans believe that there is a maximum amount CEOs should be paid relative to the average worker, regardless of the company and its performance.”<sup>42</sup> Those Americans that want to see a cap on CEO pay want to limit it to no more than 17.6 times the salary of the average worker.<sup>43</sup> These results are based on a survey of 1,200 individuals representative of age, race, gender, political party affiliation and income level.

The thinking of these individuals aligns with the thinking of Peter Drucker. Drucker was a renowned management consultant who advocated for a very strict CEO pay limit. In his 1984 essay, Drucker pronounced, “CEOs should not earn more than 20 times the average salary in a company.”<sup>44</sup> In contrast to Drucker, Edwin Locke—the former Dean’s professor of Leadership and Business at the University of Maryland—believes there should *not* be a limit on CEO pay. According to Locke, “there is no set level of pay that is ‘fair’ or that would make a CEO ‘overpaid.’”<sup>45</sup>

Both Drucker and Locke have sound reasoning for their assertions, which brings up the driving question: *should there be a limit on CEO compensation?*

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42. David Larcker, Nicholas Donatiello and Brian Tayan, “Americans and CEO Pay: 2016 Public Perception Survey on CEO Compensation,” *Stanford Graduate School of Business*, November 2015.

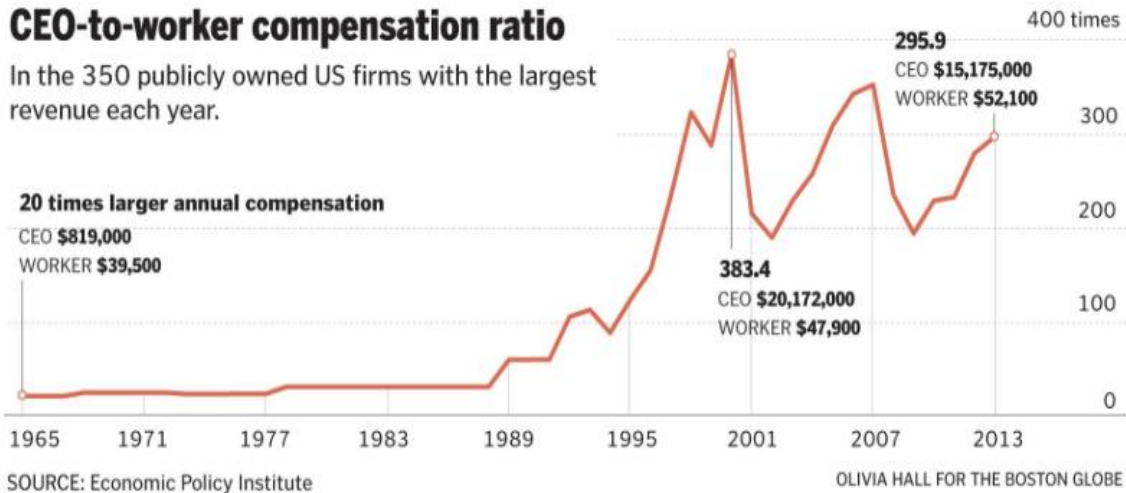
43. Ibid.

44. Karen Dillon, “The Coming Battle Over Executive Pay,” *Harvard Business Review*, September 2009.

45. Ibid.

## Arguments for Limiting CEO Pay

The following excerpt from the Boston Globe gives a visual representation of how CEO compensation has grown relative to average worker pay since 1960.<sup>46</sup>



With income inequality gaining traction as a major political issue, the widening gap between CEO compensation and worker pay has become the focal point for the argument that there should be a limit on CEO pay. According to numerous economists, a widening gap hurts the economy. Many economists argue, “when wealth is concentrated instead of broadly distributed, it curtails the spending of middle- and lower-income consumers who ultimately drive the US economy.”<sup>47</sup>

Drucker believed such a large gap between what the CEO makes and what the average worker makes can be detrimental to company morale. Drucker first suggested in the late 1970s that, “a lopsided pay balance would erode the teamwork and trust on which businesses

46. Katie Johnston, “Efforts to Regulate CEO Pay Gain Traction,” *The Boston Globe (Online)*, October 26, 2014.

47. Ibid.



depend.”<sup>48</sup> A few years later, Drucker suggested the 20 to 1 ratio was the limit for managers who did not want “resentment and falling morale to hit their companies.”<sup>49</sup> Furthermore, the findings of research conducted by Harvard Business School professor, Michael Norton, revealed, “when people know they are making considerably less than others, productivity drops.”<sup>50</sup>

### *Arguments Against Limiting CEO Pay*

In 2013, Switzerland put a proposal on the ballot that would have limited CEO pay to 12 times what the *lowest-paid* worker in the company made. Swiss voters denounced the measure with just over 65 percent voting against the proposed pay cap.<sup>51</sup> According to an annual ranking published by the IMD’s World Competitiveness Center, “Switzerland is the world’s second-most competitive country behind the U.S.”<sup>52</sup> Swiss Economy Minister, Johann Schneider-Ammann called the pay curbs “absurd” and announced at a news conference in Bern the day after the vote that the voters’ decision kept Switzerland an attractive business location.<sup>53</sup> Swiss CEOs Severin Schwan and Ulrich Spiesshofer said the measure “would crimp competitiveness and damage the economy.”<sup>54</sup> The same thing could happen in America if a limit on CEO pay were to be imposed.

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48. Drew Harwell and Jena McGregor, “This New Rule Could Reveal the Huge Gap Between CEO Pay and Worker Pay,” *The Washington Post (Online)*, August 4, 2015.

49. Ibid.

50. OpCit., Katie Johnston, “Efforts to Regulate CEO Pay Gain Traction,” *The Boston Globe (Online)*, October 26, 2014.

51. Catherine Bosley, “Swiss Voters Reject Strict CEO Pay Limits in Referendum,” *Bloomberg Business*, November 25, 2013.

52. Ibid.

53. Ibid.

54. Ibid.

Tim Worstall—a Senior Fellow at the Adam Smith Institute—acknowledges, “the value of a good CEO is extraordinarily high.”<sup>55</sup> However, as Kolb stated earlier, an excellent CEO is rare.<sup>56</sup> In his article in *The Economist*, Cornell economics professor, Robert Frank states that for CEOs, much like the rest of us, “relative salaries guide job choices.”<sup>57</sup> Frank then warns what could happen if there were to be a limit on CEO pay. According to Frank, “if salaries were capped at, say, \$2 million annually, the most talented candidates would have less reason to seek the positions that make best use of their talents.”<sup>58</sup> Keep in mind that if adhering to Drucker’s 20 to 1 limit, \$2 million annually for a CEO would be on the *high* side. Furthermore, if CEO pay was capped and salaries for other jobs were not, according to Frank, many CEOs would have more of an incentive to be hedge fund managers or lawyers.<sup>59</sup> Numerous compensation research experts have warned that firms stand to lose their most talented managers to foreign banks or hedge funds if a pay cap were to be introduced in the United States.<sup>60</sup> Thankfully, as of now, no CEOs in the United States have threatened to leave their companies over rumblings of a proposed pay cap.

A more severe potential result of a limit on CEO pay is a company leaving the country entirely. Before the 12 to 1 pay cap in Switzerland was ultimately denounced, many Swiss companies threatened to leave the country if the measure went through.<sup>61</sup> Had that happened,

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55. Tim Worstall, “In Defence of the One Percent, CEOs Aren’t Overpaid,” *Forbes*, June 16, 2013.

56. OpCit., Robert W. Kolb, *Too Much Is Not Enough: Incentives in Executive Compensation* (New York: Oxford University Press, 2012), 13.

57. Robert Frank, “Should Executive Pay Be Capped?” *The Economist*, January 3, 2009.

58. Ibid.

59. Ibid.

60. Ilya Leybovich, “Are Executive Pay Caps the Solution?” *Thomas Net*, February 18, 2009.

61. Neal Asbury, “The Assault on CEO Compensation,” *NewsMax Finance*, November 21, 2013.

Switzerland would have lost the prestige of being the headquarters to some of the world's most iconic brands in addition to losing thousands of high-paying jobs.<sup>62</sup>

Another problem with limiting CEO pay is that the limit on pay would affect different industries disproportionately. This is especially true considering that Drucker and many Americans surveyed in the Stanford poll want to see a potential limit as a proportion to what an average worker in the company makes. Financial author, Paddy Hirsch, explains the adverse impact this would have on CEOs from traditionally lower-paying industries: “the lowest paid worker - or even the average worker - in a software company or law firm is almost certainly going to earn more than the worker on the bottom run at a hotel company. Which means hotel company executives are liable to be rewarded a lot less for their work, even if their businesses employ many more workers (and are that much more valuable to society) than the law firm.”<sup>63</sup> With that in mind, many CEOs would be lured toward tech companies or financial services firms knowing they can make much more there. *But, who does that leave to run companies like McDonalds or Wal-Mart that are still vital to the American economy?*

A company's greatest asset is its human capital and at the pinnacle of that human capital pyramid sits the CEO. To remain competitive in a rapidly changing global business world, CEOs have to be able to work under an intense amount of pressure. In another article he wrote for the *New York Times*, Frank highlighted the importance of a CEO that is able to consistently make good decisions for the company. Frank stressed, “in large companies, even small differences in managerial talent can make an enormous difference. Consider a company with \$10 billion in annual earnings that has narrowed its C.E.O. search to two finalists. If one would make just a handful of better decisions each year than the other, the company's annual earnings might

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62. Neal Asbury, “The Assault on CEO Compensation,” *NewsMax Finance*, November 21, 2013.

63. Paddy Hirsch, “Why Can't We Cap CEO Pay?” *Marketplace*, January 15, 2014.

easily be 3 percent — or \$30 million — higher under the better candidate’s leadership.<sup>64</sup> Given the competitiveness of the global business environment, that three percent could make a huge difference.

In fairness, the CEO is not the only employee at the company. The company depends on its workforce to be effective and efficient, and if it cannot meet those demands, the company’s performance will suffer. When company morale is low, workers are not likely to be motivated, which can substantially hinder efficiency. However, no matter how effective and efficient a company’s workforce may be, poor management at the top of an organization can hurt a company gravely. As William Bowen puts it, “*a sick elephant can kill a healthy dog if it falls on it.*”<sup>65</sup>

While there are CEOs making a lot of money on an annual basis, it appears that many Americans are caught up solely in *what* the CEO is making. That is, the total dollar amount the proxy statement reports. The bigger picture is not so much *what* CEOs are making, but rather, *how* they are making it. The next section will explore this more in depth.

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64. Robert Frank, “Should Congress Put a Cap on Executive Pay?” *The New York Times (Online)*, January 3, 2009.

65. OpCit., William G. Bowen, *The Board Book: An Insider’s Guide for Directors and Trustees* (New York: W.W. Norton & Company, Inc., 1994), 78.

## **Chapter IV: The Components Used in Executive Compensation**

Before looking into the structure of the pay package, it is important to have an understanding of how a CEO's total compensation is calculated for a given fiscal year. According to Equilar and *The New York Times*, total compensation is calculated as the sum of base salary, discretionary and performance-based cash bonuses, the grant-date value of stock and option awards and any other forms of compensation such as benefits and prerequisites.<sup>66</sup> The CEO's base salary, bonus payout and other compensation values are taken directly from the Summary Compensation table on the proxy statement.<sup>67</sup> This is referred to as the executive's cash compensation.

For a company with a December 31 fiscal year end, stock and option award values are also taken as disclosed in the Summary Compensation table.<sup>68</sup> Grant-date values represent, "the estimated value of new stock and option awards."<sup>69</sup> Total pay, which is reported in the proxy statement, measures the *hypothetical* value of stock awards and options in the year they are awarded, as opposed to the actual value when the equities are exercised.<sup>70</sup> When the equities are exercised, it is referred to as realized pay.<sup>71</sup>

Accounting Standards Codification 718, implemented in 2009, requires companies to report the fair value of all equity-based compensation, which becomes an expense affecting the

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66. "Calculating Pay Figures," *The New York Times (Online)*, April 3, 2010.

67. *Ibid.*

68. *Ibid.*

69. *Ibid.*

70. George Erb, "Starbucks' CEO Howard Schultz Tops Realized Pay List," *The Seattle Times (Online)*, June 21, 2014.

71. *Ibid.*

income statement.<sup>72</sup> Either the Black Scholes or Binomial pricing models are used by the majority of publicly traded corporations to report the fair value of equity compensation.<sup>73</sup>

### ***The Current Structure of the Pay Package***

The vast majority of CEO compensation packages are made up of five basic components: salary, annual bonuses, contributions from pension plans, stock options and stock grants.<sup>74</sup> Historically, CEOs made the majority of their compensation from salary and annual bonuses, with compensation from options representing only about 20% of total compensation in 1992.<sup>75</sup> However, that figure began to grow in the 1990s and today, option compensation accounts for over half of CEO compensation.<sup>76</sup>

### ***Base Salary***

The CEO's base salary is awarded for his or her role in the day-to-day running of the organization.<sup>77</sup> While base salaries vary from company to company, the implementation of Section 162(m) of the Internal Revenue Code attempted to incentivize companies to set the base salary at or below \$1 million.<sup>78</sup> According to the code, the corporation is only allowed to deduct \$1 million per year for the salary of the CEO and the three highest compensated officers, excluding the CFO.<sup>79</sup> The primary goal of Section 162(m) was to reduce excessive, non-

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72. Malak Kazan, "Executive Compensation: Reporting Equity Values," *Economic Research Institute*, April 25, 2011.

73 Ibid.

74. Carola Frydman and Dirk Jenter, "CEO Compensation," *Massachusetts Institute of Technology*, December 2010.

75. Ibid.

76. Ibid.

77. "Why Do CEOs Make the Big Bucks?" *Salary.com*, 2016.

78. Steven Balsam, "Taxes and Executive Compensation," *Economic Policy Institute*, August 14, 2012.

79. "Section 162(m): Limit on Compensation," *Practical Law Company*, 2011.

performance based compensation.<sup>80</sup> However, many tax-sophisticated corporations have seemed not to care, as, “the number of executives receiving salary exceeding the maximum deductible threshold of \$1 million actually increased from 563 in 2007 to 594 in 2010.”<sup>81</sup> Setting the maximum deductibility at \$1 million also created an unforeseen impact on the shareholders. With companies still paying above the \$1 million threshold, they are prohibited from deducting that amount on their tax return. Consequently, this has resulted in decreased company profits and diminished returns to shareholders.<sup>82</sup>

### ***Cash Bonus***

A cash bonus is one type of incentive-based pay. The concept is simple: if the CEO attains or surpasses certain benchmarks, he or she is granted a predetermined amount of money. The compensation committee can use a variety of different financial metrics as the basis for achieving bonuses. According to a 2014 study by Equilar, many companies use multiple financial metrics to determine the CEO’s bonus.<sup>83</sup> Revenue is the most commonly used financial metric, followed by EPS and operating income, respectively.<sup>84</sup>

Bruce Booth—a partner at Atlas Venture, which funds early stage biotech startups—articulates that the compensation committee and the CEO should work closely together to determine what the corporate objectives for the year are, and how they plan to measure up against them.<sup>85</sup> Booth argues that benchmarking for bonuses should adhere to several concepts,

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80. OpCit., Steven Balsam, “Taxes and Executive Compensation,” *Economic Policy Institute*, August 14, 2012.

81. Ibid.

82. Ibid.

83. “Performance Metrics in Annual Incentive Plans,” *Equilar*, February 24, 2014.

84. Ibid.

85. Bruce Booth, “Deck the Halls With...Compensation Committees,” *Forbes*, December 10, 2014.

the first being that corporate goals should be aligned to creating shareholder value.<sup>86</sup> Furthermore, with regard to those corporate goals, they should be set in a way that they are measurable with little room for argument.<sup>87</sup> The goals should be concrete and include numbers, key milestones or specific deliverables.<sup>88</sup> Booth highlights that some goals are within a 95% confidence interval of the company's expectations, making them more or less expected.<sup>89</sup> Instead, Booth argues the confidence interval should hover around 75% to make the goal a "stretch."

Another benchmark used as the basis for determining a bonus is total shareholder return. However, the Senior Manager of Governance and Proxy at Capital Research and Management Group, Chad Norton, says that total shareholder return is a very fickle measure of CEO performance.<sup>90</sup> Norton claims that market forces that are largely out of the CEO's control can significantly influence the stock price, and hence, total shareholder return, either rewarding or penalizing the CEO for rising or falling market tides.<sup>91</sup> Instead, Norton recommends that bonuses be tied to more performance-based metrics.<sup>92</sup>

### *Pensions*

Many CEOs also have forms of deferred compensation in their pay packages. The most ubiquitous form of deferred compensation is a deferred pension plan, which for CEOs, are referred to as supplemental executive retirement plans (SERPs) due to the fact that their payouts

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86. Bruce Booth, "Deck the Halls With...Compensation Committees," *Forbes*, December 10, 2014.

87. *Ibid.*

88. *Ibid.*

89. *Ibid.*

90. Chad Norton, phone conversation with Senior Manager of Governance and Proxy, February 12, 2016.

91. *Ibid.*

92. *Ibid.*



greatly exceed the maximum federally insured amounts available to ordinary workers under a pension plan.<sup>93</sup> However, a study conducted by Wei Cen of the Peking University HSBC business school revealed deferred pension plans only represent “about 5.5% of overall CEO compensation.”<sup>94</sup>

### ***Stock Options***

A stock option is a contract between two parties, in this case, the company and the CEO. In such a contract, the stock option holder—the CEO—is given the right to buy an agreed upon number of shares of the company’s stock at a predetermined price within a fixed amount of time.<sup>95</sup> This predetermined price is often referred to as the strike price and represents the price the CEO can exercise the options at.<sup>96</sup> Typically, the strike price is equal to the stock price on the day of the grant.<sup>97</sup> Options typically have a ten-year life and usually vest over four years.<sup>98</sup> The use of options in executive compensation packages has risen considerably in the past 30 years. From 1982 to the year 2000, equity compensation including options grew from negligible to up to 75% of CEO compensation.<sup>99</sup> A 2014 study conducted by the Hay Group found that 54 percent of compensation for CEOs came in the form of stock options.<sup>100</sup>

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93. Rangarajan Sundaram and David Yermack, "Pay Me Later: Inside Debt and Its Role in Managerial Compensation," *The Journal of Finance* 62, no. 4 (2007): 1560.

94. Wei Cen, “The Determinants of CEO Inside Debt and Its Components,” *Cornell University School of Applied Economics and Management*, November 10, 2010, 5.

95. “Stock Option Basics,” *The Options Guide: Options & Futures Trading Explained*, 2009.

96. “Strike Price,” *The Options Guide: Options & Futures Trading Explained*, 2009.

97. Shalini Mahajan, “Role of Out-of-Money Options in Executive Compensation,” *New York University Stern School of Business*, April 1, 2002.

98. OpCit., Chad Norton, phone conversation with Senior Manager of Governance and Proxy, February 12, 2016.

99. Richard A. Booth, “Why Stock Options Are the Best Form of Executive Compensation (And How To Make Them Even Better),” *NYU Journal of Law & Business* 6, no. 281 (Fall, 2010): 280-291.

100. Tim Mullaney, “Why Corporate CEO Pay is So High, and Going Higher,” *CNBC*, May 18, 2015.

### ***Restricted Stock Units (RSUs)***

A restricted stock unit is “a grant of company stock in which the recipient’s rights in the stock are restricted until the shares vest.”<sup>101</sup> This restricted period is referred to as the vesting period. Once the vesting requirements are met, the employee owns the stock outright.<sup>102</sup> The outright ownership is the key differentiator between a share of restricted stock and a stock option. Unlike a stock option, restricted stock units have inherent value.<sup>103</sup>

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101. “About Restricted Stock Awards,” *Fidelity*, 2012.

102. *Ibid.*

103. OpCit., “About Restricted Stock Awards,” *Fidelity*, 2012.

## Chapter V: Exploring an Optimal Structure

### *Value of Stock Options to the CEO*

In their working paper for the National Bureau of Economic Research, executive compensation experts Brian Hall and Kevin Murphy highlight that CEO compensation has skyrocketed, largely thanks to stock options since the 1980s.<sup>104</sup> The upside potential of stock options for CEOs is *huge*, chiefly because CEOs receive so many options as compared to shares of restricted stock. The number of stock options granted could be 250% more than shares of restricted stock that would have been granted.<sup>105</sup>

Additionally, the risk with stock options is minimal; a CEO has the *right* to exercise the options, but not the *obligation*. If the stock price falls below the strike price, the options are said to be “underwater” or “out of the money.”<sup>106</sup> This is the primary drawback of stock options from the CEO’s point of view. If the options expire while they are “underwater,” they are worthless. However, since they were given to the CEO, not purchased, he or she loses nothing. According to Associate Professor of Strategy and Entrepreneurship at the London Business School, Freek Vermeulen, the CEO can gain—potentially massively—on the upside but cannot lose anything on the downside creating a disproportionate risk between the CEO and the shareholders.<sup>107</sup>

Bloomberg conducted a study in 2013 looking at the pay packages of fifteen of the highest paid US CEOs. Included in the study was Richard Bracken, the CEO of the nation’s

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104. Brian Hall and Kevin Murphy, “The Trouble With Stock Options,” *NBER Working Paper No. 9784*, June 2003.

105. John Olagues, “Know Your Options: Grants of Employee Stock Options vs. Grants of Restricted Stock,” *Silicon Bayou News*, March 8, 2012.

106. Phred Dvorak, “Firms Jump to Salvage ‘Underwater’ Stock Options,” *Wall Street Journal (Online)*, December 22, 2008.

107. Freek Vermeulen, “CEOs and Their Stock Options...(oh please...)” *London Business School*, 2014.

largest for-profit hospital chain, HCA Holdings. Bracken saw \$21.4 million of his total compensation of \$46.4 million come from stock options that had vested during the year.<sup>108</sup>

### ***Potential Downside of Using Stock Options From the Shareholders' Point of View***

One downside to using options is the potential for backdating. This issue first came to light in March of 2006. When an executive is granted options, more often than not, they are “at-the-money,” meaning the strike price is equal to fair market value.<sup>109</sup> Since the profit per option is the difference between the fair market value at some date in the future and the strike price, the value of an option depends critically on the strike price.<sup>110</sup> Backdating an option is the practice of reporting a grant date that is not the actual date of the grant, rather, it is, “an earlier date that, with the benefit of hindsight, is chosen because the stock price on that false, hindsight-chosen date is lower.”<sup>111</sup> Therefore, because the false strike price is lower, the executive can make more off the options. Infamously, one of the former chief executives at UnitedHealth Group paid a \$468 million civil penalty and restitution to the company for mispriced options.<sup>112</sup>

A CEO that holds stock options in his or her package has much more to gain off a rise in the stock price than the average investor. With that, there is a concern that stock options put too much of an emphasis on short-term performance as opposed to long-term performance. In a study of over 2,000 companies conducted by Equilar, researchers discovered that in the year prior to the vesting date for large option grants, CEOs spent much less on long-term investments like research and development (R&D), advertising and capital expenditures suggesting, “the

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108. Freek Vermeulen, “CEOs and Their Stock Options...(oh please...)” *London Business School*, 2014.

109. Jesse M. Fried, “Option Backdating and Its Implications,” *Harvard Law School*, 2008, 859.

110. *Ibid.*

111. *Ibid.*, 860.

112. “Former UnitedHealth Group CEO/Chairman Settles Stock Options Backdating Case for \$468 Million,” *U.S. Securities and Exchange Commission*, 2007.

pending dates were prompting CEOs to pump up short-term results while sacrificing long-term spending — moves that could, in theory, boost the share price and ultimately put their own interest above the company's.”<sup>113</sup>

Regardless of whether a company chooses to use restricted stock units or stock options, another downside is the potential impact of equity dilution on long-term shareholders. When deciding whether to vote “yes” or “no” on the fairness of a CEO’s compensation package, Chad Norton highlights that Capital Group adheres to two strict principles. The first is to look at the magnitude of total compensation on the company, that is, how much of the bottom-line the CEO is making.<sup>114</sup> Secondly, Norton examines the impact of equity dilution on long-term shareholders.<sup>115</sup>

Norton said that if one percent of the outstanding shares are being issued to the CEO yearly, that is income taken right out of their [the long-term shareholders] pocket and transferred into the pocket of the CEO.<sup>116</sup> If the company is growing and generating enough revenue, Norton claims he is okay with issuing the CEO more equity.<sup>117</sup> However, for a mature company that cannot justify this, Norton will normally cast a “no” vote if he sees that upper level management holds between 1% and 2% of outstanding shares, or more.<sup>118</sup> In fact, in 2015,

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113. Jena McGregor, “How Stock Options Lead CEOs to Put Their Own Interests First,” *Washington Post (Online)*, February 11, 2014.

114. OpCit., Chad Norton, phone conversation with Senior Manager of Governance and Proxy, February 12, 2016.

115. Ibid.

116. Ibid.

117. Ibid.

118. Ibid.

Capital Group voted “no” on approximately 40 percent of its Say on Pay votes, well above the “no” vote rate of their industry peers.<sup>119</sup>

In 2014, Coca-Cola was met with resistance from several of its institutional shareholders with regard to the company diluting the positions of its long-term shareholders. According to Coca-Cola’s proxy statement, the company planned to set aside 500 million shares for executive compensation.<sup>120</sup> In fairness, some equity plans are either forfeited or cancelled meaning not all 500 million shares would be distributed, however, the vast majority conceivably would have been. David Winters, the founder and CEO of Wintergreen Advisers, was particularly vocal in his criticism of Coca-Cola. Winters alleged: “at the current share price, these shares would be worth approximately \$13 billion. In effect, the board is asking shareholders for approval to transfer approximately \$13 billion from all of our pockets to the company's management over the next four years.”<sup>121</sup> State Street, Fidelity and Norton’s Capital Group also voted against the plan.<sup>122</sup> Bowing to pressure, Coca-Cola’s compensation committee amended its equity compensation plan to an annual “burn rate” of no more than 0.8% in 2015.<sup>123</sup> The “burn rate” is the number of shares granted as a percentage of outstanding shares.

### ***Is There An Optimal Structure?***

University of Maryland Marbury Research Professor of Law, Richard A. Booth argues, “although options are not perfect, they are the best incentive for the CEO to maximize return and

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119. OpCit., Chad Norton, phone conversation with Senior Manager of Governance and Proxy, February 12, 2016.

120. Tim McAleenan Jr., “How Much Does Coca-Cola’s Compensation Dilute Shareholders?” *Seeking Alpha*, March 25, 2014.

121. Ibid.

122. Ibid.

123. Devika Krishna Kumar and Anjai Athavaley, “Coca-Cola, Bowing to Pressure, Amends Employee Equity Plan,” *Reuters*, October 1, 2014.

thus stockholder value.”<sup>124</sup> However, on the other hand, Chad Norton feels that performance-based restricted shares are the best form of equity to use.<sup>125</sup> Performance-based restricted shares are restricted stock units awarded to the CEO for achieving certain financial benchmarks, much like a cash bonus. Though Norton says that options still have place in CEO compensation, he argues that they should make up a very small percentage of the total pay package.<sup>126</sup> Both men in addition to the numerous experts referenced in this paper make valid points regarding what the best way to compensate the CEO is, but in the end, options and grants both still should have a place in executive compensation.

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124. Richard A. Booth, “Why Stock Options Are the Best Form of Executive Compensation (And How To Make Them Even Better),” *NYU Journal of Law & Business* 6, no. 281 (Fall, 2010): 280-291.

125. *Ibid.*

126. OpCit., Chad Norton, phone conversation with Senior Manager of Governance and Proxy, February 12, 2016.

## **Chapter VI: Original Research**

### ***Goals of the Original Research***

With the ultimate goal of the compensation package being to align the interests of the CEO with those of the shareholders, the original research first sought to gain an understanding of how CEOs evaluate their performance in a given year versus how shareholders evaluate the CEO's performance in that same year. Secondly, when it comes to the question of whether there should be a limit on compensation, the original research sought to understand whether there was a significant difference in the opinions of CEOs versus shareholders in the same company. Finally, when dealing with the structure of the pay package, the original research sought to gain an understanding of whether there was a significant difference between how CEOs thought they should be paid versus how the shareholders thought they should be paid.

### ***Explanation of the Design of the Original Research***

To accomplish the stated goals, two separate surveys were generated; one was distributed to a CEO group and the other to a shareholder group. These "CEOs" and "shareholders" were actually undergraduate accounting, business and financial economics majors at the University of Redlands in Redlands, California. In total, 75 surveys were distributed, 38 to the CEO group and 37 to the shareholder group. Both surveys followed the 2015 performance of the hypothetical company, ABC Corporation, and its CEO, John Smith. ABC Corporation was said to be an automobile manufacturing company based in St. Louis, Missouri. Copies of these surveys are included in the appendix to the paper on pages 45 and 46 for reference. Both surveys asked the CEO group and the shareholder group the same five questions:

- 1) Was the company well managed in 2015?
- 2) Were you satisfied with the stock return in 2015?

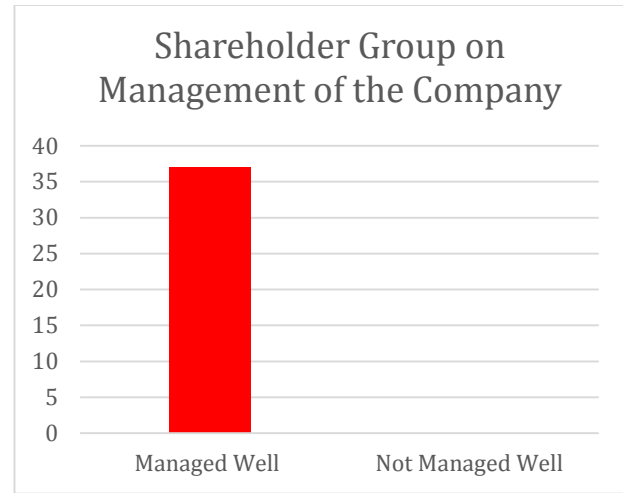


- 3) Management consultant Peter Drucker advocated that a CEO should make *no more than 20 times* what the average worker in the company makes. ABC Corp. is considering adopting such a policy. This would limit the CEO's total compensation to \$1.6 million. Do you feel this is fair?
- 4) Should there be any limit on the CEO's compensation? If yes, what is a fair amount for the CEO to have made in 2015?
- 5) In your opinion, what is the fairest way to compensate the CEO? Salary only, salary and a bonus if certain performance targets are achieved *or* salary, bonus and stock options?

To determine whether or not the difference in responses between the CEO group and the shareholder group were significant, a Chi-Square Test of Independence was performed on the results of each question. A Chi-Square Test of Independence is used to determine statistical significance between two categorical variables. The research used a confidence interval of 95%, meaning that if the generated p-value came out below .05, the null hypothesis could be rejected.

***Question 1: Was the Company Well Managed in 2015?***

The primary purpose of the first question was to determine whether or not the shareholder group was satisfied with the hypothetical CEO, John Smith's performance in 2015. With the null hypothesis being that the question would produce a random 50/50 result, the actual results from question one are displayed in the graphs at the top of the next page.



	<b>Managed Well</b>	<b>Not Managed Well</b>
<b>CEO Group</b>	38	-
<b>Shareholder Group</b>	37	-

The results from question one revealed that *all* the members of both the CEO group and the shareholder group thought the company was managed well during 2015. While a unanimous response was not necessarily expected, the results do not come as a surprise, as the CEO's performance was intentionally designed to be superb. This was done to ensure that the shareholder groups' opinions regarding the pay limit and structure were not influenced by poor performance from either the CEO or the company.

A Chi-Square Test of Independence requires expected values to be calculated in order to generate a p-value using the CHITEST formula in Microsoft Excel. However, if any of the expected values are less than five, the test cannot be used. For question one, all of the expected values fell below five, so the Chi-Square Test of Independence could not be used to determine statistical significance. Nonetheless, because the results came back 100% to 0%, the null

hypothesis can be rejected. From question one, it can be concluded that *all* members of both groups felt the company was in fact well managed in 2015.

**Question 2: Were You Satisfied With the Stock Return in 2015?**

The primary purpose behind question two was to gather results on whether the shareholder group was satisfied with the stock return in 2015. The survey as a whole was intentionally designed so that the majority of the shareholder group would be satisfied with the stock return. Like the first question, this was done to prevent the opinions of the shareholder group from being influenced by a poor return on their investment. The null hypothesis for question two was that the question would produce a random 50/50 result. However, the expected result from question two was that the majority of both the shareholder and the CEO group would be satisfied with the stock return for the year. The results from question two are displayed in the graphs below.



	<b>Satisfied with Return</b>	<b>Not Satisfied with Return</b>
<b>CEO Group</b>	<b>36</b>	<b>2</b>
<b>Shareholder Group</b>	<b>36</b>	<b>1</b>

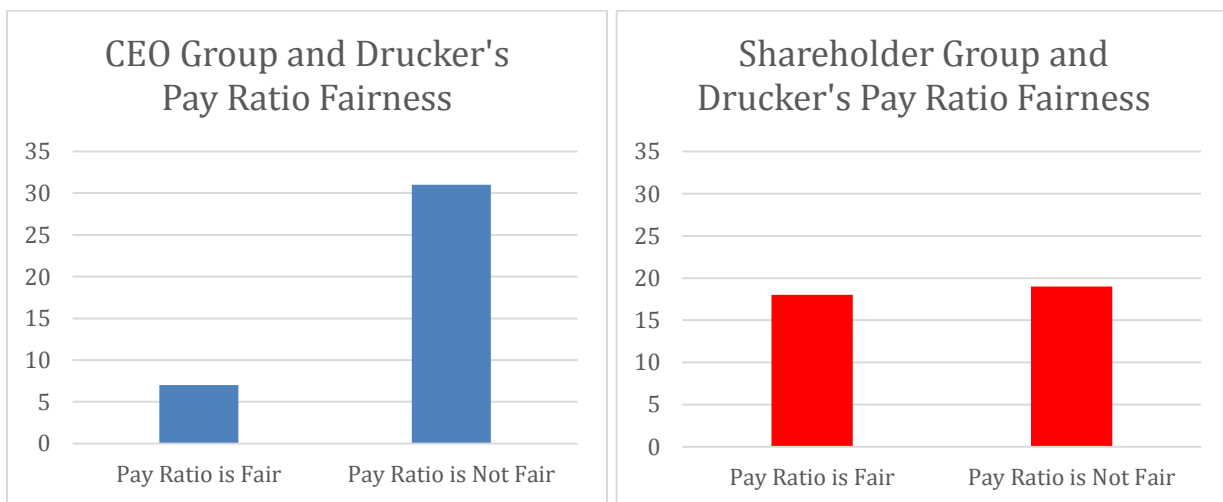
The Chi-Square Test of Independence for question two generated a p-value of .57157345. These results are not statistically significant, so the null hypothesis cannot be rejected in this case.

However, despite the lack of statistical significance, what can be taken away from question two is that an overwhelming majority of both groups were satisfied with the stock return for the year. The two members of the CEO group and lone member of the shareholder group that were not satisfied with the return claimed that the company could always do better.

Taking into account the results from questions one and two, the research safely concluded that the majority of the CEO group and the majority of the shareholder group were happy with ABC Corporation CEO John Smith's performance as well as the performance of the company as a whole.

### ***Question 3: Is Drucker's 20 to 1 Pay Ratio Fair?***

Having established that the majority of both groups were satisfied with the company, the third question asked whether Peter Drucker's 20 to 1 pay ratio was fair. The null hypothesis for question three was that there would not be a difference in the opinions of the CEO group versus those of the shareholder group with regard to the 20 to 1 limit on compensation. The results for question three are displayed in the graphs below.

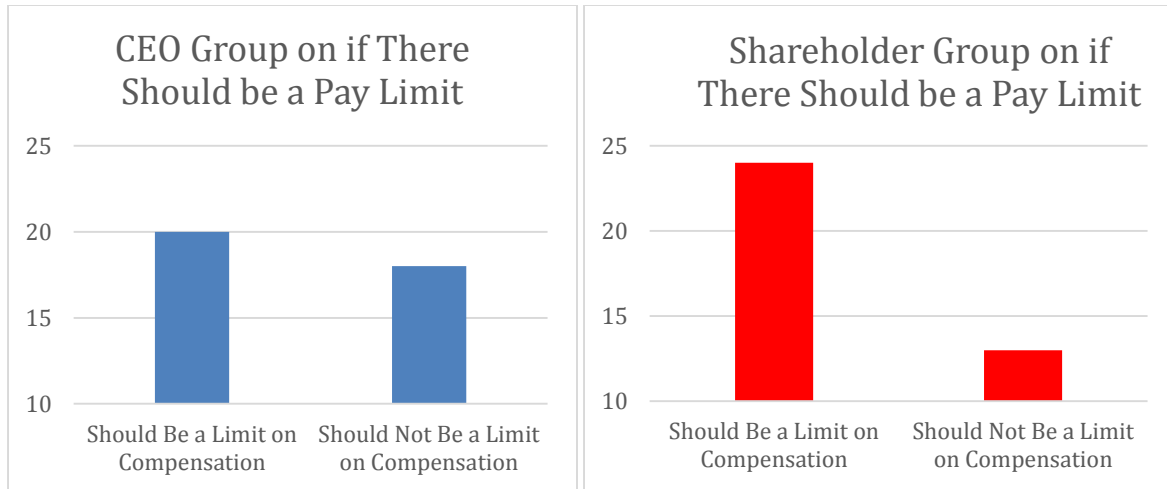


	<b>Drucker’s Pay Ratio is Fair</b>	<b>Drucker’s Pay Ratio is Not Fair</b>
<b>CEO Group</b>	7	31
<b>Shareholder Group</b>	18	19

The results of the question did come back as expected in this case; the vast majority of the CEO group said that the 20 to 1 pay ratio was not fair. On the other hand, the shareholder group was roughly split with regard to the fairness of the pay ratio. The Chi-Square Test of Independence run on question three generated a p-value of .00549755. These results were highly statistically significant at the 95% confidence interval and therefore, the null hypothesis could be rejected. From question three, the research was able to conclude that there was a difference in opinion between the CEO group and the shareholder group as the CEO group felt that Drucker’s 20 to 1 limit on their compensation was unfair.

***Question 4: Should There Be Any Limit on Compensation?***

Question four removed the 20 to 1 stipulation from the pay limit and gave both groups an opportunity to voice what, if any, an appropriate pay limit was. The null hypothesis for question four was that there would not be a difference in the opinions of the CEO group versus the shareholder group. The results from question four are displayed in the graphs at the top of the next page.



	<b>Should Be a Limit on Compensation</b>	<b>Should Not Be a Limit on Compensation</b>
<b>CEO Group</b>	<b>20</b>	<b>18</b>
<b>Shareholder Group</b>	<b>24</b>	<b>13</b>

The Chi-Square Test of Independence generated a p-value of .282096835. In this case, the results were not statistically significant, so the null hypothesis could not be rejected. However, the results for the CEO group from question four were surprising, as the majority of the CEO group agreed that there should be a limit on their own compensation. This was a limitation with the structure of the research. Remember that the CEO group was made up of undergraduate students, not actual CEOs. In this scenario, it appears that not all of the CEO group bought into the identity that they were actually CEOs. Had the survey been distributed to actual CEOs, the results likely would have been much different with far fewer, if any, of the CEOs agreeing with a limit on their compensation.

Though the results may not have been statistically significant, the shareholder groups' comments as to why there should be a limit on the CEO, John Smith's, compensation are insightful. Five of the twenty-four members of the shareholder group thought the cap should be

\$5 million while three thought the cap should be \$2 million. The shareholder group members that advocated for a \$2 million pay cap were willing to allow the CEO to make 25 times what the average worker in this company made in 2015. Recall the average salary for an employee at ABC Corporation was \$80,000.

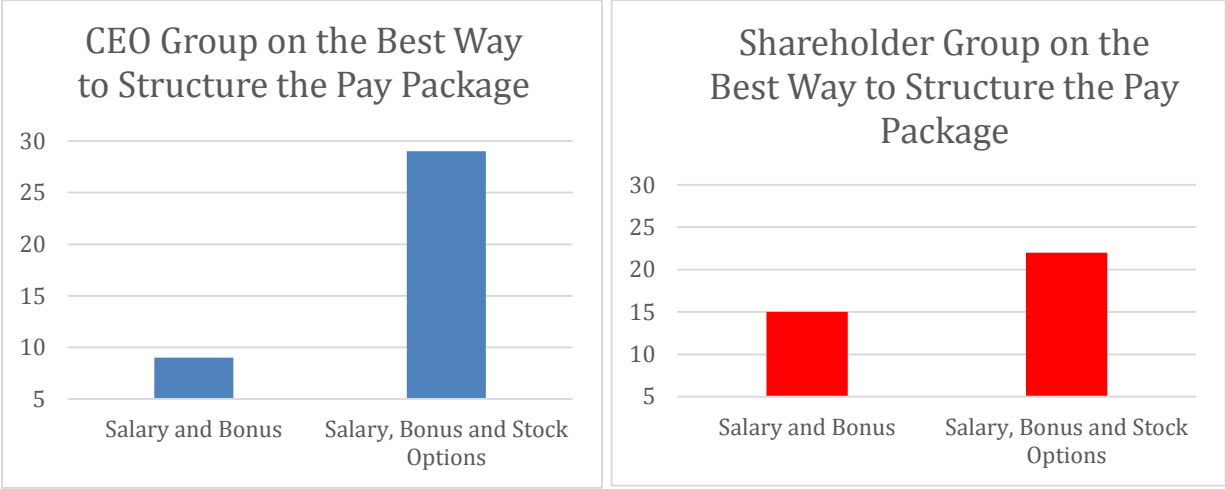
The primary reason these members of the shareholder group called for a \$2 million limit was that they felt it was not fair the CEO was making so much while the employees were paid so much less. Those willing to let the CEO make \$5 million would allow him to make 62.5 times what the average worker made. The reasoning behind the \$5 million limit was essentially the same as those who wanted a \$2 million pay limit. Recall that the Stanford survey unveiled that the average American wanted CEO pay capped at no more than 17.6 times what the average worker in the same company made. However, in this survey, after averaging all the responses, the average limit this shareholder group was willing to allow for was 63.75 to 1.

The members of the shareholder group who voted not to have a pay limit provided several intriguing reasons. Two different members of the shareholder group said that if the CEO's pay was capped, they feared the CEO would go find another job. Furthermore, two members of the shareholder group said that if the CEO can demonstrate his worth, he should be able to make whatever he can. Another interesting reason was that the CEO might try to move operations to another country to circumvent the pay limit. Lastly, another shareholder group member claimed that CEO pay should not be capped until MLB and NBA salaries are as well.

***Question 5: What is the Fairest Way to Compensate the CEO?***

The final question of the survey asked what the fairest way to compensate the CEO was. Although compensating the CEO with only a salary was an option, neither member of either group selected that option. The null hypothesis for question five was that there would not be a

difference in the opinions of the CEO group versus the shareholder group. The results of question five are displayed in the graphs below.



	<b>Salary and Bonus</b>	<b>Salary, Bonus and Stock Options</b>
<b>CEO Group</b>	<b>9</b>	<b>29</b>
<b>Shareholder Group</b>	<b>15</b>	<b>22</b>

The Chi-Square Test of Independence from question five generated a p-value of .117683252. Though the results were not quite statistically significant, they were very close. Nevertheless, at a 95% confidence interval, the null hypothesis cannot be rejected. However, what is interesting here is that all members of the shareholder group agreed that there should be some form of performance based compensation for the CEO.

***Conclusions From Original Research***

Although not all of the questions yielded statistical significance, there are still several insights that can be gained from the research, particularly from the last two questions. Although the majority of the shareholder group wanted a limit on compensation, that did not necessarily mean that they thought the CEO should not be well paid. Looking at the shareholder groups’



responses for question five, all the members agreed there should be performance-based pay for the CEO *if he earns it*, with a majority of the shareholder group willing to award the CEO stock options. However, while the shareholder group is willing to let the CEO earn more for good performance, based on the results for question four, they are only willing to reward good performance to a certain point. The primary reasoning behind that limit on the CEO's compensation aligned with Drucker's view that the CEO making too much would be damaging to worker morale. Yet, while Drucker believed that 20 to 1 was the threshold, this shareholder group, on average, believed that the CEO could make 63.75 times as much as the workers before morale would be damaged, over three times Drucker's limit.

Furthermore, the members of the shareholder group gave credit to the CEO where credit was due. The majority of the shareholder group acknowledged the fact that the CEO's performance was outstanding. Their reasoning behind a limit on compensation was rooted in the interest of protecting the workers, not because there was anything wrong with the way the CEO was running the company.

### ***Further Research***

If this research were to be continued further, there would be several changes made to the structure. To begin with, instead of giving the surveys to undergraduate students, the surveys would instead be distributed to a similar number of actual CEOs and actual shareholders. Though the undergraduate students filling the role of either a CEO or a shareholder did give useful insight, the responses of actual CEOs would likely be quite different from this CEO group. It is doubtful that any of the actual CEOs would say that Drucker's 20 to 1 limit on their compensation is fair or that any limit is fair for that matter. Furthermore, it is reasonable to

assume that most, if not all of the actual CEOs would want equity stakes in their compensation packages.

In addition to distributing the surveys to actual CEOs and shareholders, the compensation package would also be structured to include restricted stock units in addition to stock options to give the package more balance and make it more realistic. Furthermore, the potential for equity dilution would be introduced. The survey would make note of the fact that the CEO was receiving one percent of the total outstanding shares in equity awards for that year. Since the paper did address equity dilution as a major issue, it should be worked into the survey.

## **Chapter VII: Final Conclusions**

The entire research process was very eye opening. Executive compensation is a very broad topic and gives one many different ideas to consider. Though the paper by no means covered everything there is to cover regarding executive compensation, there are several key takeaways from this whole process.

First, with regard to a potential limit on CEO compensation, shareholders are willing to reward the CEO if he or she earns it. However, it is also clear that many Americans feel CEOs are making too much money. With that in mind, there are compelling arguments for both sides when it comes to the question of a potential limit on pay. Though the morale of the workers is important, ultimately, to ensure that American companies are equipped with the best leadership possible to remain competitive in the global business environment, in my opinion there *should not* be any limit on what a CEO can make.

Secondly, with regard to structure, the ultimate goal of the compensation package should be to align the interests of the CEO and the shareholders. Knowing this, each type of compensation used in the pay package plays a unique role in incentivizing the CEO to act in the best interest of the shareholders. Based on my research, I feel an effective pay package should utilize all five forms of compensation. However, while a company should utilize all five forms of compensation in an executive's pay package, due to the unique nature of each company and industry in which that company operates, I was unable to identify a uniform pay package that can be homogenously applied to all CEOs. I feel the value of a pay package should vary based upon the company and CEO's performance.

The research also presented a case for the potential of equity dilution. Equity stakes should certainly not be eliminated from the pay package, however, the compensation committee

must be wary of how many shares it is awarding the CEO. Based off Chad Norton's comments that companies where upper level management holds one to two percent of the outstanding shares will generally see a "no" vote when it comes to Say on Pay, the amount of equity that a CEO receives *in a given year* should be limited to protect the long-term shareholders, in my opinion. That, of course, begs the question of how much equity is too much equity to award the CEO.

The number of shares awarded to a CEO can be restricted by an overall total or by a limit on the number of shares awarded per year as a percentage of the total number of shares outstanding, the "burn rate." It is an intriguing idea to limit the *total* number of shares a CEO can have to a certain percentage of the overall outstanding shares. However, the problem with this arises when an exceptional CEO has a long tenure with a company. Though the average tenure for a Fortune 500 CEO is 6.9 years, certain CEOs last far longer.<sup>127</sup> CEOs like Warren Buffet of Berkshire Hathaway or Leslie Wexner of L Brands have been the CEO for over 50 years.<sup>128</sup> If restricted to holding a certain percentage of the total number of outstanding shares, after so many years with the company, they reach a point where they can no longer be paid in equity, which upsets the balance of the pay package.

For that reason, in my opinion, the number of shares awarded to a CEO should be based on the "burn rate," meaning that each year, a CEO may only be awarded a certain percentage of the company's total shares outstanding. Basing the percentage on Norton's one percent total threshold for the "no" vote, coupled with Coca-Cola's decision to restrict upper level

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127. Scott DeCarlo and Anne VanderMey, "The 14 Longest Serving CEOs of the Fortune 500," *Fortune (Online)*, May 5, 2015.

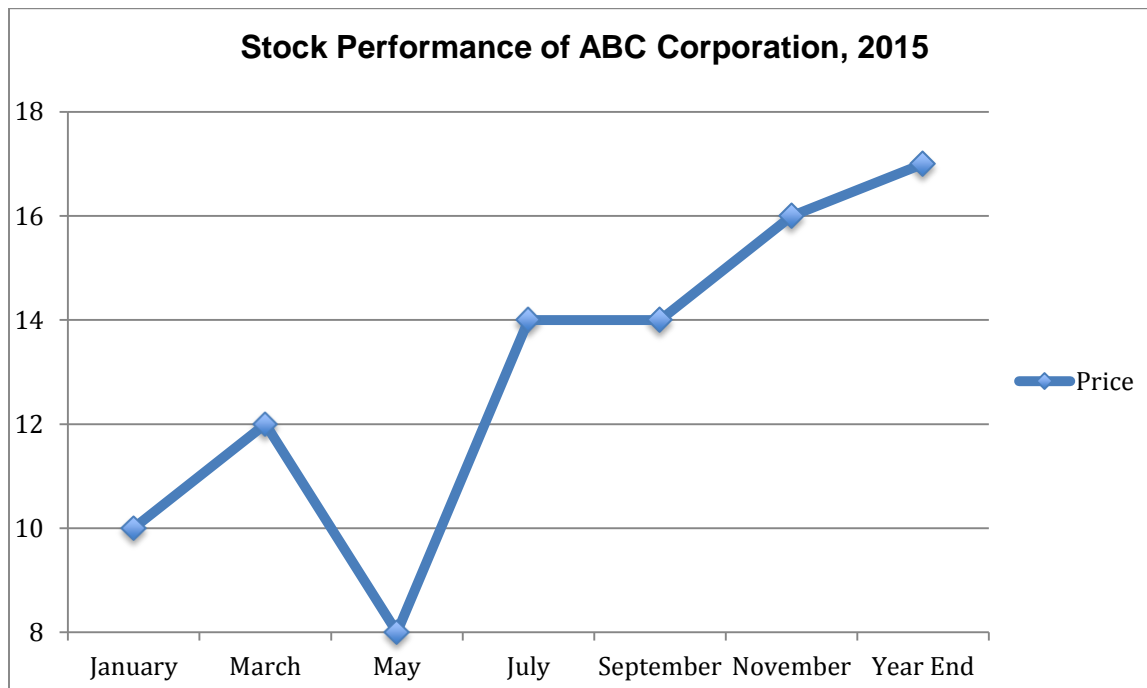
128. *Ibid.*

management to a “burn rate” of .8% per year, in my opinion, the CEO should not be awarded more than half of one percent (.5%) of the company’s total shares *on an annual basis*.

CEOs will continue to make much more in relation to the rest of the labor force. However, it must be kept in mind that these men and women are making significant contributions to the American economy. Given the nature and responsibilities of the position, I believe that CEO compensation is earned, not excessive.

## Appendix A

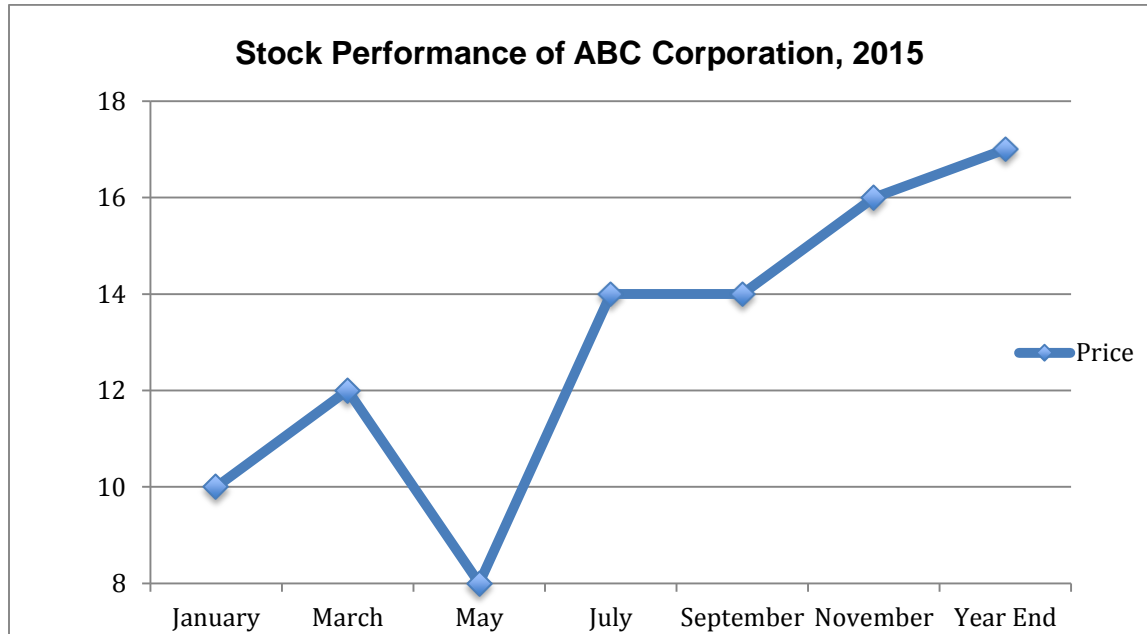
- You are the CEO of ABC Corporation, an automobile manufacturer based in St. Louis, Missouri.
- You were appointed CEO on January 1, 2013.
- The terms of your contract are as follows:
  - It is a three year contract
  - Your base salary will be \$1.5 million
  - You will be awarded a cash bonus of \$4 million for beating yearly net income targets
  - You also receive 1 million stock options
    - The options vest on 1/1/15
    - The options expire at the end of 2023
    - The strike price is \$10
- The graph below tracks the company's stock performance during 2015:



- Under your leadership, ABC Corporation's stock is trading at \$17 at the end of 2015.
  - As CEO, you increased the company's market value by \$7 billion during 2015.
- The total value of your options is \$7 million at the end of 2015.
- As the CEO, you decide to exercise the options on 600,000 shares and subsequently sell those shares, realizing \$4.2 million in cash.
  - During 2015, the auto industry as a whole did exceptionally well driven by low fuel costs and increased demand in the United States for SUVs and pickup trucks. The company's two largest competitors outperformed the S&P 500 by 50%. However, under your guidance, ABC Corp. outperformed the S&P 500 by 60%.
- In 2015, you earned \$1.5 million from your base salary and an additional \$4 million in a cash bonus for beating the net income target of \$2.5 billion for the year. The company reported net income of \$2.8 billion in 2015.
- In total, you made \$9.7 million in 2015.
  - By comparison, the average worker at ABC Corp. made \$80,000, including benefits in 2015.

## Appendix B

- You are a shareholder in ABC Corporation, an automobile manufacturer. On January 1, 2015, you bought 500 shares of common stock for \$10 per share.
- The graph below follows the stock's performance throughout 2015:



- As a shareholder, you decided to hold your 500 shares until the end of the year when the stock price is \$17.
  - On a \$5000 investment, your shares are now worth \$8500 giving you an unrealized gain of \$3500.
- For the 2015 fiscal year, the CEO John Smith's total compensation was \$9.7 million. He earned his \$1.5 million dollar base salary in addition to a \$4 million cash bonus for beating the year's target net income of \$2.5 billion. ABC Corp. reported net income of \$2.8 billion in 2015.
- Because of the stock's performance in 2015, Smith also exercised the options on 600,000 shares and subsequently sold those shares, realizing \$4.2 million in cash.
  - Under Smith's leadership, the market value of the company increased by \$7 billion.
- During 2015, the auto industry as a whole did exceptionally well driven by low fuel costs and increased demand in the United States for SUVs and pickup trucks. ABC Corp.'s two largest competitors outperformed the S&P 500 by 50%. Under Smith's guidance however, ABC Corp. outperformed the S&P 500 by 60%.
  - By comparison, the average worker at ABC Corp. made \$80,000, including benefits in 2015.

*The following were the major highlights for Smith and his executive team in 2015:*

- Introduced the company's 2015 full-size sedan equipped with Wi-Fi at the beginning of September. Under Smith's direction, ABC Corp. had previously invested over \$2 billion in research and development geared toward this project in 2013. As a result of the new sedan, ABC Corp.'s market share increased 3% in the United States, 5% in Europe and 7% in China.
- Made an attempt to consolidate manufacturing facilities in its South American market to save on operational expenses. However, difficulties in the process led to six months of downtime. During that time, its competitors took advantage and ABC Corp. lost 4% of its market share in the growing region.
- Secured a contract with the nation's largest commercial contractor to be their exclusive provider of heavy-duty commercial trucks through the year 2022.

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