

## I Introduction

The supposed excess of executive compensation has recently been the source of considerable controversy in many industrialized countries, including the United States, Great Britain, and Canada.<sup>1</sup> Consider the titles of articles on the subject in each country respectively: 'The Madness of Executive Compensation';<sup>2</sup> 'Fat Cats and Their Cream';<sup>3</sup> and 'When the Boss Gets Paid Too Much.'<sup>4</sup> On the other hand, authors have also declared that 'top executives are worth every nickel they get.'<sup>5</sup> It is remarkable that executive pay, unlike the pay of entertainers and professional athletes, for example, is subject to such intense and sceptical scrutiny. This article examines one of the causes of such scrutiny: the required disclosure in proxy statements of the details of executive compensation.<sup>6</sup>

I first outline the major issues surrounding executive pay in order to provide necessary context for the ensuing, more narrowly focused examination of disclosure. The economic importance of executive compensation, as well as potential problems in its governance, will be the focus of this first section.

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† I wish to thank Bruce Chapman, Ron Daniels, and Michael Trebilcock for comments on an earlier draft. Thanks also are due to George Triantis for helpful conversations.

1 For a general survey of the issues, see E. Iacobucci, ed., *Value for Money: Executive Compensation in the 1990s* (Toronto: C.D. Howe Institute, 1996).

2 C. Loomis, *Forbes* (12 July 1982) 42.

3 *The Economist* (22 July 1995) 19.

4 P. Cook, *The [Toronto] Globe and Mail* (28 September 1995) B2.

5 K. Murphy, 'Top Executives Are Worth Every Nickel They Get' (March-April 1986) *Harv. Bus. Rev.* 125.

6 Ontario's relevant legislation is *Regulation to Amend Regulation 1015 of the Revised Regulations of Ontario, 1990, Made Under the Securities Act* (13 October 1993). This regulation applies to most large public corporations in Canada, given that 90 per cent of the 300 largest public corporations in Canada are listed on the Toronto Stock Exchange: X. Zhou, *Essays on Executive Compensation and Managerial Incentives* (Doctoral Thesis, University of Toronto, 1997) at 57.

I then examine the effects of one of the policies designed to help minimize the problems inherent in the governance of compensation: disclosure.

Two fundamental elements of executive compensation attract scrutiny: *how* executives are paid – that is, the composition of their compensation packages across alternatives such as salary, bonuses, stock options, etc.; and *how much* executives are paid.<sup>7</sup> Disclosure affects both. Some commentators suggest that because of political pressure, disclosure results in pay that is both lower than it would otherwise be and less sensitive to the firm's performance;<sup>8</sup> that is, firms are reluctant to pay the optimal amount with optimal incentives because very high compensation packages, though profit-maximizing, will have undesirable political effects. High pay may invite explicit regulation<sup>9</sup> or may impose political costs through the firm's relationship with parties not privy to the compensation contract, such as the firm's non-managerial workforce or consumers.<sup>10</sup>

On the other hand, as I discuss below, commentary that took place prior to the introduction of disclosure rules in Canada generally accepted that disclosure would have an inflationary effect on pay and pointed to this effect to oppose the rules. These views in part motivate the analysis here. I examine various inflationary trends that have been pointed out by commentators as perhaps demonstrating flaws with disclosure rules and governance of executive compensation. I argue that disclosure may naturally tend to increase compensation, but that this tendency does not necessarily reveal any infirmities with the regime governing post-disclosure executive compensation. Better understanding of some of the reasons for the potentially inflationary effects of disclosure may help steer the political debate away from simplistic conclusions about the excesses of executive pay and possibly

7 See M. Jensen & K. Murphy, 'CEO Incentives – It's Not How Much You Pay, But How' (1990) May-June Harv. Bus. Rev. 138.

8 M. Jensen & K. Murphy, 'Performance Pay and Top-Management Incentives' (1990) 98 J. Pol. Econ. 225; Zhou, *supra* note 6.

9 In the United States, for example, the *Revenue Reconciliation Act, 1993* added s. 162(m) to the *Internal Revenue Code* to limit to \$1 million the amount of an individual's annual compensation that firms can deduct from their income for tax purposes, unless the payments are linked to the firm's performance.

10 Shareholders themselves may be motivated in part by political (i.e., non-profit-maximizing) objectives. A small shareholder of the National Bank of Canada won a court case allowing him to put various corporate governance proposals to a shareholder vote (eventually unsuccessful), including a rule that would have capped executive pay at a maximum of twenty times the average employee pay: see *Michaud v. Banque Nationale du Canada*, [1997] R.J.Q. 547 (C.S.). He is quoted as saying, 'In the present bad times, when more than 25% of the population [of Quebec] is unemployed or on welfare, it is a provocation to propose topping up exaggerated salaries': K. Yabuski, *The [Toronto] Globe and Mail* (17 January 1997) B11.

harmful interference with efficient compensation contracts. My analysis avoids discussing political forces and rather focuses on how disclosure may affect the economic actors directly involved with executive compensation: managers and owners.

I first discuss why disclosure would predictably have an effect on *how* executives are paid; the positive effect of disclosure on the sensitivity of pay to performance is frequently advanced as the justification for disclosure. Second, I examine why disclosure may also have an effect on *how much* executives are paid. I conclude by discussing the policy implications of the analysis.

## II *The Purposes of Executive Compensation and Potential Governance Problems*

### A. THE PURPOSES OF EXECUTIVE COMPENSATION<sup>11</sup>

The separation of the ownership of a corporation from the management of a corporation is frequently lamented, particularly in American scholarship. The owners of a firm, the shareholders, may have little to do with the everyday management of the firm. The problem with such a divergence is that the managers, with only an attenuated interest in the firm's profits, may manage in their own personal best interests rather than the firm's best interests. The shareholders, however, with only a fractional interest in the profits of the firm, will not have enough incentive individually to monitor and discipline management. Berle and Means put the problem in the following terms:

Though the American law makes no distinction between the private corporation and the quasi-public, the economics of the two are essentially different. The separation of ownership from control produces a condition where the interests of owner and ultimate manager may, and often do, diverge . . . . Those who control the destinies of the modern corporation own so insignificant a fraction of the company's stock that the returns from running the corporation profitably accrue to them in only a very minor degree. The stockholders, on the other hand, to whom the profits of the corporation go, cannot be motivated by those profits to a more efficient use of the property, since they have surrendered all disposition of it to those in control of the enterprise. The explosion of the atom of property destroys the basis of the old assumption that the quest for profits will spur the owner of industrial property to its effective use.<sup>12</sup>

Put another way, the problem with minimal managerial ownership of the firm is that a manager does not bear the full costs of behaviour that,

11 Much of this survey is drawn from Iacobucci, *supra* note 1.

12 A. Berle & G. Means, *The Modern Corporation and Private Property* (New York: MacMillan, 1933) at 7-9.

while privately beneficial to the manager, may be detrimental to the firm.<sup>13</sup> These 'agency costs' include the overconsumption of perquisites, such as the purchase of corporate jets,<sup>14</sup> executive consumption of leisure time, and possibly inefficient investment. The latter might arise if the risk-averse executive who wishes to retain her job seeks to ensure such retention by investing in less profitable but safe investments, rather than in profit-maximizing, risky investments.

To see the effect of minimal managerial ownership on each type of cost, consider an executive who owns 5 per cent of a firm. If firm ownership is the sole source of managerial discipline, in deciding whether the firm should purchase a corporate jet, she will trade off the private benefits, of either status or convenience, that accrue from the purchase against the private costs. While the executive will enjoy most of the benefits of an executive jet, she will incur only 5 per cent of the costs. A small personal ownership stake may give a manager an incentive to purchase the jet, even if the total costs of the purchase exceed the benefits. Agency behaviour thus results in inefficiency.

With respect to risk, compare an investment with a low expected payoff but zero risk with an investment with a very high expected payoff overall but a significant chance of disaster and the firm's bankruptcy. To isolate the agency problem of excessively safe investment, as opposed to perquisite consumption, assume that if the investment is successful, the cash would be paid out to shareholders on a pro rata basis. Risk-neutral, profit-maximizing shareholders would prefer the second investment, but since the executive reaps only 5 per cent of the higher expected payoff and bears a higher personal cost resulting from risk-aversion and the risk of termination, she may take the first option. Again, agency behaviour, specifically minimization of personal risk, results in inefficiency.

There are, however, institutions that serve to restrain executives in their pursuit of self-indulgent, sub-optimal agency behaviour. Michael Trebilcock summarizes them in the following way:

The recent literature identifies three main factors that help align the interests of principals and agents in publicly traded corporations: the market for managers, the output market and the market for corporate control. First, competition in the market among and for managers encourages greater efficiency, greater innovation and lower agency costs. Second, competition among firms in their output markets requires firms to act efficiently if they are to survive and if managers are to retain their jobs.

13 See M. Jensen & W. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 J. Fin. Econ. 305.

14 For an entertaining description of this type of perquisite consumption at RJR Nabisco under the stewardship of CEO Ross Johnson, see B. Burroughs & J. Helyar, *Barbarians at the Gate* (New York: HarperPerennial, 1990).

Third, private capital markets where firms must raise equity or debt capital will discipline weak management . . . . In addition, where a firm's shares are traded on the stock market, corporate takeovers are possible whenever a firm is being poorly managed.<sup>15</sup>

The contract between the principals, the shareholders, and their agent managers may also discipline management. In a world of complete information and zero transaction costs, the employment contract could specify managerial behaviour in whatever state of the world that comes to pass. However, given that shareholders are likely to have significantly incomplete information and transaction costs are non-zero, complete contingent claims contracts of this nature are virtually impossible.<sup>16</sup>

This is not to say that the employment contract cannot discipline management in other ways. An appropriately designed contract may indeed serve to better align the interests of shareholders and managers. A variety of contractual tools can provide private incentives to the manager to increase profit. For example, a bonus on the basis of profit could be promised to the executive. Let us return to the example of the 5 per cent shareholder-manager. The manager who indulges in a private benefit, such as leisure, now faces not only the cost to her 5 per cent shareholding of lower profit, but also, perhaps, the opportunity cost of a forgone bonus. The bonus scheme reduces the incentive to shirk. Alternatively, the manager could be paid in stock options: the manager has a right to purchase shares in the future at a given strike price; thus to the extent that the share price rises above the strike price, the manager reaps a private benefit. There are numerous other possibilities, such as stock awards, which may serve to provide the manager with incentives to act in shareholders' best interests.<sup>17</sup> Such compensation schemes reduce the divergence of interests between shareholders and managers, thereby increasing the efficiency of the firm.

The amount of compensation that can optimally be based on performance is limited because the manager – who cannot diversify her human capital specific to the firm, whereas shareholders may diversify their ownership in firms – will be risk-averse relative to the owners of the firm.<sup>18</sup> To the extent that the manager's efforts are not perfectly observable, incentive pay will rely

15 M.J. Trebilcock, *The Prospects for Reinventing Government* (Toronto: C.D. Howe Institute, 1990) at 9–10.

16 See discussion in Jensen & Murphy, *supra* note 8 at 226.

17 For more detailed discussions of various types of compensation and their effects on incentives, see Iacobucci, *supra* note 1; P. Milgrom & J. Roberts, *Economics, Organization and Management* (Englewood Cliffs, NJ: Prentice Hall, 1992); R. Elitzur & P. Halpern, 'Executive Compensation and Firm Value' in R. Daniels & R. Morck, eds., *Corporate Decision Making in Canada* (Calgary: Ministry of Supply and Services, 1995).

18 See, for example, B. Holmstrom, 'Moral Hazard and Observability' (1979) 10 *Rand J. Econ.* 74.

on proxies for her performance, such as the firm's profits or share price, which are subject to fluctuations beyond the control of the manager. Consequently, performance-related pay will impose costs of risk on managers. Pay unrelated to performance, such as salary, is likely to constitute some portion of the manager's contract in order to mitigate the costs of risk she must bear.

In summary, executive compensation, through a mix of salary, bonuses, options, and other instruments, may play a valuable role in disciplining management, while at the same time not imposing excessive costs of risk on the manager. If a manager's pay package increases as the result of improved corporate performance, the manager, even though she may own only a fraction of the firm, has an increased incentive to improve corporate performance.

#### B. PROBLEMS WITH THE GOVERNANCE OF EXECUTIVE COMPENSATION

There are numerous contexts in which a principal would enter into a contract with his agent that provides both for very high levels of compensation and for incentives to minimize agency costs. For example, a sports team may wish to provide for performance bonuses in a long-term contract with an athlete. Moreover, an athlete's compensation, like executive compensation, may be very large relative to the average person's. Aside from occasional grumblings from disgruntled fans, however, professional athletes' compensation has not invited vociferous criticism of outlandish pay, as has executive compensation. Robert Brown states:

It is interesting that, in our society, this feeling of perceived excess seems primarily directed toward executives (and politicians' pension arrangements) and not toward other highly paid individuals. The salaries of football quarterbacks, basketball jumpers, and pop singers often dwarf the salaries of senior executives in Canada and equal those of the very highest paid executives in the United States. But such enormous incomes do not seem to call forth the same feelings of envy and accountability that arise with respect to business compensation.<sup>19</sup>

As athletes are understandably wont to remind us, they are simply taking what the market will bear, as does any other employee in a society. Why, then, the criticism of executive pay?

One response is that the criticism is simply misguided. Executives, like athletes, simply take what the market will bear and should not be faulted.<sup>20</sup> In a market economy, supply and demand dictates what people are paid. If the economy values a baseball player's performance very highly and the supply of

19 R. Brown, 'Executive Compensation: Some Comments on Why We Care' in Iacobucci, *supra* note 1, 63 at 64.

20 See, for example, T. Corcoran, 'Executive pay is not about social justice' *The [Toronto] Globe and Mail* (14 May 1994) B2.

baseball players is scarce, the major-leaguer will be paid very highly.

If the governance of executive compensation were like the establishment of athletes' compensation, one would be hard-pressed to find anything to criticize, other than the economy's valuation of baseball players and executives – a rather difficult exercise in principled criticism.<sup>21</sup> However, the governance of executive compensation is dissimilar to the setting of athletes' pay, and, in my view, it is this dissimilarity that contributes to principled (as opposed to visceral) negative perceptions about executive pay.

As Graef Crystal points out, athletes' pay is generally set through negotiation between parties with opposing interests: the owners and the players.<sup>22</sup> The owners, who pay the players, understandably want pay as low as possible; the players understandably want pay as high as possible. The difficulty with executive compensation, however, is that the bargaining takes place between parties with potentially different financial stakes in the outcome. Responsibility for the establishment of executive compensation packages rests with the board of directors.<sup>23</sup> The board, of course, does not comprise the owners of the corporation, the shareholders, but rather their elected representatives who may themselves own only a small fraction of the firm. While directors owe a fiduciary duty to the corporation,<sup>24</sup> which would require them to set compensation so as to maximize the value of the corporation, they have been given considerable leeway by the courts in discharging their duty; courts are loathe to intervene in matters of executive compensation.<sup>25</sup> Moreover, various factors may influence directors to be less than vigilant in bargaining for optimal executive compensation. For example, executives themselves frequently sit on the board of directors, with

21 For an attempt at such criticism, see R. Frank & P. Cook, *The Winner-Take-All Society* (New York: Free Press, 1995).

22 See discussion in G. Crystal, *In Search of Excess: The Overcompensation of American Executives* (New York: W.W. Norton, 1991) at 31–41. Where there is widely held ownership of a professional sports franchise, some, but clearly not all, of the outlined differences between the setting of executives' and athletes' pay may be less significant.

23 In Ontario, board responsibility is found in the *Ontario Business Corporations Act*, R.S.O. 1990, c. B.16, s. 137 [hereinafter *OBCA*].

24 *Ibid.* s. 134.

25 See, for example, *Rogers v. Hill* 289 U.S. 582 (1933) (executive compensation must amount to a 'waste' of corporate assets before courts will intervene). *Heller v. Boylan* 29 N.Y. Supp. (2d) 653 (Sup. Ct. 1941) set out the classic case for judicial deference at 679: 'Assuming, arguendo, that the compensation should be revised, what yardstick is to be employed? Who or what is to supply the measuring rod? The conscience of equity? Equity is but another name for human being temporarily robed. He is not omnipotent nor omniscient. Can equity be so arrogant as to hold that it knows more about managing the corporation than the shareholders?' The Court later stated at 680, 'Courts are ill-equipped to solve or even grapple with these entangled economic problems.'

the CEO often sitting as chair. Even when compensation is voted upon by outside directors only, the CEO is often responsible for suggesting the pay packages for directors' approval. A CEO, particularly one who is the chair, may have significant influence over the composition of the board. Directors wishing to continue enjoying the pecuniary and non-pecuniary advantages of board membership may be reluctant to fight the executive suite over compensation.<sup>26</sup> One might expect, therefore, relatively friendly faces on the board as far as executives are concerned. Such friendliness is even more likely in the Canadian context, given the common phenomenon of interlocking directorships: director A may be a top executive in another corporation, and CEO B may be a director of director A's corporation.

Perhaps in light of these potential conflicts, boards in Canada have increasingly turned to compensation consultants for advice. A potential problem with consultants, however, is that they are usually hired by the executives themselves to assist the compensation committee of the board. While these consultants no doubt generally act in good faith, they must feel at least implicit pressure to satisfy the executives who hired them. Crystal describes explicit pressure from his days as a compensation consultant:

I recommended that [the CEO] cut his salary to \$100,000 [from \$160,000] to make room for a normal 60%-of-salary bonus opportunity ... . The CEO did not take kindly to my suggestion. First, he tried to argue me out of the recommendation ... . But he wasn't successful. So he looked me in the eye and posed a question to me that I will never forget: 'Just who do you think is paying your bills anyway?' ... [W]e broke up and I have never heard from him again.<sup>27</sup>

Although shareholders are the owners of the corporation, they face a number of problems in seeking to control the board of directors in setting executive compensation. Fundamental is the ubiquitous collective action problem.<sup>28</sup> The benefits of disciplinary activity, either through monitoring or influencing the board, are shared equally by all shareholders, yet each would individually bear the cost of such activity. Consequently, each shareholder faces an incentive to take a free ride on the disciplinary actions of others. Since each shareholder relies on others to take action, no action is taken, and disciplinary activity is underprovided. The collective action problem therefore reduces the likelihood of significant shareholder influence on executive compensation.

26 For a strong view about the lack of directorial independence, see C. Bogus, 'Excessive Executive Compensation and the Failure of Corporate Democracy' (1993) 41 *Buff. L. Rev.* 1 at 33-34: 'The independent director has turned out only to exist in theory; in the real world all directors are beholden to management.'

27 Crystal, *supra* note 22 at 219.

28 M. Olson, *The Logic of Collective Action* (Cambridge: Harvard University Press, 1971).



III *Disclosure and How Executives Are Paid*

Recently, both American and Canadian securities regulators have demanded increased disclosure of executive compensation.<sup>29</sup> Regulations in each country require companies to provide tables breaking down the composition of executive pay, charts comparing the financial performance of the firm with similarly situated firms, and a textual explanation of the firm's compensation policy. The purpose of increased disclosure is invariably stated to be the improved governance of the establishment of executive compensation and improved governance of the corporation generally because of the motivating effects of intelligently designed compensation arrangements. In this section, I examine how disclosure may indeed improve compensation design and therefore corporate performance.

Commentators have emphasized the importance of improved information with respect to investor control of executive compensation. Peter Dey, the former chair of the Ontario Securities Commission, praised the new disclosure requirements in 1993, stating:

Good corporate governance relies on an informed and active investor community. In some respects, this legislation recognizes their legitimate need for information that enables them to relate management's performance to the performance of the company.<sup>30</sup>

Other commentators echo this praise. Ronald Daniels states:

The revised regulations will enhance the incentives of both directors and institutional shareholders to review and control executive compensation arrangements. Under the sunlight of heightened disclosure, compensation committees will be encouraged to devise compensation arrangements that meet shareholder expectations.<sup>31</sup>

To see why disclosure assists shareholders, recall the discussion of the collective action problem. Each shareholder is 'rationally apathetic' because the private costs of monitoring pay are borne fully by the monitor-shareholder, but the benefits are only partially realized by the shareholder; all shareholders benefit, not just the monitor. Disclosure does not affect the private benefits received, but it may have significant effects on the private

29 Prior to the *Regulation to Amend Regulation 1015*, supra passed in 1993, Ontario simply required disclosure of the aggregate compensation of all executives: Zhou supra note 6 at 26. The United States has had extensive disclosure of executive compensation since the 1930s: see Jensen & Murphy (1990), supra note 8, but recently have expanded the requirements: see revisions to Item 142, Regulation S-K, 17 C.F.R. para. 229.402 (1992).

30 K. Howlatt, 'Shareholders gain advocate at OSC' *The [Toronto] Globe and Mail* (18 October 1993) B1.

31 R. Daniels, 'Executive Compensation: Perhaps Company Managers Aren't Paid Enough ...' (Spring 1994) *Can. Investment Rev.* 41 at 41.

costs of monitoring compensation. Prior to mandatory disclosure, it may have been very difficult, if not impossible, for an investor to discover the composition of executive pay packages. The cost to the shareholder of obtaining the information drops dramatically with disclosure. Moreover, the disclosure rules require the corporation to explain its compensation strategy and to provide comparative tables showing the firm's financial performance, reducing further the cost of evaluating the pay packages. The free ride becomes comparatively less attractive given that the private costs of monitoring are lower. Disclosure will predictably increase both private incentives to monitor and consequent shareholder activism.

Furthermore, an important link exists between a recent trend in corporate governance in North America and disclosure of executive compensation. The trend is the increasing presence of the institutional investor. Jeffrey MacIntosh reports that institutional investors invested \$52 billion in 1982 on the Toronto Stock Exchange, and \$68 billion in 1992. Retail investors, on the other hand, invested \$48 billion in 1982 and only \$32 billion in 1992.<sup>32</sup> Institutional shareholders have clearly played an increasingly prominent role in Canada.

Institutional investors are seen as a potential boon to corporate governance for a variety of reasons.<sup>33</sup> First, they are taken to be sophisticated investors. Second, they typically hold a larger percentage of shares than do retail investors. Bernard Black provides several reasons why investors with larger percentage shareholdings have increased incentives to monitor the corporation.<sup>34</sup> For example, while there remain positive externalities for other shareholders, a larger shareholding nevertheless increases the private benefits of monitoring and thereby reduces the rational apathy concern. Moreover, the existence of a small number of institutional investors as major shareholders in a corporation reduces the coordination costs among shareholders relative to a corporation with a great number of small retail investors. With respect to voting, the greater the share held by an institutional investor, the greater the chance that its vote will be pivotal in shareholder votes, thus increasing the private return in gathering information on the issue subject to the vote. Institutional investors with large blocs may also be restricted in doing the 'Wall Street walk' and selling their stakes if dissatisfied with management. The effect on share price from 'exiting' may encourage them to stay in the corporation and exercise their 'voice' option – that is, retain their shares and attempt to encourage better management from within.<sup>35</sup>

32 J. MacIntosh, 'Institutional Shareholders and Corporate Governance in Canada' (1996) 26 *Can. Bus. L.J.* 145 at 150.

33 See MacIntosh, *ibid.*

34 B. Black, 'Shareholder Passivity Reexamined' (1990) 89 *Mich. L. Rev.* 520.

Black also discusses the potential for economies of scale. An institutional investor in a firm may find it worthwhile to become informed about aspects of corporate governance that are relevant to its investments in other companies as well. Black further suggests that an active institutional investor in one firm may deter mismanagement in other firms. The private benefits from monitoring are positively affected by these inter-firm externalities, since the institutional investor has shareholdings in a variety of firms. There remains, however, a free-rider problem in that all investors benefit from deterrence, not just the institutional investor. A perhaps slightly more refined approach to deterrence, which limits the potential for having a free ride and thus may explain shareholder activism more convincingly, is to view deterrence as intimately linked with the institutional investor who was active in the first place because of reputational effects. Consider an institutional investor with shareholdings in, say, one hundred firms. Activism with respect to each firm on its own may not be privately worthwhile. However, an institutional investor may monitor and otherwise be active with respect to a particular firm in order to develop a reputation for activism.<sup>36</sup> The reputation for activism serves as a discipline on management in the other firms in which the investor has a stake, thus increasing the value of the investor's portfolio. Reputation, rather than more general deterrence, may thus explain institutional shareholder activism in some instances. An empirical example of such a reputation with respect to compensation may perhaps be found in the activities of the California pension fund, CalPERS. As Linda Barris outlines, CalPERS scrutinized and demanded changes to a number of firms' compensation schemes.<sup>37</sup> It is now known as a force to be reckoned with on executive pay.

Let us return to the effects of disclosure on executive compensation. It is apparent that disclosure has a desirable effect in lowering the costs of shareholder monitoring of executive compensation, which is particularly desirable in the era of the institutional investor with the potential for increased activism that that brings. Disclosure also has a beneficial effect on institutional activism because of deterrence and reputation. In order for shareholder activism with respect to executive compensation to deter management at other firms from adopting less than optimal compensation packages, or for an investor to develop a reputation for hawkishly

35 The terminology of 'exit' and 'voice' is from A.O. Hirschman, *Exit, Voice and Loyalty*, (Cambridge, MA: Harvard University Press, 1970).

36 See D. Kreps, *A Course in Microeconomic Theory* (London: Harvester Wheatsheaf, 1990) c. 14 for a discussion of game theory and the potential importance of reputation.

37 L. Barris, 'The Overcompensation Problem: A Collective Approach to Controlling Executive Pay' (1992) 68 *Indiana L.J.* 59.

scrutinizing compensation, the results of this activism must be public. A reputation cannot be fostered if others are unaware of the results of the activities that otherwise would build a reputation. Disclosure therefore serves to demonstrate publicly the fruits of the active shareholder's labour, enhancing its reputation and encouraging more appropriate compensation packages at other firms in which it has a stake. Given this spotlight, institutional activism is encouraged.

While more speculative, disclosure of the corporate compensation strategy may be important simply in requiring the compensation committee to explicitly formulate a compensation strategy.<sup>38</sup> Rather than instinctively assuming that a particular pay package makes sense, the committee is forced to justify its choice publicly. Even aside from the salutary impact of disclosure on shareholder activism, compensation committees comprising members who do not wish to appear incompetent will be compelled by disclosure to think more carefully about the underlying reasons for their recommendations. To take an admittedly extreme example, suppose a compensation committee member has typically approved relatively generous pay packages because of a friendship with the CEO. The committee member is now compelled because of disclosure to give reasons for such choice. If reputation for responsible directorships has any value, or indeed the fiduciary duty to the shareholders as a director has any legal consequences, the committee member would not justify the choice of compensation package by referring to the friendship with the CEO. The committee member is forced to abandon this motivation, at least publicly, and to provide a reasonable justification for the choice. The member must thus consider a fuller range of reasons behind executive pay. To the extent that directors do not advert to the full range of reasons for executive compensation packages, but rather are satisfied with perhaps selfish motivations, mandatory disclosure of the compensation strategy may have a desirable disciplinary effect.

Providing reasons for a compensation package may also serve as a disciplinary tool on directors acting in good faith with opposing views about the optimal package. Suppose, for example, that one director views a significant salary as necessary to compensate the executive in a manner that will not discourage risk taking. Suppose another director, however, views risk as virtually irrelevant to the choice of salary. In publicly announcing the compensation committee's views pursuant to disclosure obligations, both positions could not be offered simultaneously. It is meaningless for the committee to state that risky investment played a significant role in motivating the salary

38 For a discussion of the potential disciplinary effects of the requirement to give reasons on judges, see B. Chapman, 'More Easily Done than Said: Rules, Reasons and Rational Social Choice' (1998) 18 *Oxford J. Legal Stud.* 293.

component of the pay package and that it played an insignificant role. The opposed directors must therefore come to some consensus. The consensus requirement may force directors to consider more carefully both their positions and those of opposing directors. As long as this consideration is done in good faith, which is also more likely because of disclosure and the directors' reputations, disclosure and the requirement of public consensus may serve to discipline directors setting compensation.

My analysis thus far has shown that disclosure will, in a variety of ways, discipline directors setting executive compensation. First, it lowers shareholder monitoring costs and therefore encourages investor activism, which may be increasingly expected given the rise of the institutional investor. Second, disclosure publicizes the result of investor activism, thus permitting institutional investors to develop reputations for careful monitoring of executive compensation. Third, requiring compensation committees to disclose reasons for their choice of executive compensation packages also serves to discipline directors by encouraging them to carefully consider their choice of pay instruments.

Given the conclusion that disclosure encourages shareholder activism and disciplines directors, a separate question arises: What is the likely effect of shareholder activism and director discipline? As discussed above, the choice of executive pay programs may be vital to the success of the corporation in aligning the interests of management and shareholders. Without delving into an empirical survey of the considerable literature on the strength of the relationship between pay and performance, suffice it to say that many empirical studies have revealed only a weak link.<sup>39</sup> The apparent weakness or, indeed, absence of a correlation between pay and performance has been treated by some commentators as the central area of concern in executive compensation.<sup>40</sup>

If this concern is well-founded and the correlation between pay and performance is at present undesirably weak, increased self-interested activism on the part of shareholders and increased director discipline should increase the sensitivity of pay to performance; that is, investors will demand executive compensation that provides managers with incentives consistent with the aims of shareholders. Because of its invigorating effects on shareholder activism, disclosure is likely to increase the emphasis on pay-for-performance in the setting of executive compensation.

39 See survey in Iacobucci, *supra* note 1 at 23–26. One recent study of the sensitivity of CEO pay to performance in Canada found that the link between pay and performance was 'very weak': see Zhou, *supra* note 6 at 67. Another Canadian study also found virtually no significant link between pay and performance: Elitzur & Halpern, *supra* note 17.

40 See, for example, Jensen & Murphy, *supra* notes 7 and 8.

While this article does not attempt to test empirically the hypotheses put forward, there is in Canada at least some anecdotal support for the notion that disclosure has increased shareholder activism and directors' sensitivity to the issues of setting executive pay. Martin Harts, a compensation specialist with KPMG, has this to say of the impact of the new disclosure rules:

The [CEO] still gives the board annual recommendations for executive pay, but the dynamics between the players and the old assumptions have been challenged. No longer are the CEO's recommendations automatically approved by the compensation committee or the board. Recommendations to increase pay are now usually backed up by market data, and, increasingly, base pay is being de-emphasized in favor of an annual bonus and long-term incentives. In other words, the potential upside in the 'at-risk' portion of pay is being promoted in the belief that compensation committees and, ultimately, the shareholders will be less likely to resist such arrangements.

The new disclosure rules are also changing the role of the annual bonus or incentive payments. Increasingly, compensation committees are requiring solid evidence in the form of quantitative performance criteria to justify bonuses. Paying executives incentives for performance at or in excess of targets is examined by institutional shareholders and the popular media in the context of company performance. Since the new rules came into force, compensation committee members are very sensitive to shareholders' questions about executive compensation at annual meetings.<sup>41</sup>

Disclosure, by unleashing the disciplinary force of both shareholders and the board's requirement to give reasons for its compensation decisions, has, according to Harts, increased the emphasis on pay-for-performance in Canada.

A recent Canadian study provides some further empirical support for the hypothesis that disclosure affects how executives are paid. Zhou examines CEO compensation at a sample of Canadian firms over the period 1991 to 1994 – that is, before<sup>42</sup> and after the enactment of the disclosure rules in Ontario in 1993.<sup>43</sup> He finds that the sensitivity of pay to performance increased in 1994 relative to the period 1991–1993. He also finds that Canadian firms that had been subject to U.S. executive compensation disclosure rules prior to 1993 had a higher correlation between pay and performance than those that had not. Finally, he finds that the increase between the periods 1991–1993 and 1994 in the pay-performance correlation was greater for firms that

41 M. Harts, 'Does Canada Have a Problem with Executive Compensation' in Iacobucci, *supra* note 1, 59 at 60–61. See also similar discussion in M. Gibb-Clark, 'Executive pay likely to grow under new light' *The [Toronto] Globe and Mail* (8 September 1994) B2.

42 Firms are required to disclose compensation for the current year and the two immediately preceding years. Thus a sample of compensation schemes prior to the disclosure rule's enactment was available: see Zhou, *supra* note 6 at 27.

43 See Zhou, *supra* note 6, c. 1.4.

had not previously faced U.S. disclosure rules than for firms that had already faced U.S. executive compensation disclosure rules. These findings are all consistent with the hypothesis that disclosure increases incentive-based pay. Disclosure appears to have altered how executives were paid.

#### IV *Disclosure and How Much Executives Are Paid*

I have thus far argued that disclosure may change *how* executives are paid, specifically surmising that disclosure is likely to increase the emphasis on the sensitivity of pay to performance. In this section I argue that disclosure is also likely to have the effect of changing *how much* executives are paid. Specifically, disclosure may increase executive compensation. While such an assertion could simply be made and tested empirically, it is important from a policy perspective, in my view, to understand the reason for the inflationary effect of disclosure on compensation. Various commentators have suggested that certain patterns in executive pay result from the self-dealing that the legal and economic framework concerning executive pay permits. I suggest here, however, that the patterns observed may well result not only under the present framework, but in a more purely adversarial bargaining context. The purpose of this section of the article is to caution against casual inferences about the excesses of executive compensation drawn from what are, ultimately, ambiguous data. Better understanding of the possible reasons for pay patterns associated with disclosure may help deter simplistic political interference (either with disclosure rules or with executive compensation generally), which commentators such as Jensen and Murphy warn may be associated with disclosure.<sup>44</sup>

To demonstrate that various pay patterns are not necessarily the result of self-dealing – that is, that they are not inconsistent with a truly adversarial bargaining context – the following discussion will treat pay as the result of negotiation between the manager and a single, fully informed owner who seeks to maximize profit. The single owner clearly faces no free-rider problems and may be expected to bargain vigorously. A bargaining context, as opposed to a spot market, is appropriate since each party is likely to have significant, specific investments in the relationship so that, to some extent, the parties do not have practical alternatives and must periodically bargain over a contract. The firm has specific investment in the manager because of the training the firm has provided to the manager over the course of his employment, while the manager has invested in developing his human capital in accordance with the specific needs of the firm.

44 Jensen & Murphy, *supra* note 8.

Bargaining is a notoriously difficult economic activity to model. In what follows, I will assume that the parties will invest in bargaining according to the potential benefits to each party that might result from the bargaining. Thus, for example, if there were a 100 per cent income tax rate for pay above a certain amount, the executive would invest nothing in attempting to bargain for pay greater than that amount. Where something occurs to change the relative benefits to the parties from bargaining over executive compensation, the compensation resulting from the bargaining changes. If, for example, the 100 per cent tax rate were lowered to 70 per cent above a given amount, the executive would invest in bargaining for more than that amount.

With this framework in mind, I turn now to an analysis of various patterns of pay associated with the disclosure of executive compensation. I attempt to show that patterns that may appear to be the result of self-dealing may also result in the above-described adversarial bargaining context between a single shareholder and a manager.

#### A. DISCLOSURE, PAY-FOR-PERFORMANCE, AND PAY LEVELS

In an article opposed to increased disclosure of compensation, the CEO of Sun Life Insurance Co., John MacNeil, writes:

Executive compensation levels in countries where disclosure is not required generally are significantly lower than in countries where disclosure is required. That is not an on-the-record fact, but it is an informed opinion from sources knowledgeable about these matters.<sup>45</sup>

MacNeil goes on to say that pay in markets where disclosure is mandatory tends simply to rise to the level of the highest paid executive.

Later I will examine the latter point concerning comparative pay; here I consider the former point: disclosure increases pay. If we accept that MacNeil's premise – pay levels are higher where disclosure is mandatory – is true,<sup>46</sup> what does this imply for disclosure as a policy? MacNeil implies in his article that one of the few significant results of increased disclosure is undesirable pay inflation. In my view, the inflationary effect of disclosure on pay should not be dismissed so quickly as undesirable. I argued above that disclosure is likely to increase the focus on the way executives are paid.

45 J. MacNeil, 'Why make executives disclose their salaries?' *The [Toronto] Globe and Mail* (29 October 1993) A33.

46 Zhou, *supra* note 6, Table 1.1, finds that average CEO pay at a sample of Canadian firms was \$422,000 in 1994 (post-disclosure) and \$389,000 over the period 1991–93 (pre-disclosure), which is not inconsistent with the inflationary effect of disclosure. Moreover, the percentage increase was larger at firms that did not face U.S. disclosure requirements prior to the Ontario amendments in 1993.



Specifically, disclosure will increase pressure on directors and management to adopt pay packages that are more sensitive to corporate performance. Adoption of more performance-sensitive pay, however, may also be expected to increase pay for a variety of reasons.

First, to provide significant incentives to managers, the absolute size of compensation may need to be higher than it would be in the absence of such incentives. Suppose, for example, that optimal incentives are provided to a particular executive if he is paid five cents for every dollar of profit. If pay had previously been set without considering the effect of pay on performance, there is no reason to conclude that switching to performance pay would result in similar levels of pay. Given that the productivity of the executive and pay are linked, a significant increase in expected pay resulting from the adoption of performance-related components of pay could increase profits to the firm. This is the argument of Jensen and Murphy, who state:

How often do shareholder activists or union leaders denounce a corporate board for underpaying the CEO? Not very often – and that’s precisely the problem. Most critics of executive pay want it both ways. They want companies to link pay to performance, yet they also want to limit compensation to arbitrary amounts or some fuzzy sense of ‘what’s fair.’ That won’t work.<sup>47</sup>

Consider the bargain between the single owner and the manager. Initially, the parties bargain without concerning themselves about pay-for-performance. Essentially, the parties bargain over the surplus created by the executive, which is a fixed surplus. It is a zero-sum game – higher pay for the manager means less profit for the owner. Suppose now, however, that the parties decide to make pay sensitive to performance. No longer is it a zero-sum game, but rather profit may rise with the executive’s pay, if pay is properly geared to performance. Given that higher pay does not simply lower the owner’s profit, it could well be that a higher expected pay level will result from bargaining.

There is a further reason why disclosure’s effect on the sensitivity of pay to performance will increase pay: risk aversion. To the extent that pay is sensitive to the firm’s performance, and the firm’s performance is imperfectly correlated with the manager’s performance, the manager bears risk and its attendant costs.<sup>48</sup> Managers are risk-averse and from this perspective alone, the ideal pay package is a straight salary. Consequently, for a risk-averse manager to be indifferent between a straight salary and a pay package with risky components, such as options, the expected payoff of the risky package

47 Jensen & Murphy, *supra* note 7 at 144.

48 See Holmstrom, *supra* note 18.

must be higher than the straight salary.<sup>49</sup> Put another way, for every given level of expected compensation, the higher the risk, the lower the executive's utility from that pay package.

In the bargain between the owner and the executive, then, one may expect that, all other things being equal, increasing the riskiness of the pay package will result in a higher absolute level of expected pay. When risky pay is introduced, maintaining the same expected level of compensation would result in lower benefits to the manager. Put another way, greater risk intensifies the manager's preference for a higher level of absolute expected pay; thus the manager will invest in bargaining to realize a higher level of expected pay. To the extent that disclosure increases the sensitivity of pay to performance, managerial risk aversion and bargaining will result in higher levels of expected pay.

A final factor contributing to the *appearance* of higher pay as the result of disclosure and increased sensitivity of pay to performance is the 'outlier effect.' Much anecdotal evidence about executive pay is gathered from annual lists of the highest-paid executives published in magazines such as *Business Week* and *Fortune* in the United States and *Report on Business Magazine* in Canada. Such lists often provide background data for critical comments about executive compensation, like Loomis's reference to the 'madness' of executive pay.<sup>50</sup> The obvious problem with reliance on such lists is that they convey exactly what they are meant to convey: extremes. Moreover, as pay becomes increasingly sensitive to performance, one may expect that the range of executive pay will widen; thus the highest-paid executives will be particularly well-paid. There are two reasons for this conclusion. First, if pay is linked to performance, then extremely profitable performance will affect pay accordingly. For example, Crystal describes the pay scheme that has made Michael Eisner of the Walt Disney Company a poster-boy of extraordinary pay, which pay topped \$200 million in 1993.<sup>51</sup> When he joined Disney in 1984, Eisner took a relatively low salary and a bonus scheme that gave him two per cent of the profit above a 9 per cent return on equity, as well as stock options. Crystal, usually a critic of the size of compensation packages, acknowledges that the scheme was not overly generous from an *ex ante* perspective, given that Disney had been a sluggish performer. It was the firm's remarkable success under Eisner that resulted in remarkable paycheques.

49 See G. Milkovich & B. Rabin, 'Executive Compensation and Firm Performance: Research Questions and Answers' in F. Foulkes, ed., *Executive Compensation: A Strategic Guide for the 1990s* (Boston: Harvard Business School Press, 1991) 81.

50 See Loomis, *supra* note 2.

51 G. Crystal, 'CEO Compensation: The Case of Michael Eisner' in Foulkes, *supra* note 49, 353.

A second reason why the best-paid lists will leap once disclosure affects pay-for-performance is that longer-term incentive plans often include stock options. When an executive decides to cash in her options, even though they may represent years of performance, her pay for that particular year will jump. Thus those executives with an extremely profitable portfolio of options will further skew the already extreme list of the best-paid executives each year.

While these reasons explain why disclosure and heightened sensitivity of pay to performance give the appearance of higher executive compensation, they do not necessarily imply that overall compensation will be higher. The simple point is that increased variability of pay will predictably raise the pay of the best-paid executives; other reasons, such as bargaining and risk-aversion, are required to explain why average compensation will rise.

To summarize, disclosure, by heightening the sensitivity of pay to performance, may increase pay because higher pay is required to give the executive significant incentives to increase profit. Disclosure also increases pay because of the disutility to risk-averse managers associated with increased riskiness of pay. Finally, it creates the appearance of higher pay by further skewing the annual lists of best-paid executives.

#### B. DISCLOSURE, THE INTRODUCTION OF PAY-FOR-PERFORMANCE, AND THE ENDOWMENT EFFECT

I concluded above that disclosure increases the sensitivity of pay to performance. A related issue is how the transition to pay-for-performance will take place. Critics of executive compensation often point to the following phenomenon as demonstrating the absence of adversarial bargaining between the executive and directors: in increasing the level of performance-sensitive pay, there is often no corresponding decline in the level of pay not sensitive to performance. Suppose, for example, that an executive's pay is initially composed of straight salary. In order to provide incentives, it is decided that a bonus plan should be introduced based on the firm's return on equity. If the executive is to be paid at the same level as prior to the bonus plan, the fixed-salary component of pay needs to be reduced. However, critics contend, what frequently occurs is that the bonus plan is implemented with only a small reduction, if any, in fixed salary. Thus, the critics conclude, pay-for-performance simply becomes a method of raising the executive's salary at the expense of shareholders.

Examples of this criticism are widespread. Crystal recalls the example from his days as a compensation specialist set out above. He recommended that the CEO cut his salary from \$160,000 to \$100,000 to make room for a bonus scheme. The CEO objected strenuously, and Crystal was no longer consulted by the firm. Crystal states that he would 'bet, however, that [the

CEO] found another compensation consultant who was willing to recommend that the company adopt a new annual incentive plan without requiring executives to cut back on their base salaries.<sup>52</sup> Crystal sees the addition of an incentive plan without a significant cutback in salary not as the result of adversarial bargaining, but rather as a result of the control that CEOs wield over the pay-setting process.

Even Milgrom and Roberts, who are generally agnostic on the subject of executive pay, appear critical of the continuation of fixed pay when variable pay is introduced:

Because it often seems that large U.S. firms add various long-term incentive pay components to their CEOs' compensation packages without obviously decreasing any of the other elements, knowledgeable observers of executive compensation consider these long-term programs the source of the relative jump in CEO pay in the 1980s.<sup>53</sup>

They note that there is an

apparent tendency of boards to add new items to CEOs' compensation packages without adjusting the size of the existing ones. Given this, a recommendation to increase the linkage between CEO and shareholder wealth through stock awards amounts to an invitation to bestow large amounts of stock on the CEOs, giving away even more of the shareholders' money to already well-paid executives.<sup>54</sup>

Commentators appear content to conclude that the continued existence of fixed portions of pay with the addition of variable pay demonstrates a divergence between the will of the shareholders and that of the directors who actually participate in the setting of compensation. While I do not wish to argue that commentators are clearly wrong on this matter, I do wish to challenge their presumption that maintenance of fixed-pay levels *necessarily* indicates an absence of adversarial bargaining in the establishment of executive compensation. In my view, even in the context set out above of an arm's-length negotiation between the single owner and the executive, there may be a bias toward retention of present levels of fixed compensation, even as variable pay is added. The underlying reason for my conclusion is the endowment effect.

Economic theory assumes that there is no salient difference between a forgone gain and an out-of-pocket loss; opportunity costs and out-of-pocket costs will be considered equally in the calculus of a rational being. Without this condition, preferences may not be rational. As an illustration, consider a ticket to a sold-out hockey game. For somebody who owns the ticket, the

52 Crystal, *supra* note 22 at 219.

53 Milgrom & Roberts, *supra* note 17 at 427.

54 *Ibid.* at 441.

opportunity cost of retaining the ticket is the price at which he could resell the ticket. For somebody who does not own the ticket, the out-of-pocket cost of obtaining the ticket is the price he would have to pay for the ticket. Suppose person A would be willing to pay a maximum of \$200 for the ticket A does not own. Economic theory dictates that if A did own the ticket, A would sell if he had an offer greater than \$200; that is, A would sell if the opportunity cost of retaining the ticket is greater than what A would have paid to purchase the ticket. If A does not follow economic theory and refuses to sell at \$201, his valuation of the ticket follows an apparently contradictory pattern: the ticket is preferred to \$200 and \$200 is preferred to the ticket, depending on his theoretically irrelevant endowment. Behavioural studies, however, show that people tend to behave precisely the way economic theory dictates they should not.

Experimental economists have demonstrated that people view opportunity costs as less important than out-of-pocket costs. Consequently, there is a bias against trading what one possesses – carrying out a trade involves an out-of-pocket cost, whereas refusing to trade involves an opportunity cost. The bias toward retaining what one possesses has been called the ‘endowment effect.’ To demonstrate the endowment effect, Jack Knetsch conducted the following experiment.<sup>55</sup> A sample of participants was divided into two groups. In one group, each participant received a mug, and in the other, each received a chocolate bar. The groups were then permitted to trade with each other. If forgone gains and losses were viewed equally, one would expect each group to contain roughly the same ratio of chocolate bars to mugs after trading. Instead, about 90 per cent of each group retained their initial endowment. Such a result, which appears to confirm the endowment effect, has been replicated consistently in other studies.<sup>56</sup>

Including the endowment effect in the negotiation over compensation between the executive and the single owner may help explain the persistence of fixed-pay levels when variable pay is introduced. Suppose an executive is paid a fixed salary alone. An endowment effect may be attached to the existence of that salary; that is, giving up all or part of the salary would be more difficult given its prior existence than it would have been if never received. Given the adverse psychological impact of giving up what he already has, the

55 J.L. Knetsch, ‘The Endowment Effect and Evidence of Nonreversible Indifference Curves’ (1989) 79 *Am. Econ. Rev.* 1277.

56 See J.L. Knetsch & J.A. Sinden, ‘Willingness to Pay and Compensation Demanded: Experimental Evidence of an Unexpected Disparity in Measures of Value’ (1984) 99 *Quarterly J. Econ.* 507; D. Kahneman, J.L. Knetsch & R.H. Thaler, ‘Experimental Test of the Endowment Effect and the Coase Theorem’ (1990) 98 *J. Pol. Econ.* 1325; and R.C. Bishop & T.A. Heberlein, ‘Measuring Values of Extramarket Goods: Are Indirect Measures Biased?’ (1979) 61 *Am. J. Agricultural Econ.* 926.

executive in a bargain with the single owner will resist lowering his salary, even at the expense of forgone gains in variable pay. On the other hand, the single owner may still believe that there would be net gains from the introduction of variable pay – the variable pay will create a larger surplus to divide. Thus even if the executive gets a larger share of the surplus by clinging to fixed salary, it may be profitable to introduce variable pay. Consequently, the endowment effect and bargaining may result in a bias toward retention of similar levels of fixed pay, even though the manager is compensated with increased variable pay.

Given that disclosure is likely to increase pressure on directors to implement variable pay, disclosure may indirectly result in the addition of variable pay without a corresponding decrease in fixed pay. Such a result may obtain even where there is adversarial bargaining between a manager and single owner who decides to increase the sensitivity of pay to performance because of the endowment effect: the disutility to the manager from losing fixed salary creates greater disutility than the potential gains to be had from increased variable pay. If, however, there are gains for the owner from variable pay even if salary is maintained at similar levels, the owner may still choose to introduce it.

### C. DISCLOSURE, INFORMATION, AND THE 'RACE TO THE TOP'

Thus far I have argued that disclosure of executive compensation may increase compensation because of its effect on pay-for-performance. By increasing the sensitivity of pay-to-performance, disclosure will most likely increase the levels of pay even in an adversarial bargaining context. In the present section, however, I discuss another reason unrelated to pay-for-performance why executive pay may increase following the implementation of mandatory disclosure rules: the information that pay levels convey to the managerial labour market.<sup>57</sup>

Some commentators view the disclosure of executive compensation, comparison with other executives' pay, and subsequent pay increases as evidence of the flaws that exist in the framework governing corporate governance. Disclosure of executive compensation, these commentators suggest, simply provides executives and boards with ammunition to raise executive pay further. Derek Bok, for example, states:

Boards of directors can seldom detect the balance-sheet adjustments that may have helped their president earn a bonus, nor are they well equipped to question the

57 For a pioneering work on signalling private information, see A.M. Spence, *Market Signaling: Informational Transfer in Hiring and Related Screening Processes* (Cambridge, MA: Harvard University Press, 1974).

judgment of the consultants whom the CEO employs to recommend his pay increase for the following year.

Under these less-than-competitive conditions, market changes that would ordinarily be benign can have perverse effects. For example, efforts to publicize the earnings of chief executives in the 1980s did not stop boards of directors from authorizing large pay increases. Rather, they spurred some chief executives to press for more money in an effort to keep pace with rival CEOs and thus helped to ratchet up executive pay even further.<sup>58</sup>

Crystal also views disclosure and rising pay as the result of a flawed framework:

A statistical average – whether it is average pay or average rainfall – is made up of a series of numbers, some of which must necessarily be lower than the resulting average and some of which must necessarily be higher ... . That being the case, it does not follow, and it cannot follow mathematically, that every CEO is entitled to earn the survey average. But try convincing a CEO of the merits of this argument.

Companies have a sort of institutional pride, and consciously paying a CEO below the average constitutes a blow to that institutional pride. Talk to a member of the board about this issue, and he'll likely tell you that 'our company is as good as anyone else's, and therefore we're not going to be cheap and pay below the average.' This pernicious thinking leads to a phenomenon called 'survey ratcheting.' If a company shows to be below the average, the CEO is given a raise to the average; or, if not all the way to the average, at least an outsized raise. Unless CEOs who are being paid above the average are given pay cuts to the average, these raises cause the survey average to rise the next year and to contribute to another round of the same behaviour. And, of course, it is virtually unheard of for a CEO to take a pay cut.

Other commentators do not offer a sinister explanation for the relationship between disclosure and pay, but rather simply treat as a given that pay levels rise as a result of comparison. For example, an editorial in *The [Toronto] Globe and Mail* speaks of the pay disclosure laws in the following manner:

The discovery that a competitor's president is paid more to do a comparable job at a comparable price will not likely push the higher-paid president's salary down, but may well force the lower-paying company to move its president's salary up or risk losing him or her. The United States has by far the world's highest-paid executives, and U.S. regulators have required disclosure of executive compensation for fifty years.<sup>59</sup>

In predicting the effect of the disclosure laws, MacNeil states that 'pay will gravitate toward the highest-paid individuals in a given class, with modest differentials that reflect the relative size of the companies.'<sup>60</sup>

58 D. Bok, *The Cost of Talent: How Executives and Professionals Are Paid and How It Affects America* (New York: Free Press, 1993).

59 'Paying the Public Pipers' *The [Toronto] Globe and Mail* (2 April 1996) A18.

60 MacNeil, *supra* note 45.

Canadian experience with extensive disclosure of executive compensation is obviously limited, but there is some suggestive evidence supporting these commentators. For example, in reading accounts of executive compensation, one discovers that increased compensation is often attributed to the influence of comparison with rivals. *The [Toronto] Globe and Mail* reported, for example, that an increase in the pay to executives at MacMillan Bloedel was motivated by a wish to have executives paid at the median level in the industry.<sup>61</sup> A Sobeco-Ernst and Young study reported in *The [Toronto] Globe and Mail* found that executives and senior management enjoyed a 7.8 per cent pay raise in 1995, while the raises for middle management and non-management employees were 5 per cent and 4.3 per cent, respectively.<sup>62</sup> Interestingly, an Ernst and Young partner is quoted as stating that one of the reasons for the increase in executive pay was the disclosure requirement:

[D]isclosure laws imposed in 1993 requiring Canadian public companies to reveal pay levels of their top [CEO] and top four executives have helped those executives negotiate raises to bring compensation in line with counterparts at other companies.<sup>63</sup>

Notwithstanding the confidence of commentators in the inflationary comparative-pay phenomenon and the existence of some empirical support for it, from a policy perspective, it would be useful to have a better understanding of the reason why this phenomenon might occur. Bok and Crystal present one possibility: boards of directors do not act as vigorous bargainers on behalf of shareholders. Disclosure allows directors to boost executive pay by relying on comparison with competitors. If a competitor pays more than the firm in question, the directors of that firm may justify to shareholders their decision to raise executive pay by comparing it with that of competitors. With each board of directors following this strategy, executive compensation will ratchet upward.

There are, however, significant flaws in this argument, at least insofar as it is used against increased disclosure of executive compensation. If directors are not effective bargainers to begin with, it is unclear why disclosure would make them worse in this respect. While pay comparison lists may well be a useful justificatory tool for directors in setting compensation, if compensation were not exposed, there would be no need for directors to

61 P. Lush, "Bargain" MacBlo Chief Got Big Raise', *The [Toronto] Globe and Mail* (21 March 1996) B1.

62 G. MacDonald, 'One-third got no raise in '95: Survey' *The [Toronto] Globe and Mail* (11 August 1995) B2.

63 Ibid.



justify the pay packet in the first place. If anything, disclosure of compensation would seem to invite tougher bargaining by directors concerned about their reputations. Exposing executive compensation should not necessarily lead to higher compensation because of infirmities in corporate governance.

Other commentators, such as *The [Toronto] Globe and Mail's* editorialist, do not necessarily treat disclosure and higher compensation as the result of weak directors; but at the same time it is difficult to discern what their view of the causal relationship is. They seem simply to accept that, for example, disclosure of two competitors' executive pay packages will result in the gravitation of pay toward the higher amount (a 'race to the top'). This poses a puzzle. In the first place, it is unclear why comparison provides lower-paid executives with an incentive to seek higher pay. Presumably, executives were content with their pay before disclosure, so why would the amount someone else earns affect their pay? Perhaps one reason is that they revise their estimate of their worth outside the relationship with their own firm, thus increasing their view of their worth to their present firm. In any event, even if, as the commentators above suggest, the lower-paid executive seeks higher pay as the result of learning what a rival earns, why does the board of the rival not equally seek to lower compensation as the result of learning what the other executive earns? That is, if pay is somehow related to the opportunities available in the market, the lower-paid person should maintain that he is underpaid, but equally the rival's board should assert that it is overpaying its executive. Pay under this process should gravitate to the middle, not to the top.

Accepting for the sake of argument that, as an empirical matter, pay does in fact rise as the result of comparison with rivals, there may be explanations that do not depend on directorial misbehaviour but rather on market forces that would exist even in the context of adversarial bargaining. First, the endowment effect may provide the better-paid manager with incentives to invest in bargaining to resist a fall in pay, despite realizing that he is paid more than the market average. Second, executives may be motivated by envy of their peers, so that discovering a better-paid peer will result in vigorous bargaining for higher pay.<sup>64</sup> A third explanation, which I will detail in this section, depends on hidden information about the executive's ability.

Consider the following model. There is a single shareholder and a single executive. The executive creates some surplus for the firm. Given that each party has specific investments in the relationship, neither party receives the

64 See Zhou, *supra* note 6, c. 1.3.3.

full surplus; rather there is bargaining over the surplus, the result of which is the executive's pay. To focus the analysis on how much executives are paid, rather than how, I will assume that the surplus created by the executive does not depend on the structure of pay; other factors serve to motivate optimally the executive. I will also assume that the surplus created depends only on the ability of the executive, which is known by the executive and the shareholder in bargaining.

To establish the informational aspect of pay that will drive the relevant result of the model, assume, for the moment, that the parties negotiate strictly over the surplus created for the firm by the executive (not over the effect of pay on future pay, as I will discuss below). I will bound the bargaining result only by stating that neither party will accept a negative sum; pay must be equal to or greater than zero, but equal to or less than the total surplus created by the executive. Both parties would prefer not to trade than to accept a negative sum. Suppose from reading annual reports that outside observers have some notion of the total surplus created by the firm, but do not know the proportion of surplus for which the executive is responsible; outsiders do not know the executive's ability. For simplicity, assume that the total surplus is 1, and the proportion of the surplus created by the executive is distributed uniformly between 0 and 1. Put another way, the ability of the executive may be represented by a uniform distribution between 0 (lowest ability) and 1 (highest ability).

It is clear in this model that, all other things equal, higher pay indicates higher ability. To take an extreme example, suppose that the bargaining skill of the executive is very high, such that she is known to capture the full surplus that she creates. Her pay is equal to her ability, since her ability is equal to the surplus she creates. Alternatively, rather than capturing the full amount of the surplus she creates, suppose the executive is expected by outside observers to capture some proportion of the surplus she creates,  $b$  (where  $0 < b < 1$ ). Her expected ability is  $1/b$  times her pay. Put another way, observation of some pay levels will eliminate certain possibilities with respect to the estimated ability of the executive. For example, the outside observer would know from the non-negative condition on the bargain that ability is at least as great as pay.

Pay thus may indicate ability. Disclosure of executive compensation permits this effect to take place. Without disclosure, obviously, there is no indication of ability from pay since outsiders do not know the pay. To the extent that transmitting this information will affect executive pay, then, disclosure will predictably affect executive compensation.

The issue now is how hidden information about ability may be predicted to affect executive compensation. I assume that although terminating the relationship between the shareholder and the executive is costly because of

bilateral specific investments, the executive knows that there is some positive probability in the future that she will no longer have a job at the firm, perhaps because of the firm's failure. I also assume that her reputation will affect her future expected pay<sup>65</sup> – that is, the higher the estimated ability of the executive by outside observers, the higher her expected future pay. The executive clearly has an interest, from the perspective of earning higher income in the future, to seek greater pay in the present in order to indicate high ability.

In bargaining with the single shareholder once disclosure is established, the executive now has an added incentive to seek higher pay. Consequently, in a bargain over executive pay, disclosure, by unleashing an incentive to indicate high ability, may result in higher pay. Whether higher pay results depends to a large extent on the effect of information on the single shareholder's incentives to bargain. Higher pay to the executive implies that factors of production in the firm other than management were less productive. The shareholder may wish to indicate that these other factors of production are indeed valuable assets, and thus may resist the executive's desire to indicate her own ability. The shareholder may also want to conceal the manager's ability from the market. On the other hand, the single shareholder may wish to signal the skill of the firm's management to capital markets, or may wish to signal to future potential managers that the firm is one in which a skilful manager can do very well, and thus may not vigorously resist the manager's desire to indicate her ability to the market.

Private information may also help explain why competitors' pay is relevant to executive pay. When outsiders observe a level of pay, as discussed above, all things being equal, the higher the level of pay, the higher the estimated ability of the executive. However, suppose now that the information about ability is obscured by a lack of knowledge about the firm's circumstances. Suppose, for example, that pay is a function of the executive's ability, bargaining skill, and other exogenous factors, such as industry conditions, which affect the size of the potential surplus that the firm, and hence the executive, can create. In observing the executive's pay, outsiders may learn something about the executive's ability, given that the executive will not be paid more than she creates in surplus, which depends in part on ability. However, it may be difficult to determine whether the surplus she produced was affected by factors exogenous to the executive's ability, such as industry conditions; thus the information about ability from observing pay may be less precise where the firm's potential surplus is unknown.

65 For a discussion of the impact of the managerial labour market on a manager, see E. Fama, 'Agency Problems and the Theory of the Firm' (1980) 88 *J. Pol. Econ.* 288.

Consider now the information conveyed by the results of bargaining in two similarly situated firms. If each executive invests in bargaining in similar ways, and if the maximum potential surplus available to each firm is correlated across firms, the observer of executive pay has better information about the ability of the executive. For example, if pay for one executive is low, an outsider observing this alone may not be certain whether exogenous industry conditions or low bargaining power contributed to this low level of pay. If, however, the executive in a similarly situated firm is paid very well, the outsider may infer that the executive with low pay created less surplus for her firm than the executive with high pay. Comparison reduces the uncertainty about the causes of the executive's pay and thus may provide better information about the executive's ability.<sup>66</sup>

We have seen that while pay in itself conveys information about ability, comparative pay may provide further information to the observer, narrowing the estimated range of the executive's possible ability. Consequently, not only will the executive want higher pay in order to indicate higher ability, but she will for the same reason want to ensure that her pay compares favourably with her rivals'. Such a benefit from a favourable comparison will grow if there is some benefit to the executive from an impressive ordinal ranking among executives (for example, if only one of the two executives in the above example will have a job in the industry in the future). If relative worth is important to the executive in the future job market, she will have an additional reason to seek compensation at least similar to, and preferably higher than, her rivals'.

In a bargain, then, between the executive and the shareholder, not only may disclosure invite higher pay because of the added intensity of the executive's desire for higher pay in itself, which desire results from pay's own informational value, but disclosure may also result in higher pay for executives seeking favourable comparisons with their rivals. Executives paid below average will have a strong desire to seek compensation closer to the average, and if they are successful through bargaining, in the future, higher-ability executives now paid around the average will seek to distinguish themselves with still higher pay. The process described by Crystal and others, whereby pay is ratcheted higher because of disclosure and pay comparisons, may well occur even in an adversarial bargaining context because of the importance of the information conveyed by pay.

As set out above, there may be countervailing considerations with respect to the single shareholder's incentives. For example, the owner may wish to develop a reputation for being a hard bargainer and resist high pay. On the

66 See B. Holmstrom, 'Moral Hazard in Teams' (1982) 13 *Bell J. of Econ.* 324 for a discussion of the positive informational effects of comparisons.

other hand, where the firm's potential surplus is unknown to outsiders but known to the executive and owner, and the owner wishes to signal a high potential surplus – perhaps to raise capital – higher pay may indicate a higher potential surplus. Thus the owner may also have an interest in high pay.

In all the above situations, an important complication arises from the fact that in negotiating pay partly with a view to conveying information, pay is affected, thus perhaps partially obscuring the informational value of pay; that is, if observers know that higher compensation is demanded by executives attempting to indicate high ability, observers will account for this potentially inflationary effect on compensation in inferring ability from observed pay. However, this distortionary effect will probably not entirely undermine the informational effect. If the owner has an opposing desire to set low pay also in order to convey information to the market, it remains true that pay may be linked to ability. No matter how much an executive with low ability wishes to emulate an executive with high ability, the non-negative condition on the firm's share of the surplus limits her capacity to do so.

Where the owner too has an interest in paying the executive well, perhaps to indicate a large surplus, the non-negative condition is not a straightforward limit on compensation. The owner could conceivably pay more than what the executive is worth in order to signal a high potential surplus, which in turn may obscure the informational value of higher pay. On the other hand, the amount a firm could pay would be limited. At some point, a low-surplus firm would probably find it too expensive to overpay its executive in an attempt to emulate a high-surplus firm, in which case, pay will convey information about ability and the firm's surplus. For example, solvency concerns may limit the capacity of a firm to pay high amounts in order to signal a high surplus.

The conclusions in this section are not definite with respect to the effects of disclosure on pay; the effects depend on the managers' and owners' bargaining incentives in reality. However, these conclusions present at least one possible explanation both for an inflationary effect of disclosure and for the importance of comparing pay.

#### *V Conclusion: Policy Implications*

I have discussed in this article several phenomena associated with disclosure of executive compensation. Disclosure is predicted to increase shareholder control over the way executives are paid. Disclosure lowers the shareholders' cost of monitoring the setting of executive compensation and publicizes the results of shareholder activism, thus encouraging shareholder supervision, particularly because of the recent rise of the institutional investor.

Moreover, disclosure compels directors to give reasons for their choice of compensation structures, and therefore directors who care about their reputations will carefully consider how executives are paid. From a policy perspective, the better alignment of executive pay with the wishes of shareholders is the most important aspect of disclosure. There is evidence that adopting incentive-enhancing performance pay has significant, positive effects on shareholder value. For example, Brickley, Bhagat, and Lease find that adopting a long-term incentive plan increases the return to shareholders by 2 per cent.<sup>67</sup> As *The Economist* states, 'pay can have a powerful effect on managerial behaviour. It is worth getting right.'<sup>68</sup> Disclosure helps shareholders get it right.

On the other hand, disclosure may also have an inflationary effect on compensation levels. The article attempted to provide reasons for this tendency that are independent of the various infirmities in corporate governance that commentators associate with the setting of executive pay. The policy conclusion to be drawn from this discussion is that political interference either with disclosure specifically or with executive compensation generally should not be based on casually drawn inferences.

Part of the inflationary effect, I have suggested, is attributable to the impact of disclosure on shareholder control over pay. If shareholders decide that pay should be more closely linked to performance, increased pay-for-performance may require higher pay in order to provide appropriate incentives. Moreover, the increased variance of pay will increase the cost of the packet's risk to the executive. An executive with an aversion to risk is thus in a position to bargain for a higher level of pay to compensate for the higher risk. Given that disclosure better aligns pay with shareholders' wishes, if the reasons advanced here are responsible for higher pay, there should be no hesitation in confirming disclosure regimes as desirable. Shareholders will adopt variable pay to create wealth and will accept the minor redistribution to executives that may coincide with it.

A potentially misleading (but, I suspect, important to the public) aspect of disclosure is its effect on increased variable pay, and the subsequent effect on the extremes observed in 'Top Fifty' lists. Such lists, which are often the focus of popular discussions of executive compensation, will not reflect the overall effect of disclosure on compensation levels. There is no policy principle to be drawn from the observation that the highest-paid individuals

67 J. Brickley, S. Bhagat & R. Lease, 'The Impact of Long-Range Compensation Plans on Shareholder Wealth' (1985) 7 *J. of Accounting Econ.* 115. See also H. Tehranian & J. Waegelin, 'Market Reaction to Short-Term Executive Compensation Plan Adoption' (1985) 7 *J. of Accounting Econ.* 131.

68 *The Economist*, supra note 3 at 19.

are better paid under disclosure and thus increased variable pay. Even if there were legitimate concerns about very generous compensation, 'Top Fifty' lists do not demonstrate higher overall compensation.

The endowment effect may disturb the transition to more variable compensation schemes. Absent such an effect, an executive may be indifferent between continuing to receive a certain salary and discontinuing the salary in exchange for receiving a more variable pay package with a higher expected value to compensate for risk. Given the psychological attachment to what he has received in the past, however, the executive may successfully bargain to retain a larger fixed component of pay than what otherwise would have resulted. Given that increased incentive pay may increase shareholder wealth regardless of the executive's receipt of a salary, the endowment effect may result in a bargain whereby the executive retains his salary, but is granted an additional variable pay package.

The addition of variable pay without a corresponding decrease in fixed pay does not, as some commentators have implied, necessarily mean that there is a corporate governance problem in the establishment of executive pay. A similar outcome could result from adversarial bargaining between an executive and a single, informed shareholder who has decided to increase the sensitivity of pay to performance. From a policy perspective, therefore, an increase in variable pay without a similar (risk-adjusted) decrease in fixed pay is not necessarily a matter of concern. The endowment effect may redistribute funds from shareholders to managers, but it will occur independent of any corporate governance policy. The important policy point is that disclosure may permit shareholders greater involvement in the decision to implement variable pay. The implication this in turn has for wealth creation is the point of central concern.

The discussion thus far has centred on the effect of disclosure on performance pay and hence on pay levels. But disclosure, by potentially conveying information about the executive's ability, may also have a direct impact on pay levels. Executives wishing to indicate superior ability will seek higher compensation and compensation that compares well with that of their rivals. Again, the apparent phenomenon not only of higher pay as the result of disclosure, but of reliance on comparison to achieve the higher pay does not necessarily imply that weak directors are using comparison pay to justify overpaying executives. Bargaining between true adversaries could bring about a similar result.

It is more difficult to answer whether the informational effect resulting from disclosure should be viewed negatively from a policy perspective. The other factors pushing pay higher depend on a socially desirable transition to increased pay-for-performance, whereas the informational effect, if it occurs, results independently of desirable changes to incentive pay. It affects

how much executives are paid without affecting how executives are paid. To the extent that policy is concerned about the distribution of wealth in society, this may serve simply to make the wealthy wealthier in a socially undesirable way. On the other hand, a social benefit may arise from the provision of additional information to the managerial labour market.

As mentioned in the introduction, commentators have suggested that disclosure may unleash political pressures that serve to constrain the efficiency of the contracts offered to executives.<sup>69</sup> I have in this article set out several reasons why various observed phenomena in the setting of executive compensation following disclosure may not necessarily result from flaws in the governance framework, but rather may occur in an adversarial model. Disclosure may have a natural tendency to inflate pay, but this may largely result from a desirable transition to variable pay. Such analysis cautions against politically treating executive compensation any differently from high pay in other settings, such as the entertainment and sports industries. Even if disclosure results in higher pay, this may be the result of socially desirable developments, such as more efficient reliance on incentive pay, and thus not worthy of censure.

69 Jensen & Murphy, *supra* note 8; Zhou, *supra* note 6.