Introduction

Society has a perennial fascination with money. Horace, for example, counselled, “If possible, honestly, if not, somehow, make money.”¹ Executive compensation became a key aspect of corporate governance debate during the 1990s, a period when the regulatory pendulum swung away from legislative intervention in favour of self-regulation. Pay for performance offered the prospect of a self-executing governance technique to align the interests of management with those of shareholders. Since that time, however, academic debate in the United States and elsewhere has raged on the question whether executive compensation is determined efficiently by disinterested corporate directors, reflecting the existing corporate governance system (the optimal contracting model) or skewed due to a power imbalance between managers and shareholders (the managerial power model).

Recent corporate scandals and crises, including the global financial crisis, have again brought executive compensation to center stage and onto the regulatory agenda. Indeed, according to the UK Turner Review, the global financial crisis challenged fundamental assumptions about the market’s efficiency, rationality and ability to self-regulate, which had previously underpinned financial law.² These developments have focused public and academic attention on many facets of executive compensation. In this introduction, we highlight a few of the key debates in the field, and then discuss how the contributors to this Handbook have addressed them.

OPTIMAL CONTRACTING VS. MANAGERIAL POWER

There are two competing schools of thought that dominate academic discussions about US executive compensation practices today: managerial power and optimal contracting theory. Managerial power theorists argue that American CEOs dominate friendly boards of directors comprised of their loyal subordinates and largely passive outsiders. These compliant directors and their well-paid, amenable compensation consultants will, according to this model, make little attempt to negotiate the CEO’s pay in a manner that forcefully protects the shareholders’ interests. Rather, they will prefer to rely on industry surveys of pay levels which have the (un)intended consequence of continuously ratcheting up executive pay levels.

Optimal contracting theorists respond that executive compensation contracts are designed to maximize shareholder value net of contracting costs and transactions costs. Thus, according to this competing model, executive contracts minimize agency costs and the costs of any residual divergence of interests between a principal and agent. Contracts reflect the underlying US corporate governance system, which although imperfect may in

¹ The Epistles.

² Financial Services Authority (UK), *The Turner Review: A Regulatory Response to the Global Banking Crisis*, 39ff (2009).

fact be extremely good given the existence of information costs, transactions costs, and the existing legal and regulatory system. As will become apparent in reading the chapters of this Handbook, scholars tend to be divided between these two camps.

CONCENTRATED VS. DISPERSED OWNERSHIP

American corporations generally have more dispersed share ownership structures than most other jurisdictions. For US firms, the dispersed ownership structure means that the interests of managers and shareholders can diverge in important ways. Agency costs pose a crucial problem because there is no single shareholder, or group of shareholders, with sufficient equity ownership to monitor managers as closely and effectively as would be possible in many other jurisdictions. US shareholders will therefore seek alignment mechanisms which can ensure that managers behave as if their interests were identical with those of shareholders. Stock option and equity-based compensation is often regarded as fulfilling this function. Unsurprisingly, US CEOs' pay packages on average contain far more equity-based pay than those of the foreign CEOs.

In controlling shareholder-dominated companies, which are the dominant form of organization in most countries outside the US (excepting the UK and perhaps Australia), the owners have the practical ability to dismiss, or otherwise discipline, the managers that run the company on their behalf. Theoretically, at least, there is less need for stock options and other forms of equity-based pay in this scenario because the controlling shareholder can already effectively constrain self-serving managerial conduct, eliminating the agency costs rationale for incentive-based pay. Monitoring, in other words, can function as a substitute for performance-related compensation.

PAY FOR PERFORMANCE: PANACEA OR PROBLEM?

Stock options, and other forms of equity-based compensation, have become an increasingly important part of executive pay packages at companies all over the world. Reward-based and incentive-based rationales exist to explain their use. In the US and UK, this form of remuneration is frequently justified on the grounds that it represents pay for performance, by linking an executive's remuneration to an increase in corporate value. Options are said to stimulate managers to work harder to increase the corporation's value by providing them with a share of any gains that they helped to create. Viewed in this way, options may align the incentives of managers and shareholders to maximize firm value. As noted above, this is particularly important in widely held public companies.

Despite this apparent shift toward greater use of equity-based pay, some disadvantages of this trend have become apparent over time. As the global financial crisis highlighted, stock options have little downside risk. Executives holding large quantities of options potentially have incentives to take significant risks in order to drive up their companies' stock prices, thereby increasing the value of their options. However, executives will also tend to undervalue the downside risks of failure, as appeared to be the case at some financial institutions during the recent crisis.

Options may also create opportunities for corporate executives to exploit their informational advantages over shareholders. Corporate insiders with access to superior information about their companies than outside shareholders will have critical knowledge about the timing of important corporate disclosures or major industry changes. The ability of insiders to exercise options provides them with an excellent and relatively inexpensive means of capitalizing on this informational advantage.

GOVERNMENT INTERVENTIONS: MISGUIDED OR EFFECTIVE?

Its political salience, particularly in the light of populist backlash during the global financial crisis, has increasingly made executive compensation the subject of government regulation. Although these reforms are generally well-intentioned, there is fierce debate as to whether they are beneficial to shareholders and, more generally, society as a whole. Broadly speaking, managerial-power theorists support government regulation to address perceived excesses in this area, though admittedly, the devil is in the design of such regulatory efforts to reduce pay levels and improve pay structure.

Optimal-contracting theorists are less sanguine in this regard. They almost unanimously condemn such government regulation, on the basis that it is costly, ineffective, and cumbersome. These theorists argue that politicians are uniquely unsuited to intervene in labor markets, that courts are less knowledgeable than directors about appropriate pay levels, and that shareholders also lack the requisite information and skills to make these determinations.

AN OVERVIEW OF CHAPTERS IN THIS HANDBOOK

The Handbook addresses these and many other issues concerning executive compensation. It provides a contemporary analysis of executive compensation from a variety of perspectives, and against the backdrop of the global financial crisis. The chapters are written by leading scholars in the field of corporate governance across several continents.

In Part I, consistent with the view that it is impossible to understand the present without an appreciation of the past, the Handbook starts with an examination of the history and theory of executive compensation. Kevin J. Murphy leads off with an in-depth exploration of the history of legislative efforts in the United States to regulate executive pay beginning with the Depression-era regulations and ending with the 2010 Dodd-Frank Act. He documents the assorted ways in which this regulation has been attempted: tax policies, accounting rules, disclosure requirements, and direct limitations, among others. Overall, Murphy concludes that these regulations have frequently been reactions to reported isolated abuses, typically during recessions or economic downturns, and that they have generally been fruitless and ineffectual.

Harwell Wells follows with a historical analysis of executive pay in the United States, using as his starting point the 1930s, when pay issues first attracted national attention. His chapter recounts the rise of executive compensation over the last century, shedding

light on the political, social and legal factors that influenced its path. Wells shows that changes in executive compensation are, and continue to be, inextricably tied to the evolution of the US industrial system as a whole.

Next, Steve Thompson looks back on twenty years of UK corporate governance reforms and their effect on executive remuneration in that country. Beginning with the establishment of the landmark Cadbury Committee, he traces the effort to tie executive remuneration practices more closely to shareholder interests and to tighten the connection between executive rewards and corporate performance. He then evaluates the empirical evidence about the efficacy of these efforts on the role of independent directors in setting pay; the sensitivity of pay to performance and company size; executive job tenure; and shareholders' role in the pay setting process, including the use of "say on pay."

Luc Renneboog and Grzegorz Trojanowski pursue a similar line of inquiry in their empirical study assessing whether UK reforms adopted in the 1990s were successful in curbing excessive executive compensation. They assess the effectiveness of these governance changes and find evidence of contractual alignment of manager and shareholder incentives, as well as some indication of potential managerial self-dealing. By analyzing both executive pay and the potential for termination of managers simultaneously, Renneboog and Trojanowski's work sheds light on the interaction of these two important aspects of the managerial labor market.

Bill Bratton looks at contemporary executive compensation practices through the prism of agency theory. He asks whether these practices support the view that unaccountable managers are grossly overpaid, or, rather, if they legitimately enhance and reward wealth creation on behalf of shareholders. Noting that executive pay is a highly politicized subject, he explores the differences between the "hierarchies" perspective of agency cost analysis, embedded in the managerial power critique of current pay practices, versus the "markets" strand of agency theory, which supports the optimal-contracting model of pay-setting practices. Bratton concludes that the various positions of participants in the classic executive compensation debate are best explained by adherence to particular strands of agency theory.

In Part II, we turn to the structure of executive pay, with particular emphasis on the relationship between pay and performance and potential flaws in executive compensation design. The global financial crisis highlighted the vital role of executive pay practices at financial institutions. The next two chapters, one by Guido Ferrarini, and the second by Sanjai Bhagat and Roberta Romano, distil some of the lessons of that experience by investigating executive compensation practices of banks and other financial institutions. Ferrarini questions the widespread assumption that, in the lead up to the financial crisis, the structure of executives' compensation at banks was predominantly short-term. Instead, he argues that existing empirical evidence is consistent with the view that bankers' pay was largely aligned with shareholders' long-term incentives. Ferrarini further claims that banking regulators should not, as a matter of policy, set executive pay, but rather assume a much more limited role in this area.

Bhagat and Romano recognize that the political fallout from the financial crisis has made regulatory reform to some extent inevitable. They offer a reform proposal (for financial institutions that receive government funding, or potentially pose a systemic risk to financial markets) which is, however, considerably less radical than those advanced by

some other commentators. Bhagat and Romano seek to promote long-term shareholder value and reduce excessive risk by requiring that incentive compensation at these institutions should comprise only restricted stock or stock options, with a holding period of two to four years after the recipient leaves office. They defend the superiority of their proposal on the basis that it is straightforward, transparent and leads to the creation of long-term value for shareholders.

Lars Oxelheim, Clas Wihlborg and Jianhua Zhang highlight the difficulties of structuring executive pay to reflect skill and effort, as opposed to good (or bad) luck. In particular, they focus on controlling for macroeconomic fluctuations that affect firms and estimate these effects for Swedish companies during the period from 2001 to 2007. They find that macroeconomic conditions had a strong positive effect on executive pay at their sample companies.

Although most literature in the field relates to compensation packages at mature firms, Salim Chahine and Marc Goergen scrutinize CEO stock options at IPO (initial public offering) firms. They argue that two competing forces are at work with stock option awards in the IPO setting: options provide CEOs of IPO firms with incentives to take additional risks that may improve corporate performance, but they may also give the same executives a means of expropriating wealth from other pre-IPO shareholders. Chahine and Goergen conclude that the role played by stock options at IPO firms depends on the effectiveness of other monitoring mechanisms in place at firms.

In his contribution, Jaap Winter engages in a fundamental reassessment of the basic behavioural assumptions of modern performance-based pay. In a searching critique building upon current research in the field of cognitive science, he questions whether performance-based pay can ever be effective. Winter concludes that performance-based pay cannot work because people do not behave in the way that its proponents assume, and that it should accordingly be abandoned.

In Part III, the Handbook shifts its attention to the relationship between corporate governance structures, regulatory interventions and managerial compensation. Jennifer Hill explores the impact of recent financial shocks, such as the global financial crisis, on the regulation of executive pay across three common law jurisdictions – the United States, the United Kingdom and Australia. She asks whether executive pay is excessive in America, whether it contributed to the recent financial crisis, and whether subsequent regulatory developments will affect pay in the future. Hill concludes that it is too soon to tell if regulatory responses will result in long term shifts in pay practices.

Noting the growing role of institutional investors in corporate governance, Joseph McCahery and Zacharias Sautner evaluate institutional investor preferences regarding levels and structure of executive pay in the United States and the Netherlands. They discover that a majority of these investors prefer reductions in the level of severance payments for departing CEOs in both countries. By contrast, McCahery and Sautner determine that a majority of institutions do not support reductions in overall CEO pay levels in the Netherlands, although they do in America.

Shareholder advisory votes on executive compensation packages, so-called “say on pay” votes, are another relatively recent change in corporate governance practices. Kym Sheehan undertakes a qualitative analysis of changes in compensation practice and the impact of say on pay during its first three years of operation in the United Kingdom and Australia. She conducts an empirical study of say on pay’s operation in those two

countries and finds that the vote has had more of an effect on *ad hoc* payments to executives than on overall remuneration practices. Sheehan concludes that governments seeking to lower overall pay levels by granting this power to shareholders are likely to be disappointed.

Glen Loutzenhiser reflects on the extent to which tax law can be used as a “tool of social policy” by governments seeking to control the level and structure of executive pay. He argues that traditional principles of tax policy point toward treating all forms of executive compensation in the same manner, although implementation of such a strategy will be difficult. Loutzenhiser then examines recent tax measures enacted in the United States and United Kingdom and concludes that they were not consistent with good tax policy.

Some commentators have advocated tougher government regulation of insider trading and market manipulation to control a potential dark side of performance-based compensation. M. Todd Henderson’s chapter examines the implications for insider trading policy of the major shift in the last thirty years from cash to equity-based compensation, the growth in trading by insiders, and the regulatory impact of Rule 10b5-1 of the Securities Exchange Act 1934 from this perspective. He claims that government efforts to regulate insider trading have failed. Instead, Henderson supports a *laissez-faire* approach to the perceived problem, arguing that significant benefits will flow from allowing insiders to trade.

Compensation consultants have become an increasingly important aspect of the executive compensation regulatory landscape in recent years. Ruth Bender’s chapter investigates the various reasons why corporations use consultants, including the need for legitimation, and surveys the executive compensation consulting industry, which is dominated by a small number of large firms. She considers the forces that affect the consulting industry and their effect on its customers. Bender finishes with a review of research on the impact of consultants on executive compensation levels and structure, concluding that companies using consultants pay more and grant more stock options than companies which do not, although the reasons for these differences are unclear.

Finally, Part IV of this Handbook critically examines the executive pay systems of a number of other international jurisdictions. Even if one accepts that either the optimal-contracting, or the managerial-power model of executive compensation, has greater explanatory power in the United States, this will not necessarily be the case in other countries. Other jurisdictions can therefore reveal fascinating similarities and differences in the executive pay arena.

Focusing first on Australia, Randall Thomas’s chapter provides an overview of the evolving regulatory environment for executive compensation there. Using data based on interviews with Australian remuneration consultants, directors and other corporate governance participants, he reveals interesting differences in the regulatory system for pay, and the role played by compensation consultants, in Australia and the United States. Thomas maintains that Australia’s experience with regulatory reform should be carefully examined by other countries if they are considering implementing more regulation.

Turning next to Asia, Katsuyuki Kubo focuses on three topics: recent changes in the pay setting process at Japanese corporations, including the new disclosure rules; empirical evidence on presidents’ salaries in Japanese corporations; and changes in the pay for performance sensitivities in Japanese executive pay. He finds that the new disclosure rules

do not apply to most Japanese presidents because their pay levels are below the disclosure threshold. Kubo also demonstrates that there have been rapid increases in presidents' salaries since 2000 and that executive compensation has become more sensitive to performance in Japan over that same time period, although it is still far lower than in the United States.

The two following chapters take a close look at executive compensation in China, addressing the traditional dearth of empirical data in this regard. Michael Firth, Tak-Yan Leung and Oliver Rui describe senior executive pay in "the world's largest transitional economy," beginning with a review of Chinese economic reforms and performance. They then provide empirical evidence on pay levels, the effect of corporate governance on pay, and several other determinants of executive compensation. They observe that pay levels have increased rapidly in recent years, that the determinants are similar to those in the United States, and, finally, that there are also signs of an emerging labor market for executives in China.

Martin Conyon and Lerong He examine the influence of the Chinese state control ownership on patterns of executive compensation, the level of correlation between pay and performance in state controlled firms, and the impact of firm size on pay. They discover that stock options and equity-based pay are new developments in China, but that pay is positively correlated with performance. Firm size, they determine, is a driver of pay levels, in much the same way as in the western countries. Conyon and Lerong also show that state control has a negative effect on the pay for performance nexus at controlled firms.

In relation to India, another booming Asian economy, Rajesh Chakrabarti, Krishnamurthy Subramanian, Pradeep Yadav, and Yesha Yadav discuss recent executive salary trends in Indian listed companies. Their analysis highlights the effects that the presence of a private control shareholder may have on executive pay, a fact that distinguishes the Indian corporate governance scene from that in China (state control ownership) or the United States (dispersed ownership). They conclude that executive pay levels are much higher at larger firms and include a higher proportion of variable pay, but that overall pay levels have increased rapidly at all size levels. The presence of a private control shareholder is also correlated with higher pay levels.

Three chapters focus on executive pay in the European context. Niamh Moloney leads off with a regional approach, assessing the European Union's (EU) experience with executive pay and the efficacy of EU regulation in this regard. The EU, she claims, provides an interesting model because it contains both dispersed and concentrated ownership systems, and has had substantial experience with harmonization of executive pay regulations. Moloney concludes that the EU experience provides a dramatic illustration of the impact of different governance structures on executive pay, and the pitfalls of importing a system designed for dispersed-ownership countries into jurisdictions with concentrated ownership.

Brigitte Haar provides an overview of executive pay practices in Germany in the aftermath of the high profile *Mannesmann* case. She gives an in-depth summary of the existing empirical evidence on managerial compensation, the German corporate governance system, and its legal rules governing executive pay. Haar carefully explains how *Mannesmann* has led to significant changes in executive pay rules and practices in Germany.

In the final chapter, Carlo Amatucci and Manlio Lubrano di Scorpaniello discuss the complex web of regulation governing executive compensation in Italian public listed and unlisted corporations. Their comprehensive treatment of Italian law covers a wide variety of topics, including the effects of concentrated ownership on pay, the key regulatory principles established by the Italian market regulator, Consob, and the operation of the Italian Stock Exchange's corporate governance code.

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Jennifer Hill and Randall Thomas
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