CEO COMPENSATION

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EXECUTIVE COMPENSATION

The compensation program serves three main purposes.

1. It must attract executives with the skills, experiences, and behavioral profile necessary to succeed in the position.

2. It must be sufficient to retain these individuals, so they do not leave for alternative employment.

3. It must motivate them to perform in a manner consistent with the strategy and risk-profile of the organization and discourage self-interested behavior.

ELEMENTS OF COMPENSATION

The compensation package includes some or all of the following:

- **Annual salary**

  Fixed cash payment made evenly over the year. The IRS limits the tax deductibility of compensation greater than $1 million, unless it is performance driven.

- **Annual bonus**

  Additional payment (usually cash) awarded if performance exceeds predetermined targets. Generally expressed as a percentage of salary and includes a guaranteed minimum and a specified maximum. Targets are based on quantitative and/or qualitative factors.

ELEMENTS OF COMPENSATION

- Stock options

  Right to buy shares in the future at a fixed exercise price, generally equal to stock price on the grant date. Typically vest evenly (e.g., annually over four years) and expire at the end of the term (generally ten years).

- Restricted stock

  Outright grant of shares that are restricted in transferability and are subject to vesting. Once vested, they are economically equivalent to outright ownership of stock.

- Performance units (shares)

  Cash (or stock) granted if specified targets are met over a three- to five-year period. Size of the award is generally expressed as a percentage of base salary. Performance units are similar to a longer-term version of the annual bonus.

ELEMENTS OF COMPENSATION

- **Perquisites**

  Other amenities purchased or provided by the company (such as personal use of company airplane).

- **Contractual agreements**

  Other cash or stock payments stipulated in the employment agreement, such as severance, post-retirement consulting, and change-in-control payments ("golden parachutes").

- **Benefits**

  Other benefits such as health insurance, post-retirement health insurance, 401(k), supplemental executive retirement plans (SERPs), life insurance, payment for use of financial planner, and certain tax reimbursements.

Do compensation programs need to be this complicated?

RESTRICTIONS ON COMPENSATION

Compensation programs might also be subject to restrictions:

- **Stock ownership guidelines**

  Executive is required to own a minimum amount of company stock, generally expressed as a multiple of base salary (e.g., five times).

- **Pledging restrictions**

  Executive is restricted from using shares as collateral for personal or margin loan.

- **Clawbacks**

  Company can reclaim compensation in the future if it determines that it should not have been awarded. Clawback policies are required under the Dodd-Frank Act.

The most common triggers of a clawback are a financial restatement, ethical misconduct, or violation of a noncompete clause. Clawbacks tend to improve financial reporting quality.

Equilar (2013); Chan, Chen, Chen, and Yu (2012)

DESIGNING THE COMPENSATION PROGRAM

- The compensation committee recommends compensation of the CEO and other executive officers.
- Packages are approved by independent directors of the full board. Shareholders approve equity-based compensation.
- Details are disclosed in the annual proxy:

COMPENSATION PHILOSOPHY	PAY EQUITY, CEO vs. OTHER EXECS
ELEMENTS OF COMPENSATION	PAY EQUITY, CEO vs. AVERAGE EMPLOYEE
TOTAL COMPENSATION AWARDED	STOCK OWNERSHIP GUIDELINES
TOTAL COMPENSATION REALIZED	CLAWBACK POLICIES
PEER GROUP, COMPENSATION DESIGN	SEVERANCE AGREEMENTS
PEER GROUP, PERFORMANCE	GOLDEN PARACHUTES
CRITERIA FOR AWARDING VARIABLE PAY	POST-RETIREMENT COMPENSATION

DETERMINING THE LEVEL OF COMPENSATION

- Most boards benchmark CEO pay against a peer group of companies comparable in size, industry, and/or geography.
- Common practice targets cash compensation (salary + bonus) at 50th percentile and long-term pay at the 75th percentile.
- There are potential drawbacks to benchmarking:
  - Might lead to ratcheting.
  - Is based on size rather than value creation.
  - Is highly dependent on companies included in peer group.

Companies include unrelated firms in peer group, and the inclusion of these firms tends to increase pay.

Faulkender and Yang (2010)

COMPENSATION CONSULTANTS

- Most companies use a third-party consultant to advise on compensation levels and program design.
- Compensation consultants might be subject to conflicts of interest if they provide other services to the company, such as benefits consulting or pension asset management

CEO pay is higher among companies that use a consultant. Evidence suggests this is due to governance quality, not the use of the consultant.

Conyon, Peck, and Sadler (2009); Armstrong, Ittner, and Larcker (2012)

COMPENSATION LEVELS

COMPENSATION PAID TO U.S. CEOs

FIRM SIZE	TOTAL EXPECTED COMPENSATION	MARKET VALUE ($ THOUSANDS)
Top 100	$13,713,000	$104,413,000
101 to 500	$10,656,000	$21,710,000
501 to 1,000	$6,458,000	$6,086,000
1,001 to 2,000	$3,981,000	$2,016,000
2,001 to 3,000	$2,092,000	$624,000
3,001 to 4,000	$900,000	$144,000
1 to 4,000	$2,869,000	$1,143,000

Median values. Based on Equilar compensation data, fiscal years ending June 2013 to May 2014.

COMPENSATION LEVELS

- Are CEOs overpaid?
  - Long-term changes in CEO pay are almost entirely explained by changes in company size.
  - Long-term changes in CEO pay are no different than changes among other "highly paid" professionals (venture capitalists, hedge fund managers, private equity, lawyers, athletes, entertainers, etc.).
- Still, compensation levels themselves might be systematically too high (or too low).

Among individual firms, weak governance is associated with excessive pay—pay that is above average based on peers of similar size and performance.

Gabaix and Landier (2008); Kaplan and Rauh (2010); Core, Holthausen, and Larcker (1999)

COMPENSATION LEVELS

Three basic ways to measure executive compensation:

1. Expected pay. The value of compensation promised in a given year.
2. Earned (realizable) pay. The value an executive "earns the right to keep" as cash is delivered and vesting restrictions removed.
3. Realized pay. The value an executive takes home in cash, as cash is delivered and vested awards are sold.

- The ultimate value of compensation will depend on the CEO's ability to achieve performance goals, based on changes in stock price and operating performance.
- The "pay for performance" imbedded in a compensation contract will depend on how closely incentives are correlated with performance goals.

RATIO OF CEO PAY TO OTHER TOP EXECUTIVE PAY

- There is a large pay differential between the pay granted to the CEO and the pay granted to other senior executives.
- On average, the CEO earns 1.8 times the pay of the 2nd highest officer. The 2nd highest earns 1.2 times the 3rd.

(+) Might reflect relative value creation of these jobs.

(+) Pay inequity provides incentive for promotion.

(-) Might reflect management entrenchment.

(-) Discourages executives who feel they are not paid fairly.

(-) Might reflect lack of internal talent development.

Internal pay inequity is positively associated with firm performance, but also risk.

Kale, Reis, and Venkateswaran (2009); Kini and Williams (2012)

RATIO OF CEO PAY TO AVERAGE EMPLOYEE PAY

- The Dodd-Frank Act requires that companies disclose the ratio of CEO pay to that of the average employee.
- Because of delays implementing the rule, broad descriptives are not available. Recent estimates peg this ratio between 200 and 500 times.
- Results vary based on:
  - Industry, size, location, and workforce composition.
  - Expected v. realized compensation.
  - Mean v. median calculations.

CEO-to-employee pay ratio among commercial banks, 1995 to 2012:

- Median: 8.4 times
- Mean: 16.6 times
- 90th percentile: 32.8 times
- Highest observation: 821 times

Crawford, Nelson, Rountree (2014)

COMPENSATION MIX

- The board also determines the structure of CEO pay.
- The mix of compensation should be appropriate to attract, retain, and motivate executives in the short and long terms.

COMPENSATION PAID TO U.S. CEOs

FIRM SIZE	SALARY	BONUS	STOCK OPTIONS	RESTRICTED STOCK & LONG-TERM AWARDS	OTHER
Top 100	18.9%	23.4%	8.6%	38.8%	10.3%
101 to 500	14.3%	20.5%	14.8%	43.3%	7.2%
501 to 1,000	16.1%	21.1%	14.1%	42.1%	6.6%
1,001 to 2,000	21.1%	22.0%	13.2%	38.4%	5.3%
2,001 to 3,000	30.4%	19.7%	15.6%	29.5%	4.8%
3,001 to 4,000	46.9%	15.9%	14.5%	16.0%	6.8%
1 to 4,000	28.5%	19.6%	14.3%	31.5%	6.0%

Based on Equilar compensation data, fiscal years ending June 2013 to May 2014.

SHORT-TERM INCENTIVES

- Short-term incentives offer an annual payment (usually cash) for achieving predetermined performance objectives.
- The size of the bonus is expressed in terms of a target, with a minimum and maximum level.
- The board should consider the following:
  - How difficult are the performance targets?
  - Does the plan encourage a short-term focus?
  - Does management defer investments to achieve targets?
  - Are earnings deferred after maximum targets are met?
  - Are earnings manipulated to increase payouts?

LONG-TERM INCENTIVES

- Long-term incentives are added to the mix to encourage long-term investments to increase value.

- Stock and stock options:

  (+) Increase in value with stock price.

  (+) Vesting allows for deferred realization of value.

  (-) Rewards can be capricious in a volatile market.

  (-) Might encourage excessive risk-seeking to increase value.

- Performance awards tie compensation value to multiple performance metrics, not just stock price.

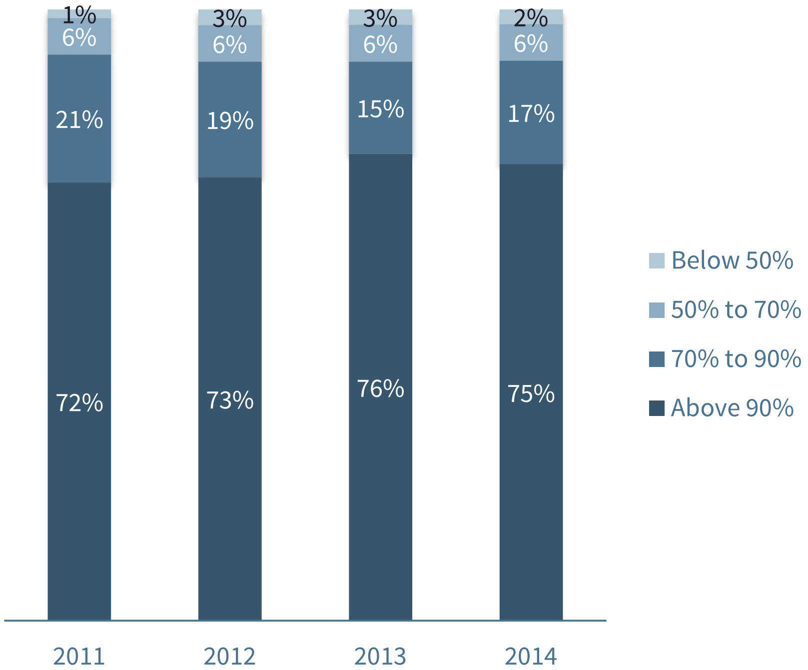
SAY ON PAY

- Say on pay is the practice of granting shareholders the right to vote on a company's executive compensation program at the annual meeting.

- The Dodd-Frank Act requires U.S. companies to hold an advisory (non-binding) vote at least once every three years.

- Despite expectations that shareholders would voice dissatisfaction with pay levels, average support remains high (90 percent).

SAY ON PAY VOTE RESULTS



Semler Brossy (2014)

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