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Responses and rejoinders to commentaries

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Responses and rejoinders to commentaries

Abstract

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YAOWEN SHAN AND TERRY WALTER

Responses and Rejoinders to Commentaries

We are fortunate to have received 13 excellent commentaries on our paper. Each commentary is quite unique, perhaps reflecting how controversial is the topic of trying to set down fundamental design principles for managerial reward systems.

Below we provide a brief response to each of the commentaries, setting out a summary of the issues that are raised and pointing out particular aspects that contribute to our ultimate goal of obtaining a consensus among finance and accounting academics on the central issue. Of course, once this set of papers are in the public domain, there will be further discussion and exchange of ideas.

In accord with academic norms, we respond to each paper in alphabetical order.

Beaumont *et al.* (2016) conduct an empirical experiment to gauge whether CEO pay is too high in the US, Australia and the UK. They do so by comparing the pay of CEOs to that of athletes in professional sports. The conclusion from this empirical analysis is that in the US ‘the shape and nature of the distribution of CEO pay appears quite similar to that of professional athletes’ (p. xx) and ‘the data suggests [sic] that the bulk of the CEOs receive low pay’ (p. xx). For Australia and the UK (where the sample sizes are much more limited) the conclusion is that Australian CEOs ‘receive roughly twice the compensation of the ... professional athletes’ (p. xx) whereas in the UK ‘CEOs earn higher equity-linked salaries than soccer players, but lower base salaries than these players’ (p. xx). While we find this analysis interesting, especially in relation to some of the historical insights that are developed in the commentary, it does not offer any specific recommendations on the principles we set down. We also doubt the validity of a comparison to professional sporting reward systems, remembering that CEO rewards are dominated by stock-based incentive-aligning payments, which do not exist for most professional sports athletes. Our understanding of the remuneration structures for athletes in the major leagues in the US is that they tend to have salary caps with pre-determined maximum tenures, salaries and salary growth rates and are tied to the income of the league. These issues make comparisons to CEO compensation even more dubious.

Boyle (2016), while generally sympathetic to the task we have undertaken, offers several insights that we did not canvass in our discussion. In particular, he alludes to a third ‘camp’ of theories of executive compensation, namely the view articulated in Dorff (2014) who rejects both the efficient contracting and managerial power paradigms in ‘favour of a behavioural approach in which psychological factors cause well-meaning but befuddled directors to excessively remunerate CEOs’ (p. xx). Boyle, however, sets this up as a ‘straw man’ because he states in footnote 2 that he finds the view to be unconvincing. Of more importance are the points Boyle makes in relation to compensation consultants, and the conflicts they face in providing advice to boards and CEOs who employ them as consultants. Boyle suggests that truly independent labour economists (and we would add financial economists) be employed to analyze the data. If the data are share prices, and if standard and accepted models of excess returns are employed, perhaps some of these conflicts could be avoided. But this assumes, as pointed out by Boyle (2016), that CEO performance is a primary driver of sharemarket returns for their firms. Suppose there are events, and Boyle provides some examples, where exceptional sharemarket returns are unrelated to CEO skill or effort. For

example, exceptional performance might be due to luck or to the resolution of disputes that arose before the CEO was hired. In such circumstances strictly tying bonus pools to excess returns would be counterproductive. These issues have, however, caused us to develop a tenth principle. Specifically, we now propose that the compensation committee be given discretionary power to investigate unusual circumstances in the firm's sharemarket performance that are unrelated to CEO skill and effort, and make adjustments to the bonus pool. Boyle also provides additional discussion of public sector firms where similar controversies have arisen in relation to CEO pay. However, he cautions us to not venture into this minefield. We accept this advice.

Brown and Szimayer (2016) make several valuable contributions to our paper. In particular they concentrate on the 'value gap', that is, the difference between the cost to the company of granting stock and option compensation and the value of that compensation to the CEO. They provide several references to papers that collectively show 'that the key properties of ESOs can pose serious difficulties when attempting to value them, and ... can lead to substantial cost overstatements' (p. xx). The discussion of the value gap concludes the authors' claim that 'could easily be 20% or more'. One issue not canvassed in our paper is whether there is an optimal pay-performance sensitivity, and if so, what determines it. While theoretical and empirical research in this area is shown in Brown and Szimayer (2016) to be ongoing it seems from the existing literature that performance vesting is an essential element for effective CEO remuneration design. Brown and Szimayer (2016) also discuss how dividend adjustments might be incorporated and provide practical guidance and precision to the principle we set out. They also propose, in the spirit of making remuneration systems more implementable, the use of a total shareholder return (TSR) rather than the less familiar academic models of excess performance that we propose. The main point we make on this issue is that the bonus pool should be based on a performance benchmark that measures shareholder wealth creation relative to an appropriate benchmarked set of peers. But if accountants and financial executives can come to grips with Black-Scholes option pricing valuations, is it unreasonable to expect that they could also feel comfortable with a market model or a Fama-French three factor model? We also wish to highlight an issue raised by Brown and Szimayer (2016) with which we strongly agree. In order for our principles to be incorporated into executive remuneration systems it is essential that the compensation committee has the help of independent experts. A conflict of interests potentially exists here because if a remuneration expert demonstrates poor CEO performance that expert may not be re-hired.

Da Silva Rosa (2016) provides a lengthy and erudite discussion of three themes of central concern to our objectives. Specifically he argues that (a) there is a plausible case that the controversy over CEO pay is a sideshow with little impact on how CEOs are remunerated, (b) we do not robustly understand the drivers of CEO pay, and (c) we risk asking too much of the market in tying CEO pay to abnormal equity returns. Da Silva Rosa also argues that the Murphy and Jensen (2011) claim 'that almost all CEO and executive bonus plans are deeply flawed' is severely overstated. Perhaps this is why the paper remains unpublished. Further, he objects to our second principle, which recommends that the market for managerial talent be used as an input in setting and adjusting CEO pay, arguing that such a recommendation will not contribute significantly to settling the controversy over CEO pay. We believe it will be important for compensation committees to gain access to professional advice so that a proper understanding of current pay arrangements is incorporated. And, of course, there will be negotiations between the board and a new CEO over base pay arrangements. We have, however, as a result of the feedback and suggestions we have received not only from the Da Silva Rosa commentary, added a tenth principle. We believe that this principle alleviates many of the concerns that have been espoused in Da Silva Rosa's critique. Specifically, we now propose that the compensation committee be given discretionary power to investigate unusual circumstances in the

firm's sharemarket performance that are unrelated to CEO skill and effort, and make appropriate adjustments to the bonus pool. Such committees would need to draw on expert inputs from compensation consultants and might benefit from the advice of labour economists and financial economists.

Hillier *et al.* (2016) offer suggestions on how information from the market for managerial talent might be operationalized in practice. However, they object to our [previous](#) suggestion that there should be an upper limit on the size of the bonus pool. We agree that this suggestion might be misinterpreted and hence we have changed the wording in this principle. We do not object to managers who are responsible for huge value creation being handsomely rewarded, and while we do not wish to set a particular percentage on what proportion of shareholder wealth increases might go into a bonus pool, it is in that spirit we suggested a cap on the size of the bonus. It would be entirely self-defeating if the bonus pool was 100% of the shareholders' wealth increases. Hillier *et al.* (2016) also propose additional disclosures as to the composition of the peer group used in benchmarking and whether the performance criteria used are set independently. We agree that additional disclosure is a worthwhile topic for further development subject to a recognition that disclosure can impose costs on the firm. Our thinking was somewhat more general in relation to disclosure of remuneration practices. We thought our principles might eventually become a code of 'good executive remuneration practice' and that firms that adopted these principles might simply say that their practices complied with the principles of this code.

Howieson (2016) adopts the view that executive compensation design can be informed by, and thus ought to take into account, other perspectives than the economic perspective emphasized in our analysis. In particular he suggests that the literature in organizational studies, ethics, and law (especially the legal and moral fiduciary duties of CEOs from which a conclusion drawn is that it is the responsibility of the CEOs themselves to reject excessive pay).¹ Howieson does not comment specifically on any of the nine principles we set out, but he does suggest as a conclusion another principle designed to 'promote and demonstrate the transparency of executive appointment, remuneration, and evaluation and that require executives to have undertaken appropriate training in practical skills in value clarification and ethically informed decision making and policy setting' (p. xx).

Matolcsy and Spiropoulos (2016) approach this topic with an unashamed contention 'that on average executive compensation is efficient' (p. xx). They provide additional discussion of areas not covered in our paper, in particular in relation to the CEO pay slice (the ratio of the CEO pay to the pay of the five highest paid executives which is used in research as a proxy for CEO power and poor governance), further analysis on the 'say on pay' regulations in the US and Australia, and gender diversity in compensation committees. Matolcsy and Spiropoulos (2016) then comment more specifically on our proposed measures of performance, suggesting the use of economic value added (EVA) or residual income (RI). We agree that such performance measurements are valuable, particularly in evaluation of unlisted firms or listed firms where equities are not efficiently priced. They also discuss benchmarks cautioning that share prices reflect 'more than just contemporaneous performance' (p. xx). We agree, but surely a shareholder whose stock has appreciated by 30% more than an agreed benchmark will be more inclined to agree to a CEO bonus in that period (remembering that we propose that the bonus will vest over several periods conditional on future

¹ Clearly the notion of what is excessive is of central concern. For example, total pay of \$100 million might not be regarded as excessive by a CEO who managed a firm during a period when shareholder wealth creation was \$50 billion. Remember also that such a payment would vest over several periods under the proposals outlined in Shan and Walter (2016).

performance)? Matolcsy and Spiropoulos (2016) also provide additional discussion on the performance window especially in relation to termination payments and consider whether additional thought be given to compensation in private companies, public sector utilities, and not-for-profit organizations. As we state above, it is here that EVA and RI measures would be particularly relevant.

Roberts (2016) suggests that ‘further attempts to realize the elusive ideal of effectively linking individual executive pay to performance, are bound to fail’ (p. xx). He adopts the view that pay is an ‘essentially ethical and political issue that should confront executive self-interest and opportunism directly’ (p. xx). Roberts concludes that ‘looking simply to find better ways to align executive self-interest to the interests of shareholders will likely only feed the problem further’ (p. xx). It will come as no surprise that we disagree. Recent development in financial economics have developed well accepted models whereby excess firm performance can be isolated in markets that are efficient. Further, our proposals are essentially based on managerial reward systems being tied to these performance measures, with appropriate safeguards via our proposals for vesting of bonus compensation.

Smith and Zhou (2016) agree with our proposition to use market based measures of performance and provide additional ways in which superior performance can be isolated. Specifically they propose the use of Alpha Indexes, defined in equation (1) in their paper. The downside of this proposal is that such Indexes are generally not available in Australia, but given their future availability, we agree that they provide an additional and valid measurement system to the models we proposed. Smith and Zhou (2016) also propose the use of ‘Golden Handcuffs’ as a vesting mechanism such that the bonus in a particular period is not paid in full in that period, but spread over subsequent years subject to continued satisfactory performance. We agree. We also agree with the sentiments developed in relation to ‘Golden Parachutes’ as a way of *ex ante* contracting for termination payments. Smith and Zhou (2016) propose consideration of stakeholders, rather than managers and shareholders, suggesting employees, customers, suppliers and society in general (particularly in relation to sustainability) be considered. Yes, but we need to learn to walk before we can run. In conclusion Smith and Zhou (2016) conclude that in regard to CEO pay design that the principles should be simple and fair and that outstanding performance should be recognized and acknowledged by reference to market benchmarks.

Swan (2016) concludes that the nine principles we outlined ‘provide good general guidance. However, these principles are relatively silent in the advice they provide on the critical pay mix— incentives versus cash—and shed very little light on the compensation for pay risk, managerial effort, and managerial talent’ (p. xx). Swan’s commentary is designed to highlight revisions that are necessary to provide even more useful advice in future. In particular there is considerable discussion in relation to the cash component of compensation, the inability to observe managerial talent *ex ante*, the mechanisms that need to be in place to ensure appropriate levels of risk-taking (where it is proposed that options with downside protection might be considered) and issues that might arise in cases where the CEO is dismissed for poor performance or illegal conduct. Swan (2016) also suggests that our fifth principle should be reworded to ‘say that the talented CEO will value equity-linked compensation at more than its notional cost’ if information about the talent of the CEO is privately held and if the CEO knows his talent will lead to future abnormal performance of the firm. Principle 8 called for the peer group of firms to be ‘independently set’. Swan (2016) argues that this is difficult because most ‘independent’ directors are not truly independent. However, as noted in Matolcsy and Spiropoulos (2016), in the US the SEC has required (since 2006) compensation committees to report peer-group comparisons of executive pay. Matolcsy and Spiropoulos state, drawing on Bizjak *et al.*

(2011), that 'so far the evidence suggests that, on average, peer firms are chosen efficiently based on the economic characteristics of the firm' (p. xx).

Taylor's (2016) comments are in many respects quite similar to those of Da Silva Rosa (2016). He argues that our principles give too much weight to the role of stock prices and not enough weight to accounting performance measures as the basis for measuring periodic executive performance. However, our fundamental point is that we consider compensation as a vehicle to align management's interests with shareholders' interests, which is ultimately measured by stock prices. The bottom line in our paper is that, compared to other measures such as accounting numbers, stock prices ultimately reflect shareholders' interests (either in the short or long run). Taylor (2016) poses another primary concern stating that a lack of a 'positive' theory of executive compensation makes it difficult to evaluate recommendations for change. We agree that ideally policy recommendations should be based on sound theory and sound empirics, but the reality is that these do not exist. We therefore, to some extent, 'put our heads on the chopping block'. We did so because we believe that the main building blocks of corporate finance for our empirical and theoretical research—theories we work with in finance, namely efficient market theory, portfolio theory, asset pricing theory, agency theory, and option pricing theory—have important implications for understanding executive remuneration design, especially when there is a separation of ownership and control. We provide a simple justification for our reliance on stock prices. Suppose we are assessing a firm's performance and the firm has a beta of one. Suppose its share price rises 20% in a year, yet comparable peers (also with an average beta of one) have price increases of 30%. We argue that shareholder wealth has decreased and that they would therefore be dismayed if an argument was put that a large bonus pool should be provided because the share price had increased by 20%. Alternatively suppose its share price drops 20% in a year, yet comparable peers drop 30%. Here the abnormal performance is positive and supports the award of a bonus. The firm, in the face of difficult economic circumstances, has been able to perform less badly than its peers. We recommend safeguards, particularly in relation to vesting arrangements, and have added an additional tenth recommendation to our principles that we believe alleviates many of the concerns that arise in Taylor (2016). If Taylor is prepared to benchmark accounting performance measures to the weighted median of comparable firms' accounting performance measures we have more sympathy with his arguments. In any event, given our tenth principle, compensation committees would be able to fully incorporate measurements from accounting systems in their discretionary judgements about bonus pools.

Wright (2016) argues that the first three sections of our paper are conventional, providing the theory, descriptive statistics, and a literature review. The fourth section jumps to a normative statement of suggested principles. We make it quite clear that these statements are developed from 'intuition and a review of the extensive theoretical, regulatory and empirical literature' (p. xx). Wright (2016), as too indeed does Swan (2016), suggests that the link between the first three sections and the fourth is not sufficiently strong. We accept that criticism. Wright also argues that there is 'no discussion of other approaches or even combinations of a selected number of the nine design principles espoused' (p. xx). She proposes that CEO compensation might, as an example of an alternative principle, be limited to 'x' times the lowest salary in the firm. We alternatively propose that CEO compensation should be linked to measures of abnormal performance. Wright also concludes that 'it is important for the literature to consider and debate alternative models that are not observed in practice' (p. xx). We thought we had invited such suggestions when we stated in the abstract that our purpose in setting out our principles was 'to generate broad debate and discussion leading to a consensus as to the principles that should be present in all executive compensation contracts such that the interests of shareholders and managers are more closely aligned'.

Yermak (2016) argues that the nine principles we set out (a) do not follow directly from the analysis in the paper and (b) that they would straightjacket companies into offering only certain types of compensation contracts. As we have stated above, we acknowledge that the link between the first three sections of our paper and the fourth (where the normative principles are stated) is not as strong as it might be. In fact our principles are primarily derived from intuition. However, we do not see these principles as putting firms in straightjackets. In essence we argue that firms with listed securities should assess the excess or abnormal performance of a firm using models that are well accepted in the financial economics literature. We suggest vesting arrangements be put in place, but are not overly prescriptive as to how these might be applied. We suggest the use of price signals from the market for managerial talent. We propose dividend adjustments for equity-linked grants. We make recommendations about independently selected peer groups for benchmarking. Yermak argues that if our recommendations are adopted, little would change. The examples we provide in our paper suggest otherwise. Yermak rejects our principles, and instead provides six points of his own for reforming executive compensation. We will not repeat his six principles here but we note that (a) his first recommendation is perfectly consistent with our principles, (b) abolition of employment contracts (recommendation 2) is unlikely to occur in Australia, (c) the elimination of perks is unnecessary, providing the value of these perks is properly recorded as compensation, (d) that the important role of inside debt compensation be recognized in compensation arrangements, (e) that accounting data and peer-based compensation be removed from performance evaluation, and finally (f) that greater disclosure and transparency be required.

Based on the comments and suggestions we received from these 12 commentaries we have modified some of our principles and added a tenth. The modified set is presented below.

1. Executive compensation should consist of two broad elements, a base pay and a flexible bonus element.
2. The base pay should be set taking into account the market for managerial talent. It can be adjusted to reflect changes in the market for managerial talent.
3. The bonus element should be based on performance of the firm, and its payment should vest over several years depending on performance outcomes over those years.
4. The bonus amount or bonus pool should be based on a share of the risk-adjusted wealth increase that shareholders have achieved in the contemporaneous period.
5. Bonus payments can be divided into equity-linked, cash, and perquisite components. It should be recognized that a CEO values equity-linked compensation at less than the cost of those awards to shareholders.
6. Equity-based compensation grants should be adjusted for dividend payments. The exercise price of executive options should be adjusted downward, while restricted stock should have dividend entitlements and the entitlement to shares should be adjusted upward by assuming the dividend is re-invested to acquire additional stock. Equity-based option and stock grants should have their exercise/subscription prices adjusted upward or downward to reflect movements in the share prices of the independently selected set of peers (see principle 8 below).

7. Performance measurement is subject to measurement error, and accordingly performance should be classified as: (a) statistically superior to the benchmark; (b) statistically indistinguishable from the benchmark; and (c) statistically below the benchmark. Performance that is statistically below the benchmark should result in no bonus reward for the current period. The performance bonus should be higher for statistically superior performance than it is for performance that is statistically indistinguishable from the benchmark. The performance rankings should be positively correlated to the bonus pool.
8. Firm performance should be measured relative to an appropriate independently selected set of peers taking risk into account. Bonus awards should be based on a measure of abnormal performance calculated as the firm's actual performance less the performance that is expected, given the actual performance of the benchmark peers. Firms with listed securities should use sharemarket returns in assessing abnormal performance, if the securities are efficiently priced.² Audited accounting-based measures of performance can also be used providing that these are prepared on a consistent basis. Audited cash-flow measures of performance should be used as a check on the reasonableness of earnings measures. Accounting measures of performance should be adjusted for the cost of capital. Other non-GAAP measures of performance, especially RI and EVA measures, should also be used in assessing the reasonableness of GAAP income. Accounting performance measures should, where possible, be compared to peer firm performance measures so that abnormal performance can be determined.
9. Termination payments should be a function of the benchmark adjusted performance of the firm during the tenure of the executive. Three broad categories of performance (as in 7 above) should be developed. Entitlements to incentive payments that have been earned but that have not yet vested should vest on a CEO's resignation, however, these should be subject to some clawback. A CEO who is dismissed for poor performance or inappropriate or illegal conduct should receive no termination bonuses.
10. The compensation committee, where it lacks relevant expertise, should independently recruit remuneration consultants, labour economists or financial economists to guide the

² In *Cammer v. Bloom* (1989), 711 F.Supp. 1264, 1276 (D.N.J.), United States District Court for the District of New Jersey, Judge Alfred J. Lechnmer outlined five factors that have become known as the 'Cammer factors' that that would help establish whether a security traded in an efficient market. Since then, dozens of courts have relied on the five 'Cammer factors' in evaluating market efficiency. The factors are '(1) the stock's average weekly trading volume; (2) the number of securities analysts that followed and reported on the stock; (3) the presence of market makers and arbitrageurs; (4) the company's eligibility to file a Form S-3 Registration Statement; and (5) a cause-and-effect relationship, over time, between unexpected corporate events or financial releases and an immediate response in stock price'. Since then Courts have supplemented the five Cammer factors with other measures such as market capitalization, bid/ask spread, float, and analyses of autocorrelation (see Buckberg, 2012).

implementation of these principles in initial contract design and subsequent measurement of performance. The major elements of design in the contract and measures of performance used should be disclosed to shareholders. The consultation committee should have discretion to investigate any material unusual circumstances in the firm's sharemarket and accounting-based measures of performance that are unrelated to CEO skill and effort, and make adjustments to the bonus pool. Any such adjustments should be justified and disclosed to shareholders.

References

Bizjak *et al.* (2011)

Buckberg (2012)

Dorff (2014)

Murphy and Jensen (2011)