What is a CEO worth?
Don’t look to peers

Peer group comparisons skew the board’s determination of a CEO’s intrinsic value. A new performance metric is required — and we have conceptualized what that should be.

By Charles M. Elson and Craig K. Ferrere

The controversy over executive pay in the United States seems unending. Pay has escalated dramatically over the past two decades, significantly outpacing shareholder returns in most years. Two explanations for this phenomenon have typically been proffered. The first relates to poor board function. Management-dominated, passive boards have failed to negotiate effectively with management over pay, leading to rapidly growing pay packages unrelated to performance rendered. The second explanation claims that higher pay is simply the natural consequence of a highly competitive market for scarce executive talent.

While there is some validity to both opinions, we believe an alternative explanation exists which may accommodate both disparate viewpoints and help lead to a resolution of the pay controversy. It is true that boards have been lax in many instances in negotiating pay, leading to higher and higher pay on demand. It is also true that a marketplace for talent does exist that acts to escalate pay levels. But little attention has been paid historically to the mechanical process by which boards actually set pay. Typically, boards rely on data that show pay at comparable enterprises. It is this reliance that has in large part significantly and dramatically increased pay to the levels that have created popular and shareholder outrage. We will explain how this process has so acted, critique its application, and offer an alternative that we believe will improve its mechanics and ultimate results.

Any understanding starts here
Understanding the internal mechanism of the pay process used by most boards is critical to any attempt to solve the compensation controversy. Typically, boards engage compensation consultants who aid in the structuring of the pay package to be negotiated with the executive concerned. These consultants, advising the board’s compensation committee, are asked to put the package into some perspective vis-a-vis the overall competitive job market. They construct a framework of comparative metrics based on levels of pay at companies deemed similar — as selected by the compensation committee and consultants, often with varying degrees of input by management. The executive’s proposed compensation is based on this comparison. Generally, each board will choose to create a package that is in the 50th, 75th, or 90th percentile of their target peer group. Targeting levels below the 50th percentile is rarely, if ever, done.

But why these levels? It is because any other action would place the board in an uncomfortable and
disadvantageous position. In the current construct, pay below the 50th percentile does not simply send a message of the relative performance and merit of an executive, as embodied in one’s compensation relative to one’s peers. Instead, such board action may raise concerns over the executive’s position within the company, possibly undermining that individual’s ability to lead effectively. Additionally, boards seem to use the 75th and 90th percentiles as a common method to signal institutional aspiration and standards, in the same way that the terms “better” and “best” are designed to enhance product differentiation. In a similar sense, pay below the median would consequently signal “worse.”

After the compensation committee selects the appropriate percentile level a package is then designed by the consultant to meet that numerical goal. This is typically accomplished by using a mix of salary, bonus, and long-term incentives — usually restricted stock or stock options. The package so created and recommended by the compensation committee is then approved or ratified by the full board. Obviously, a major ingredient in creating the pay is a significant reference to how comparable executives at comparable companies are paid.

The critics’ focus

Traditionally, critics of executive pay have focused their efforts on the composition of the board and the alignment of the compensation consultants. Demands for equity-holding, independent board members advised by compensation consultants who are solely retained by and responsible to the board have met with great success (as evidenced by several provisions of the Dodd-Frank legislation).

The real problem with the compensation process that is unaffected by board compositional-based reform is the use of comparable data to set pay. These metrics were originally used as a way to simulate the operation of a competitive labor market where, in fact, the effective operation of that market was impaired by the nature of executive retention. The board has a limited pool of talent that has many firm-specific attributes that constrain the free flow of human capital necessary for effective market operation.

Further, the exact role and contribution of an executive is very difficult to define, and each executive’s skills are somewhat idiosyncratic in nature; thus boards in this constrained marketplace have

---

A CEO’s lament: the dastardly scoreboard

By George M. Keller

Ed. Note: A CEO boldly admitting that CEOs are overpaid — how rare is that? Well, George M. Keller did so in Directors & Boards in an article he authored in 1994. By then he had retired as chairman and chief executive officer of Chevron Corp. His legacy included executing the largest corporate takeover at the time — the acquisition of Gulf Oil Co. in 1984, a deal that transformed Standard Oil Co. of California, which he had joined in 1948, into Chevron Corp. Keller died in October 2008 at the age of 84. Following is a passage from his remarkably candid article that touches on the problem of peer groups.

American corporate CEOs, in general, are significantly overpaid. Their job responsibilities and risks just do not justify multimillion-dollar compensation. Let me hasten to acknowledge that I was a beneficiary of a good part of the inflation of the CEO’s income before retiring at the end of 1988.

Today’s typical corporate compensation profile looks like a pyramid with the Eiffel Tower poking out the top — the CEO and one or two other executive officers far above the madding crowd. At present compensation levels, most CEOs are working to generate funds for their grandchildren, their favorite philanthropies, and the IRS.

Of course, the board compensation committee is aware of the widening gap between the CEO and the rest of his organization. Practical economic considerations preclude our moving toward a more equitable relationship by simply doubling the lower-level salaries, so we pursue a sort of pseudo-equity by trying to restrain further expansion of the gap and by relating the CEO’s compensation more closely to his success in generating value for the business as a whole.

We are faced with the need to be competitive — whatever that means — in order to hire and retain qualified executives and to reward success. The question is: Competitive with whom? Movie stars? The Cubs’ second baseman? Or the true entrepreneur, the inventor, the creator, who bets his skills, imagination, and assets against long odds?

I think not! Generally speaking, these cases have few parallels in the typical career-based companies that make up the bulk of the Fortune 500. Yet, within these companies the so-called “market” analogy has spawned a self-fulfilling prophecy of increased compensation. Data on peer CEOs is available in proxy statements, if one can decipher them, or numerously consultants stand ready to show you that your CEO is in the third or fourth quartile when his total compensation is ranked with his corporate neighbors, thus propagating the ratchet effect in which CEO salaries steadily leapfrog one another upward, ever upward.

I was asked at one time in a TV interview if, during my last year as chairman, I was overpaid. My answer: If you rephrase the question and ask if I would have worked just as hard at my job for much less, I would say “definitely yes.”

But my senior managers and I would have been seriously embarrassed, as industry competitors with whom we dealt on a continuing basis wondered how come my board thought my job (or I, as CEO) was worth only half as much as my peers. I call this the “scoreboard effect,” and I view it as a particularly difficult impediment for compensation committees to deal with.
struggled to define that individual’s worth. Because boards may have very different views of the intrinsic value of an individual, and other boards’ estimations may be higher, they are forced to rely on extrinsic comparisons between companies as a necessary step for retention. This is the reasoning behind and the origin of peer grouping that today is central to pay design.

There are major problems with the use of peer groups that have led to the ratcheting up of pay that is seemingly unrelated to performance rendered. One issue involves how the peer groups are selected. There is a natural incentive to pick as peers companies with significant compensation, even if they are different in size, scope and performance from the company in question. The higher the compensation of one’s peers, the higher the consequent compensation of the target company executives. There is no real objective standard in existence to precisely identify a peer because of the significant and multiple variables that go into selecting peer companies. This is why the process may be subject to manipulation by the consultant, the board and the executive. And, this is why reform efforts have focused on more independently comprised boards and greater independence from management on the part of the compensation consultants. The idea is to provide the proper incentive and structure to create more realistic and unbiased peer groups.

A real problem
Manipulation of the peer group sampling is a real problem. But simply fixing the alignment of those in the peer group selection process will not ultimately solve the pay issue. First, as discussed, boards typically gravitate in setting compensation to a set of arbitrary targets — i.e. the 50th, 75th and 90th percentiles of peer group pay. A blind reliance on these pay targets has resulted in a mathematically-based upward pay spiral. If all aspire to the 50th, 75th or 90th percentile, it is clear that pay has and will continue to rise significantly and indefinitely. Additionally, and more importantly, the process itself is highly amorphous and subjective, incapable of precise and uniform design. Therefore, the actions of every shareholder-conscious participant has been and will continue to be distorted.

Can the spectrum of an individual’s talents and capabilities be so neatly packaged into fixed percentiles? An individual executive may deliver phenomenal per-
Peer groups: Clear drawbacks, but the jury is still out

By David Larcker and Brian Tayan

The compensation committee and the board of directors are responsible for determining the level of compensation paid to the CEO and other officers. They must also select the mix of short-term and long-term elements to achieve a payout structure that is consistent with the firm’s strategy. In theory, this should be a straightforward exercise, with the level of total compensation set to be commensurate with the value of services received.

The process might work as follows: First, determine how much value the company expects to create during a reasonable time horizon (for example, five years). Then determine how much of this value should be attributable to the efforts of the CEO. Finally, determine what percentage of that value should be fairly offered to the CEO as compensation.

Although many boards may implicitly follow this type of approach, it is exceedingly difficult to measure the value creation attributable to the efforts of a specific executive.

Instead, most boards determine compensation levels by benchmarking their CEO’s pay against that of a set of companies that are comparable in size, industry, and geography (peer group). Interviews with compensation consultants reveal that companies commonly aim to provide cash compensation (base salary and annual bonus) at the 50th or lower percentile of the peer group and long-term incentives (primarily equity-based compensation) at the 75th percentile. These figures represent the board’s assessment of the market wage opportunity of the CEO and other executive officers. The compensation committee also needs to make sure that the level of pay suggested by the benchmark has a similar level of risk as the compensation.

The process of peer group selection is under considerable scrutiny by securities regulators and shareholder activists.

David Larcker directs the Corporate Governance Research Program at the Stanford Graduate School of Business and is senior faculty at the Stanford Rock Center for Corporate Governance. Brian Tayan is a member of the Corporate Governance Research Program. They have co-authored many case studies and articles on governance. This article is excerpted from their new book, Corporate Governance Matters, copyright ©2011 by Pearson Education Inc., published by FT Press, a Pearson imprint (www.ftpress.com). Reprinted with permission.
An attractive alternative to a peer index

By Alfred Rappaport

Corporate boards can overcome many of the serious shortcomings of standard stock option programs by adopting a plan that rewards executives only if they create superior long-term value. One potential solution is an indexed-option plan that requires executives to retain a meaningful fraction of the equity they obtain well after the vesting date.

Unlike standard options that have a set exercise price, indexed options have an exercise price that rises or falls based on an index of the company’s competitors or a broader market index. For example, if the chosen index increases by 10 percent, then the exercise price of the options increases by the same percentage. As a result, the options are worth exercising only if the company’s shares rise by more than 10 percent.

Indexed option plans, unlike fixed-price option plans, ensure that underperforming executives are not rewarded simply because the market is rising. Nor do they penalize superior performers in a falling market. If the peer group or market index declines, then so does the exercise price, which provides executives with a continuing incentive to increase value. With standard option plans, a bear market can overshadow superior performance and cause executives to lose wealth precisely when they provide the best relative results. Both the free ride in the bull market and the undue penalty in a bear market undermine the effectiveness of the standard stock option plan. Indexed options, by contrast, reward superior performers in all market environments.

Some observers object that executives profit when they outperform the index even if the stock price falls below the exercise price at grant date. To counter this objection, boards can require that options be exercised only if the company’s stock is trading above its price at grant date or if shares have appreciated at a specified minimum annual rate.

One practical challenge in implementing an indexed option plan is determining whether it is better to tie the exercise price to an index of the company’s competitors or to a broad market index, like the S&P 500. A market index is transparent and easy to track, but does not reflect the specific factors that affect the company’s industry. As a consequence, a market index is not an ideal benchmark for measuring management performance. An index of the company’s competitors is a better choice. But many companies do not have a clear and suitable set of peers. This is particularly true for diversified companies.

There is an attractive alternative for companies unable to develop a reasonable peer index called an equity-premium option plan (EPOP). EPOPs require a higher level of threshold performance than standard fixed-price options but, unlike indexed options, do not require the construction of an index. Specifically, the exercise price of the option rises by the yield to maturity on the 10-year U.S. Treasury note plus an equity premium minus the dividends the company pays.

For example, suppose a company’s shares are trading at $50 at the option grant date, the yield on the 10-year Treasury note is 4 percent, and the equity risk premium is estimated to be 5 percent. The exercise price would rise by 9 percent over the next year, from $50.00 to $54.50, before consideration of dividends. If the company pays dividends during the year of $1.00 per share, the end-of-the-year exercise price would be adjusted to $53.50. (The plan deducts dividends from the exercise price so as to remove any incentive for companies to hold back distributions when there are no value-creating investment opportunities.)

Choosing an equity-premium rate for an EPOP plan becomes a much less daunting task when corporate directors recognize a few considerations. To begin, nobody can accurately predict future return spreads between stocks and Treasury notes. That said, most forecasts tend to cluster in a relatively narrow range of 4 to 5 percent. Finally, any forecast error in the equity-premium rate pales in comparison with the failure of standard options, which incorporate no shareholder opportunity cost, not even the risk-free rate on Treasury securities.

By rewarding executives only when the company’s stock price increases at a rate greater than the 10-year Treasury note plus an equity risk premium, EPOPs overcome the criticism that performance targets are too low.

formance and be likewise compensated, but why should that individual’s contribution to their company be relevant to another individual’s actions at another company on an absolute basis? Comparisons to that individual must not be so unconditionally based. An executive is not freely interchangeable; their performance will be different than another’s at every company they head. A talented individual who is paid on a scale deserving of their abilities should not, through the peer group mechanism, be allowed to bolster the pay of less able executives; particularly when those executives would be paid less if serving in a similar fashion (attributable to a performance-based decline in pay).

Blind matching of pay through peer groups and percentile targeting fails to identify for boards the most crucial component to the negotiation. Peer grouping, by focusing simply on absolute pay levels in making an elementary company-to-company analysis, fails to determine the intrinsic worth of the executive in question and does nothing to identify the outside opportunities available to an executive that are necessary in determining a retention wage. For this, pay structures must be tempered by a specific consideration of an individual’s talent and that person’s actual external opportunities.

In an efficiently operating competitive market, the most talented individuals should be sought after and acquired for the highest price, while the wages of marginally talented individuals should reflect their lower expected and realized contribution to shareholder return. In the case of executive compensation, where that competitive process is impeded, the system of banding and peer grouping was created to reconstruct those results. But, with no conception of talent beyond the narrowly defined percentiles used in practice (50th, 75th, 90th), how can the process arrive at a fair approximation of a competitive result? The talents of diverse individuals cannot be so neatly distributed, and it must be true that half are always below the median. The result is a market construct where pay levels are created by mathematical operation, which ratchets upwards the pay of all involved, especially those at the lower end of the talent distribution.

**How it should be done**

So what is the solution? An efficient negotiation process determines the level of pay necessary to retain and incentivize a CEO — no more or less should be paid. Once an appropriate amount is determined, boards and compensation consultants can devise an optimal mix of cash, stock, and/or options that will create the required incentive. For the purposes of determining this amount, a realistic appraisal of the executive’s outside opportunities as measured by that individual’s performance record and experience needs to be made. An executive’s past actions can be a useful indicator of future performance. A common metric to evaluate a CEO’s performance, regardless of industry or company size, should be formulated. For example, by using an analysis of such historic financial measures as return on assets, return on equity, or revenue growth during an executive’s tenure, we can create a consistent and objective gauge for relative effectiveness.

Rather than using peer group analysis based on firm attributes, boards should use a common and universally applicable metric in determining the appropriate level of pay based on how a CEO compares with other chief executives. The individual’s proven abilities will be central to the process used in deriving this metric. The authors, with the support of the IRRC Foundation, intend to create such a method of analysis.

In the classic model of the market for CEO pay, as described by proponents of competitive market theory, the condition of scarce CEO talent creates an environment where the most talented executives, who can deliver the greatest excess returns, are sought after and engaged by larger companies where their actions can have more impact. The competitive positioning and the dynamics spurred by disparate expected returns are the economic justification for paying executives so much for their contributions.

**Rectifying the shortcomings**

Unfortunately, the current peer grouping process with percentile targeting of compensation has failed to produce efficient allocation of executive human talent and is responsible for inefficient compensation contracts. However, replacement of the peer group process with the performance metric that we have conceptualized should help rectify this shortcoming by properly aligning talents with compensation and ensure a better competitive process.

By inquiring into the intrinsic worth of an individual’s contributions, rather than blindly referencing the pay of others, we can arrive at more equitable and less controversial compensation. This will bode well for the health of the corporation and, more importantly, its shareholders.

The authors can be contacted at elson@udel.edu and cferrere@udel.edu.