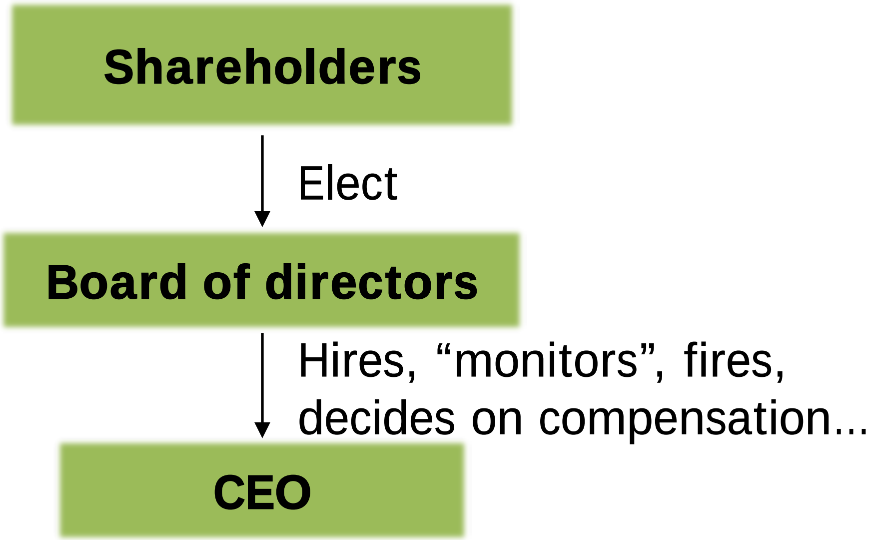
CORPORATE GOVERNANCE AND EXECUTIVE COMPENSATION

Agency Problems

- Owners (shareholders) of large corporations can’t run a firm by themselves, and so need to hire managers → **Separation of ownership and control**
- Agency problems is when managers put their own self-interest ahead of the interests of the owners
- If the CEO owned the entire firm there would be **no** agency problems, but very few good managers have enough wealth to own a major corporation, and wealthy people may not be the best managers!



The Gulfstream G650:
A really nice private jet!

Illustrating agency conflicts: The case of private jets

- Green St. Grocers (GSG) is a grocery chain with market cap of $1 Billion
- GSG's CEO proposes buying a $100 M Gulfstream jet for use by its executives
- Buying the jet will save the company valuable executive time, airfare (first class tickets), etc.
  - The present value of these savings to the company (airfare and time) is $20 million
- The CEO also gets personal enjoyment from being able to fly a private jet
  - The CEO values his personal enjoyment from having a private jet at $1 million
- The CEO owns 0.2% of the firm's shares, worth $2 million, so he will be affected as a shareholder in every decision that affects the firm's value

1. Is buying the jet a good idea for shareholders?
2. How much is the net benefit to the CEO (in present value) from the jet?
3. What if shareholders could pay the CEO less in salary in lieu of this perk; would that matter?

Some Examples of Agency Problems

- Lavish perks
- Palatial office buildings
- “Shirking”, i.e. not working very hard
- Hiring (underqualified) friends or family to high positions
- Using corporation’s money to push personal political agenda
- “Empire-building”

An example of “empire-building”…

John Thain's office renovation at Merrill Lynch (or the case of the $87,000 office rug…)

Big ticket items included:

- $87,000 for an area rug (and another area rug for $44,000)
- a "mahogany pedestal table" for $25,000
- a "19th Century Credenza" for $68,000
- a pair of guest chairs for $87,000
- four pairs of curtains for $28,000
- a "parchment waste can" for $1,400.
- a "George IV Desk" for $18,000
- fabric for a "Roman Shade" for $11,000
- etc…

(this is what a 19th century credenza looks like)

http://www.thedailybeast.com/articles/2009/01/22/john-thains-87000-rug.html

Corporate Governance

Definition:

The **system** of **controls, regulations, and incentives** designed to **minimize agency costs** between managers and investors and prevent corporate fraud

Is this an agency problem?

From Martha Stewart's 2015 employment contract with Sequential Brands Group:
https://www.sec.gov/Archives/edgar/data/791770/000114420415038744/v413830_ex99-1.htm

(h) **Expenses**. The Company shall directly pay or reimburse the Founder for customary and reasonable expenses incurred in connection with her performance of duties for the Company in accordance with the Company's expense reimbursement policy for its senior executives and for other reasonable and customary expenses (not to exceed $100,000 per year) as are approved in advance by the CEO. *In addition, the Company shall directly pay or reimburse the Founder for all reasonable expenses she incurs in connection with any service days spent providing Promotional Services (including first class travel, hotel accommodations,* ***and hair and make-up services****);* for the avoidance of doubt, such payments shall not be subject to or taken into account with respect to the $100,000 cap referred to in the immediately-preceding sentence

Is CEO compensation too high?
CEO pay in largest 1,500 companies (2014)

CEO PAY: ($ '000)	Mean	Std.dev.	Median	"Top 1%"
Salary	829	388	790	2,000
Bonus	205	857	0	4,000
Stock awards	2,425	3,576	1,387	15,000
Option awards	1,085	2,800	228	9,289
Nonequity incentive compensation	1,246	1,839	774	8,581
Pension	447	1,262	0	6,142
Other compensation	260	1,123	67	3,618
Total	6,492	6,700	4,582	30,553

Is executive compensation too high?

- CEO pay has risen manifold since the 1980s…
  - But so has the pay of top lawyers, bankers, sports stars, music artists, movie stars, chefs, doctors, etc…
  - We increasingly live in a “superstar” economy where the top 0.01% in almost any field make a lot more than everyone else
- Concern that board members too close with CEO
  - Board members are often also CEOs themselves (at other firms)
- Since 2011, shareholders have had an “advisory” vote on executive compensation (“say on pay”)
  - But essentially all of these votes pass with large majorities!

The CEO is often involved in choosing directors

- Any problems with this?


EXECUTIVE COMPENSATION REVIEW BOARD
HOW MUCH SHOULD WE PAY OUR CEO IF HE JUST SHOWS UP FOR WORK?
scottadams@aol.com
www.dilbert.com
FIFTY MILLION DOLLARS!!!
HONK HONK
© 2006 Scott Adams, Inc./Dist. by UFS, Inc.
THE CLOWN MAKES A GOOD ARGUMENT.
AYE!

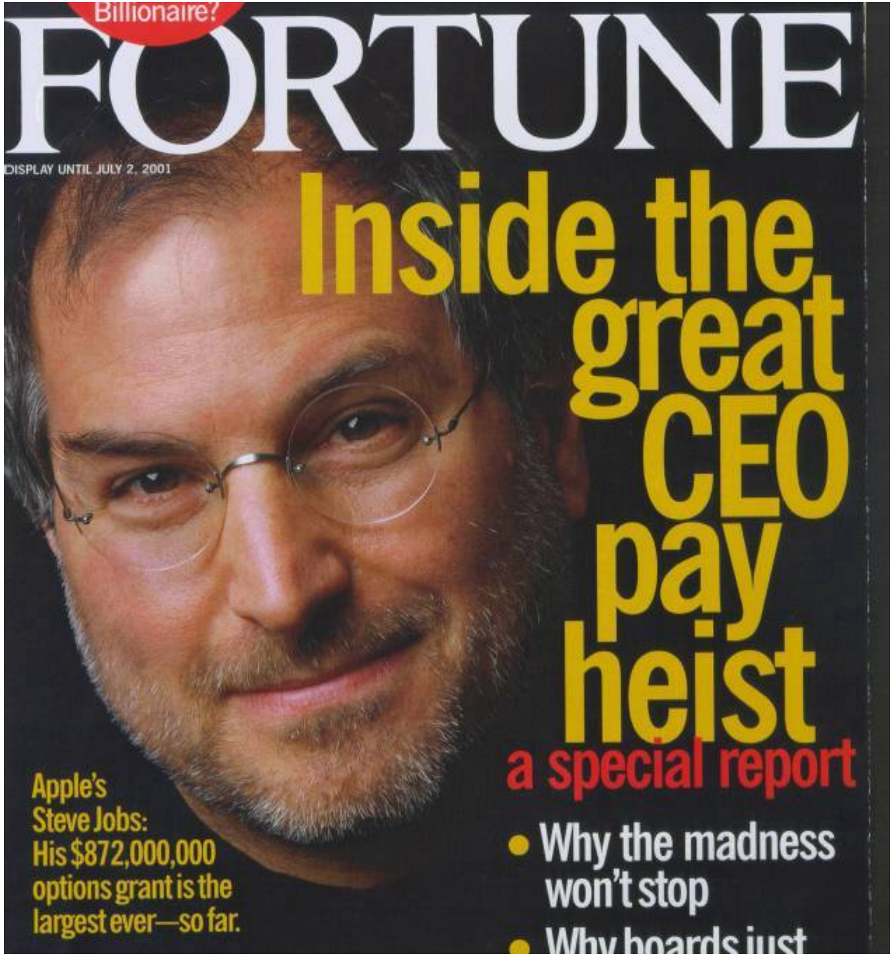
How might we mitigate agency problems?

1. Pay-for-Performance
2. Monitoring by board of director and other monitors
3. Shareholders may try to replace directors in board elections ("proxy fight")
4. Hostile takeover: someone buys the entire firm, and replaces the board and management

- Even the *threat* of dismissal, proxy fight, or hostile takeover may discourage managers from acting against shareholders

Pay for performance

- Ways to link managers' pay to their performance:
  1. Grants of stock or stock options to executives (links compensation to stock price)
  2. Explicit performance bonuses (e.g., based on earnings per share, or other measures like revenues)
- CEO's wealth has about a 1% sensitivity to firm value in large firms
  - This sensitivity is a lot higher than a few decades ago, but still leaves room for agency problems
- But…
  - Possibility of executives scamming the system (e.g., options backdating, manipulating earnings, short-term focus on stock prices…)
  - Possible public outrage at extreme levels of pay



Source: *Fortune* magazine (July 2001).

Typical Features of Executive Stock Options

- American call options (*i.e.*, can exercise early)
- Typical life = 10 years
- Usually granted “at-the-money” (exercise price = share price at the time of the grant)
- Rarely dividend protected
- Cannot be sold (non-transferable)
- Have vesting restrictions, *i.e.*, if CEO leaves the firm before the option vests, option is forfeited

A Compensation Trade-off

- Greater managerial ownership → "better incentives"
- But, costs a lot of money to shareholders
- The Big Question:
  - Do stock options and other pay-for-performance grants cause managers employees to work better/harder to justify their value?
  - It could be, but it's really hard to tell…

Board of directors

- The main job of boards is to "monitor" CEO
- Have a fiduciary duty to shareholders to maximize firm value
- The majority directors on firms' boards are supposed to be **independent** from management
  - Inside Directors
    - Employees, former employees, or family members of employees
  - Gray Directors
    - Not directly connected to the firm like inside directors, but may have, for example, a business relationship with the firm
  - Outside ("Independent") Directors
- "Captured boards": When a board's independence has been compromised because of connections to management
- However, even independent boards may not have an **incentive** to monitor managers closely
  - E.g., monitoring could be time-intensive or strain personal relationships
  - Directors' compensation is usually insensitive to firm performance, so they may not care
  - "Who monitors the monitors?"

Other Monitors

- **Employees**
  - Most likely to detect be whistleblowers on corporate misconduct
- **Regulators**
  - E.g., the Securities and Exchange Commission (SEC)
- **Lenders**
- **Equity analysts**

Shareholder voting

- Shareholders can influence the firm through voting, but can vote only on a few limited things:
  - Board of directors
    - Annually, but sometimes not for all directors if board is “classified”
  - Say-on-pay
    - Every one to three years
  - A few large corporate events or legal changes, for example:
    - Mergers (but usually only the target’s shareholders)

Proxy Fights

- The current board proposes which directors should be nominated for next year’s board
- Most board members are appointed in **uncontested** elections based on these nominations
- A group of shareholders that doesn’t agree with the current board (usually called “dissidents”) can introduce rival director nominations for election to the board
  - Can be a only one alternative director, or a “full slate” (i.e., as many alternative directors as there are board seats)
- This results in a “proxy fight”, where board voting is competitive
  - For example, there may be 13 directors competing for 10 board seats
  - Most shareholders don’t attend the annual meeting – instead vote by “proxy”, hence the name
  - Now shareholders get to choose which directors to vote for
- Proposing rival directors is a common strategy by “activists” who want the firm to make some strategic changes

Proxy fights can be seen as healthy competition in “the market for corporate control”

- Proxy fights tend to be associated with **abnormal returns**
- Can make boards more **responsive** to shareholder opinions

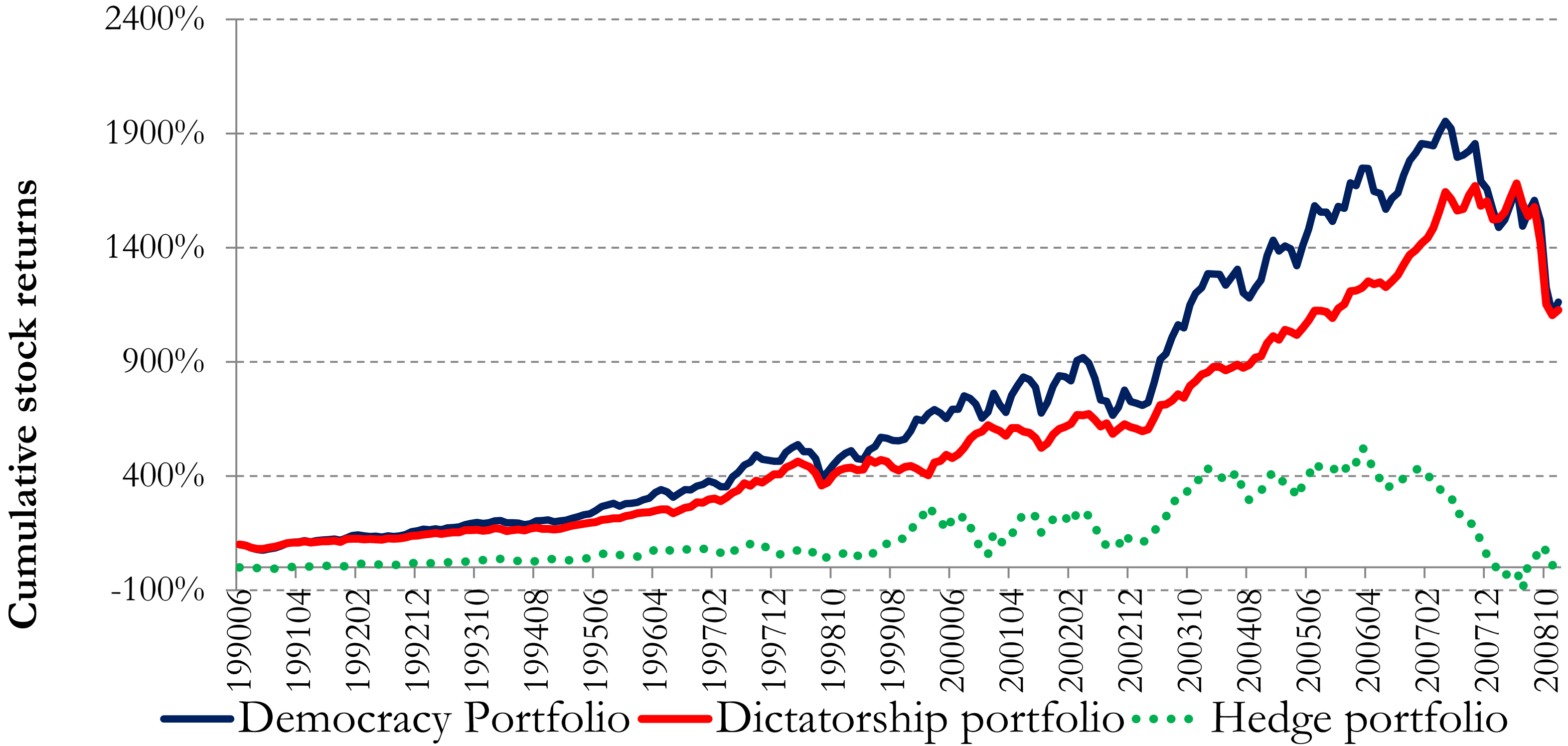
Not Everyone Agrees …

- “Shareholder activism is **destroying the role, focus, and collegiality** of the board of directors …”
- “Activists create pressure on boards [and managers] to manage for s**hort-term** share performance rather than long-term value.”
- “…**shareholders do not deserve** more shareholder democracy because ‘the majority of them are intermediaries, such as pension funds and mutual funds, which have **governance problems of their own**.”

Can we measure corporate governance?

- Perhaps… in a famous paper, Gompers, Ishii, and Metric (2003) came up with a "governance index."
  - Sorting firms into "Democracy" and "Dictatorship" portfolios by counting 24 corporate charter (or bylaw) governance-related provisions:
    - <=7: **Democracy**
    - >=14: **Dictatorship**
  - Examples of some provisions that make a firm more like a dictatorship:
    - Supermajority voting rules
    - Poison pills
    - Golden parachutes
- GIM found that democracy firms had **higher returns**, but this result hasn't held up in the period after the paper was published

Is “democracy” good for shareholders?



What about other stakeholders?

- Corporations have many **stakeholders**:
  - Shareholders
  - Debtholders
  - Employees
  - Customers
  - Community they operate in, public health, the environment
- Corporations have a **legal duty only** to shareholders, which is to maximize firm value
  - Exception: Benefit corporations (e.g., Patagonia, Etsy, Ben & Jerry's)

Does this mean that "Capitalism" is bad for everyone except shareholders?

- Not necessarily, making money for shareholders **requires** making sure that lenders, employees, customers are also happy
  - If they're not happy--it becomes really difficult to make money!
  - Companies also have obvious profit-motivated interests to make sure that their communities are attractive place to live, e.g. nice parks and amenities
  - Perhaps a company can exploit banks, customers, employees, communities, for a little while, but in the long run, it becomes really difficult to remain a successful business that way…
  - Adam Smith: "It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest."
- Does a company also have a duty to other stakeholders **beyond** keeping them happy (enough) for the firm to make money?
- This is the idea of Corporate Social Responsibility (CSR)
  - Firms must **"go beyond" the law and shareholders' self-interest** in doing what's good for other stakeholders
  - There's an active debate on the merits of CSR

Examples: Questions of Corporate Social Responsibility

- Is Exxon doing enough for the environment?
- Are Walmart’s employees paid enough?
- Should Apple design its products so they are less harmful for children?
  - https://thinkdifferentlyaboutkids.com/

Corporate Social Responsibility (2)

- Milton Friedman (1970): “**The Social Responsibility Of Business Is to Increase Its Profits”**
  - **“**What does it mean to say that ‘business’ has responsibilities? Only people can have responsibilities.”
  - http://query.nytimes.com/mem/archive-free/pdf?res=9E05E0DA153CE531A15750C1A96F9C946190D6CF
  - His basic point is that CSR means spending *other people’s money.* Shareholder’s money or the government’s money (due to less profit and less taxes), customers’ money if higher prices, employees’ money if lower wages
  - An executive, shareholders, or employees can support any cause they want to with **their own money**
  - A common example: A corporation gives a donation to a university, which names a building in honor of the CEO. Good idea?

- Larry Fink (CEO of BlackRock) in a letter to CEOs:
  - “Society is demanding that companies, both public and private, serve a social purpose… To prosper over time, every company must not only deliver financial performance, but also show how it makes a **positive contribution to society**.”
  - “**Without a sense of purpose**, no company, either public or private, can achieve its full potential. It will **ultimately lose the license to operate from key stakeholders.** It will succumb to short-term pressures to distribute earnings, and, in the process, sacrifice investments in employee development, innovation, and capital expenditures that are necessary for long-term growth. It will remain exposed to activist campaigns that articulate a clearer goal, even if that goal serves only the shortest and narrowest of objectives. And ultimately, that company will provide subpar returns to the investors who depend on it to finance their retirement, home purchases, or higher education.”

- See also Matt Levine’s commentary here “Should companies add value to society?”: https://www.bloomberg.com/view/articles/2018-01-16/spotify-will-pay-banks-to-cut-out-the-banks