

On Executive Pay, Simpler Is Better

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Back in 1990, Michael Jensen wrote a landmark HBR article arguing that "[It's Not How Much You Pay CEOs, But How.](#)" He wanted boards to adjust pay according to company performance as shown by stock price. [V.G. Narayanan's recent post](#) in this debate goes a step further, arguing that executive pay should be tied aggressively to a company's specific strategy.

The Jensen article was cogent, but it led to an explosion in supercharged stock-option grants in the 1990s. Jensen initially favored restricted stock (full shares made available only years after being awarded). As he saw to his dismay, boards heard only part of his message, the part about tying compensation to stock. Issuing stock options allowed boards to respond to the market pressures they felt to boost executive pay. And in those heady days, options grants had no immediate impact on the company's books. Executives responded--rationally--by managing earnings long enough to prop up stock prices, regardless of long-term consequences. In Jensen's words, they became hooked on stock price like addicts on heroin.

Narayanan's arguments would likely have the same unintended consequences. In theory, it makes perfect sense to tie executive compensation closely to specific strategic objectives. The trouble is that aggressive incentives are likely to lead to a laser-like focus on the particular metrics at the expense of executive judgment about the company's evolving needs. It's hard to establish a metric that won't later come to haunt the company.

It's unrealistic to expect boards to establish careful metrics in an area as charged as executive compensation. Alfred Rappaport [wrote a powerful article in HBR in 1999](#) urging companies to index their stock options to peer companies or the larger market. He wanted them to avoid situations where executives reap windfalls simply because they're in a growing market, regardless of their own performance.

But few boards have ever paid attention. Boards have been responsive only to the downside risk, by replacing or repricing underwater options. Their concern tends to be with smoothing out executive compensation rather than strongly motivating excellence. Many boards have also been complicit in springloading or even backdating options. Instead of lecturing boards further, we're better off finding out why boards have resisted rigorous pay for performance.

[In a separate post in this debate](#), Lucian Bebchuk and Jesse Fried offer a complex timing scheme of vesting and cashing stock options. They're trying to retain the intense incentives of stock options while preventing gamesmanship. It's hard to see boards going along, once the outcry over executive compensation fades.

That's why restricted stock is worth a new look. These grants would still give CEOs some incentive to focus on long term corporate performance. Yet the upside potential would not be great enough to tempt executives into earnings management and other manipulation. The

simplicity of relying on restricted stock would also free up board time for more direct oversight of executives. Restricted stock also allows companies to pay executives handsomely, which is what boards mainly care about.

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