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An empirical examination of the role of the CEO and the compensation committee in structuring executive pay ☆

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Abstract

Motivated by the potential for opportunistic behavior in pay decisions, recent SEC and IRS regulations essentially preclude inside directors from serving on a firm's compensation committee (CC). We examine whether greater CC independence promotes shareholder interests and whether the CEO's presence on the CC leads to opportunistic pay structure. We find little evidence that greater committee independence affects executive pay. Moreover, committees consisting of insiders or the CEO do not award excessive pay or lower overall incentives. For example, we find no evidence that pay decreases or total incentives increase when CEOs come off the CC. Our results suggest that regulations governing committee structure may not reduce levels of pay or achieve efficiencies in incentive contracts.

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1. Introduction

Executive compensation plays a fundamental role in attracting and maintaining quality managers and provides motivation for executives to perform their duties in shareholders' best interests. For most large companies, the specific design of executive pay is delegated to a subcommittee of the board of directors, the compensation committee (CC). This board subcommittee plays an important role because it must be concerned with setting and structuring pay packages that attract and retain top management so as to provide the right incentives for managers to operate in shareholders' interests.

The view that CCs are important, and the potential problems with committee makeup, is reflected in recent government regulations. In particular, concern over opportunistic behavior by company insiders sitting on CCs led to government intervention in the design of committee structure. In 1992, the SEC adopted provisions encouraging directors without ties to the firm to be more responsible for establishing executive pay by increasing disclosure requirements when corporate insiders serve on CCs. In addition, the 1993 congressional tax code stipulates that CCs must be composed solely of two or more outside directors or performance-based executive pay in excess of $1 million is not tax deductible. [1]

While the general focus of government regulation has been to encourage outside board representation on CCs, the presence of insiders on the committee does not preclude the design of pay contracts that are in shareholders' interests. CEOs that own substantial equity, who manage recently created firms, or who are founders may choose to sit on the CC to effectively design incentive programs for other executives. Moreover, insiders may understand the specific social and political aspects of a company that are useful for compensation advisors or CCs in structuring incentives. Consequently, insiders may provide beneficial monitoring and transmission of information that minimizes organizational costs (Coase, 1937), which suggests that the SEC and IRS regulations may interfere with what is otherwise an effective voice in setting executive pay.

The purpose of this paper is twofold: first, to examine the CC's role in setting executive pay and second, to provide some evidence on the rationale for government regulation in the design of board committees. We begin by examining the role that outside board members and non-CEO insiders who sit on the CC play in executive pay design. Next, we investigate the CEO's influence on pay practices by examining CEO pay when CEOs are members of their own CC. Finally, we analyze pay changes, if any, when CEOs come off the CC. CEOs sitting on their own CCs perhaps provide the cleanest example of agency problems that can occur between self-serving executives and shareholders. If as regulators suggest, agency conflicts

[1] Shareholders are also showing concern over pay practices set by CCs. In 1996, disappointment with the structure of pay set by the CC at AT&T lead to the California Pubic Employees Retirement System (CalPERS) to vote its 8.5 million shares against re-seating four members of the firms board of directors.