



Director Notes



Peer Groups

Understanding CEO Compensation and a Proposal for a New Approach

by Charles M. Elson and Craig K. Ferrere

Nearly all large public companies currently rely on a comparative peer benchmarking approach to design their executive compensation packages. We believe that such an approach is based on a flawed assumption and suggest that boards instead consider an internally focused approach.

Peer Benchmarking

In setting CEO pay, boards, often with a compensation consultant's assistance, assemble a "peer group" composed of companies in similar lines of business that are of comparable size and complexity and have other characteristics the board believes are pertinent. The consultant gathers data specifying the level of compensation at each company.

This *Director Notes* is based on and partly excerpted from Charles M. Elson and Craig K. Ferrere, "Executive Superstars, Peer Groups, and Over-Compensation—Cause, Effect, and Solution," *Journal of Corporation Law*, 37 (forthcoming in 2013) (<http://ssrn.com/abstract=2125979>). For an opposing viewpoint, as well as additional discussion, debate, and resources on this topic, see The Conference Board Director Roundtable: Executive Compensation and the Utility of Peer Groups (www.conference-board.org/directorroundtables/peergroups).

Then, to complete this process of "competitive benchmarking," the board decides where in the distribution they wish to target the total compensation of their CEO. Most companies choose to target the median level (50th percentile). Others choose to target the 75th or 90th percentiles. Companies rarely target below the median. The typical justification for these targets is that the company must pay to "attract and retain" highly talented executives. In marketing parlance, the targets represent "good," "better," and "best." Below median pay would evidently suggest "worse."

Benchmarking is not only a significant factor in the process of determining executive compensation, it is currently seen as the essential element. Developing this comparative group is the first task assigned to the consultant by the compensation committee. Once a target is chosen, it



becomes the anchor for the subsequent design. An endless variety of possible apportionment between long- and short-term incentives, bonus structures, cash, or whatever other components are desired can be devised to meet the prespecified numerical target for the value of actual, expected pay. To be sure, when all is said and done, a compensation committee member's ultimate concern is whether the target has been met. A study by John Bizjak, Michael Lemmon, and Lalitha Naveen in the *Journal of Financial Economics* confirms the significance of peer groups. The authors found that peer groups had a greater effect on changes in pay than CEO performance. A CEO whose pay fell below peer group medians received a raise the next year that was, on average, \$1.3 million more than a CEO who was above the median.¹

The influence of benchmarking does not stop there. It provides the frame of reference by which external constituents evaluate and rationalize compensation awards. The Securities and Exchange Commission mandates disclosure and discussion of peer groups and targeted percentiles.² The major proxy voting advisory firms have gone so far as to create their own peer groups.³ Rather than having a frank discussion of the actual dollar amounts of compensation and whether they are appropriate, the exercise turns into a battle of the peer groups, with a proxy advisor and a company, each equipped with their own peer groups, debating which companies can be used for comparison in some abstract, objective universe. Presumably, the purpose of this exercise is to achieve the board's stated desire to "attract and retain" talented individuals capable of effectively running large and complex businesses. For this reason, it is seen as critical that Pepsi be included in Coca-Cola's peer group, Microsoft be included in Apple's, and Exxon be included in the peer group of a newly public company that hasn't yet recorded a profit. Otherwise, the argument goes, the CEO will leave to take a better offer at a competitor's shop.

In our recent paper, and also in other preliminary and subsequent work, we evaluated this process and the assumptions that underpin it, and we found that, contrary to the standard belief, a CEO's skills are specific to his/her company and therefore are not transferable.⁴ If this is true, then external benchmarking comparisons, which are made under this assumption of transferability, must be rethought.

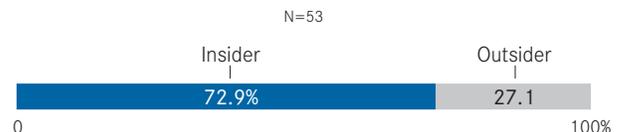
A myth about "superstar" CEOs has woven its way into the fabric of American corporate lore. The concept is best summed up by the noted and controversial corporate "icon" Al Dunlap, who once wrote that the "best bargain is an expensive CEO."⁵ The thinking is that a talented CEO

is a precious commodity worth paying dearly for because he or she will deliver tremendous returns for shareholders. Based on this logic, boards believe that if they do not pay the "market rate" reflected in the peer benchmarking data, their own superstar CEO will be lured away. This myth is simply not consistent with the reality. More often than not, the CEOs of large public companies are long-time insiders rather than the more recognized external hires. The operation of a successful business requires intimate knowledge of its operations that goes beyond the simple, general management talent that can be transferred from company to company. The data show that companies hire a CEO from outside only when forced to by poor performance or changing industry structures that necessitate a dramatic turnaround, restructuring, or sale. The executives who are recruited for this messy and risky task are rarely sitting CEOs, but are more often their junior reports. According to our research, it is quite rare for a CEO to jump from one company to another. Opportunities to do so simply do not exist in any significant respect. Therefore, the retention concern commonly cited as a justification for widespread peer benchmarking is unfounded.

CEO Successions in 2012

The Conference Board annually tracks CEO succession events among the S&P 500.⁶ In 2012, there were 53 CEO transitions. Of those, 72.9 percent involved insiders. In the 2009–2011 period, approximately 75 percent of incoming CEOs were inside hires.⁷ High-profile successions involving outside hires included Yahoo! and Avon, both of which experienced significant turmoil and were reportedly in need of "change agents."

Chart 1
Inside CEO promotions and outside hires



Source: Jason D. Schloetzer, Matteo Tonello and Melissa Aguilar, *CEO Succession Practices: 2013 Edition*, The Conference Board, Research Report 1520, forthcoming, 2013.

Marissa Mayer, formerly a vice president at Google, was hired by Yahoo! after the former CEO, another outsider, left the company amid a controversy involving inaccuracies in his academic record. Mayer faced "a daunting assignment to turn around a company that in recent years has struggled with flat-lining revenue and a moribund stock

price,” the *Wall Street Journal* reported.⁸ Sheri McCoy, who was previously a candidate for the top job at Johnson & Johnson, replaced Andrea Jung at Avon, a company *Forbes* described as “ready for a makeover.”⁹ Other companies that hired outsiders in 2012 included Best Buy Co. Inc., Quest Diagnostics, and Computer Sciences Corp. The top leadership position at the defense company SAIC was filled by a veteran board member.

Most companies promote insiders, many with long tenures at their organizations. According to The Conference Board report *CEO Succession: 2013 Edition*, the average tenure of internally promoted CEOs last year was 15.8 years.¹⁰ For example, Inge Thulin had been at 3M since 1979. After a long career, he was promoted to CEO in 2012. Thulin had held positions in the company’s sales and marketing, life sciences, vision care, orthopedic products, and skin health divisions. He had managed subsidiary and general company operations. He had experience with 3M in Canada, Russia, Sweden, Europe, and the Middle East, and, finally, with 3M’s international operations.¹¹ His well-rounded internal development is more characteristic of the new style of CEO than the firm- and industry-leaping practices associated with superstar executives.

The 2012 data show that, in reality, CEOs are typically hired from inside the company. This is not really surprising, since much of the corporate knowledge that may be considered mundane—such as inside-out familiarity with the supply chain or how the widgets are made—is the type of critical experience that best determines CEO effectiveness. Such skills are learned carefully over a long tenure with a company and, therefore, are not transferable to other companies.

Empirical Support

Scholars have long recognized a distinction between firm-specific and general skills. Successful CEOs leverage not only their intrinsic talents but also, and more important, a vast accumulation of firm-specific knowledge developed over a multiyear career. Whether it is deep knowledge of an organization’s personnel or the processes specific to a particular operation, this skill set is learned carefully over a long tenure with a company and cannot be easily replicated at other firms. This has important implications for the pay conundrum and for appropriate succession planning. It is very likely that a CEO’s best opportunity is where he or she is currently employed. Also, for a board, more often than not, the best candidate for the CEO slot is an insider.

Empirical evidence in academic literature gives credence to the fact that executive skills are, in large part, specific to the companies where they are acquired. Data on CEO turnover and compensation are relatively easy to come by. Wharton Research Data Services (WRDS) maintains proxy-disclosed data on executives, their compensation, and other variables. For researchers, this tool gives access to information on the largest 1,500 U.S. public companies for the years 1993–2012.

Contrary to “market rate” arguments for peer benchmarking, detailed analysis reveals that CEOs rarely run multiple public companies during their careers. Even rarer are instances of CEOs “jumping” from one company to another. Except for turnaround situations, internally promoted and internally trained executives are the norm.

Several academic papers, each with independent research objectives, have analyzed the data for CEO turnovers. Since there is little ambiguity with regard to where and when a particular individual was employed, the choice of which study to reference is inconsequential. Our own analysis is consistent with the findings of these studies.

A 2012 paper by Huasheng Gao, Juan Luo, and Tilan Tang that analyzed nearly all of the WRDS data set showed results consistent with our peer benchmarking thesis. The researchers defined an executive as “job hopping” if they left one job and took another within three years. For the top executives at the 1,500 or so largest companies during the period from 1993 to 2009, the researchers identified 1,069 “hops.” Most (767) were nonCEO executives moving to other nonCEO positions, while a fair amount (267) involved a nonCEO moving to become a CEO at another company. Only 27 CEOs “jumped” to become CEOs at other firms. On average, there were less than two instances of such jumps per year among all the companies studied. Another 16 CEOs became nonCEOs at another firm.¹²

A 2004 paper by C. Edward Fee and Charles J. Hadlock examined S&P 500 companies and found only six such CEO moves during a five-year period. “Jumping” to a new employer as a reason for a CEO departure represented only 2.93 percent of the 205 departures identified. The most commonly identified reason was retirement, which was the explanation given for more than 50 percent of turnovers. Mergers, ownership changes, and forced departures represented another 30 percent of the identified events.¹³

A 2011 study by Martijn Cremers and Yaniv Grinstein revealed another dynamic that is needed to understand CEO transferability and test the “market rate” justification for peer groups. Even if a company decides to hire a new

CEO from outside the company, the job is usually filled by a more junior executive and not by a sitting CEO. For instance, 374 (68 percent) of the outside CEO hires between 1993 and 2005 were nonCEOs from either public or private companies.¹⁴ This is for a good reason. Companies typically recruit from the outside only when forced to do so because they are in need of a turnaround or lack substantial managerial depth. These are simply not attractive job opportunities for most sitting CEOs. Turnaround positions are typically of interest to a particular type of executive—either a senior executive who was passed over for the CEO job or one who specializes in restructuring and mergers and acquisitions work.

What This Means for CEO Pay

CEO compensation is not a story of competitive markets determining pay levels. Compensation committees have the ability to determine the appropriate level of CEO pay. If a CEO is really unable to move in the free fashion that is used as the basis for the concept of peer compensation benchmarking, then the earnings of other CEOs should be virtually irrelevant to the design of a specific CEO's pay package.

Supporters of the system of median benchmarking argue that it is a fair and reasonable means of arriving at a salable number. Given the uncertainty inherent in valuing a CEO's contribution and determining how much of that contribution he or she should retain as compensation, targeting pay at the peer group median may be viewed as a resolution device of sorts. However, this benign characterization misses the real problem with peer group benchmarking—the creation of a structural bias for higher and continually rising pay. Compensation critics have long argued that if all executives are paid at or above the median, the result is a never-ending escalation in pay levels—the so-called “Lake Wobegon” effect.¹⁵ Additionally, several recent studies have demonstrated that peer groups are often manipulated to include larger peers, which results in even higher pay.¹⁶ Variables such as CEO pay typically move up and down, and pay levels are either higher or lower in response to market conditions and other local factors. The overreliance on benchmarking has added pressures that make pay predominately responsive to external market survey data. The influence of this data can result in a bias for companies to make upward adjustments that can move pay amounts incrementally upward for all other companies as well. The compounding effect of this steady upward ratchet has been an inexorable rise in CEO pay. Internal factors would provide an important countervailing influence.

This rise in pay has come at the expense of effective incentive and motivation structures. A business organization, particularly a large public corporation, is a team-driven and communal enterprise. For better or worse, individuals working within companies compare and react to each other's pay and rewards. Therefore, the pay of individuals within the organization is highly interrelated, and the pay of even one individual must be carefully and holistically designed. A CEO's pay, which is a very public data point, cannot stand alone because it is the keystone to an effectively designed pay structure. If you are not convinced that a CEO's pay is an important driver or, conversely, an inhibitor, of corporate performance, just look at the response to any CEO who has taken the symbolic \$1 paycheck. The compensation at the top is a powerful component of an effective corporate culture.

Due to the inherent flexibility of the process and the potential impact on morale, designing a truly effective pay package requires much effort and creativity. While metrics such as peer benchmarks are helpful, compensation committees must be careful not to be lulled into complacency by the sense—or appearance—of objectivity that they provide. Boards should rely on their own judgment and independent analysis of the many subjective factors important to the design of an effective pay scheme. A computer program or a consultant's data tabulations cannot replace the actual board's expertise and understanding of the company.

Board Guidance

The chief executive's pay profoundly affects the entire incentive structure of the organization and must be carefully considered. Exclusive reliance on the peer benchmarking process is insufficient. A board that neglects to take into account the many complex costs involved when determining appropriate compensation has not functioned appropriately.

As benchmarking has become universally accepted and applied, even the most independent shareholding boards use comparative metrics in setting pay. Even when applied by a model board, an exclusive reliance on peer grouping is unjustified and can lead to a steady increase in compensation. A more nuanced approach is needed.

Ultimately, the process of setting compensation should not be mechanistic. When appropriately determined, it should be based on objective factors and nuances. The key to an effective process is a group of directors who are appropriately objective and motivated to consider the money involved and reach a reasoned conclusion on the

appropriate amount of pay. Shareholders elect directors for their good and objective judgment, not the mechanical and rote application of some formula. In an invigorated process, benchmarks should be viewed as one data point among many that directors must consider.

But how should the process function? Setting pay is an art, not a science. In commissioning a work of art or music, one does not attempt to supplant the artist's judgment with his or her own by dictating the precise technique or form. Likewise, we propose only general guiding principles for setting pay so as not to unduly constrain the art or judgment of the directors, who are those most informed on the matter.

We believe that, as a starting point, the board should be properly composed and given the proper incentives to ensure their ability to effectively negotiate with management about pay. Directors must be independent of management and possess a personally meaningful equity stake in the company to ensure that compensation is negotiated in earnest. An effective board-level review of executive pay must begin with this fundamental foundation. The risk of a chief executive departing because of a compensation issue is less than the "competitive" benchmarking rhetoric or the executives themselves would lead people to believe. An overreliance on peer group analysis and median targeting can lead to an unwarranted complacency. Given the flexibility involved in setting pay, directors have an obligation to exercise their discretion effectively.

Boards are currently predisposed to bias pay upward; to a large corporation, a few million dollars to meet an executive demand or peer group target seems immaterial. However, the expense far exceeds the visible payment. Since CEO pay affects the organization's cost and incentive structure, the true cost can be substantial. The bias should be toward lower pay. Executive disappointment can be managed by the board, but the damage to employee morale and motivation caused by excessive CEO compensation is far more difficult to resolve.

The board review of CEO pay should be conducted within the context of pay for the organization as a whole. Since the CEO is an employee of the corporation, his or her pay should be considered an extension of the infrastructure that governs the rest of the company's wage structure. Internal consistency or pay equity throughout the organization, up to and including the CEO, is a natural and reasonable objective. The board should not consider executive pay separately from the structures that govern compensation for other employees. It should be built upon the same foundations and precepts. Participation in bonus pools in

kind with other employees may be helpful to produce this mindset. Board ratification of the CEO's contract should not be viewed singularly; it is an implicit examination and approval of the entire organization's wage and incentive structure. Current peer grouping practices assume that internal consistency must succumb to market pressure when setting CEO pay. We believe these market concerns are overblown. Boards can, and should, restore some internal consistency.

For many years, the DuPont Company was well known in compensation circles for its highly regimented internal pay equity plan for its CEO's compensation. Describing this approach, DuPont chairman and CEO Edgar S. Woolard, Jr., wrote in 2005:¹⁷

We're going to look at the people who run the businesses, who make decisions on prices and new products with guidance from the CEO—the executive vice presidents—and we're going to set the limit of what a CEO in this company can be paid at 1.5 times the pay rate for the executive vice president.

This simple, intuitive approach seemed equitable to him. The company was successful at both retaining executive talent and returning shareholder value. We believe this type of balanced approach to CEO pay formulation is worth serious consideration.

How past performance should affect executive compensation is an issue that, again, calls for careful evaluation by a board. Much of an executive's prior performance has previously been rewarded through compensation in accordance with prior contractual commitments. When objectives are met, bonuses are paid. When stock price accretion is achieved, the value of an executive's equity holdings increases in turn. A board is not obligated to reward performance further by increasing the level of compensation during the next period. However, the board may feel in some cases that performance that far exceeded expectations was not adequately compensated under the previous contractual limits. In such instances, increasing compensation further is certainly acceptable. An executive who delivers results beyond expectations should be assured that exceptional efforts will be rewarded in kind. Performance should be measured and evaluated based on both internal and external considerations. For example, a board that views customer satisfaction as integral to the company's future competitive strength may take customer survey results into account. When an executive's initiative results in a marked improvement in these survey results, the board should reward the executive accordingly. Other internal performance metrics used may include revenue

growth, cash flow, or various measures of return, to name a few. Bonuses and incentive payouts, as initially contracted, should reward the achievement of various objectives related to those factors. When expectations are exceeded, additional rewards may be warranted based on achievement over short and extended periods.

Used appropriately, external metrics may also be important to the evaluation of an executive's achievement with respect to continuing or improving the competitiveness of the enterprise and, therefore, may be relevant to the provision of additional compensation. Objectively constructed peer groups used for the purpose of a relative performance evaluation are necessary. If Pepsi's performance far exceeds that of Coca-Cola, Pepsi's CEO certainly may deserve relatively more generous compensation.

Conclusion

We believe that the use of external peer benchmarking in setting executive compensation has contributed significantly to the problem of high and rising pay in the United States. The pay awarded to CEOs is becoming profoundly detached from not only the pay of the average worker, but also from the companies they run. Offsetting the current reliance on external metrics with the use of internal metrics and benchmarking should help curb the persistent escalation of pay. If directors are not constrained by notions of "competitive" pay that are based on a false belief that CEO talent is transferable, then they may be able to reduce the ratcheting of pay and deliver compensation that is more acceptable to shareholders. This proposal may well result in more reasoned executive compensation schemes, more effective board oversight, and, most important, a healthier, more competitive corporation. Deemphasizing the peer group process in setting CEO pay may not be a comprehensive cure to the overcompensation problem, but the costs of doing so are minimal and provide a good starting point.

Endnotes

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