

What Corporate-Governance Reforms are Still Necessary?

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Executive Pay: A stronger link to performance and more transparency to investors are needed.

One key area of corporate governance that still needs substantial reform is executive compensation, which remains insufficiently sensitive to performance and not transparent enough to investors.

As Jesse Fried and I discuss in our book *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press, November 2004), existing pay arrangements have significant and widespread flaws that are costly for both investors and the economy. The aggregate compensation paid by public companies to their top-five executives from 1993 through 2002 was about \$250 billion. That aggregate compensation was equal to 10% of aggregate corporate earnings in 1998 through 2002, up from 6% from 1993 through 1997. If compensation could be reduced without weakening managerial incentives—and we show it could—the direct gains to investors would have real, practical significance.

Excessive pay isn't the only cost of flawed compensation arrangements. Executives' influence over their boards has produced pay arrangements that dilute and sometimes pervert incentives. Though the need to provide executives with adequate incentives is often given as the reason for the escalation of pay levels during the past decade, pay is much less linked to performance than is commonly recognized, and bonuses are often only weakly linked to performance. Also, much compensation is provided through stealth compensation such as retirement benefits that are largely decoupled from performance.

Furthermore, a substantial portion of the gains that executives obtain from equity-based compensation comes from market or sector movements or from short-term increases in stock price. "Soft-landing" arrangements that provide generous treatment to executives pushed out the door due to their own failure further contribute to the inequities.

To address these problems, we must begin by making pay more transparent. It's not enough for the information to be in the public domain; it must be made clearly accessible to investors.

Companies should place a monetary value on each of the forms of compensation that executives get or become entitled to in any given year, and they should report this value to investors in their annual proxy statements.

Also, companies should tighten the link between pay and performance. Among other things, they should redesign equity-based compensation plans, using reduced-windfall options that reward executives mainly for company-specific stock-price increases, but not marketwide movements. Executives should be required to hold options for a fixed number of years after vesting. Retirement payoffs should be made dependent on performance and the reasons for the executive's departure. With such improved design, incentives could be enhanced with the same or lower cost.

Perhaps most important, we need fundamental reforms that make boards more accountable to shareholders and more attentive to their interests. Recent reforms have focused on strengthening director independence. These are beneficial, but they fall far short of what's necessary. Increasing independence doesn't ensure that directors will have incentives to focus on shareholder interests, nor that directors will be well-selected.

To that end, we should eliminate arrangements that insulate directors from shareholders. Shareholder power to replace directors should be turned from myth into reality. Shareholders should also get the power to initiate and adopt changes in the corporate charter. Such reforms offer the most promising route to improving executive compensation and corporate governance.

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