CEO Pay: Up, Up and Away! Results: Not So Great

As Executive Compensation Soars, are Investors Getting What They Pay For?

By Michael Mathai

Recent research suggests that the explosion in executive pay over the last few decades has had little to do with improved shareholder outcomes.

The job of corporate executives is to deliver value for shareholders. Well-designed, transparent compensation schemes — implemented by strong company boards that truly represent shareholders' interests — should incentivize a company's leadership to do just that. If executive compensation worked as it should, one might think that skyrocketing executive compensation in recent years indicates that management is delivering on its obligations to shareholders to an unprecedented degree. But recent research, news, and legislative developments underscore that executives and directors often create compensation arrangements that not only fail to promote shareholder value, but in fact undermine it — enriching management while adding little to no value, and even permitting or encouraging fraud.

High-level executive pay has increased dramatically in recent years. Indeed, an analysis by the corporate research firm Equilar shows that, in 2018, median pay among the 200 highest-paid executives in the US grew to $18.6 million, a 6.3 percent increase from the year prior — nearly double the growth of average workers' wages. Looking back further, a recent analysis by the Economic Policy Institute found that the average CEO's pay grew by over 1,000 percent from 1978 to 2017 — almost twice the growth of the stock market over that period. Concerns about extraordinary CEO pay, particularly relative to workers' pay, have grown apace. In a recent, high-profile example, Abigail Disney — great-niece of Walt Disney — made headlines when she strongly criticized the compensation received by Bob Iger, the CEO of Walt Disney. Iger received

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almost $66 million in 2018 alone, more than 1,000 times the median Walt Disney employee. The company defended Iger's pay, claiming that he "delivered exceptional value for shareholders."

But several pieces of recent research suggest that the explosion in executive pay over the last few decades has scarcely improved shareholder outcomes. An analysis by The Wall Street Journal revealed a severe disconnect between CEO pay and performance: in 2018, median CEO compensation for leaders of S&P 500 companies grew 6.6 percent from the prior year, even as the median S&P 500 company returned *negative* 5.8 percent for investors. That analysis further showed that the median CEO compensation for the best-performing 20 percent of S&P 500 companies was $14 million — barely more than the $12.6 million median CEO pay at the *worst*-performing 10 percent of companies. Similarly, investment research firm MSCI Inc. divided more than 400 large companies into quintiles based on CEO pay, and found that, over a ten-year period, the ones that paid their CEOs the least generated over 60 percent larger returns for shareholders than the ones that paid their CEOs the most. Consistent with these findings, the Economic Policy Institute anecdotally observed that CEO pay often increased for reasons clearly unrelated to performance, such as when increases in world oil prices caused oil company CEOs' compensation to spike. The Economic Policy Institute also reviewed research showing that nearly half of unanticipated CEO deaths are associated with a stock price *increase*. This result is inconsistent with the idea that CEOs are extraordinarily talented individuals who are *essential* to the success of their companies, a common justification for executives' exorbitant pay.

One cause for the disconnect between CEO pay and performance may be a lack of transparency in performance metrics. Recent research from Robert Pozen and S.P. Kothari of MIT and Nicholas Guest of Cornell University analyzed S&P 500 firms that report high non-GAAP (Generally Accepted Accounting Principles) earnings relative to GAAP earnings (in other words, companies whose financial reporting includes bespoke, non-standardized measures that generally make the company look much better than standardized metrics do). They found that companies using non-GAAP metrics also tend to pay CEOs excessively — to the tune of approximately 16 percent extra — even though their present and future performance and stock returns tend to be relatively poor. Reacting in part to this research, Pozen and SEC Commissioner Robert Jackson wrote in an op-ed in The Wall Street Journal that "[t]he SEC's disclosure rules have not kept pace with changes in compensation practices, so investors cannot easily distinguish between high pay based on good performance and bloated pay justified by accounting gimmicks," and they called on the SEC "to require companies to explain why non-GAAP measures are driving compensation decisions — and quantify any differences between adjusted criteria and GAAP," noting: "A few public companies already provide investors with this kind of transparency. Others can too."

Of course, rules mandating transparency are also an important safeguard against overt fraud, as the recent scandal concerning former Nissan chairman Carlos Ghosn underscores. Ghosn allegedly hid tens of millions of dollars in compensation from the public, in part due to vagueness in Japanese disclosure rules. Even in the US, which has stricter rules than Japan and many other countries, important transparency loopholes exist that need to be closed with thoughtful regulation.

The rules around insider trading serve as a useful example. The securities laws make trading on non-public information illegal, but corporate executives — who naturally possess inside information — sometimes need to trade stock for legitimate reasons, such as to pay taxes or diversify investments. To help executives avoid accusations of inappropriate insider trading, SEC Rule 10b5-1 allows them to schedule stock sales in advance pursuant to a "10b5-1 plan."

In theory, because such sales would be automatic and nondiscretionary, they should not reflect inside information that the executive has learned after the date the plan was made, and therefore should provide some assurance that the sales are above board. In reality, however, numerous holes in the rules governing 10b5-1 plans likely render them far less effective at preventing fraud. For example, because no rules either specify how far in advance a 10b5-1 plan must be established before trading under that plan can begin, or prevent cancellation of plans, executives can legally enter into such plans mere days before starting to trade, or cancel planned sales on short notice. Similarly, executives are not required to disclose many relevant details about their 10b5-1 plans, including their existence or termination, their specific provisions, or the changes made to them.

These weaknesses undermine the spirit of the 10b5-1 planning process, and may explain how executives have been able to adhere to the letter of the rules while still appearing to trade opportunistically. For example, research from the University of Colorado at Boulder found that 46 percent of the early terminations of 10b5-1 plans calling for stock sales happened

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shortly before the company announced positive news, thereby allowing the executives in question to enjoy the resulting stock appreciation, while only 11 percent of such terminations occurred before negative news was released — suggesting that corporate management might very well be cancelling trading plans in order to profit from inside information.

With the support of investors, legislators are currently working to close some of these loopholes and improve transparency into executives' 10b5-1 planning process. In January 2019, House Financial Services Committee Chairwoman Maxine Waters (D-CA) and Ranking Member Patrick McHenry (R-NC) introduced H.R. 624, the "Promoting Transparent Standards for Corporate Insiders Act" (the "Act"). The Act would require the SEC to examine potential modifications to Rule 10b5-1: (i) to limit insiders' ability to trade at certain times, maintain multiple trading plans, or modify or cancel existing plans; (ii) to establish mandatory delays between the adoption of a trading plan and the execution of trades under it; and/or (iii) to require trading plan adoptions, amendments, and terminations to be publicly filed with the SEC. Institutional investors have reacted positively to the new legislation, which builds on years of investor efforts to rein in abusive insider trading practices. For example, shortly after the Act was introduced, the Council of Institutional Investors ("CII") wrote to Representatives Waters and McHenry to praise the Act, noting that it reflected numerous concerns the CII had raised years earlier in a rulemaking petition to the SEC.

Quotable

"Anyone who thinks that the stock market is a level playing field obviously has no contact with reality."

The Hon. Jed Rakoff of the Southern District of New York to attorneys for the government prosecuting an insider trading case.

Executive compensation will likely remain a topic of heated public debate, but it looms especially large for shareholders. A lack of transparency allows unscrupulous executives to manipulate compensation arrangements to their benefit — and to shareholders' detriment — in a variety of ways, including by extracting generous payouts for lackluster performance. In response, investors must continue demanding performance, transparency, and accountability. ■

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