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Executive Pay Norms In the U.S

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1. Introduction

"**In judging whether corporate America is serious about reforming itself, CEO pay remains the acid test. To date, the results aren't encouraging**"[1] (Warren Buffet, 2004).

The matter of executive pay norms in the corporate world has been in the center of public interest for many years. Researchers, practitioners and investors alike have recognized its importance. Public interest grew in similar ratio to the dramatic increase in executive pay in the past twenty years.

The recent financial crisis is, by far, the deepest economic crisis since 1929. The "shock waves" that started in the summer of 2007 hit almost every economy on the face of the earth, leaving behind it a path of destruction. Although there are many reasons that might explain how the biggest and richest economy in the world was brought to its knees, dragging the rest of the world after it, compensation is definitely among the first on the list. Compensation in significant financial institutions is one factor among many that contributed to the creation of the financial crisis that began in 2007[2], but its roots were planted long before.

Executive compensation, it is now acknowledged, led the executives of the biggest financial institutes in the world to buy and sell "toxic" assets in the form of securitized mortgage loans, while completely ignoring the obvious risks of such actions. This short-termism was fueled by the fact that pay arrangement in banks have provided executives with short-term incentive[3], which in turn, contributed to the excessive risk taking that we have witnessed.

The financial crisis have proven beyond any doubt that managers of publicly traded companies, including financial institutions, mutual funds and others were in fact compensated in ways that decoupled pay from performance and provided incentive for short-term profit taking. These executives took excessive risks on the account of their shareholders, bondholders, government and the public taxpayer, without bearing the consequences and without giving any accountability of their actions.

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[1] Warren Buffet, Letter to the shareholders of Berkshire Hathaway, Inc., February 2004

[2] Financial Stability Forum paper from September 25, 2009 (available at http://www.financialstabilityboard.org/publications/r_090925c.pdf)

[3] See e.g. the statement by the chairman of the Federal Reserve System, Ben S. Bernanke, "The Financial Crisis and Community Banking", speech given at the Independent Community Bankers of America's National Convention and Techworld, Phoenix Arizona (20/3/2009), available at http://www.federalreserve.gov/newsevents/speech/bernanke20090320a.htm (accessed 26/9/09).

In chapter two I will provide evidence that executive compensation has increased in the period between 1993 - 2003 and explain how compensation structure changed in that time. In chapter three I will review the basic problem of CEO – directors relationship, and the raise a few reasons why executive pay increased so much. In chapter four I will examine the main problems in financial institutions and demonstrate why current bank's structure induces excessive risk taking by executives. In chapter five I will present the "pay-without-performance" problem in the U.S. In chapter six I review the assertion that markets have sufficient influence over executive compensation, and explain why this assertion does not hold in reality. Chapter seven revolves around the claim that the U.S. regulation is suboptimal, as well as on the problem with current regulation in constraining abusive compensation arrangements. In Chapter eight I reviewed the main efforts to deter abusive compensation norms, in the international level, in corporate governance level, through market norms and through litigation.

2. The growth in executive pay

"**There seem to be two different economic realities operating in our country today. And the rules of compensation in one world are completely different from those in the other. Most Americans live in the world where economic security is precious and there are real economic consequences for failure. But our nation's top executives seems to live by a different set of rules**" [4] (Henry A. Waxman, 2008)

There is much evidence that CEO compensation have been increasing in the last decades[5]. A study performed by Bebchuk and Grinstein[6] has examined, both empirically and theoretically the growth of pay during the period between 1993 – 2003 (hereinafter "**The Relevant Period**"). They used information from the standard ExecuComp database. The dataset included all of the S&P 500, Mid-Cap 400, and small Cap 600 (also known as the S&P 1500). Bebchuk and Grinstein define the executive's total compensation in a given year as the sum of the executives' salary, bonuses, long-term incentive plans, the grant-data value of restricted stocks awards and the (grant-data) Black & Scholes value of granted options[7]. Information regarding executives' pension was not included since firms are not required to disclose their dollar values[8]. Thus, the information lacks major source of compensation for many executives.

Table 1 displays the mean compensation levels of the chief executives officers (CEOs) and the top five executives during the Relevant Period[9]:

[4] Opening statement of Rep. Henry A. Waxman, Committee on Oversight and Government Reform Executive Compensation II: CEO Pay and the Mortgage Crisis, March 7, 2008
[5] View the most recent data regarding compensation of two hundred CEOs in 198 public companies as compiled by the compensation research firm Equilar (available at http://projects.nytimes.com/executive_compensation)
[6] Lucian A. Bebchuk and Yaniv Grinstein, "The Growth of Executive Pay", Oxford Review of Economic Policy, VOL. 21 No. 2, (2005) [hereinafter: "**The Growth of Executive Pay**"]
[7] Monetary figures were translated to 2002 dollars in order to adjust to inflation
[8] Since then than the SEC has ruled further disclosure regulation, which is discussed in chapter 6
[9] The Growth of Executive Pay, 285

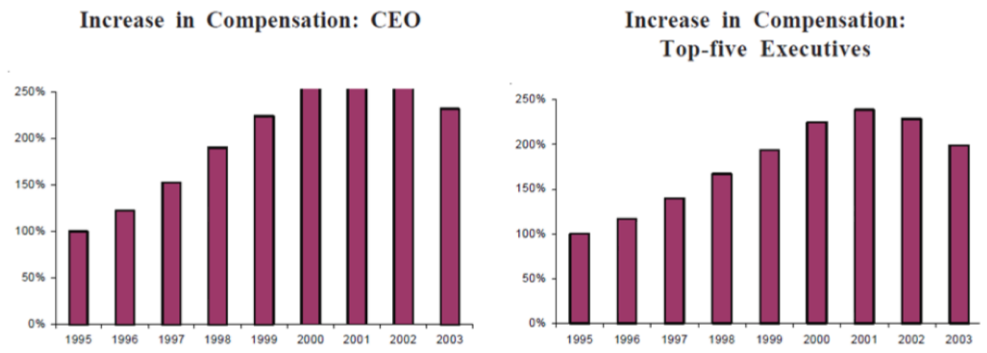
Table 1
Mean Compensation Levels (Sm), 1993–2003

	CEO			Top five executives		
Year	S&P500	Mid-Cap400	Small-Cap600	S&P500	Mid-Cap400	Small-Cap600
1993	3.7	2.2	1.3	9.5	5.8	3.2
1994	4.4	2.6	1.6	10.7	6.4	3.9
1995	4.8	2.9	1.5	11.9	6.8	4.0
1996	7.0	3.3	1.9	15.8	8.1	5.0
1997	9.1	4.2	2.2	20.0	9.9	5.4
1998	10.7	4.6	2.4	23.7	10.4	5.6
1999	12.7	5.1	2.3	28.3	11.4	5.7
2000	17.4	5.1	2.5	36.6	12.1	5.9
2001	14.3	4.7	2.6	31.9	10.6	5.7
2002	10.3	4.7	2.2	23.5	10.3	5.2
2003	9.1	4.0	2.0	21.4	9.4	4.7

It is clear from the table above that the average CEO compensation among S&P 500 companies increased by 146% and top five executives' compensation by 125%.

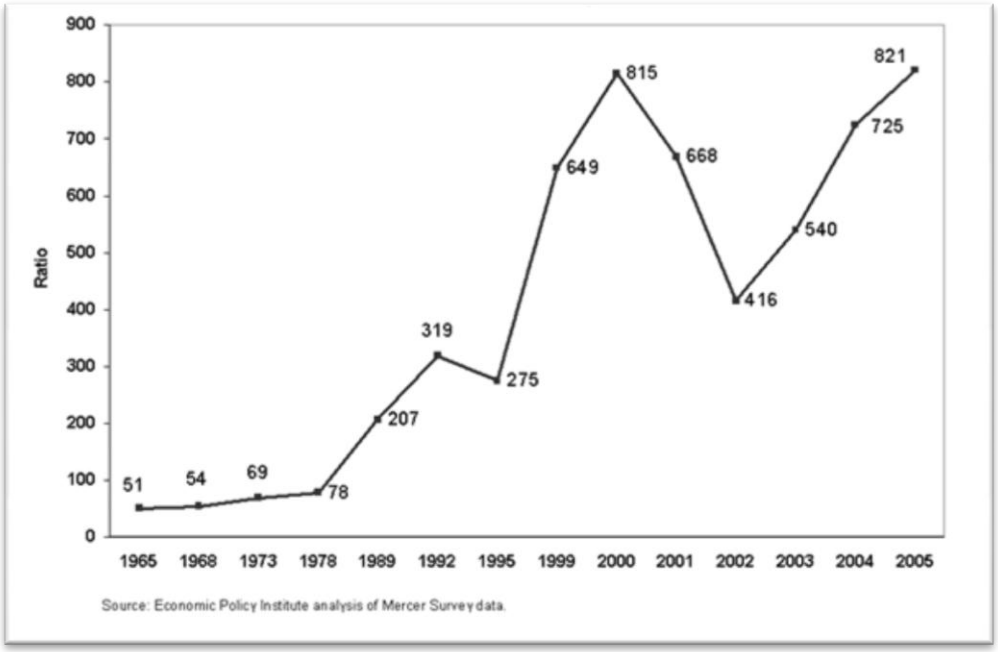
Figure 1[10] shows the steady increase in the rolling[11] three years average of compensation levels **relative** to the compensation levels in 1993.

Figure 1
Changes in Rolling Average of CEO and Top-five Compensation, 1993–2003

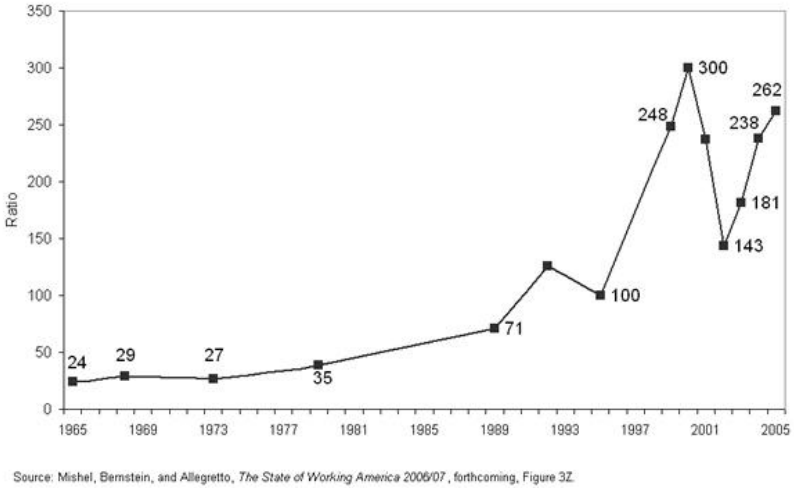


[10] Id. At 286
[11] Rolling average is defined as the average of its compensation level in that year and the preceding 2 years

To demonstrating how much the increase in executive pay in the U.S. is un-proportional to the rest of the employment market, I present the ratio between average annual compensation of CEOs (including all bonuses and incentives) to the annual compensation of a full-time, full-year minimum wage earner (assumed to receive an average amount of benefits) Between 1965 - 2005. As the data shows, this ratio has increased significantly[12]:



The next graph presents the ratio of CEO pay to average worker pay in the period 1965 - 2005[13].



[12] Economic Policy Institute (EPI), "CEO-Minimum Wage Ratio Soars" analysis of mercer survey date (can be viewed at www.epi.org/economic_snapshots/entry/webfeatures_snapshots_20060627/)

[13] Economic Policy Institute (EPI), "**CEO-to-worker pay imbalance grows", (can be view at www.epi.org/economic_snapshots/entry/webfeatures_snapshots_20060621)**

Growth in compensation level can result by changes in firm size, performance and industry mix. As shown in the table below, during the Relevant Period[14], firm size have increased, hence, might be accountable for some growth in compensation level.

Firm size –the increase in average size of firms (inflation adjusted) in the period 5/1993 to 3/2001:		
S&P 500	Mid Cap 400	Small Cap 600
40%	**30%**	**51%**

Bebchuk and Grinstein examined how compensation levels changed during the examined period (after controlling for changes in firms characteristics) by estimating the following regression[15]:

$$Log(compensation_{i,t}) = a_0 + a_1 Log(sales_{i,t-1}) + a_2 Log(1 + ROA_{i,t-1}) + a_3 Log(1 + Return_{i,t-1}) + a_4 Log(1 + Return_{i,t-2}) + Year\,dummies(1994 - 2003) + f_i + \varepsilon_{i,t}. \quad (1)$$

In this regression, the ROA is the ratio of operating income to book value of assets. Sales were used to control for size, ROA and past returns to control for performance. The year dummies indicate how much (holding firm attributes fixed) log compensation went up relative to 1993. They ran two regressions, one using CEO pay as the dependent variable and one using the top five compensation levels as the dependent variable.

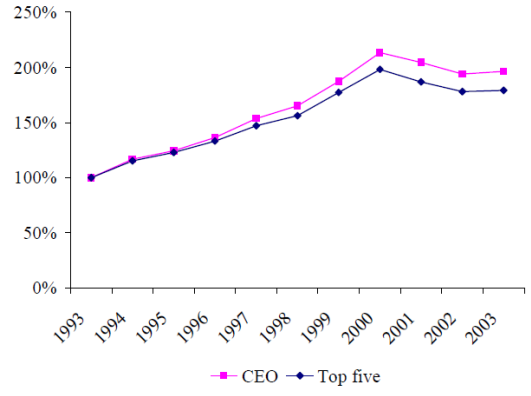
[14] The Growth of Executive Pay, 286
[15] Id.

Table 2
Growth Unexplained by Size and Performance: Fixed-effect Regression

	Dependent variable: Log(total CEO compensation)	Dependent variable: Log(total top-5 compensation)
Log(Sales (*t*–1))	0.138***	0.171***
	(0.014)	(0.009)
Log(1+Firm *ROA*(*t*–1))	0.110*	0.108
	(0.062)	(0.007)
Log(1+Firm return (*t*–1))	0.128***	0.024***
	(0.012)	(0.007)
Log(1+Firm return (*t*–2))	0.016	0.015
	(0.012)	(0.043)
1994	0.059***	0.058***
	(0.022)	(0.014)
1995	0.132***	0.123***
	(0.022)	(0.014)
1996	0.147***	0.127***
	(0.023)	(0.015)
1997	0.239***	0.207***
	(0.023)	(0.015)
1998	0.228***	0.202***
	(0.024)	(0.015)
1999	0.288***	0.261***
	(0.024)	(0.015)
2000	0.316***	0.300***
	(0.025)	(0.016)
2001	0.245***	0.212***
	(0.025)	(0.016)
2002	0.352***	0.283***
	(0.026)	(0.016)
2003	0.450***	0.370***
	(0.026)	(0.017)
Observations	15,397	14,154
Adjusted R^2	56%	74%

The results of both regressions indicate that compensation levels increased far more than can be attributed to changes in size and performance. Controlling for firm size and performance, the level of CEO compensation increased by 96%, and top five executives compensation increased by 76% in the related period[16], as shown in Figure 2 below:

Figure 2
Increase in Compensation after Controlling for Size, Performance, and Fixed Effects



Notes: The figure displays the changes in compensation to CEOs and top-five executives among firms that belong to the ExecuComp database after controlling for size, performance, and fixed effects. The year 1993 is the reference point (100 per cent). All variables used to generate the figure were first adjusted for inflation.

[16] The Growth of Executive Pay, 288

When running a regression only on companies that existed throughout the related period, the CEO compensation increased by 166% and top five executives by 98%. The coefficiency (0.69) of the fixed effect regression show that the change in firm size and performance can only explain 66% of the total 166% increase in CEO compensation, and only 20% of the top five executives increase[17].

According to Bebchuk and Grinstein, equity based compensation, hence options and restricted stocks received by executives as a percentage of total compensation to CEO and top five executives in S&P 500 companies has grew from 41% and 37% (respectively) in 1993 to 59% and 55% (respectively) in 2003[18]:

Table 4
Equity-based Compensation as a Percentage of Total Compensation

(*a*) CEO

Year	S&P500	Mid-Cap400	Small-Cap600	New economy	Firms not classified as new economy
1993	41	46	47	58	42
1994	48	53	53	63	49
1995	49	48	48	72	44
1996	56	55	52	76	51
1997	63	60	55	77	58
1998	70	66	61	86	63
1999	71	70	56	87	63
2000	78	67	57	92	66
2001	76	66	58	86	66
2002	67	59	53	83	59
2003	59	54	44	76	53

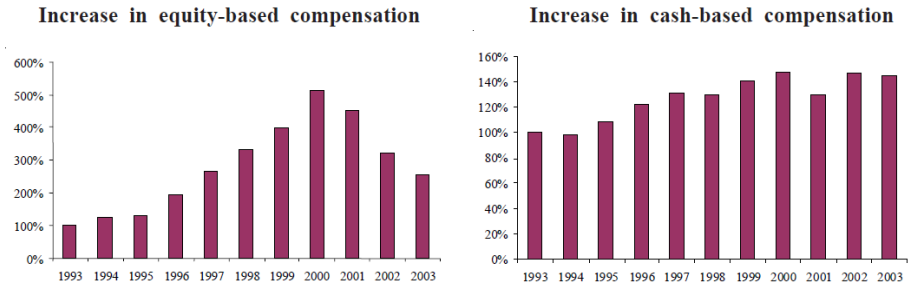
(*b*) Top-five executives

Year	S&P500	Mid-Cap400	Small-Cap600	New economy	Firms not classified as new economy
1993	37	41	34	50	36
1994	42	45	43	57	41
1995	42	42	40	62	38
1996	50	49	46	69	45
1997	57	54	49	72	52
1998	63	58	52	80	55
1999	65	63	50	82	58
2000	72	63	50	87	60
2001	72	60	52	83	63
2002	62	54	48	77	54
2003	55	51	41	69	50

it is obvious that the percentage of equity based compensation increased more in new economy firms than in other firms. Moreover, its obvious from the data chart below that along with the increase in equity based compensation, there was an increase in cash-based compensation in the relevant period, and that there was no substitution effect between them[19]:

[17] Id. at 287-288
[18] Id. at 290
[19] Id. at 292

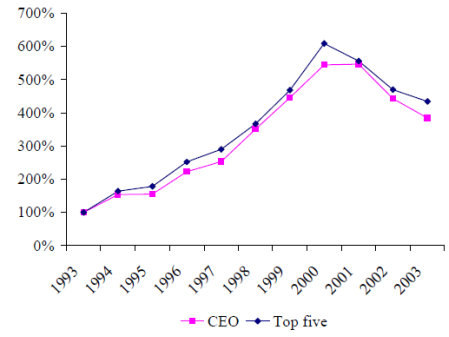
Figure 3
Relative Increase in Equity-based and Non-equity-based CEO Compensation



Note: The figure displays the changes in CEO equity-based compensation in firms that belong to the S&P500, Mid-Cap 400, and Small-Cap 600 indices.

When controlling for changes in firm size and performance, and using firm fixed effect (looking at the same firms - See appendix 1), equity based compensation has increased in the relevant period. The 2003 coeffiencies indicated that, controlling for changes in firm size and performance, the levels of CEO equity compensation increased by 285% and top five executives increased by 334% in the Relevant Period[20]:

Figure 4
Increase in Equity-based Compensation after Controlling for Size, Performance, and Fixed Effects

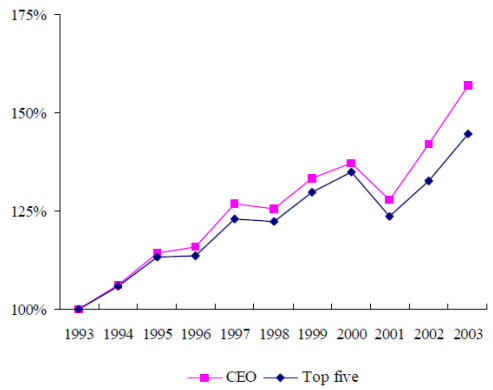


Notes: The figure displays the changes in equity-based compensation to CEOs and top-five executives among firms that belong to the ExecuComp database, after controlling for size, performance, and fixed-effects. The year 1993 is the reference point (100 per cent). All variables used to generate the figure were first adjusted for inflation and translated into 2002 dollars.

[20] Id. at 291

When holding firm attributes constant (see appendix 1) the level of cash-based compensation paid to CEOs and top five executives increased by 56% and 45% (respectively) in the Relevant Period:

Figure 5
Increase in Non-equity Compensation after Controlling for Size, Performance, and Fixed Effects



Notes: The figure displays the changes in non equity-based compensation to CEOs and top-five executives among firms that belong to the ExecuComp database, after controlling for size, performance, and fixed effects. The year 1993 is the reference point (100 per cent). All figures used were adjusted for inflation and translated to 2002 dollars.

In order to establish whether pay and performance where tied together[21], Bebchuk and Grinstein examined the changes in ratio between aggregated executive compensation to aggregated earnings during the Relevant Period[22]:

Table 8
Compensation and Corporate Earnings

Period		Aggregate top-five compensation to aggregate earnings (%)
3-year periods:	1993–5	5.0
	1994–6	4.9
	1995–7	5.2
	1996–8	5.5
	1997–9	6.0
	1998–2000	6.5
	1999–2001	8.6
	2000–2	12.8
	2001–3	9.8
5-year periods:	1993–7	5.2
	1999–2003	8.1
Full period:	1993–2003	6.6

Notes: The table shows the ratio of the sum of compensation to top-five executives paid by a large set of pubic firms to their aggregate earnings (net income). The set of firms includes all ExecuComp firms and Compustat firms with market cap larger than $50m except for firms for which there is no income information in Compustat, as well as real estate investment trusts, mutual funds, and other investment funds. Income information is obtained from Compustat, and the estimates of aggregate top-five compensation are calculated in the same way as in Table 7.

[21] See also Brick, Palmon and Wald, "CEO Compensation, Director Compensation and Firm Performance: Evidence of Cronyism", (1 may, 2002) (available at Http://papers.ssrn.com/sol3/papers.cfm?abstract_id=303574&rec=1&srcabs=236033)

[22] The Growth of Executive Pay, 297 (see appendix 2)

The data reveals that the ratio increased in the relevant period from 5% in 5/1993 to 9.8% in 3/2001, thus, compensation in that period has increased more than the earnings. These findings support the assertion of many academics that executive compensation in the U.S is not correlated with performance.

In the next chapter I will discuss the many possible explanations to why executive pay have increased so dramatically in the past decades, and how this phenomenon is a result of executives role and influence in the firms.

3. Explaining the Growth of Executive Pay

"The evidence indicates that there is a link between managerial power and pay. The more power managers have, the more favorable their compensation arrangements are"[23]

a. The Agency Problem

The complex relationship between the principles (shareholders) and the agents (managers) of a dispersed company was first documented in Berle and Gardins's study from 1932[24], which described the "agency relationship" as one of the key problem in modern corporate law. According to Berle and Gardins, ownership and control are essentially separated in publicly traded companies[25], since multitudinous and dispersed ownership cannot efficiently monitor or direct the actions of the managers, who exert day-to-day control over the company. In fact, the principles cannot insure that the agents will act in the principles best interest. Moreover, the fact that each shareholder holds only small percentage of the company deters his incentive to control corporate management effectively, a phenomenon that is recognized as the "Agency Problem". As a result of the "agency problem", managers might involve in inefficient behaviors, thus inflicting "agency costs" on the corporation and diminishing the corporate "pie".

Eight Del.C. § 141[26] provides that the board of directors (which hold fiduciary duties toward the company and shareholders[27]) is vested with the power to direct the company's business and affairs, to hire or replace the CEO and to supervise and monitor the managers of the corporation, hence preventing the "agency problem". Managers' tendency to act in self-serving behaviors, thus inflicting "agency costs", were meant to be contained by the sanction of board intervention[28]. There are many who claim that directors do not possess the right skills[29], get enough information or spend sufficient time (independent director devoted

[23] Lucian A. Bebchuk and Jesse Fried, "Pay without performance: The Unfulfilled Promise of Executive Compensation", Harvard University Press [hereinafter:"**Pay without Performance**" or "**B&F**"]
[24] Adolf A. Barle jr and Gardine C. Means, "the modern corporation and private property", (New York: Macmillan, 1932)
[25] It is worth mentioning that modern corporations in the U.S are characterized by dispersed ownership (taken from pay Without performance, 15).
[26] The Delaware Corporate Law, Section 141
[27] Perlman v. Feldman 219 F.2d 173 (2d Cir. 1955)
[28] Pay without performance, 17
[29] Patrick McGeehan, "Quick, What's the Boss Making?" , New York Times, September 21, 2003, sec 3, 1.

between a hundred[30] and one hundred and ninety[31] hours a year) to monitor the managers and to ensure the benefit of the shareholders is being served[32].

Several mechanisms have evolved to reduce "agency costs". First, if the company runs inefficiently, its products or services will be relatively expensive (as a result of high operating costs to the firm), thus, lowering revenues and eventually might leads to the replacement of the management (the effects of the product market are explained in chapter 6). Second, minority shareholder's interests are over sighted by owner of share blocks in the corporation (usually institutional investors), who have incentive and ability to restrain insubordinate managers. Finally, one of the most important means of reducing "Agency Costs" are the capital markets. Public companies' management and performance are evaluated on a day-to-day basis by the capital markets. Trading the stock in the open market provides accurate pricing of the company (only in an assumption of high level of market efficiency)[33], and are considered a "barometer" for its success.

The issue of executive compensation is an obvious case of the "Agency Problem", since naturally executives would rather get higher compensations for less work. The board of directors is vested with the responsibility to make decision regarding executive compensation. According to Jensen and Murphy, Since the board of directors do not have the ability to influence managers directly to act in the good of the company and shareholders, executives' compensation plans should be designed in a way that will reduce "Agency Costs", increase share value and maximize the company's performance. This can be achieved by increasing the sensitivity between compensation contract to the company's performance, in such way that induces and rewards performance[34].

b. Arm's Length Bargaining

The official theory of executive compensation read that the board is assumed to bargain at arm's length[35] with executives over their pay levels, while taking under exclusive consideration the interests of the company and its shareholders. Such arm's length bargaining of contracts is characterized by (1) providing the executive value that matches or exceeds the value of other opportunities ("Reservation Value") and (2) the contract would tend to avoid

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[30] Jay W. Lorsch and Krishna G. Palepu, "Limits to Board Effectiveness", Working Paper, Harverd Business School, 2003, 3.
[31] Judith Burns, "Everything You Wanted to Know about Corporate Governance.... But Didn't Know to Ask", Wall Street Journal, October 27, 2003, R6.
[32] Id. 19
[33] Kenet greenfield, "the failure of corporate law",48, the university of Chicago press, 2006
[34] Michael C. Jensen and Kevin j. Murphy, "Performance Pay and Top Management Incentives". Journal of political economy 98 (1990); 225-264
[35] "The parties to a transaction are independent and on an equal footing" (taken from Merriam Webster online dictionary at http://www.merriam-webster.com/dictionary/arm%27s%20length)

inefficient terms that reduce the size of the "pie" produced by the contract (for example, tax subsidized compensation in compensation plans)[36]. The increase in executive compensation under the arm's length bargaining can be explained by (1) the value of executive services to companies go up (demand side), (2) executive's reservation price goes up (supple side) or (3) the job's nature or requirement become more demanding or costly for the executive[37].

The arm's length view assumes that directors serve the interests of the shareholders. In reality, this assumption does not hold, since directors have financial and non-financial incentives to cooperate with executives. One of the reasons is the minor interest of the directors in the company's share value, since their holding is usually very small[38].

In contrast with the official view of scholars, Core et al (2005)[39] argue that arm's length contracting amounts to a standard of theoretical perfection that can exist only in a world without contracting and transaction costs. Their claim is that arm's length bargaining cannot be a relevant benchmark for evaluating pay contracts to executives. Optimal contracting was explained and revoked by Jensen and Meckling in their 1976 article "Agency Costs and the Theory of the Firm"[40]:"**Finding that agency costs are non-zero (i.e., that there are costs associated with the separation of ownership and control in the corporation) and concluding therefrom that the agency relationship is non-optimal, wasteful or inefficient is equivalent in every sense to comparing a world in which iron ore is a scarce commodity (and therefore costly) to a world in which it is freely available at zero resource cost, and concluding that the first world is "non-optimal" - a perfect example of the fallacy criticized by Coase and what Demsetz characterizes as the "Nirvana" form of analysis".**

Moreover, the fact that CEOs with more power receive more pay does not necessarily mean that the shareholder's and the company's interests are not optimized. Core et al (2003) define an optimal contract (or efficient contract) as "**One that maximizes the net expected economic value to shareholders after transactions costs and payments to employees**", or alternatively, "**minimize agency costs**"[41]. Core et al (2005) defines optimal compensation as "**One that maximizes net shareholders value given that the board is optimized to perform several functions**".[42] This definition arise from their view, in contrast to Bebchuk and Fried's,

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[36] Pay without performance, 18
[37] The Growth of Executive Pay, 298
[38] Id. at 23
[39] John E. Core, Wayne R. Guay and Randall S. Thomas, "2005 Survey of books related to the law: is U.S CEO compensation inefficient pay without performance?", 13, 103 Mich. L. Rev. 1142 (2005) [Hereinafter:"**Core et al (2005)**"]
[40] Michel C. Jensen and Willian H. Meckling, "Agency Costs and the Theory of the Firm", 3 J. Fin. Econ. 305, 328 (1976) [hereinafter "**Jensen & Meckling**"]
[41] John E. Core at el, "executive equity compensation and incentives: a survey, 9 Fed. Res. Bank, N.Y. Econ. Pol'y Rev. 27 (2003) [hereinafter: "**Core et al (2003)**"]
[42] Core et al (2005), 15

that the board of directors shouldn't be completely independent of the CEO, since directors have other responsibilities toward the company (beside executive compensation contracts), that are best fulfilled by non-independent boards. According to Fama and Jensen[43] the most influential members of the board (taking under consideration it's comprised of experts) are internal managers with valuable firm-specific information about the company. It is worth mentioning that in order to enhance the independence of board members, board members would have to be replaced every year. Hence, demand for total independence will result in increased costs, and therefore is not optimal[44].

In his earlier work, Murphy observed that the manager's influence over compensation is typically indirect, and that pay is set by the judgment of well-intentioned boards, which tend to systematically favor the CEO. Thus, facing competitive pay levels for CEO in the market, boards tend to err on the high side, in favor of the CEO[45]. There is no evidence in this data to prove that executives are effective in exploiting these opportunities, or to explain any of the patterns and practices of CEO pay[46].

c. The Managerial Power Hypothesis (MPH)

"**Like the arm's-length contracting view, the managerial power analysis begins by recognizing the agency problem inherent in the manager-shareholder relationship**[47]".

As mentioned earlier, the board is responsible to set the compensation of the company's top executives, and this is done within the compensation committee. The committee is made of three or four "independent" directors (73% of the companies in the S&P 1500 in 2002)[48], hence, they are not current or former employees of the company, and are not affiliated with it in any way beside their directorship. Tax laws[49] in the U.S. have created an incentive for companies to include only independent board members in the compensation committee, and have penalized companies who did not do so. As I will demonstrate in chapter 8, compensation decisions have been largely insulated from judicial review, since courts have enforced compensation plans that were recommended to the board by a compensation

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[43] Eugene F. Fama & Michel C. Jensen, "Separation of Ownership and Control", 26 J.Fin. Econ. 301, 314 (1983)
[44] Core et al (2005), 15
[45] Kevin J. Murphy, "Executive compensation", in Orley Ashenfelter and David Card, eds, 3B The Handbook of Labor Economics 2485, 2517 – 18 (Elsevier 1999)
[46] Kevin J. Murphy, SYMPOSIUM: "Management and Control of the Modern Business Corporation: Executive Compensation & Takeovers: Explaining Executive Compensation: Managerial power Versos the Percieved cost of Stock Options",4, 69 U. Chi. L.Rev. 847 (2002) [Hereinafter: **"Murphy (2002)"**]
[47] pay without performance, 61
[48] Stacy Burk, Glenn Davis, Chris Loayza, Conor Murphy and Sergio Schuchner, "Board structure/board pay 2002 (Washington D.C: investor responsibility research center, 2002, 41-43
[49] I.R.C. § 162(m) 2000 the exception for non performance-based pay is in §162(m)(4)(c)

committee. Stock exchange rules also require independent directors on boards and compensation committees, but these are secondary to similar requirement of the SEC[50].

The influence of the CEO on directors is achieved mostly through the reelection mechanism. Serving on the board holds many financial and nonfinancial benefits for board members, ranging from generous salary and additional perks (complimentary use of the company's assets for example), to prestige and connections. Hence, directors have many reasons to be placed on the company's slate, and to be reelected (statistics show they usually are reelected[51]). The responsibility of accepting nominees is placed on the nominating committee. The nominating committee is not composed solely of independent directors (only 50% of the companies in the S&P 1500 in 2002[52] were totally comprised of independent directors), and the CEO can be a member. Hence, the influence of CEOs on the nominating committee and their ability to block nominations of directors is obvious and clear. It is also clear that directors that will not comply with the CEO's compensation demands will find themselves out of the board. In 2003, new listing requirement by the SEC, NYSE, NASDAQ and AMEX were ruled[53] in an effort to reduce the CEO's influence on the nominating process. Even so, directors are still influenced to stay in good relations with the CEO, since they have to work together. Moreover, "rebellious" directors will be frowned upon within the board, since it undermines the board's collegiality[54].

While Bebchuk and Fried find the SEC's requirements acceptable, they stress that these requirements are not very beneficial against executive influence. The reason is that they may force committee members to devote more attention to executive compensation and to articulate their decisions, but they do not address the directors' incentive to favor executives in their compensation decisions, and do not deter them from doing so[55].

Murphy claims that the increase in number of independent directors in boards (as mentioned by Bebchuk and Fried) seems directly inconsistent with their hypothesis[56] that CEO patterns and practices are driven by managerial power[57]. Murphy compared the compensation of CEO's hired from the outside (without establishing connections to the board) to CEOs hired from inside the firm (which might have connection to the board) in the period

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[50] Pay without performance, 25
[51] Lucian A. Bebchuk, "The Case for Shareholders Access to the Ballot", Business Lawyer 59 (2003) 43-66
[52] Stacy Burk, Glenn Davis, Chris Loayza, Conor Murphy and Sergio Schuchner, "Board structure/board pay 2002 (Washington D.C: investor responsibility research center, 2002, 49
[53] SEC Release No.34-48745 (November 4, 2003); NASDQ Rule 4350; NYSE Listed Company Manual Rule 303A; American Stock Exchange Company Guide, sec 804;
[54] Pay without performance, 26
[55] Id. at 195
[56] See Bebchuk & Fried's answer to that criticism in "pay without performance", 72
[57] Murphy (2002), 4

1992 – 2000, in order to see whether or not CEOs influenced directors who were connected or affiliated with them, as suggested by the managerial power hypothesis (MPH). The results show that by the full fiscal year, cash and total compensation were significantly higher for CEOs hired from outside of the firm than CEOs hired from the inside. These results are inconsistent with the premise of the MPH[58].

The CEO's influence on directors manifests itself in other benefits within the power of the CEO, and does not end in the reelection mechanism. Although listing standards adopted by stock exchanges in 2003 (as mentioned supra) limit CEO's influence to some extent, CEOs are able to reward independent directors in many ways, such as setting their compensation, self dealing with them etc. For example, if the CEO of company **A (CEO_A)** is a director in company **B**, and a director in company **A** is the CEO of company **B (CEO_B)**, then they are "Interlocking" directors. In such a case, CEO_A can benefit CEO_B by approving his compensation plan as a director in company A and vice versa. The fact is that in 8.3% of publicly traded companies, the board is CEO-interlocked[59]. Stock exchange listings were changed so interlocking CEOs are not considered independent (where they serve as directors) [60]. CEOs can also influence director's discretion through their effective control over information providers. Compensation consultants and human resource departments are facing strong incentives to please, or at least, not to get into a quarrel with the CEO[61].

The relative cost to director for favoring the executive divides to (1) the value of the director holdings in the company and (2) his reputational cost. It seems that the cost of decrease in holding value is usually small since holdings are minor. As for reputational costs, as long as compensation schemes are within the limit of what is considered normal and acceptable, the directors are unlikely to bear any costs in their reputation[62] (outrage costs)[63].

For conclusion, the Managerial Power Hypothesis can be explained as the cause for many abusive pay norms, such as (1) the absence of reduced windfall options[64] ,(2) granting executives with at-the-money options[65] ,(3) backdoor repricing of options when stock price fall below exercise price[66] and (4) the move toward restricted stocks[67].

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[58] Id. at 5
[59] Kevin Halloc, "Dual Agency: Corporate Boards with Reciprocally Interlocking Relationships" in "pay without Performance" page 30
[60] Pay without performance, 30
[61] Id. 39
[62] Id. 36
[63] Id. at 64
[64] Pay without performance, 144
[65] Id. at 159
[66] Id. at 167

d. "Boom" Period Increase in Executive Pay and Other explinations

It is a well-known phenomenon that in boom period in the markets, demand for executives goes up, which in turn raises the pay levels for executives[68]. This phenomenon can be explained as a result of the "Bull" markets increase in the wealth of executives, hence, increasing their reservation wage by increasing the monetary amount to induce executives to work[69].

Gravix and Landier found that "**The role of average firm size provides a novel explanation of the rapid surge in US CEO pay since 1980. While previous papers attribute this trend to incentive concerns or managerial entrenchment, we show that it can be explained by the scarcity of CEO talent, competitive forces and the six-fold increase in firm size over the same period**"[70]. According to their argument, while managerial power has decreased, executive pay has been increasing rapidly[71]. This argument might fit better to older CEO's, where the other alternative than work is enjoying leisure and stay home[72]. Another explanation read that during boom periods, executives have to exert more effort, hence, increased level of compensation are required to induce them. Yet, it has not been proven that boom period require more from the executives than "Bear" market period[73].

Another explanation for the growth in executive pay is that CEOs bargaining position have increased since the beginning of the 1990's, maybe because CEO marginal productivities increased[74]. Another reason might be that that general "managerial capital" has become important relative to firm specific capital[75].

e. Conforming With Conventions

According to Bebchuk and Fried, inefficient compensation arrangements may arise and persist simply because of board's conformity with conventions. Directors are more willing to approve pay arrangements that are similar to those of other companies. However, their claim is that the desire to conform cannot explain the ways in which compensation

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[67] Id. at 170
[68] Charles P. Himmelberg and R. Glenn Hubbard, "Incentive Pay and the Market for CEOs: an Analysis of Pay For performance sensitivity at 3-4, Working paper (2000) [hereinafter:"Himmelberg & Hubbard"] and Hubbard (2005)
[69] Spatt (2004)
[70] Xavier Gabaix & Augustin Landier, "Why Has CEO Pay Increased So Much" (Jan. 8, 2007) (available on http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1291579)
[71] Geoffrey A. Manne, "The Hydraulic Theory of Disclosure Regulation and Other Costs of Disclosure", 10, 58 Ala L.Rev 473 (2007)
[72] The Growth of Executive Pay, 298
[73] Id.
[74] Himmelberg & Hubbard
[75] Murphy (2002), 5

arrangements have evolved nor can it predict future developments. **"To provide full account of executive compensation, norms and conventions must be combined with another theory, such as arm's-length contracting or managerial power"**[76].

The myriad of factors I have described supra enabled executives to have considerable influence to set their compensation and to use their power to obtain compensation far more favorable than they would get under arm's-length bargaining. This additional value in compensation that is obtained beyond arm's-length bargaining is referred to by Bebchuk and Fried as extracting "Rents" from the firm. In the next chapter, I will show how compensation arrangements provided bank executives incentive to take excessive risks, which contributed to the creation of the worst financial crisis since the 1930's.

[76] pay without performance, 75

4. Executive Pay Norms and the Financial Crisis

Excessive risk taking in financial institutions resulted from the well-understood problem of moral hazard[77]. In the capital structure of modern banks, the provider of capital (equity) capture the full upside, while most of the downside is borne by the government as insurer of deposits[78,79]. Shareholders and executives (which received shares as part of their incentive pay) are insulated from the effect of a decline in the value of bank assets on the capital that comes from bondholders and the government at either the bank level or the bank holding company level.

The case is even graver with options on common shares, since executives have even more incentive for risk taking than common shareholders of bank holding companies. "**When the executive has options on the shares of the bank holding company, the executive position is equivalent to holding shares with a non-recourse loan on those shares which equal to the current price of the shares. This makes the executive's position with respect to the bank's capital even more leveraged. This is an additional layer of leverage added on top of the deposits and loans, and each layer of leverage strengthens the incentive to take risks**"[80].

The structure of modern banking organization and the compensation structure of bank's executives created an incentive for excessive risks taking. Such excessive risk taking can be explained as "**taking actions that may either increase or decrease the value of the bank's assets but whose expected effect on the banks value is negative**"[81]. Executives' excessive risk taking was the result of asymmetric payoff, meaning, executives expected to capture a share of possible gains in case of success, but bear a smaller fraction of possible losses.

In this next example, I will demonstrate the insulation of shareholders in banks from risk, and their incentive to take excessive risk. A bank is holding $100 in assets, and funded by capital of $10 and $90 in deposits (which are senior to capital), Let us assume that a strategy would produce a 50/50 chance of increasing or decreasing in the bank assets. The bank had decided to pursue a risky strategy with 50% chance of reducing the assets value by

[77] See Jensen & Meckling, 334-337
[78] The Federal Deposit Insurance Company (FDIC)
[79] Regulating bankers pay, 8
[80] Id. at 19
[81] Lucian A. Bebchuk and Holger Spamann, "Regulating Bankers Pay", 7, Harvard University, John M. Olin Center for Law, Economics and Business, Discussion paper No. 641 (July 2009) (available on http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1410072) (accessed 20/9/09) [hereinafter "**Regulating Bankers Pay**"]

$20 or 50% chance of increasing it by $X. if X is less than $20, than the risky strategy will have a negative expected value. Bear in mind that in the event of a loss of $20, the shareholders will not bear the loss fully, only $10, which is their capital invested in the bank. The remainder $10 is borne by depositors and/or the government as the insurer. In the event that the risky strategy is successful, the shareholders will benefit the full increase of $X in the asset value. The outcome of this example is that taking the risky strategy will have a positive expected value for the shareholders as long as X is more than $10. Thus, when X is greater than $10 but smaller than $20, the risky strategy has a negative expected value, but will still have an economic interest for shareholders[82]. Going back to the financial crisis, since compensation arrangement shielded bank executives from personal losses, they took excessive risks that were socially excessive (yet privately optimal), Risks that eventually led to the financial crisis[83].

Bebchuk & Spamann illustrate their point with the example of the two biggest banks in the U.S. (at the time) Citigroup and bank of America. Both banks were heavily leveraged, yet met the Fed's requirements for "well-capitalized institutions"[84]. Both CEO's were not invested in their company's bonds but rather heavily invested in their company's stock. This created a powerful incentive to underweight the possible downside of a strategy relative to its upside. Their options encouraged even more risk taking, since most of them had an exercise price of 20% below the stock price at the option grant day. The meaning of this is that the executive's were indifferent to any decline in asset value beyond 20%, since the option value would then be worth nothing. Alternatively, the CEO's would benefit in full any increase in the equity value[85].

One might wonder whether depositors themselves might deter such risky strategies by banks, or alternatively, the regulator - through prudent regulation. It is well acknowledged that excessive risk taking by bank does not deter potential depositors from using the bank's services, since the government protects deposits, and since small depositor lacks resources to monitor banks' behavior. Moreover, the supporters of prudential regulation ignore the fact that regulators' information is limited, and therefore cannot be counted to eliminate all excessive risk taking by banks[86].

In theory, bondholders could insist on covenants that would preclude such pay arrangements, or alternatively, demand a higher risk premium for lending funds to the firm.

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[82] The example is taken from Regulating bankrs' pay at 9
[83] Id.
[84] 12 C.F.R. 225.2(r) (defining "well capitalized")
[85] Regulating bankers' pay, 21
[86] Regulating bankers pay, 10

However, bondholders cannot be relied upon to deter such compensation arrangements, since they do not bear the full cost of such arrangements. In case of bank failure due to risky behavior, much like depositors, a substantial part of the cost will be borne by the government as guarantor of deposits. Moreover, bondholders' incentive to limit risk taking activities is decreased even more by directs and indirect benefit from a government bailout in case of financial collapse[87]. As financial institutions became "too big to fall" in the last 20 year, partially as a result of deregulation[88], it is almost impossible for the government to commit not to bail a large failing financial institution. "**For example, in the recent crisis, the government has injected substantial capital into many banks in the form of preferred shares that are junior to the claim of bondholders, insured some banks against a decline in the value of some of their toxic assets, and initiated a program to provide government subsidies to funds that will purchase toxic assets from banks – all actions that benefited bondholders and provided them with partial protection against the consequences of the banks' losses**[89]".

As a result of the recent financial crisis, the value of banks assets and capital has been eroded drastically, while the decrease in the value of shares in the bank holding company was not as drastic. Bebchuk & Spamann claim that since executives hold common shares and options on shares of the holding company as part of their compensation arrangement, it increases the divergence between the interest of the executives and the interests of bondholders, depositors and the government. They explain that a reduction in the value of the common shares and options reduces the potential loss of executives as a result of their actions, hence, executives will be more prone toward negative expected value strategies, for which the possible private gains to executives and other common shareholders outweigh the private possible losses to them[90].

The latest regulation on financial institutions was the enactment of the Grayson-Himes "Pay for Performance" Act of 2009 [91], which prohibited non-performance based compensation for executives of financial institutions received TARP funds. Today, when the panic that followed Lehman brothers' collapse seems like a distant memory, the chances that the further regulation on executive pay in all financial institutions seems slim.

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[87] Id. at 21

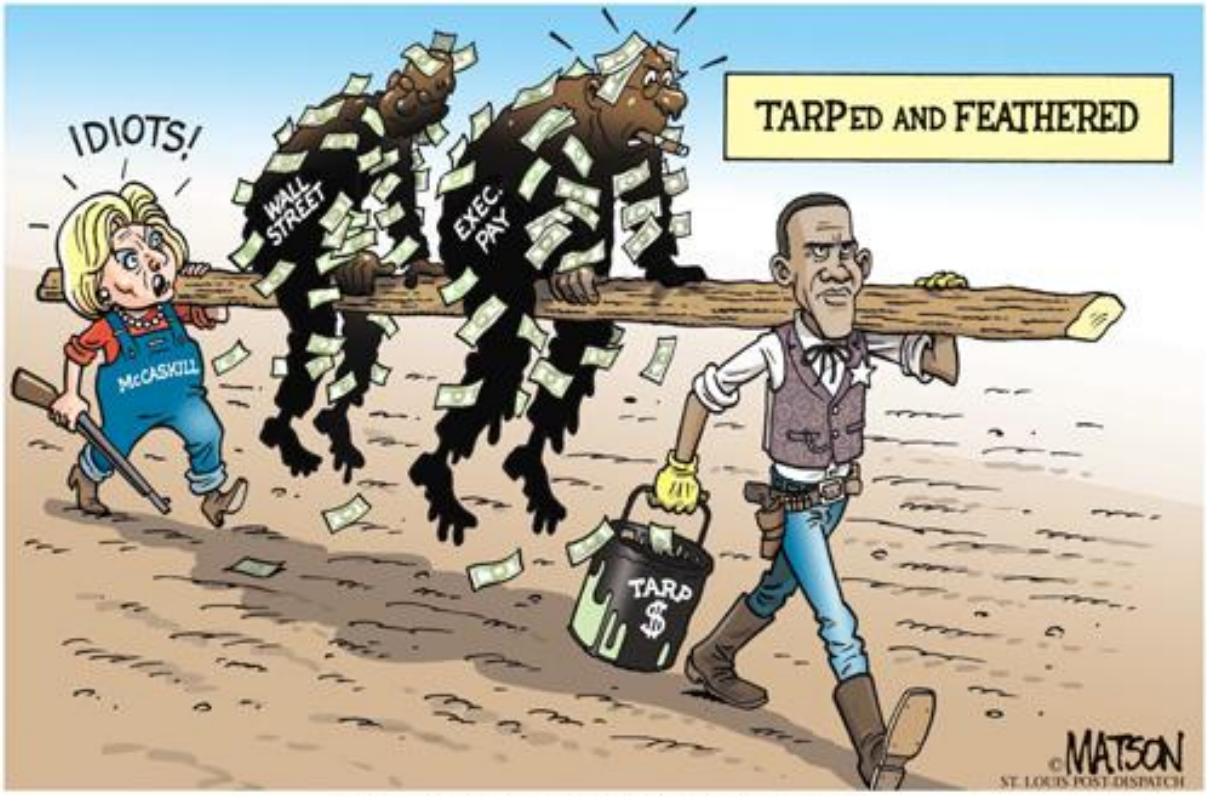
[88] For more on deregulation of the banking system, see Douglas W. Arner, "The global Credit Crisis of 2008: Causes and Consequences", Asian Institute of Financial Law (AIIFL), Faculty of Law, The university of Hong-Kong, available at (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1330744) [hereinafter: "**Arner**"]

[89] Id. at 22

[90] Id. at 25

[91] H.R.1664 - Grayson-Himes Pay For Performance Act of 2009 (released March 23, 2009) (available on http://www.house.gov/apps/list/press/financialsvcs_dem/hr_1664.pdf

Until now, I reviewed the increase in executive pay and the factors that caused it, as well as the contribution of pay arrangements to the creation of the financial crisis. In the next chapter, I will present evidence that executive pay contracts in the U.S. are constructed to provide too little pay for performance, partly due to equity based pay that provides "windfalls" to executives.



"$500,000 A YEAR BARELY COVERS IT!"

5. Pay With or Without Performance

a. Exercise Price of Options

Options are believed to counter the tendency of insufficiently diversified and risk-averse executives to hesitate to take desirable chances/risks for shareholders. Essentially, options are granted to provide executives with a financial incentive to take risks. The amount in which the option will encourage an executive to take risk, as well as the cost effectiveness of options, depends on their exercise price (strike price)[92]. Options are issued with an exercise price lower (in-the-money), equal (at-the-money) or higher (out-of-the-money) than grant-date market price.

From the firm's point of view, the **perceived cost** of issuing options with an exercise price equal or higher than the grant-date market price ($X \geq S$) is **lower** than issuing options with an exercise price below grant–date market price ($X < S$), since it incurs an accounting charge, as well as creating a tax event according to section 162(m) of the Internal Revenue Code[93]. Executives on the other hand, will prefer options issued with an exercise price equal or lower grant-date market price ($X \leq S$). It is therefore clear why in reality, options are often issued with an exercise price **equal** to grant–date market price ($X = S$). A study from 1999 have shown that more than 95% of options granted to CEO's of the 1000 large companies in 1992 were granted at-the-money[94]. A different study found that "**out-of-the-money options often generate much higher pay-for-performance sensitivity per dollar of expected value than do conventional options**[95]" and that "**there is some empirical evidence suggesting that giving managers out-of-the-money options rather than at-the-money options does, on average, boost firm value**[96]".

Even though tax and accounting rules could account for the almost complete absence of in-the-money options, according to Bebchuk and Fried, this is an evidence of the Managerial Power Hypothesis[97]. Practitioners claim that incentive plans are most efficient when at least partial payouts are likely. Taking under consideration the data regarding low

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[92] Pay without performance, 159
[93] I.R.C. § 162(m). The exception for non performance-based pay is in §162(m)(4)(c)
[94] Kevin J. Murphy, "Executive Compensation", in Handbook of Labor Economics, Vol. 3, bk. 2, ed. Orley Ashenfelter and David Card (New-York; Elsevier, 1999), 70, table 5. in pay without performance, 160
[95] Brian J. Hall, "A Better Way to Pay CEO's?" pay without performance, 161
[96] Michael A. Habib and Alexander P. Ljungqvis, "Firm Value and Managerial Incentives: A Stochastic Frontier Approach", working paper, London School of Business and stern school of Business, New-York University (2003)
[97] Pay without performance, 162

cash pay and high option issuing to executives, it seems that setting a high exercise price will reduce the probability of a payout, and hence, reduces the executive's incentive for risk averse undiversified executives[98].

Bebchuk and Fried assert, that "**because stock prices rise on average over time, an option issued at the current market price is likely to become progressively more in-the-money as time passes, and, correspondingly, to produce incentives progressively more like those of an in-the-money option. Furthermore, as time progresses, the fact that the stock price exceeds the exercise price will be less an less indicative that managers have increased shareholders value since the option was issued**"[99].

Moreover, backdoor repricing of executives' options is a common action taken by firms when stock price fall below the options exercise price. Repricing options weakens even more the link between pay and performance, rewards poor stock performance and reduces the managers' incentive to perform[100].

b. Windfalls

Core et al (2005) defines two **equivalent** ways of providing incentive for executives. First, by contracting the managers' pay to vary with the corporate performance (**pay incentives**) and second, granting the executive with stocks and options that vary with performance (**portfolio incentive**). In **pay incentive**, the contract should be constructed to provide the executive with basic salary and further incentive (bonus) based on market adjusted stock return, which is the difference between the return on the firm's stock (R<firm>) and the market return (R<market>) (similar to Jensen's Alpha, A.Y). Such optimal contracting will only reward CEOs when firm performance exceeds market performance.

In **portfolio incentive**, the executive is paid a basic salary and is required to use his own wealth to purchase the company's stocks or options (which exposes his pay to the company's performance). The two contracts can be constructed to deliver the executive total identical[101] wealth change and risk exposures, and therefore deliver identical incentives[102].

It is important to mention that the **pay incentive** contract requires both the firm and the executive to make a contractual agreement to transfer cash ex post (transfer to the executive when market adjusted stock return increases and to the firm when it decreases). Hence, **pay incentive** contract are more difficult to enforce. On the other hand, **portfolio**

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[98] Murphy (2002), 11
[99] Pay without performance, 161
[100] Id. at 166
[101] See example in appendix 3
[102] Core et al (2005), 19-21

incentive is easier to enforce, since the executive purchased the stocks or options ex ante, and directly benefits from (or punished by) any stock price increase (decrease) [103].

According to B&F, "**while connecting pay with executives' relative performance can provide good incentives, tying pay to stock price or earning increases that are unrelated to executives' effort does not**"[104].

In order to provide an executive with efficient incentive, one should be rewarded for good performance. Executives' good performance is measured against that of his peers. Bebchuks and Fried's claim that there is no incentive value in rewarding executives for an increase in stock price or accounting earnings that are not tied to his own efforts or decision making, but rather reflect general market or sector change (windfall), or in other words, pure luck. Thus, salary and bonus amounts must depend on the executive's own performance in order to provide desirable incentive. Empirical studies indicates that managers' cash compensation has been weakly tied to their own performance[105].

On the contrary, Jensen and Murphy (1990)[106] established that majority of U.S executive compensation contracts are designed as "portfolio incentives". Thus, executive pay contracts exhibits much pay-for-performance since executives hold stocks and options of the company. Stock and option compensation increase equity ownership, and thereby link pay to performance in such a way that provide executives with incentive to serve shareholders value[107]. Although this might be true, the fact that equity ownership can provide incentive to serve shareholders interest does not mean that granting executives more shares and option regardless of their costs is always good for shareholders[108]. A recent study found that boards give CEO too many options, hence, the incentive benefit of the last option granted (the marginal option) is less than the cost to the shareholders[109]. A different study found that S&P 500 firms that heavily compensated both executives and workers with options have underperformed the index[110]

Although Bebchuk and Fried assert that U.S. executive compensation should be designed more as "pay incentive", which vary in correlation with the company's performance[111], Core et

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[103] Id. at 34 (n35)
[104] Pay without performance, 123
[105] Id. at 122. For more on bonus plan, see "pay without performance", page 124
[106] Michael C. Jensen and Kevin J. Murphy, "Performance Pay and Top-Management Incentives, 98 J. Pol. Econ. 225 (1990)
[107] Pay without performance, 137
[108] Pay without performance, 138
[109] Michael A. Habib and Alexander P. Ljungqvis, "Firm Value and Managerial Incentives: A Stochastic Frontier Approach", working paper, London School of Business and stern school of Business, New-York University (2003)
[110] David Leonhardt, "Report on Executive Pay: Will Today's Huge Rewards Devour Tommorow's Earnings?" New York Times, April 2, 2000 sec. 3,1 (available at http://www.nytimes.com/2000/04/02/business/report-on-executive-pay-will-today-s-huge-rewards-devour-tomorrow-s-earnings.html?scp=1&sq=Report+on+Executive+Pay&st=nyt)
[111] Pay without performance, 19

al (2005) however, argue that their assertion ignores the finding of Hall and Liebman (1998): "**A common view is that there is little correlation between firm performance and CEO pay. Using a new fifteen-year panel data set of CEOs in the largest, publicly traded U.S. companies, we document a strong relationship between firm performance and CEO compensation. This relationship is generated almost entirely by changes in the value of CEO holdings of stock and stock options**" [112].

Hall and Liebman's conclusion is illustrated more clearly in the table below, gathered by Core et al (2005) which represent the median CEO pay, portfolio value and incentives[113] for S&P 500 firms in the period 1993 - 2003[114]:

	(1)	(2)	(3)	(4)
Year	Total Annual Pay	Beginning-of-Year Portfolio Value	Beginning-of-Year Incentives	Fraction of Value Vested
1993	$ 1,983,000	$ 9,275,000	$ 125,000	76.7%
1994	2,444,000	10,306,000	152,000	75.6%
1995	2,765,000	10,623,000	157,000	70.8%
1996	3,257,000	13,220,000	191,000	72.8%
1997	3,989,000	19,574,000	286,000	71.3%
1998	4,578,000	27,563,000	403,000	69.2%
1999	5,470,000	37,041,000	492,000	65.9%
2000	6,947,000	43,484,000	567,000	63.8%
2001	7,351,000	50,215,000	647,000	60.1%
2002	6,585,000	38,105,000	552,000	58.8%
2003	6,578,000	30,137,000	430,000	52.8%
Ten-year growth rate	12.7%	12.5%	13.2%	3.7%

Core et al (2005) measured the incentives to the median CEO pay as an increase (decrease) in the value of the executive's stock and option portfolio as a result of a increase (decrease) in the stock price by 1% (shown in column 3). For example, in 2003, the median CEO pay was 6.6 million dollar. For every change of 1% in the company's stock price, the CEO'S wealth changes by $ 430,000. So, if the firm's stock go down by 30%, than the change in the CEO's wealth is 30 times $ 430,000, which is equal to a decrease of 12.9 million Dollar, thus, he is obligated to transfer the company 6.3 million dollar (the median pay minus 12.9 million $). Because of their large stock and option portfolios, U.S. executives

[112] Brian J. Hall and Jeffrey B. Liebman, "Are CEOs Really Paid Like Bureaucrats?", 113 Q.J. Econ. 653, 653 (1998)

[113] **(1) The Total Annual Pay** is the median CEO salary, bonus, stock and option grants, and other pay for the year shown. (2) The **Beginning-of-Year Portfolio Value** is the median total value of stock exercisable and unexercisable options held By the CEO at the beginning of the year shown. (3) **Beginning-of-Year Incentives** is an estimate of the change in the beginning-of-year value of CEO stock and option holdings for a 1% change in stock price. (4) the **Fraction of Value Vested** is the fraction of beginning-of-year portfolio value that the CEO could obtain if all vested stock was sold and all vested in-the-money options were exercised (for options, the value vested is the intrinsic value, which is equal to the beginning-of-year stock price less the exercise price times the number of options).

[114] Core et al (2005), 22

experiences vary large wealth change when stock price changes as a result of their "portfolio incentive", and thus, have very large pay-for-performance incentive, very much on the contrary of Bebchuk and Fried's assertion. A "common view", as Liebman and Hall said, is to ignore the portfolio incentive and only look at the executive pay, which is not performance sensitive.

Bebchuk and Fried's answer to the claim of Core et al (2005) is that although managerial compensation is linked to absolute changes in the stock price, and they incur losses when the market or firm's sector declines, in the overall, being exposed to both negative and positive "shocks" is beneficial to managers for a couple of reasons. First, since markets tend to increase over time, the expected value of future market changes is positive. Second, the structure of option securities creates an asymmetry between the risk of the executive as an option holder (in worst case equals zero) and the benefits (unlimited)[115]. Moreover, according to Black & Scholes formula for valuating of options, increased volatility in the markets adds value to Call options, and thus, beneficial for executives[116].

Shareholders and policy makers have looked to equity-based compensation in order to strengthen the connection between pay and performance. As I showed in chapter 2, the use of options in compensation plans grew larger in the last decade. It is important to mention that there is evidence that in certain range of ownership level, executives, which held more equity, generate more shareholder value[117].

In recent years, firms are displaying great willingness to replace conventional options with restricted stocks rather than with reduced-windfall options. It is an evidence of managerial influence since restricted stocks tend to increase windfalls rather than reduce them. It can be explained in the following matter:

Conventional options issued at-the-money have a strike price ($X = $S). Thus, if the executive exercise the option at a later date when the stock value is $V(V>X), than the executive's profit is than $V-$X. In contrast, a restricted stock that is sold when the stock price is $V, benefits the executive in the sum of $V. this example shows that using restricted stocks benefit executive even more that conventional options[118], and thus, shareholders should recognize that a move toward restricted stock grants is not necessarily in their interest[119].

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[115] Pay without performance, 139
[116] Prof. Rafi Eldor, "options and futures", 471, 522 (2006)
[117] Id. at 137
[118] Pay without performance, 170
[119] Id. at 190

c. Unwinding Incentives

Bebchuk and Fried claim that CEOs in the U.S are using the broad freedom given to them to unwind incentives, hence, to exercise stocks and option whenever they become exercisable, even though stockholders preference is that they hold them for incentive reasons[120]. Bebchuk and Fried suggest that "**It might be efficient to pay the executive with options that cannot be exercised for a specific period even after they vest, for example, that vest in three years but can be cashed out only after, say, three additional years**"[121].

Alternatively, if unwinding incentives does occur, one might expect to see a fall in CEO holding over time, but according to Hall and Liebman, the opposite is true. Column four of the table presented in the previous part demonstrates that CEO's vested holding rose in the last twenty years, and in 2003, about 53% of the median CEO's pay was vested and thus cannot be realized. According to the logic of Bebchuk and Fried, one would expect that CEOs would own no stocks or options (as soon as they become tradable), since they had the knowledge and intention to extract rents and destroy shareholders value, and yet, the data shows that this is not the case[122].

Murphy claims that since issuing options and stocks is perceived by the firm as a low cost way to compensate executives (as explained supra), allowing at least partial unwinding of stocks an option is compatible with this view. For an undiversified executive who is restricted by formal and informal ownership guidelines from hedging his investments (formal - inside information, short selling, informal - competition), it is important to allow at least a partial liquidation of his holdings[123].

Core et al (2005) claim, that as executive's incentive level increases, executives bear more risk in holding the firm's stock and options, and thus require more non-equity pay to compensate for that risk. Bebchuk and Fried agree with this claim[124]. A study conducted by Conyon and Murphy[125] on executive compensation in the U.S. and U.K found that U.S CEOs in 1997 earned about 2.7 times more pay than their British counterparts, and held 4.2 time more stock. This could also explain the growth in pay observed by Bebchuk and Fried as discussed in chapter 2. It is also obvious from the table above that the median CEO pay (column 1 – 12.7%) grew in almost the same ratio as the median CEO beginning of the year

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[120] Id. at 174
[121] Id.
[122] Core et al (2005), 27
[123] Murphy (2002), 12
[124] B&F, 19
[125] Martin J. Conyon and Kevin J. Murphy, "The Prince and the Pauper? CEO pay in the United States and the United Kingdom, 110 Econ. J.F. 640 (2000)

stock and options (column 2 – 12.5%) and very similarly, the annual change in the CEO beginning of the year incentive (column 3 - 13.2%). The results proofs that CEO pay contracts were efficient, and CEOs received more pay as (1) incentive grew and (2) the size and complexity of the firm grew[126]. In conclusion, Core et al (2005) claim that even though U.S CEOs received higher pay in compare to CEOs in other countries, they also hold much more incentive than their counterparts, and there is no conclusive evidence that they receive inappropriately high pay given the incentive risk they bear[127].

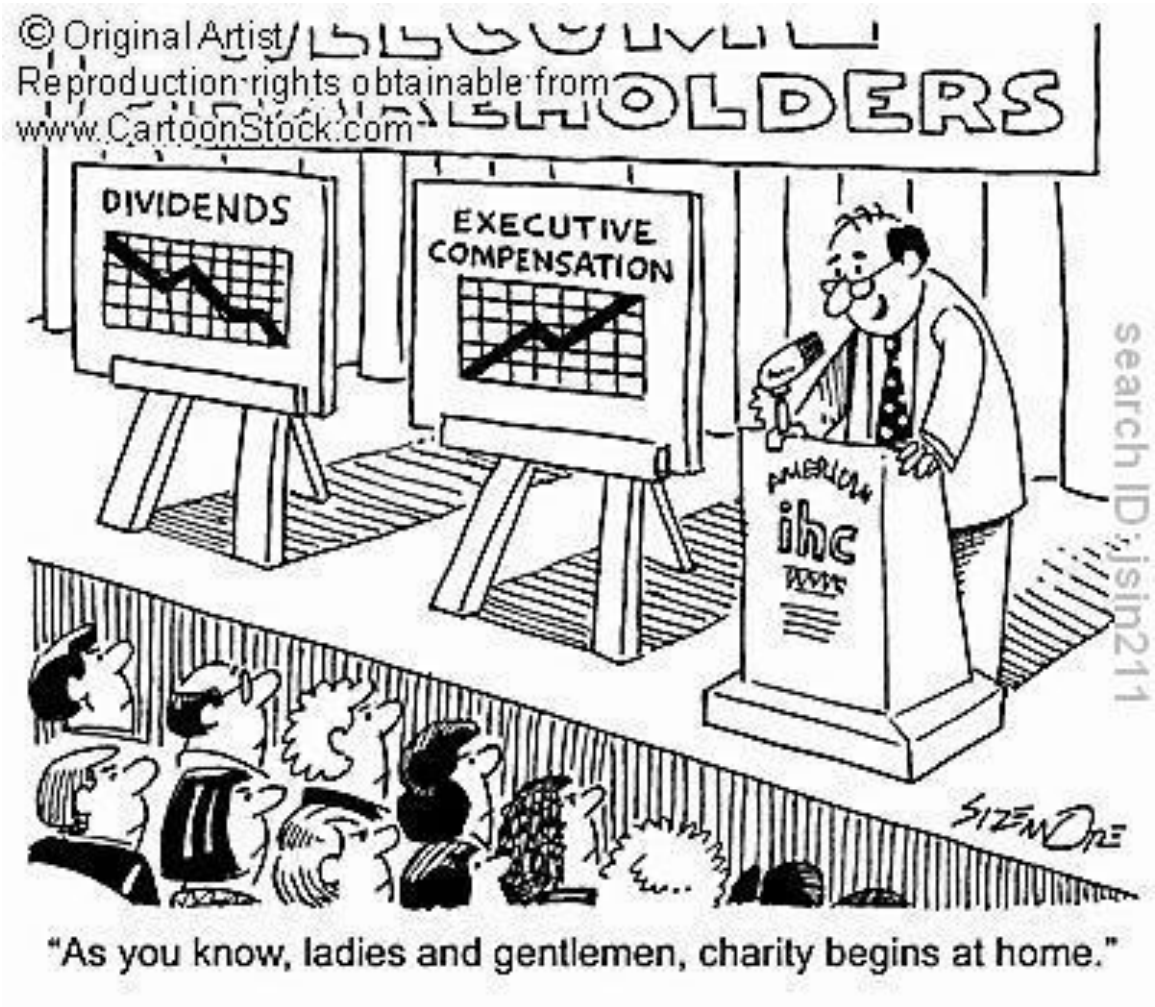
Core et al (2005) considers Bebchuk and Fried's criticism on the design of equity compensation to be unfair. First, let's consider that instead of paying the executive $X amount in cash and $Y amount in stocks and options, it grant him (I assume no trading costs) with stocks at the value of $X and $Y amount of stocks **and** options. Soon after, the executive can sell his stocks in the value of $X (since stocks are like options with exercise price of 0$), and it is clear that the structure of the equity compensation is irrelevant. Second, if the company grant's the executive with **vested stocks**, which he cannot trade for certain period of time, than he holds stocks and option in the value of X+Y, and thus, increase the risk premium required by the executive, and he would quit unless there will be an increase of compensation (compensated by the lack in liquidity, A.Y). These example come to show that incentive and pay must move together.

Murphy notices two main assumptions in order to understand his view why option compensation increased in the last decade. First, when vested options are granted to an undiversified, risk averse executive, the value of the options is not computed accurately by B&S formula, since the options are not freely traded in the market, and the executive values the options at only a fraction of their B&S value (illiquid assets)[128]. The executive will demand more of the same compensation thus resulting in the observation that there is an increase in option holdings by executives. Second, the perceived cost of granting options is far below their true economic cost. This is caused by the fact that they can be granted without any cash transfer and without resulting in an accounting charge. Moreover, the U.S accounting and tax laws state that, while exercising options does not incur any change in accounting income, it reduces the taxable income for the firm. Hence, the main cost of options as

[126] Core et al (2005), 24
[127] Id. at 25
[128] Brian J. Hall and Kevin J. Murphy, "Stock Options for Undiversified Executives", 33 J Acct Econ 3, 13-15 (Feb 2002)

perceived by board members is the "dilution cost", which can be diminished by a buyback of stocks by the firm[129].

Bebchuk and Fried are skeptical that "**directors have failed to realize that conventional options involve substantial costs for shareholders, whose holdings are diluted by the option grants**[130]". They also doubt that directors have been unaware that market indexed options bare less cost for shareholders. Even if these misperceptions and mistakes do exist, they make additional evidence to the managerial power rather than an alternative solution[131].



[129] Murphy (2002), 8
[130] Pay without performance, 77
[131] Id. at 78

6. Markets Forces Failed to Restrain Executive Pay

One of the most common arguments on corporate governance is that market forces regulate executive compensation in the best way. The main supporters of the market forces theory is The "Chicago school", whose members are, among others, such legal academic as Frank Easterbrook (Chief Justice of the U.S. Court of Appeals for the Seventh Circuit), Daniel Fischel and Supreme Court Judge Richard A. Posner, as well as financial economists such as Eugene Fama. Market forces, so the argue say, puts sufficient pressure on boards to bargain in arm's length on compensation arrangements. Bebchuk and Fried agree that to some extent the market does constrain executive compensation, yet it is "**far from tight enough to ensure that compensation arrangements do not substantially deviate from what arm's-length contracting would produce**"[132]. An early study by Bebchuk[133] has found that market forces cannot correct agency problems in all types of managerial decision, but only some of them. He showed that the market mechanism cannot deter executives from taking advantage of their managerial power and thus perform "significantly redistributive actions" (like extracting higher compensation). The benefit executives reaps by taking such action is likely to exceed the penalty that markets might impose on the executive (which holds equity as part of his pay) for the resulting share price[134]. I will now turn to examine the different kinds of market forces and the unlikelihood that they will provide tight constrains on executive pay.

a. Managerial Labor Markets

The **managerial labor markets** differ from the **employees' labor market** in the way that the CEO cannot be promoted within the organization. Thus, the only promotion for a CEO is always externally from the company, in other larger more prestigious companies. External promotion is very dependent on the CEO's performance (performance sensitive), but it has no connection with the CEO's pay package in his current firm (unless they pay visibly falls outside the range of conventions). Alternatively, since executive will only leave their workplace when they are offered with an equal or better compensation (reservation value) at another firm, they have more incentive to obtain favorable pay arrangements. The fear of

[132] B&F, 53
[133] Lucian A. Bebchuk, "Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law", 1840-1846, Harv L.Rev 102 (1989)
[134] B&F, 53

Dismissal does not deter the CEO from demanding large compensation, since there is little connection between the reason for firing the CEO and the compensation package he received[135].

b. Market for Additional Capital

Since companies finance themselves by the equity market (among other funding sources), executives have to exercise self-discipline and negotiate their compensation in a manner that will appear to be in arm's length. However, the main sources of finance for firms are retained earnings and external debt, while equity finance is only third on the list. Hence, the incentive for most executives to bargain in arm's length is slim. Moreover, the equity market's only "punishment" for greedy executives is that it raises the price of equity finance for the company (since investors will only be willing to pay less for its shares, the company will have to issue more stocks), which most and foremost harms the shareholders. Taking in mind that executives hold equity as part of their compensation, it is usually a small fraction of the firm's shares and thus bears only a small fraction of the reduction in the shareholders wealth[136].

c. Product Markets

The product market is said to be an importent punitive tool against greedy executives, since in a competitive market, excessive pay and managerial slack would produce competitive disadvantage, which in turn shrink profit, raise operational costs and even result in a failure of the company. Bebchuk and Fried claim that "significantly redistributive actions" by executives has no significant effect on the company's operation that produces these profits. The nature of the product markets, as not being totally competitive (oligopolic or monopolistic), allow certain companies enough market power to give distorted pay arrangements to their executives, without the threat of failing the business. Again, even in the case of poor performance following a dismissal or a failure of the company, the "golden parachute" clause eliminates any incentive for executives to bargain at arm's length on their compensation package[137]. Even in the aggregated, it seems that market forces are unlikely to deter executives from extracting huge sums of compensation, and even though they may impose some constraints, and may deter sharp deviation from arm's length bargaining, they permit substantial departure from that benchmark[138].

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[135] Id. at 54
[136] Id. at 57
[137] B&F, 57
[138] B&F, 58

d. Market for Corporate Control

The first to emphasize the importance of the market for corporate control in aligning the interest of executives and shareholders was Manne in his article 1965[139]. It is a well known fact that when a company is not performing well, its share price declines. It is then when the company is more vulnerable to hostile takeovers, which in many cases results in replacement of the CEO and board by the new owner. Thus, according to Manne, corporate control is an effective way to compel executives and directors to design pay packages to maximize shareholders value. Bebchuk and Fried claim that corporate control has left managers with considerable autonomy, since incompetent managers do not fear control contest. This is because in reality, proxy contests are very rare, and managers usually use the "staggered board" defense[140] and other anti-takeover strategies to confront hostile takeovers. Moreover, successful bids by a hostile acquirer will usually trigger generous "golden parachutes" clause and other benefits for the target's executive, which weakens the disciplinary forces of takeovers even more[141].

[139] Henry G. Manne, "Mergers and the Market for Corporate control", Journal of Political Economy 73 (1965): 110-120
[140] Found in most public companies, "staggered board" defense is an arrangement that prevent a hostile acquirer from gaining control of the board of directors for at least a year.
[141] Pay without performance, 55

7. The Problems with Current Regulation

a. Suboptimal governance system

Core et al (2005) claims that the governance system in the U.S is not suboptimal as Bebchuk and Fried suggested in their book. In order to define how optimal the governance system in the U.S., one has to establish a benchmark for contract efficiency (optimum) that would evaluate whether observed managerial power is evidence of suboptimal contracting or not. By using the benchmark, it will be easy to distinguish between (1) contracts that are optimal (taking under consideration the presence of contracting costs) and (2) suboptimal contracts[142]. One proposed benchmark is the governance systems in other countries. In the presence of less efficient governance systems, economic indicators (such as market valuation and productivity) are expected to be lower. Holmstrom and Kaplan gathered stock returns and productivity growth information in the U.S stock market as benchmarks for the U.S governance system. Their results indicated that: "**Although the U.S. stock market has had negative returns over the last several years, it has performed well relative to other stock markets, both recently and over the longer term. In fact, the U.S. market has generated returns at least as high as those of the European and Pacific markets during each of the five time periods considered - since 2001, since 1997, since 1992, since 1987, and since 1982... [Stock returns] reflect publicly available information about executive compensation. Returns, therefore, are measured as the net of executive compensation payments. The fact that shareholders of U.S. companies earned higher returns even after payments to management does not support the claim that the U.S. executive pay system is designed inefficiently; if anything, shareholders appear better off with the U.S. system of executive pay than with the systems that prevail in other countries**[143]".

Moreover, there was no evidence of increased contracting costs in the U.S, that would indicate that executives have been taking advantage of suboptimal contracting or that rents were extracted through excess compensation[144].

Furthermore, Core et al argues that U.S executive pay norms are not inefficient as Bebchuk and Fried assert (nor does he claim that they are optimal), since Bebchuk and Fried ignore executive's stock and option portfolios, which provide executives very large pay for

[142] Core et al (2005), 17
[143] Id. taken from Bengt Holmstrom & Steven N. Kaplan, "The State of Corporate Governance: What's Right and What's Wrong", 2-4, Nat'l Bureau of Econ. Research, Working Paper No. 9613 (2003)
[144] Core et al (2005), 17

performance incentive (as argued in chapter 4), as well shareholders supervision (boards are obligated to put the option plan to shareholder's vote in order to deduct the access pay over $1m according to the 162(m) of the I.R.C as performance based pay)[145]. According to core et al, there is no justification for the broad policy recommendation of Bebchuk and Fried. They claim that Bebchuk and Fried have not provided any potential benefits for any changes in governance practice, and their potential cost on firms. Such a cost can be greater that the net benefit, and therefore inefficient[146].

b. Compensation Disclosure and the "Hydraulic Theory"

As discussed in chapter 2, in the last decades there was an increase in executive compensation. This phenomenon yielded new disclosure regulation targeting both performance based (options and bonuses) and non-performance-based (salary and other benefits) compensation[147]. The new regulation focused mainly on accounting based performance targets such as bonuses[148]. The proponents of the new regulation hoped that compensation levels will decrease, but the reality was that it just shifted to performance-based incentives. As a result of the 1992 executive compensation disclosure reforms[149], firms have expanded the use in compensation consultants and compensation committees in the board of directors. However, the evidence shows that total pay levels did not decrease in that period, but rather increased[150].

In the year 2000 Congress has adopted Section 162(m) of the I.R.C in an effort to deter "excessive" executive pay. Section 162(m) read that non-performance based compensation in excess of $ 1 million is not deductable as compensation expense for the firm. The Section defines performance based compensation as compensation paid to particular executive pursuant to a pre-established objective performance formula or standard that precludes discretion. Compensation does not qualify for the performance-based exception if the executive has a right to receive the compensation notwithstanding the failure of (1) the compensation committee to certify attainment of the performance goal (or goals) and (2) the shareholders to approve the compensation[151]". The enactment of section 162(m) has had the reverse effect on executive compensation. It caused many companies to increase executive

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[145] Pay without performance, 49
[146] Core et al (2005), 28
[147] Id.
[148] Pay without performance, 95, 102, 109
[149] Executive Compensation Disclosure, Exchange Act Release No. 33-6962, *57 Fed. Reg. 48,126, 48,138* (Oct. 21, 1992)
[150] Geoffrey E. Manne, "The Hydraulic Theory of Disclosure Regulation and Other Costs of Disclosure",10, 58 Ala. L.Rev. 473 (2007) [Hereinafter:"**Manne (2007**)"]
[151] Taken from "Present Law and Background Relating to Executive Compensation" paper scheduled for hearing before the Senate Committee on Finance, September 6, 2006).

salaries to the $ 1 million cap, and grant executives with performance based compensation such as stock options, worth many times the limit.[152]

These examples represent Manne's "hydraulic theory" of disclosure regulation, according which: "**As disclosure rules impose costs on behavior subject to disclosure, where behavior can be altered at a lower cost than the cost of disclosure, disclosure rules will induce behavioral changes rather than increased information flow. Where it is more costly to alter behavior -- where the full costs of disclosure are either sufficiently low or sufficiently externalized -- disclosure rules may be effective in their behavioral aims. But where the costs of disclosure may be avoided at lower cost by substituting other, unintended behavior, the effect is, at best, ambiguous**"[153].

According to the findings of Gravaix and Landier (see chapter 3), managerial power have decreased while executive pay levels have increased. If that is correct, then any regulation such as increased disclosure, targeted to reduce managerial power, will not significantly reduce compensation levels. Such regulation might change the form or timing of compensation, but will not alter the magnitude of it[154]. They explain that by making pecuniary compensation[155] less desirable through regulation (tax, accounting or plain limitation), such compensation would be reduced, but it does not mean that the total compensation will be reduces. It is more likely (in an assumption of a rational market for corporate managers[156]) that more compensation will be received in non-pecuniary forms, which are more difficult to measure: **"If wealth cannot be taken out of an organization in salaries or in other forms of personal pecuniary property, the terms of trade between pecuniary wealth and non-pecuniary business-associated forms of satisfaction turn against the former. More of the organization funds will now be reinvested . . . in ways that enhance the manager's prestige or status in the community. Or more money can be spent for goods and services that enhance the manager's … utility "**[157].

Further complications are expected with the shift from more legitimate ways of compensation to less legitimate ones. As it becomes harder to maintain sufficient large legitimate (and mainly pecuniary) compensation in the face of harsher regulation and public

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[152] the exception for non performance-based pay is in §162(m)(4)(c)
[153] Manne (2007), 9
[154] Id. at 10
[155] Manne divides the main forms of executive compensation in two. The first are **pecuniary compensation**, made up of income, stock, stock options, bonuses etc. the second are **non-pecuniary compensation**, or in-kind compensation, which include prestige, idiosyncratic work environment, light work load and perks such as fancy jets, expensive dinners, etc. executive and firms choose the mix between these two types of compensation according to their utility curb.
[156] That managers are rewarded according to their precived productivity
[157] Armen A. Alchian, Uncertainty, Evolution, and Economic Theory, 58 J. POL. Econ. (1950), reprinted in Armen A. Alchian, Economic Forces At Work 161 (1977).

scrutiny, it is likely that less transparent form of compensation as well as illegitimate ways of compensation (mainly non-pecuniary) will arise[158].

It is worth mentioning the limited benefits of the disclosure regime. Small stake Ordinary investors are rationally uninterested in the same information that the SEC finds so important. "Too much" information might cause an information overload on the regular investor, which imposes costs on inappropriate decision-makers. "**It is well-known that stockholders are relatively uninformed and apathetic in their roles as "owners" of public companies: Small stakes, diversification, and attenuated influence render the acquisition and use of most firm-specific information far more costly than they would be worth… This criticism fundamentally challenges one of the stated goals of the SEC's disclosure regime: specifically, the provision of information for well-informed investing by individual shareholders. It is precisely individual shareholders who are not in a position to evaluate complex information regarding, for example, executive pay packages. But it is also precisely these individuals at whom mandatory disclosures are directed.** [159]

c. The Disclosure regime

Before 1992, firms were required by the SEC to publicly disclose executive compensation in the format of their choice. Firms took full advantage of their discretion to obscure the amount and form of their executives' pay. In 1992 the disclosure rules were tightened by the SEC, thus providing standards for reporting on information regarding executive compensation in the form of formatted tables. This new form made compensation camouflage more difficult yet has **"hardly brought an end to firms' ability to camouflage the amount and form of executive pay**"[160] (for the reason that it was regarded as a rigid form of disclosure that was easy to manipulate, A.Y). According to Bebchuk and Fried, the table format of disclosure required a reform in order to provide better disclosure on the value of exercise and sale of options and shares, as well as executives' retirement's benefits and pension plans[161]. Core et al concurred[162].

In 2006, the final ruling of the SEC on executive compensation was published. The SEC believed that tabular approach remains a sound basis for disclosure, however, "**especially in the light of the complexity of and variation in compensation programs, the very formatted nature of those rules has resulted in too many cases in disclosure that does not inform**

[158] Manne (2007), 13
[159] Id. at 15
[160] B&F, 67
[161] B&F,87 - 111
[162] Core et al (2005), 28

investors adequately as to all elements of compensation. In those cases investors may lack important information that we believe they should receive. We are thus today adopt an approach that builds on the strength of the requirements adopted in 1992... ... Today's amendments do represent a thorough rethinking of the rules in place prior to these amendments, combining a broader-based tabular representation with improved narrative disclosure supplementing the tables. This approach will promote clarity and completeness of numerical information through an improved tabular presentation, continue to provide the ability to make comparisons using tables, and call for material qualitative information regarding the manner and context in which compensation is awarded and earned"[163].

[163] See SEC final ruling on executive compensation and related person disclosure, CFR 17 parts 228,229 et el, release Nos: 33-8732A; 34-54302A (2006)

8. Suggested Solutions for Abusive Compensations Norms

As the magnitude of the recent financial crisis is unveiled, it is recognized that pay arrangements provided executives with incentive to focus on short term results. Standard executive compensation plans have rewarded executives on the basis of short term results, even though these results are subsequently reversed. As presented in previous chapters, short-term compensation based on short-term results encouraged executives to seek short-term gains on the account of long-term value[164]. Here are some suggestions on how to correct some of the abusive pay norms that were presented in this work.

a. Say on Pay

The disclosure reforms advanced by the SEC in the last years provides the marketplace with important information regarding executives' compensation plans, but this information alone cannot not change the norms of executive pay[165]. In his article on the "hydraulic theory", Manne criticizes the broad regulation "net" of the SEC: "**The relevant question is not whether each form of compensation (**pecuniary and non-pecuniary, my addition A.Y**) can be independently justified but whether the marginal increase in one form of compensation and corresponding decrease in another occasioned by a shift in regulation provides a net gain to shareholders. Unfortunately, the SEC does not appear to consider the relevant, marginal question... ... The broad-brushed nature of federal regulation effectively precludes a firm-by-firm marginal analysis**" [166].

In their testimony on empowering shareholders on executive compensation[167], Bebchuk et al claim that investors must have the ability to use such information in order to bring a change. Regardless of shareholders proposals using Rule 14a-8[168] (and all its downsides), Shareholders annual meeting should include advisory votes (precatory [169]) on executive compensation, similar to the U.K. and Australia. This would empower shareholders

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[164] Lucian A. Bebchuk, William J. Friedman and Alicia T. Friedman, Written testimony before the committee on financial services, United States House of Representatives, Hearing on Compensation Structure and Systemic Risk, June 11 2009

[165] Written testimony submitted by Lucian A. Bebchuk, William J. Friedman and Alicia Townsend Friedman before the committee on financial services, united states House of representatives, hearing on empowering shareholders on executive compensation, March 8, 2007 [Hereinafter:"**testimony on empowering shareholders on executive compensation**"]

[166] Manne (2007), 11

[167] Testimony on empowering shareholders on executive compensation,

[168] 17 C.F.R. 240. 14a-8 (1987)

[169] Precatory since they are not binding on the board even if they garner support from a majority of the voting shareholders (B&F, 51).

to influence pay arrangements and change the executive compensation norms in the U.S to serve the best interest of shareholders. The collective judgment of the shareholders will signal the board of directors whether the compensation is in their best interest, and the board might consider it (even though it might be ignored) when voting on a compensation plan, especially since the outcome of these votes will be known to potential investors and in the general public.

There are several claims against shareholders' "say on pay" . **First**, shareholder should not have advisory vote on matters outside shareholders constitutional powers in the company, even though they have already become a standard practice in the U.S.[170]. **Second**, "informal" channels of communication already exist for shareholders to influence the board, and thus, "formal" advisory vote is unnecessary. Yet, the answer to this claim is that while some boards are attentive to their shareholders, some are not, hence, formal advisory vote can improve the communication remarkably. **Third**, boards might find it difficult to interpret to which element of the compensation plan the shareholders opposed. Yet, it seems that this claim is not acute, since the board would know (by "informal" communication with investors) exactly which element caused the opposition from the shareholders. **Fourth**, shareholders might have less information than the board in order to assess the compensation plan properly, yet they have the best incentive to act in their own best interest, and hence, assess the compensation plan accordingly. **Fifth**, shareholders with special interests might use the vote in order to advance self-interests on the expense of other shareholders. Bebchuk argue that the mechanism of standard advisory vote would destroy most chances of blackmailing by interest shareholders. **Sixth**, "Back Sit Driving", hence, the ability of the shareholders to affect the firm in ways other than by their representatives to the board is unwanted. Shareholders have the ability, so the argument says, to replace incumbent board members, and this is their way to influence the firm's actions. According to Bebchuk, it is desirable that shareholders have the power to change the board's compensation strategy while keeping the directors in office. **Finally**, some may argue that imposing wide range mandatory rules on public companies has negative impact on the companies, and that the market can self-regulate its own governance arrangements. This argument ignores the fact that the advisory vote does not impose any process that could produce binding outcome for companies, and thus, bare no negative impact on the companies themselves[171].

[170] Testimony on empowering shareholders on executive compensation,
[171] Id.

The latest development on the subject of "say on pay" came from two sources. First, the treasury proposed guidelines, which requires from recipients of exceptional TARP assistance that: "**[t]he senior executive compensation structure and the rational for how compensation is tied to sound risk management must be submitted to a non-binding shareholder resolution**".....**"[e]ven beyond companies receiving financial recovery assistance, owners of financial institutions – the shareholders – should have a non-binding resolution on both the levels of executive compensation as well as how the structure of compensation incentives helps promote risk management and long-term value creation for the firm and the economy as a whole**[172]". Second source is The Shareholder Vote on Executive Compensation Act[173] from 2007 that, "**would empower shareholders to express their views on their company's executive compensation practices without setting any caps on the size or nature of executive compensation... ... it simply requires that shareholders have a nonbinding say on their company's pay disclosure**"[174]. According to the 2007 Act, companies are required to include the following information in their proxy statement to the shareholders: (1) an annual non-binding advisory vote on the company's executive compensation disclosure and (2) an additional non-binding advisory vote if the company award new (not already disclosed) "Golden Parachute" package while simultaneously negotiating the purchase or sale of the company.

Even though "say on pay" is influence executive compensation levels in a positive way, and might even constrain them, Bebchuk & Spamann argue that "say on pay" proposals are meant to align the interests of executives with those of the shareholders, an act which is a desirable in companies in general . In the case of banks that receive financial assistance by TARP, the government should not peruse the objective of tightening the interests between executives and common shareholders. They argue that such an alignment of interests might push for more divergence from the interests of the government as investor in the banks and "**as de jure and de facto guarantor of some of their obligations**"[175].

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[172] See US Department of the Treasury, press release of 02/04/09 available at http://www.ustreas.gov/press/releases/tg15.htm
[173] H.R 1257 The Shareholder Vote on Executive Compensation Act (20 April 2007), available at http://law.du.edu/images/uploads/corporate-governance/legislation-shareholders-vote-eca-hr.pdf
[174] http://financialservices.house.gov/pdf/FactsOnHR1257.pdf
[175] Regulating bankers pay, 32

b. Derivative Litigation

Shareholders derivative litigation is a well-known legal instrument for changing abusive corporate pay practices. Shareholders can file a derivative action in such cases where the board's actions harmed the corporation, and indirectly - its shareholders. The derivative action can be submitted on the grounds of breach of fiduciary duties[176] by directors toward the company, as well as a breach of duty of care, duty of loyalty and waste[177]. Derivative claim, in its nature is a claim on behalf of the corporation, and therefore subjected to variety of safeguards, first and foremost, the demand requirements. The shareholders are required to make a demand to the board to take corrective action against the abusive pay practice, or alternatively have to argue and prove that such claim would be in vain[178]. Shareholders need to create a reasonable doubt that, a majority of board members are not independent (for example, that they are financially interested in the compensation decision), or that the board's actions were not executed according to a valid exercise of the business judgment rule[179]. It is worth mentioning that proving a lack of independence in publicly held companies is much more difficult for shareholders than in private companies, since executive compensation plans are decided by compensation committees, which allegedly are total independent from management, but in fact are dependant in many ways (as I described in chapter 3). The result is that shareholders have a substantial hurdle to pass in order to challenge executive compensation[180]. Thomas and Martin found, that after the supreme court of Delaware ruled in Aronson V. Lewis[181] (which raised the bar for plaintiffs by posing the demand requirements), defendants raised a motion to dismiss derivative suits on the ground of failure to make demands in 75% of the cases, Compared to only 14% prior to Aronson V. Lewis[182].

Past the procedural hurdles, the plaintiff has to endure substantial difficulties in order to succeed in a suit against compensation practices.

"**Claims of a breach of the duty of care attack the procedures that a board has used, and the information that the board has considered, in making its decision about the challenged executive compensation package**"[183]. In suits on the ground of breach of **duty of care**, the plaintiff bares the burden of proof that the directors were grossly negligent in fulfilling their

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[176] B&F, 45
[177] Randall S. Thomas, Kenneth J. Martin, F.hodge o'neal Corporate & Securities Law Symposium: "Corporate Accountability: Litigating Challenges to Executive Pay: An Exercise In Futility?",5, 79 Wash U.L.Q. 569 (2001) [hereinafter:"**Thomas and Martin**"]
[178] Id.
[179] Aronson V. Lewis, 473 A.2d 805 (Del 1984)
[180] Thomas and Martin, 6
[181] Aronson V. Lewis, 473 A.2d 805 (Del 1984)
[182] Thomas and Martin ,7
[183] Id. at 8

duty to consider "**all material information reasonably available"** by exercising a **"degree of skill, diligence, and care that a reasonably prudent person would exercise in similar circumstances**"[184]. Thomas and Martin found that the overall success rate[185] of plaintiffs bringing duty of care claims rose from 0% to 33% after Delaware's Supreme Court ruled in Smith V. Van Gorkom[186]. They also found that plaintiffs are more successful with claims against closely held companies than in publicly held companies[187].

For shareholders to win a **waste** claim, they must demonstrate that the company failed to receive even minimal consideration for the compensation awarded. This has become a very difficult claim to substantiate. Since corporations have been using compensation committees and consultants, compensation decisions have become immuned from judicial review unless it is proven that they constitute a waste of corporate assets[188]. The Supreme Court in Brehm v. Eisner said that the waste standard is an "**extreme test, [that is] rarely satisfied by a shareholder plaintiff**"[189]. A study conducted by Mark Loewenstein reported that there were almost no appellate courts that ordered to reduce managerial compensation as a result of a waste claim in a publicly traded corporation[190].

Executive often sit in the board of directors of the company they are running. When negotiating a compensation arrangement for themselves, executives have an obvious financial interest in the compensation arrangement that directly conflicts with their **duty of loyalty** to the company and its shareholders. The determination whether or not an executive breached his duty of loyalty, court look at the following factors: " (1) **evidence of the compensation received by similarly situated executives,** (2) **the ability of the executive,** (3) **whether the Internal Revenue Service has allowed the corporation to deduct the amount of salary alleged to be unreasonable,** (4) **whether the salary bears a reasonable relation to the success of the corporation,** (5) **the salary history of the executive,** (6) **the relation of increases in salary to increases in the value of services rendered and** (7) **the relation of the challenged salary to other salaries paid by the employer**"[191].

Concluding this part, Thomas and Martin found that executive compensation decisions are more susceptible to be attacked at closely held corporations, mainly since the use of

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[184] Id. taken from Brehm v. Eisner, 746 A.2d at 259; Robert Charles Clark, Corporate Law 123 (1986)
[185] Thomas and Martin define success as defeating a motion to dismiss for failure to make demand, a motion to dismiss for failure to state a claim, or a motion for summary judgment, or prevailing at trial or on appeal.
[186] Smith V. Van Gorkom 488 A.2d 858 (Del 1985)
[187] Thomas and Martin, 8
[188] Id. at 9, The waste doctrine holds that directors cannot give away corporate assets without any consideration. See In re Walt Disney Co. Derivative Litig., 731 A.2d 342, 362-63 (Del. Ch. 1998)
[189] Zupnick v. Goizueta, 698 A.2d 384 (Del. Ch. 1997)
[190] Mark J. Loewenstein ,"Reflections on Executive Compensation and a Modest Proposal for [Further] Reform", Southern Methodist University L.Rev 50 (1996) 201-223
[191] Id. at 9, taken from Rodman Ward, Jr. et al., Folk on the Delaware General Corporation Law 122 (4th ed. 1999)

compensation committees in publicly held companies, and the meticulousness in procedural formalities decreases the chances of the plaintiff to establish his claim.

Shareholders litigation over compensation feeds from few different legal resources. First, The ALI principles[192] (an important secondary source of law) which addressed the appropriate standards for judicial review on executive compensation decisions. The ALI proposition is that corporate law should be more deferential to board's compensation arrangements than other types of self-interested conduct. Second impact came from the Delaware's Supreme Court decision in Brehm v. Eisner[193]. The court in Brehm v. Eisner showed hostility toward executive compensation derivative litigations, a precedent which may deter future plaintiffs. The Delaware Supreme Court Chief Justice Myron T. Steele commented on Eisner case: "**People forget that Michael Ovitz was the owner of a very successful agency before (**before he joined Disney, A.Y**) and could have earned $200M. To take the risk, leave his agency and join Disney he demanded a compensation for what he could have earned... ...I know the wrong solution is for the Congress to interfere. The congress should not interfere more than it interferes with baseball players' salaries**"[194].

Bebchuk and Fried do not believe that the executive compensation problem can be resolved by judicial review, since courts are ill equipped to judge the desirability of compensation packages and policies. Courts have avoided involvement in compensation arrangements and design, and have not been very helpful for injured shareholders. Under the well established **Business Judgment Rule** of the Van Gorkom case and under certain process requirements, courts will not interfere with board's judgments on executive pay. Courts have generally approved compensation packages that have been reviewed by compensation committees that were made up of independent directors and compensation consultants[195]. The cases where the court interferes are where the compensation package is so irrational that "**no reasonable person could approve it and it is therefore constitute waste**"[196].

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[192] See American Law Institute., "Principles of Corporate Governance: Analysis and Recommendations", 5/03 (1994))
[193] Brehm v. Eisner 746 A.2d 244 (Del.Sup 2000)
[194] Taken from "The Marker" 14.1.09. available on: http://www.themarker.com/tmc/article.jhtml?ElementId=skira20090114_1055302
[195] B&F, 46
[196] Brehm v. Eisner 746 A.2d 244, 262 (Del.Sup 2000)

A recent case of excessive executive pay arrangement in a U.S. mutual fund might be a turning point for shareholders/investors derivative litigations against board members and executives. Judge Posner dissented from the majority of the panel and said the following things: "**The panel's "so unusual" standard (in 527 F.3d at 632, A.Y) is to be applied solely by comparing the adviser's fee with the fees charged by other mutual fund advisers... ... The panel opinion points out that courts do not review corporate salaries for excessiveness. That misses the point, which is that unreasonable compensation can be evidence of a breach of fiduciary duty**"[197]. The New York Times said that "**Jones v. Harris Associates, may turn out to be the court's first significant statement on the corporate culture that helped lead to the Great Recession... ... when public sentiment, economic research and even Judge Posner argue for more vigorous judicial examination of whether compensation is fair, the Supreme Court may just agree**[198]".

[197] Jones v. Harris Associates L.P 537 F.3d 728 2008 U.S. App.
[198] http://www.nytimes.com/2009/08/18/us/18bar.html?_r=1&hp

c. International Regulatory Agencies

The Basel Committee on Banking Regulation has issued a report in 2006[199] recognizing the importance of enhancing corporate governance in banking organizations, but "**Under its' framework, banks were encouraged to develop internal risk models for all major categories of risk, with regulators setting minimum parameters in which these models were to operate and recognized for regulatory purposes... ... The result was to place enhanced reliance on quantitative risk management techniques which prove to be less robust than previously thought when subjected to circumstances of extreme stress**"[200]. More importantly, While the report stresses the importance of banks' **internal** governance processes, including executive pay decisions, **"It fails to recognize that boards selected by shareholders cannot be generally counted on to eliminate risks for excessive risk taking – in the same way that they cannot be fully counted on to avoid excessive risks in deciding how much capital to maintain and how to invest the banks' assets "** [201].

In the international level, the regulatory reaction offered by the **Financial Stability Board**[202] **(FSB)**[203] and the group of 20 **(G-20)**[204] have been so far the most significant ones[205]. In October 2008, the FSB (at that time - FSF) met in the context of the G-7 finance minister meeting, and affirmed their earlier report from April 2008. In that meeting, the FSB extended the attention of international regulatory reform on compensation arrangements:"**The interests of authorities and shareholders broadly aligned in this area but firms face a collective action problem. The FSF will examine the appropriate role for regulators and supervisors in reinforcing sound compensation practices or mitigating associated risks, including through the use of supervisory reviews under Pillar II of the Basel II**" [206]. Their recommendations were that "**The financial industry should align compensation models with long-term, firm-**

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[199] Basel Committee, International Convergence of Capital Measurements and Capital Standards: A Revised Framework – Comprehensive Framework (June 2006)(Basel II)

[200] Arner, 25

[201] Regulating bankers pay, 37

[202] Formally known as the Financial Stability Forum i.e FSF

[203] The FSB has been established to address vulnerabilities and to develop and implement strong regulatory, supervisory and other policies in the interest of financial stability. It comprises senior representatives of national financial authorities (central banks, regulatory and supervisory authorities and ministries of finance), international financial institutions, standard setting bodies, and committees of central bank experts (available at http://www.financialstabilityboard.org/about/overview.htm).

[204] For the G-20 working group 1: enhancing sound regulation an strengthening transparency (March 25 2009) (available at http://www.g20.org/Documents/g20_wg1_010409.pdf); Meeting of Finance Minister and Central Bank Governors, London, September 4-5 2009: "Declaration on Further Steps to Strengthen the Financial System" (available at http://www.g20.org/Documents/FM__CBG_Declaration_-_Final.pdf); Leaders Statement in the Pittsburg Summit, September 24-25, 2009

[205] Douglas W. Arner, "The Global Financial Crisis of 2008: Causes and Consequences",154, The international Lawyer Vol. 43 No.1 (2009) [hereinafter: "**Arner II**"] (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1330744)

[206] Financial Stability Forum, Report of the Financial Stabilility Forum on Enhancing Market and Institutional Reliance: Follow-Up on Implementation, page 9, 2 (2008) (available at http://www.financialstabilityboard.org/press/pr_081009f.pdf)

wide profitability. Regulators and supervisors should work with market participants to mitigate the risk arising from inappropriate incentive structures" [207]. Bebchuk and Spamann concur with the FSB report, and consider it a welcome development[208].

The FSB latest release is their principles for sound compensation practices from September 2009[209]. The FSB's principles focus on significant financial institutions, and revolve around five main areas: (1) Corporate Governance, (2) Compensation and Capital, (3) Pay Structure and Risk Alignment, (4) Disclosure (5) Supervisory Oversight. I will now review these principles.

(1) Corporate Governance

Significant financial institutions should have a board of remuneration committee, which will be integrated in the governance structure, which shall oversee the compensation system design and operation on behalf of the board of directors. The remuneration committee shall be constituted in such a way that will insure it exercises competent and independent judgment on compensation policies and practices, and the incentive created for managing risk, capital and liquidity. It should also evaluate the practice of compensation based on potential future revenues, whose timing and likelihood remain uncertain. Moreover, it should make sure that compensation practices are compliant with the FSB principles and standards, as well as insuring an annual compensation review and adequate performance measures[210].

Bebchuk and Fried argue that recent reforms in the area of corporate governance cannot by themselves ensure that boards properly carry out their critical role. The independence requirements of the stock exchange listing standards fail to provide affirmative incentive for directors to enhance shareholders value. Instead of reducing the incentive, these requirements must eliminate incentive what so ever to serve executives. Moreover, "**as long as director compensation remains within existing ranges, the financial cost to directors of many value-reducing steps (though not all) would remain small even if more or most of their compensation were equity based**[211]"…"**As long as directors' election and compensation ultimately depend on other directors, even if not the firm's executives, the corporate governance system lacks an anchor that would securely tie board decisions to shareholders interests**[212]". The most effective way to improve board performance, according to Bebchuk

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[207] Id. at 15
[208] Regulating bankers pay, 37
[209] FSB Principles for Sound Compensation Practices – Implementation standards (September 25, 2009)(available at http://www.financialstabilityboard.org/publications/r_090925c.pdf) [hereinafter: "**FSB principles**"]
[210] Id. at 2
[211] Pay without performance, 205
[212] Id. At 207

and Fried, is to increase the power of shareholders vis-à-vis directors. This can be achieved by increasing the role of shareholders in appointing and reappointing of directors to the board, thus countering "**some of the factors that incline directors to pursue their own interests or those of executives rather than serve shareholders**[213]".

(2) Compensation and Capital

Significant financial institutions should ensure that total variable compensation does not limit their ability to strengthen their capital base. National supervision should limit variable compensation as a percentage of total net revenues when it is consistent with the maintenance of a sound capital base.

(3) Pay Structure and Risk Alignment

Significant financial institutions should take into account the size of the variable compensation pool and its allocation within the firm. The firm's Subdued or negative financial performance should lead to a considerable contraction of the total compensation variable, including both current compensation and a reduction of payout previously earned, by a way of Claw back provisions , that would enable companies to reclaim money if profits turn out to have been illusory after an executive has been paid[214]. Regarding senior executives' compensation, whose actions have a material impact on the firm's risk exposure, a large proportion of compensation should be variable and paid on an individual, business unit and firm-wide basis, which measures performance adequately. Moreover, for the most senior executives, over 60% of variable compensation should be payable under deferral arrangements over a period of no less than three years (or any other period that align with the nature of the business).

More than 50% of variable compensation should be awarded in shares or share-linked instruments, as long as it is aligned with long-term value creation and the time horizons of risk and subjected to appropriate share retention policy[215]. Such long-term incentive can be created by awarding restricted or vested stocks. The remaining portion of the deferred compensation can be paid as cash compensation vesting gradually. In case of Subdued or negative financial performance in any year during the vesting period, any unvested portions are to be clawed back[216].

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[213] Id. For further suggestions on improving corporate governance see "pay without performance", page 210
[214] http://www.nytimes.com/2009/09/19/business/economy/19pay.html?_r=1&scp=2&sq=edmund%20andrew&st=cse
[215] Id. at 3
[216] Id

In an event of exceptional government intervention to stabilize or rescue the firm, supervisors should have the ability to restructure compensation to align it with sound risk management and long-term growth, as well as subordinate compensation structure of the most highly compensated employees to independent review and approval. The FSB propose to ban guaranteed bonuses, since they are not consistent with sound risk management or pay for performance principle. Minimum bonus should only occur in context of hiring new staff, and should be limited to one year. Existing employment termination contracts ("Golden Parachutes", A.Y) should be re-examined and remain only if they are aligned with long-term value creation, prudent risk taking and performance based.

Finally, significant financial institutions are required to comply with the FSB's compensation standards immediately, as well as demand their executives to commit not to use personal hedging strategies, compensation or liability-related insurance to undermine the risk alignment effect embedded in their compensation arrangements[217].

(4) Disclosure

The FSB principle requires a public, timely basis, annual report on compensation, that would include, in addition to any national requirements also (1) the decision making process of compensation policy, (2) the most important design characteristics of the compensation system and (3) aggregated quantitative information on compensation, divided into senior executives and employees with material impact on the firm's risk exposure[218].

Bebchuk and Fried also call for certain accounting changes that will improve transparency and thus enhance disclosure of executive pay. The FASB[219] should adopt rules that require employee options to be expensed: "**From accounting perspective, expensing is desirable because it leads to a more accurate reflection of the firm's financial situation**"[220]. Another suggestion is that firms should place monetary value on all forms of compensation and to include these amounts in the compensation table contained in the firm's financial reports. This way, companies cannot "**provide executive with substantial "stealth**

[217] Id. at 4
[218] Id.
[219] Financial Accounting Standards Board, "*the Financial Accounting Standards Board (FASB) has been the designated organization in the private sector for establishing standards of financial accounting. Those standards govern the preparation of financial statements. They are officially recognized as authoritative by the Securities and Exchange Commission Such standards are important to the efficient functioning of the economy because investors, creditors, auditors, and others rely on credible, transparent, and comparable financial information*" (available at http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176154526495).
[220] Pay without performance, 193

compensation" by using pension, differed compensation and post-retirement perks and consulting contracts[221]**"**.

(5) Supervisory Oversight

Effective implementation of the FSB principles should be ensured by supervisors, which should be integrated in the national regulation agencies. Supervisors should require from significant financial institutions to demonstrate that risk, capital, liquidity and timeline of earnings were taken in account in the compensation system when setting incentive for executives. A failure to implement the FSB policies should result in prompt remedial action, and, if necessary, appropriate corrective measures to offset any additional risk that may result by such failure, such as provided under national supervisory framework or Pillar II of the Basel II capital framework[222].

[221] FSB principles, 4
[222] Id. at 5

d. Monitoring and Regulating Executives' Incentives

According to Bebchuk & Spamann, since pay arrangements can provide powerful incentive for excessive risk taking, bank regulators should monitor and assess executives' pay arrangements in order to assess the risks posed by the banks.

As mentioned in chapter 4, excessive risk taking can be measured as the insulation from down side risk, which depends on "**the amount of debt at various levels of the banking organization, the amount of shares and options held by or promised to the executive and the strike price of options, if any**"[223]. This information can be easily obtained by the regulator (some is already available today), and thus, regulators can calculate the sensitivity of executive pay to an increase/decrease of the bank's holding company's assets value. If the executive is too protected from downside risk, hence, its' sensitivity is extremely a-symmetric, the bank's risk assessments should be adjusted upwards by the regulator. Such an adjustment can result in a demand for additional capital or a demand to decrease other risk factor[224].

Bebchuk & Spamann suggest that executives' payoff should be linked to the value of broader basket of securities representing a larger part of the corporate pie, rather to the value of equity or options on common shares of the company. For example, in banks that received financial assistance from TARP, and the government is the holder of preferred stocks, it would be in the government best interest to link executive compensation in such banks to the value of both common and proffered shares. Moreover, payoff could be tied to a set percentage of the aggregated value of common shares, preferred shares and all outstanding bonds, thus, exposing the executive to a broader fraction of the negative consequences of risks taken, and reducing the incentive to take excessive risks. In order to tie a link also the interests of the government as an insurer of deposits, Bebchuk & Spamann suggest decreasing from this aggregated value, any payment done by the government to the bank's depositors (as well as any other to support the bank financially) in the consequent year after the executive has departure the bank[225].

Furthermore, executives' bonus should be tied to broader accounting measures (apart from return on equity or earning per common share, which are of substantial interest to common shareholders), such as earnings before any payment was made to bondholders[226].

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[223] Regulating bankers pay, 38
[224] Id.
[225] Id. at 39
[226] Regulating bankers pay, 39

e. Reducing Windfall

Shareholders and policy makers have looked to equity-based compensation to strengthening the connection between pay and performance. As showed in chapter 2, the use of options in compensation plans grew larger in the last twenty years. There is evidence that in certain range of ownership level, executives which held more equity generate more shareholder value[227]. Although share price is the most informative measure to base pay upon, and thus seem a useful tool, without significant adjustment however, changes in share price do not measure the executive's **own** performance. A study of the U.S. stock prices over the recent ten years period have indicated that only 30% of share price movement reflects corporate performance[228]. "**From the shareholder's perspective, an option plan should be designed either to maximize incentive for the dollar spent or to achieve a certain level of incentive at the lowest possible cost**[229] **"**. Another study found that the cost of providing executives with conventional options is 41% higher than the cost of providing them with options that screen out market effects[230]. The cost of option compensation can be substantially reduced by using reduced windfall options. I will now review the most common ways to reduce option's windfall.

a. Indexed options

Indexing the option's exercise price is the most familiar way to reduce windfalls. Indexing is essentially screening out the effect of sector or market movement on the stock price of the company by adjusting the exercise price to a certain index[231]. Indexing options is a contractual action and thus can take many forms. Options can be indexed either to the market average or to the average of a basket of peer firms, or a more "moderate" form of indexing in which the exercise price is increased by a certain fraction of the increase in sector stock prices. Exercise price can be adjusted to the performance of companies in the market or industry (bottom quartile or decile for example). "**options that are indexed to the average performance of a particular industry screen out not only broad market effect but also effects associated with the firm's sector** [232]**"**. They tighten the link between compensation and performance and thus generate more incentive per dollar spent.

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[227] Id. at 137
[228] Pay without performance, 138, a study by SCA Consulting reported in Simon Patterson and Peter Smith "How to Make Top People's Pay Reflect Performance", Sunday Times (London) August 9, 1998, business section, 12
[229] Pay without performance, 139
[230] James J. Angel and Douglas M. McCabe, "Market-Adhusted Options for Executive Compensation", 14, Global Business and Economics Review 4 (2002)
[231] see also the definition of "pay incentive" in chapter 5(b) on windfalls
[232] Pay without performance, 141

b. Vested options

A good way to reduce windfalls is the use of performance-conditioned vesting. According to this method, the options granted to the executive are vested, so managers cannot unwind them, unless they meet certain performance targets (covenants). If the manager does not meet his performance target he forfeits the option. Performance targets could also include index or benchmarks such as market performance or a basket of similar stocks over a period of time.

Murphy read that Relative Performance Evaluation (RPE) instruments (such as indexed and vested options) impose additional risk on the recipient since he is facing with a much larger probability of realizing a zero payout than with conventional options. This risk can be mitigate by offering the indexed options at a lower exercise price, an act that might be perceived by academics such as Bebchuk and Fried as evidence to the existence of "managerial power" [233]. Moreover, granting indexed option in the money would be subjected to accounting charges and would not be considered as performance based for tax purposes (see chapter 7), and therefore more costly for the firm[234]. Bebchuk and Fried reject this arguement (as discussed in chapter 4) since it is "**the most common explanation given for the widespread failure of companies to adopt reduced-windfall options…**[235]**".**

[233] Pay without performance, 159
[234] Murphy (2002), 10
[235] Pay without performance, 147

9. Conclusions

"There is little evidence that investors sell their shares, or mount effective campaigns to remove boards, because of concerns about executive compensation. One interpretation of these facts is that executive compensation is not an important issue to investors today. Shareholders may accept boards' claims that the current high levels of CEO pay are justified as pay for performance, or necessary to retain talented executives in a tight international labor market. Until recently, long running bull stock market may explain the tremendous value of the stock option grants that boards have awarded to executives"[236].

As the magnitude of the recent financial crisis has unveiled, and as I have showed in this work, pay arrangements provided executives with incentive to focus on short term results. Standard executive compensation plans have rewarded executives on the basis of short term results, even though these results are subsequently reversed. This compensation based on short-term results encouraged executives to seek short-term gains[237] on the account of long-term value[238].

Some suggestions set forth in this work could be regarded as "excessive interference" in executive pay arrangements that target specifically corporate governance processes in significant financial institutions. The rational behind strict supervision and regulation of financial institutions is that "**Banks present a special case, because, given a systemic cost of bank failure and the government guarantee of bank deposits, a body of regulation is in place to limit shareholders from making business decisions that would serve their interests but produce excessive risk and impose an externality. Because regulating executive pay can improve the effectiveness of banking regulation in achieving its widely accepted goals, it could be appropriate to constrain banks' freedom to set pay structures while not imposing such constrains outside the banking sector**"[239].

Taking under consideration the Hydraulic theory of regulation (as set forth in chapter 7), and the disadvantages of setting limits for executive pay in absolute numbers (quantitative techniques), regulators have to consider new models in order to create incentive and reduce excessive risk taking by executives. The proponents of self-regulation argue that since optimal setting of executive arrangements requires substantial information, it should be left to be set

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[236] Thomas and Martin, 22
[237] http://www.nytimes.com/2009/08/10/business/10pay.html?_r=1
[238] Lucian A. Bebchuk, William J. Friedman and Alicia T. Friedman, Written testimony before the committee on financial services, United States House of Representatives, Hearing on Compensation Structure and Systemic Risk, June 11 2009
[239] Regulating bankers' pay, 40

by banks themselves. If we learned something from the recent financial crisis, it is that any attempt to leave banks to self-regulate their own executives' pay is futile, since current compensation arrangement create much divergence between interest of executives and other stakeholders.

I do not suggest that executive pay should be limited in absolute numbers, nor do I claim that executives do not have the right to demand whatever compensation arrangements they wish. One might ask if there is a difference between an executive of a public company and N.B.A athletes. Well, the main difference is (as I showed in chapter 3) that the executive have broad influence over his compensation schemes, as well as the freedom to unwind it at will. Moreover, the athlete negotiates his compensation at arm's length, while the executive does not[240]. My main claim in this work is that international regulator should set standards of corporate governance that will deter companies from providing their executives huge compensation packages, without any performance to follow.

New models to assess combined bank risks such as market, credit, operating and liquidity risks as well as compensation risks must be developed in order to asses the full risk profile of banks, especially in an era of banks that are "too big to fall". Such risk assessment models can be used to measure the banks excessive risk sensitivity, similar to other sensitivity models such as VAR and VAR Monte Carlo. Alternatively, regulators need to set certain covenants for pay setting, which can be easily monitored and measured on a quarter-to-quarter basis. Furthermore, any change in regulation has to take into account that executive pay must provide long-term incentive to create value for the company, in the form of "Claw backs", conditioned bonuses, indexed option and vested stocks.

Following the financial crisis, academics and practitioners are calling for legislation that will constrain or at least reduce executive pay, especially in the finance sector. The proponents of executive pay reforms face dire resistance by corporate management, whose influence on lawmakers is very significant. Last year for example, executives in Wall Street took huge sums of money, even though their company's shares dropped sharply. Still, there is no sign of strict regulation to counter such behaviors[241]. The main claim is that excessive regulation will prevent corporations from recruiting good managers, since they will not stay in the job market and thus, executive pay needs to be left for self regulation of the markets. As I showed in chapter 6, the markets forces were not sufficient to restrain executive pay so far,

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[240] Pay without performance, 21

[241] http://www.nytimes.com/2009/07/31/business/31pay.html;
http://www.nytimes.com/2009/04/26/business/26pay.html

and there is no reason to believe they will succeed in doing so in the future. Days will tell whether congress, SEC and stock exchanges will cease this historical opportunity to change executive pay norms, and thus maybe reduce (while not prevent) the chance of another crisis in the future.

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11. Appendix

Appendix 1: Table 6

Table 6
Non-equity-based Compensation Fixed-effect Regression

	Dependent variable: Log(CEO non-equity compensation)	Dependent variable: Log(top-5 non-equity compensation)
Log(Sales (*t*–1))	0.214***	0.230***
	(0.014)	(0.012)
Log(1+Firm *ROA*)	0.211***	0.206***
	(0.062)	(0.010)
Log(1+Firm return (*t*–1))	0.228***	0.138***
	(0.012)	(0.010)
Log(1+Firm return (*t*–2))	0.155***	0.190***
	(0.012)	(0.059)
1994	0.155***	0.143***
	(0.022)	(0.020)
1995	0.217***	0.206***
	(0.022)	(0.020)
1996	0.311***	0.287***
	(0.023)	(0.020)
1997	0.430***	0.386***
	(0.023)	(0.020)
1998	0.502***	0.446***
	(0.024)	(0.021)
1999	0.627***	0.573***
	(0.024)	(0.021)
2000	0.758***	0.685***
	(0.025)	(0.021)
2001	0.716***	0.626***
	(0.025)	(0.022)
2002	0.662***	0.577***
	(0.026)	(0.022)
2003	0.675***	0.583***
	(0.026)	(0.023)
Observations	15,421	14,154
Adjusted R^2	66%	71%

Appendix 2: Table 7

Table 7
Aggregate Top-five Executive Compensation 1993–2003 ($ billion)

Period	All ExecuComp firms	Non-ExecuComp firms	All firms
1993–2003	212	139	351
1993–7	68	55	123
1999–2003	122	70	192

Appendix 3 –

example from Core et al for identical incentives–“pay incentive” vs “portfolio incentive” – Core et al (2005), 19-21 pages 19-21

Comparison of "Pay Incentives" and "Portfolio Incentives" Contracts

"Pay Incentives" - CEO

receives salary of $ 2 million, a bonus that is equal to the product of $ 10 million and the firm's market-adjusted return, and has $ 20 million of wealth invested in the market portfolio.

Firm and market			
stock returns			
Firm return	50%	0%	50%
Market return	0%	0%	0%
Market-adjusted	50%	0%	50%
return			
CEO compensation and			
incentives			
Salary	$ 2	$ 2	$ 2
Bonus	$ (5.0)	$ -	$ 5.0
Change in Firm Stock	$ -	$ -	$ -
Value			
Change in market	$ -	$ -	$ -
holdings			
Total wealth change	$ (3.0)	$ 2	$ 7.0

"Portfolio Incentives"

CEO receives salary of $ 2 million, invests $ 10 million of wealth in firm stock, and has $ 10 million of wealth invested in market.

Firm and market			
stock returns			
Firm return	50%	0%	50%
Market return	0%	0%	0%
Market-adjusted	50%	0%	50%
return			
CEO compensation and			
incentives			
Salary	$ 2	$ 2	$ 2
Bonus	$ -	$ -	$ -
Change in Firm Stock	$ (5.0)	$ -	$ 5.0
Value			
Change in market	$ -	$ -	$ -
holdings			
Total wealth change	$ (3.0)	$ 2	$ 7.0