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INTERVIEW

Reformers Fall Short on Executive Compensation

Lucian Bebchuk

Lucian Bebchuk, Professor of Law, Economics, and Finance and Director of the Corporate Governance Program at Harvard Law School, has been a central figure in debates on corporate reforms.

In a recently published book, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press), Bebchuk and co-author Jesse Fried strongly critique the practices companies now use to determine executive compensation and propose improvements.

Vanguard Group founder John C. Bogle called it "a book that must be read … by any citizen who cares about our society." In an interview with the *Securities Fraud Monitor*, Bebchuk discussed the book, his recent empirical work on corporate governance, and his ideas for reform.

SECURITIES FRAUD MONITOR: How important is the subject of executive compensation to the economy? What is at stake?

LUCIAN BEBCHUK: The problems of executive pay have practical significance for investors and the economy. The amounts involved are substantial, even relative to the large market capitalization of public firms. In a recent empirical study with Yaniv Grinstein, we found that public firms paid their top five executives an aggregate compensation of about $250 billion during the decade 1993-2002. Furthermore, aggregate compensation for the top five executives equaled 10% of aggregate corporate earnings in 1998-2002, up from 6% of aggregate corporate earnings during 1993-1997. Thus, if we could cut compensation without weakening managerial incentives, which we show in the book to be possible, the effect on shareholders' bottom line would be significant.

Moreover, executives' excess pay is not the only cost — probably not even the main one. Current pay arrangements provide diluted and sometimes perverse incentives. Eliminating such distortions could produce substantial benefits.

SFM: How much is an executive's pay linked to his or her performance?

LB: Pay is far less sensitive to performance than is commonly recognized. To begin, there is evidence that cash compensation, including the large amounts paid in bonuses, correlates little with managers' own performance. In addition, executives receive a lot of value through what we call "stealth compensation" – forms of pay whose dollar amount is not included in publicly filed compensation tables. This stealth compensation also isn't tightly linked to performance.

Even with respect to equity-based pay, the link between pay and performance is much weaker than it could be. Most of the payoffs from executives' equity-based compensation do not depend on managers' long-term performance but come from market-wide and industry-wide movements, as well as from short-term fluctuations in stock prices.

Furthermore, compensation contracts and provisions provide executives with substantial downside protection that further weakens the link between pay and performance. Compared with other employees, executives receive an unusually large portion of their full-term compensation if they leave due to poor performance.

Finally, current compensation arrangements not only fail to provide incentives to enhance shareholder value in a cost-effective way, but also provide perverse incentives. For example, broad freedom to unload options and shares has given executives incentives to produce short-term stock price increases instead of long-term value.

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SFM: How could pay be improved?

LB: Institutional investors could use our findings to pressure boards more effectively on executive compensation. Our analysis identifies the pay arrangements that institutions should resist, and those that they should encourage. For example, investors should urge firms to use equity-based schemes that filter out windfalls, to substantially limit managers' freedom to unload equity incentives and avoid contractual provisions that provide executives with soft landings in the event of failure.

To constrain boards' ability to camouflage executive pay, the SEC should ensure that firms make the total amount of an executive's pay and its sensitivity to performance transparent to a wide range of outsiders. *Pay without Performance* proposes various changes in disclosure requirements that would increase transparency. For example, firms must be required to place a monetary value on all benefits given or promised to executives and to include them in the compensation tables.

The most promising remedy, but the one most difficult to obtain politically, would be to adopt reforms that make boards more attentive to shareholder interests. Having directors that focus on shareholder interests would produce better pay arrangements, and improved board performance in general.

SFM: How much can recent corporate reforms address past problems?

LB: Recent reforms to strengthen director independence are beneficial.But they fall far short of what's necessary. Our work shows that the new stock exchange listing requirements weaken executives' influence over directors but do not eliminate it. Moreover, increasing independence can only go so far on its own. Independence does not ensure that directors will have incentives to focus on shareholder interests, nor that directors will be well selected. Directors must not only become independent of shareholders but also dependent on shareholders. To that end, we should eliminate the arrangements that currently entrench directors and insulate them from shareholders. Such reforms offer the most promising route for improving executive compensation and corporate governance.

SFM: Do you support the SEC shareholder access proposal?

LB: I have supported this proposal in a recent *Business Lawyer* article as well as in hearings the SEC held on the subject last spring. My article put forward evidence that the incidence of electoral challenges to directors has been practically negligible in the past decade. Believing that shareholders now have the power to replace directors is largely a myth. To make directors more accountable, we need to turn this power from a myth into a reality. The SEC proposal is thus a step in the right direction — a mild step that should be supplemented with other changes.

SFM: Other changes you recommend?

LB: Getting rid of the staggered boards most public companies now have and putting up all directors for annual election. Staggered boards provide a powerful protection from removal in either a proxy fight or a hostile takeover. In a recent empirical study, Alma Cohen and I found that staggered boards significantly reduce firms' economic worth. In a subsequent study with Allen Ferrell, we identified several additional governance provisions that insulate boards from shareholders (such as limits on bylaw amendments) that correlate negatively with firm value.

In addition to making director removal viable, shareholders need to obtain the power to initiate and adopt charter amendments. I develop the case for such a change in a recent article, *The Case for Increasing Shareholder Power.* In this article, I provide evidence that boards have been avoiding governance changes that they disfavor but shareholders view as maximizing value. For example, in most of the companies where shareholder resolutions to dismantle staggered boards passed with a majority, we still have staggered boards in place. Allowing shareholders to set governance arrangements would operate over time to improve the whole range of governance arrangements without outside regulatory intervention.

SFM: How likely are these changes?

LB: There are powerful vested interests that would resist any reforms to reduce management insulation and increase shareholder power. Even the mild SEC proposal for limited shareholder power to nominate directors has garnered such fierce opposition that it remains blocked. Fundamental legal reforms in the allocation of power in public companies will not be possible unless investors and public officials fully appreciate how pervasive and costly the flaws in our corporate governance system are. I hope *Pay without Performance*, and the other work I am doing on corporate governance, will help bring about such an understanding. ■