By Lemma W. Senbet

The Rise of Equity-Based Compensation: The Bright and The Dark

"A well designed equity-based compensation can serve as a key mechanism for corporate governance."

In thinking about the most significant development in the field of corporate governance over the last quarter of a century, I have been influenced by the two landmark events of the last decade, which have profoundly sharpened the role of finance in the public domain. In the wake of the last decade, the burst of the information technology boom and the ensuing massive corporate scandals triggered a collapse of well-known companies, such as Enron, WorldCom, and Adelphia. Moreover, by the end of the last decade, the burst of the housing bubble and the subprime crisis led to a shutdown of the credit market and a collapse of venerable financial institutions which got rescued by public funds.

There is an ongoing debate both in academic and policy circles on the extent to which corporate governance failures might have contributed to these landmark episodes. There is near consensus on the link between the scandals surrounding the dot.com bubble and failures in corporate governance. However, the link between the ill-designed incentive features of compensation and financial crisis is still being debated. It is clear, though, that executive compensation and governance in general have received wide public attention.

The last 25 years also saw a robust pay-for-performance movement. The long-standing question has been whether executive compensation structures provide sufficient incentives for executives to align them with shareholders. Agency theory suggests that the primary means by which shareholders ensure incentive alignment is to tie executive pay to company performance. In fact, consistent with this, during the late 1980s and early 1990s there was an increased pressure from institutional investors, such as the United Shareholders Association, the Council of Institutional Investors, and large state pension funds, for companies to tie executive pay closely to company performance. The pay-for-performance movement had an impact on the structure of compensation, with dramatic shift toward equity-based compensation, inclusive of both equity participation and option-based pay. The accumulated academic evidence over the years suggests that a substantial portion of CEO wealth is, in fact, tied to company performance, and better incentive alignment has been a source of increase in shareholder wealth over the years.

However, there was a dark side to the pay-per-formance movement. There were several cases in which executive pay rose dramatically even though the companies were doing poorly and their stock prices were plummeting, suggesting, on the surface, insufficient linkage between pay and long-term corporate performance and the possibility that executives were paid excessively. In fact, the public concern about excessive pay lead to the adoption of the Section 162 (m) of the Internal Revenue Code, which ended up creating unintended consequences by distorting the structure of composition to be heavily biased toward incentive pay, with a dramatic rise in option-based compensation.

The global financial crisis has now generated extensive debate on the role of executive pay in the propagation of the crisis. This in turn has weighed in prominently in the debate about financial policy reform pertaining to our largest financial service companies. The issue here is more about excessive risk-taking stemming from aggressive incentive features of compensation, rather than excessive pay.

Thus, over the last 25 years we have witnessed: (a) extensive debate on excessive pay; (b) the advent of 162 (m), (c) financial excesses; and (d) a crisis of epic proportions. Equity-based compensation, particularly stock option compensation, has been central to these issues. This leads me to conclude there is one aspect of corporate governance that has become the unifying link for these issues, namely the rise of equity-based compensation, and I consider this as the most significant development over the last 25 years.

The positive and the dark: Well designed equity-based compensation can serve as a key mechanism for corporate governance. Shareholder-manager incentive alignment leads to value creation and contributes to the overall economic growth and employment creation. This is positive news. However, there is also a dark side to equity- based compensation. Flawed compensation schemes can destroy value and detract from the overall economic performance. As an example, compensation schemes that motivate excessive focus on

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short-term profits to meet short-run analysts' expectations can destroy long-run shareholder value. Moreover, if the stock is overvalued, equity-based compensation may incentivize the manager to over-invest or manipulate earnings to justify the firm's current stock price. Some have convincingly argued that such manipulations have contributed to the corporate scandals surrounding the dot.com bubble (Jensen 2005).

Excessive pay debate: There is also a widely held view that executive compensation in the U.S. is excessive in the sense it is higher than that required to retain and motivate executives. In the 1990s average CEO compensation increased significantly, both in absolute and in relative terms. The inflation-adjusted level of average CEO pay for S&P 500 companies stood at $14.7 million in 2000, five times the average 10 years before. On another metric, the 2000 level was about 400 times that of average employee compensation, up from only 42 times in 1980 (see *Business Week*, Sept. 11, 2000).

But what is excessive? Presumably it is higher pay than the executive could command in a competitive market for executives. It is safe to say there have been instances of mega stock option grants being made to undeserving top-level executives. For instance, Dennis Kozlowski, former CEO of Tyco, was granted nearly six million options valued at $81 million at the very time that he was allegedly looting the company. However, it is difficult to generalize from these cases about whether the average level of executive compensation was excessive.

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Section 162 (m) and the rise of option-based compensation: Section 162 (m) was enacted in 1993 as a means of mitigating excessive pay. The statue disallows tax deductibility for all compensation paid to "proxy-named executives" in excess of $1 million, unless such compensation is "performance-based." However, it ended up creating unintended consequences. On an after tax basis, performance-based compensation, particularly stock options, became less expensive than base salaries and stock grants. Stock options did satisfy the "performance-based" test, since they are directly linked to the underlying stock. This must have lead to a dramatic rise in option-based compensation. In fact, the average grant-date value of options soared from near zero in 1970 to over $7 million in 2000 (Hall and Murphy, 2003).

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Executive pay and financial crisis: Executive compensation has been a prominent and visible target of regulators and policy makers in response to the crisis. A key question in these policy responses is whether, and to what extent, flawed compensation structures at financial firms contributed to the crisis. Given that shareholders of levered institutions benefit from excessive risk, paying executives with stock or options and aligning them with shareholders can have the perverse effect of pushing executives to take on extra risk**.**

There is evidence suggesting that the incentive structure of pay is different between financial and non-financial firms (DeYoung, Peng, and Yang (2009). In particular, the sensitivity of executive pay to volatility (vega) diverged between banks and non-banks after 1999. As a consequence, an argument can be made that there were incentives for excessive risk-taking, as reflected in more credit risk and more private mortgage securitizations. One consequence of this form of risk-taking is an elevated level of systemic risk in which banks become especially stressed during economic downturns.

However, this is suggestive and a causation is yet to be established. Overall, whether flawed incentives in compensation are the critical driver of the financial crisis remains an empirically interesting question for future research.

LOOKING AHEAD: THE NEXT 25 YEARS

I make the following predictions based on a simple guiding principle that I believe will prevail over the next 25 years. The principle is that the level of executive pay should not be legislated or regulated, directly or indirectly. In particular, the choice of compensation structures should be left to the firm, and regulatory and tax reforms should not favor one form of compensation over another.

1. Section 162 (m) will be repealed. This rule is a misguided effort to regulate the level and structure of executive compensation, and should be repealed. Companies, through their boards and shareholders, will be free to determine the optimal form and level of executive compensation. In those cases where corporate boards are not exercising this function in a responsible way, there will be changes in corporate governance institutions or other mechanisms (e.g., "say on pay") to enhance the power of shareholders to monitor executive compensation directly.

2. Longer vesting periods will prevail: Due to longer vesting periods, there will be improved linkage of pay to long-term performance and less to cash out based on short-term favorable results. Even bonuses will be based on multi-year metrics to better align executives with long-term shareholder wealth maximization.

3. Shareholders will directly influence executive pay: Shareholders will have a more direct mechanism for influencing the level and structure of executive compensation. All top-management compensation plans, including salary, equity-based compensation, and severance packages will be subject to a shareholder proxy vote. Due to limited experience and information possessed by individual shareholders, an advisory vote will prevail in well-governed companies. Thus, good governance will be rewarded.

4. Compensation committees will be independent and finance

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literate: Compensation committees will be composed entirely of independent directors to ensure that compensation is set in an arms-length bargaining process. The committees will be aided by compensation committees supported by independent compensation consultants.

Equally important, compensation committees will have sufficient expertise in finance to sufficiently understand the compensation contracts and the methods used to value properly the incentive features in these contracts.

5. There will be more expanded disclosure involving all elements of pay: Disclosure will be more explicit and expanded to cover all elements of executive compensation, including retirement benefits, severance packages, perquisites, and other direct or indirect schemes of compensation. Moreover, financial transactions by executives, particularly hedging transactions, that affect pay-performance sensitivity, will be disclosed to boards and compensation committees.

6. There will be increasing state dominance of governance around the world: We have already witnessed the advent of pay czar as a consequence of TARP bailouts. For the first time in history, the financial crisis led the U.S. government to acquire exorbitant ownership stakes in our largest companies. It has also emerged as a dominant creditor.

This crisis has inspired more, and even invasive, regulation both in the financial and non-financial sectors, and the role of the government in corporate governance and financial regulation has actually expanded. Thus, the role of the government in corporate governance, including executive pay, through direct ownership and implicit guarantees is likely to increase unless the pendulum shifts as a result of some backlash from industry.

However, the increasing role of the government is consistent with what is happening around the world, since state-owned corporations in fast growing BRICs (Brazil, Russia, India, and China) have emerged as serious competitors to the traditional corporations, with the resultant state capitalism emerging as an alternative form of the traditional corporate governance. At this time it is difficult to predict the economic consequences of the global trend in the increased state role in governance of corporations.

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