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Two CEO pay challenges that Mike Jensen has left us to keep working on

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INTRODUCTION

The late Michael Jensen was the most influential finance and corporate governance scholar of the last century. And Mike and his colleague Kevin Murphy have been the most noted academic thinkers on executive pay.

As a practitioner who has long tried to use academic theory to improve company practice, I've long admired Mike and Kevin because they have not been just good at theory, but very interested in corporate practice and gone to great lengths to understand and improve it. Mike served on the board of Armstrong World Industries, and Kevin spent a year on leave at Towers Perrin to learn more about the compensation consulting business. In their widely cited 1990 article in the *Harvard Business Review*, "CEO Incentives—It's Not How Much You Pay, It's How," Mike and Kevin began by expressing their conviction that "compensation policy is one of the most important factors in an organization's success."[1] They then went on to create a new kind of executive compensation survey, one that reports "who's paid the best" and not "who's paid the most." In so doing, they looked at annual pay while also making estimates of executive wealth, including the present value of expected future pay, and used that information to measure the sensitivity of an executive's wealth to changes in shareholder wealth. The conclusion their analysis led them to was that "corporate America pays its most important leaders like bureaucrats"—an assessment that is widely seen as sparking the explosion in executive pay after 1990.

In a series of other papers—and in a book (as yet unfinished) they were working on called "CEO Pay and What to Do About It: Restoring Integrity to both Executive Compensation and Capital-Market Relations"[2]—Mike and Kevin identified what they saw as ten major problems with existing corporate bonus plans, and then cited several public company plans that went at least part of the way in solving such problems.

As a practitioner and a big fan of Mike and Kevin's work, I've been disappointed that these two major contributions to the executive pay literature—their proposals for better bonus plans, and their development of a wealth-based measure of incentive strength that takes account of expected future pay—have ended up having so little effect on US corporate pay practices (apart from the big increase in overall level of CEO pay). US public companies, along with compensation consultants and proxy advisors, have long continued to be content with using percentage of pay at risk as a proxy for incentive strength while making no effort, as Mike and Kevin did, to estimate the sensitivity of expected future pay to changes in shareholder wealth. The bonus plans of US companies also continue to rely heavily on the use of caps, floors, and discontinuities (or "kinks"), thereby ignoring Mike and Kevin's call for uncapped fixed percentage interests.

In this article, I'd like to start by paying tribute to Mike and Kevin's work on executive pay, and then offer my own explanation of why its impact on corporate practice (again, apart from today's higher levels of executive pay) has been so limited.

TWO EXEMPLARY BONUS PLANS

Let's start with the two public company bonus plans that Mike and Kevin offer (in Chapter 8 of their unfinished book) as examples to guide other companies, a management bonus plan at Expeditors International and Michael Eisner's plan at Walt Disney. Mike and Kevin were attracted to these two plans mainly because both provided *uncapped* fixed sharing based on a single measure of profit. And both plans appear to have worked well for a long time. The Expeditors International plan has now been in place for over 39 years, and the Eisner plan was used for 13 years, a very long life for an executive incentive plan. But, as we'll see, both plans encountered problems that led to the introduction of the plan features like caps and floors that Mike and Kevin objected vigorously to.

[1] Jensen, and Murphy. 1990. "CEO Incentives – It's Not How Much You Pay, But How." *Harvard Business Review*, 139.

[2] Though the book was never completed, drafts of several chapters have been published or posted online. Chapter 8, which I rely on here, was posted online as "CEO Bonus Plans: And How to Fix Them," and it's available at ssrn.com/abstract = 1935654. A shorter version of this article appears in this issue of the *JACF*.

EXPEDITORS INTERNATIONAL

In 1985, Expeditors International adopted a bonus plan that gave management 10% of quarterly operating income subject to a so-called high-water mark. The high-water mark required that any operating losses be recovered before new bonuses were paid. Mike and Kevin liked this plan because the stated sharing percentage, combined with the high-water mark, ensures that it provides fixed sharing in a *dollar* measure (as opposed to a ratio)[3] of cumulative performance. One big virtue of fixed sharing is that, unlike most conventional bonus plans, it provides "no incentive to engage in excess risk-taking, since the rewards for positive profits are the same as the penalties for losses."[4]

In the conclusion of chapter 8, Mike and Kevin say that the sum and substance of their recommendations for corporate bonus plans can be "implemented in five simple steps"—and here they are:

> "First, use only performance measures that are expressed in dollars (e.g., operating income, net income, economic profit) [thus avoiding ratios, which are easier for managers to game]. For executives involved in capital decisions, it is important that [the] performance measure includes a direct or indirect capital charge."
>
> "Second, use only performance benchmarks (or standards, targets, etc.) that are not controlled by the executives in the plan, or that do not change based on prior-year performance."
>
> "Third, give managers an uncapped percentage share of performance (measured in dollars relative to the benchmark)."
>
> "Fourth, introduce direct or indirect 'negative bonus' opportunities [that is, adjustments or clawbacks for substandard performance] through the use of cumulative performance, bonus banks, or salary reductions coupled with enhanced bonus opportunities."
>
> "Finally, always reserve the right to make ex post adjustments to bonuses (including recovery of already-paid bonuses)."[5]

In what follows, I credit the Expeditors plan with achieving not all five, but just three and a half, of Mike and Kevin's prescribed steps because the plan lacks a capital charge, and it fails to make completely adequate provision for subjective ex-post adjustments to bonuses.

The Expeditors plan was adopted in 1985 and, although it has remained in effect through at least the end of 2023, it has drawn a lot of criticism from proxy advisors and other investors over the years. The Expeditors' Say on Pay approval rate in 2014 was only 44%. This limited approval was due, in part, according to the company's 2016 proxy, to the following perceived shortcomings of the plan: award of an $8 million "retirement bonus" to the retiring CEO, coming on top of "perceptions" that "NEO [Named Executive Officer] incentive cash compensation was… too large in relation to recent growth," that "equity should represent a larger component of overall NEO compensation," and that "there should be a cap on NEO cash compensation."[6]

In response to these criticisms of its by then long-established plan, the Expeditors' Compensation Committee reduced the pool allocations to the top five executives and adopted, for the first time since the start of the plan almost 40 years ago, a payout cap. The quarterly payout cap was 115% of the highest bonus paid in the prior three comparable quarters. In 2017, this cap was replaced by a provision that reduced calculated bonuses by 5% when operating income growth was less than 5%. In addition, the bonus awards for NEOs were reduced by the target value of their performance share awards.[7] Also red flags for Mike and Kevin, the revenue and EPS targets for the performance shares were based on budgets, and the awards were limited by performance thresholds and caps.[8]

Mike and Kevin were adamantly opposed to the use of targets based on budgets because, in their words, "tying bonuses to budgets not only distorts the budgeting process, but is one of the major forces leading to the general loss of integrity in organizations; these plans teach CEOs and their subordinates to lie in annual budget negotiations."[9] They also objected strongly to the use of thresholds and caps because they "destroy value by providing incentives to withhold effort, to shift earnings and cash flow unproductively from one period to another, and to manipulate earnings counterproductively in other ways."[10]

At the same time, Mike and Kevin recommended that the performance measures providing the basis for Expeditors' top management bonus plans be amended to include a charge for the use of investor capital. But it seems worth pointing out here that although the use of a capital charge would have reduced the shareholder cost of the bonus plan at Expeditors, it's not clear that it would have been enough to silence the investor complaints.

MICHAEL EISNER'S BONUS PLAN AT DISNEY

In 1984, when Michael Eisner joined Walt Disney from Paramount Pictures, he agreed to a 6-year contract that provided an option grant on 2.04 million shares exercisable at the current market price of $14.36 and a bonus plan that provided for an

[3] Jensen was fond of saying about corporate performance measures in general, "If it's a ratio, it must be wrong."
[4] "CEO Bonus Plans: And How to Fix Them", p. 12.
[5] "CEO Bonus Plans: And How to Fix Them," pp. 59–60.
[6] Expeditors International proxy statement, March 24, 2016, p. 26.
[7] Expeditors International proxy statement, March 23, 2017, p. 5.
[8] Expeditors International proxy statement, March 23, 2020, pp. 22–23. The sixth of Mike and Kevin's 10 recommendations in the body of the chapter is "Performance measures should not be ratios." (p. 31) They note that "this ratio performance measure [EPS] will lead to incorrect decisions." (p. 30)
[9] "CEO Bonus Plans: And How to Fix Them," p. 18, 4.
[10] "CEO Bonus Plans: And How to Fix Them," p. 2.

annual bonus equal to 2% of net income in excess of 9% of book equity. Mike and Kevin praised Eisner's plan as solving "many of the problems we've discussed in this paper" by providing fixed sharing in income, including a capital charge, and using a fixed performance standard—the capital charge percentage—instead of "a benchmark based on budgets, prior-year performance, or any other metric that Eisner directly or indirectly influences."[11] But it didn't have all of Mike and Kevin's "five simple steps"; it lacked a high-water mark to ensure that any earnings shortfall below 9% was recovered before additional bonus was paid, and it didn't provide for any subjective ex-post adjustments to bonuses.

In 1989, when Eisner renegotiated his employment contract for a 10-year term, he received a second option grant on two million shares, with 75% of the options exercisable at the current market price of $68.56 and the other 25% exercisable at $78.56, as well as a revised bonus plan that provided for an annual bonus equal to 2% of net income over 11% of book equity.[12]

Things went fine for Eisner and Disney until July 1995, when Disney acquired ABC, and the bonus plan no longer seemed to work. The crux of the problem was that the acquisition of ABC—which closed in February 1996—added $18 billion of goodwill to Disney's balance sheet; and by increasing the company's common equity from $6.7 billion to $16.1 billion, required Disney to earn an extra $1 billion just for Eisner to maintain his old bonus. The result of such merger accounting—and the unforeseen disruptor of Eisner's bonus arrangement—was that the merger caused Disney's return on equity to plummet from 21% in 1995 to 8% in 1996, reducing Eisner's formula bonus to zero.[13]

The completely sensible response of Disney's board was to change the calculation of Eisner's 1996 bonus to "the pro-forma financial results of the Company for fiscal 1996," which excluded "the effects of the acquisition of ABC."[14] But one consequence of the merger was that, in the years after 1996, Eisner never again had bonuses with fixed sharing or based on a formula.

But, again, the crux of the problem in this case was neither Eisner's bonus formula (nor his performance), but the inability of conventional acquisition accounting to capture economic reality. This was a problem that Disney was either never able, or never found it worthwhile trying, to figure out how to solve. But here's how they—and Mike and Kevin—might have thought about the problem:

Acquisitions, particularly large stock-for-stock deals, sometimes transfer value from buying to selling shareholders. The acquired company's stock price goes up, while the acquirer's stock price goes down. But conventional acquisition accounting can greatly reduce economic profit (i.e., profit minus a capital charge) even when an acquisition is perceived by the market to have immediate significant net benefits to the acquirer—and the acquirer's stock price rises to reflect those benefits.

But economic profit goes down in such cases because conventional GAAP accounting puts the entire market value of the acquired company on the acquiring company's balance sheet. To avoid such a drop in economic profit, the acquiring company needs to find a way to earn a current cash return equal to the cost of capital on the market value of the acquired company. And since the drop in Eisner's formula bonus reflected bad accounting, not poor performance, what Disney might have done was to adopt the kind of "strategic value accounting" we developed at Stern Stewart in the early '90s to reflect the gradual returns on promising long-term investments (which Disney's acquisition of ABC clearly turned out to be).[15]

But instead of adjusting its internal accounting, what Disney's board did instead was to develop a new Cash Bonus Performance Plan that became the basis for Eisner's bonuses in 1997 and 1998. This was a discretionary plan (as opposed to the capless, formula-driven, fixed-sharing plan it replaced) that was designed to qualify as "performance-based compensation" under the tax law. It allowed the use of multiple measures and set an annual bonus cap of $15 million for Eisner.

In 1999, Eisner's employment contract was modified yet again to provide a new formula bonus. This formula gave Eisner a declining share of net income growth in excess of 7.5% cumulative growth,[16] in accordance with which Eisner's share declined from 5.75% in 1999 to 0.40% in 2006.[17] This formula, although approved by shareholders, never ended up being used to determine Eisner's bonus.

In 1999, Disney and Eisner further amended his employment agreement to provide that his bonus for 1999 would be determined under the Company's Annual Bonus Performance Plan and a new formula would be negotiated for future years.[18] And in 2000, they agreed to determine his bonus under the Annual Bonus Performance Plan for the remaining 6 years of his employment agreement.[19]

As this example makes clear, it was basically problems with acquisition accounting that led Disney do things that Mike and Kevin had major objections to. They abandoned fixed sharing across time, added payout thresholds, and rewarded income growth without regard to capital and its cost.

PROBLEMS LEFT UNADDRESSED BY MIKE AND KEVIN'S BETTER BONUS DESIGN

Mike and Kevin were looking for a bonus plan design that succeeded, to the extent possible, in identifying and rewarding "the CEO's personal contribution to the value of the firm."[20] Expeditors and Disney represented progress in this effort but were by no means the end of development. Mike and Kevin's efforts have inspired others and, in so doing, led to further bonus plan improvements.

[11] CEO Bonus Plans—And How to Fix Them", p. 38.
[12] Crystal, Graef S. 1991. *In Search of Excess: The Over-Compensation of American Executives*, 164–65. New York, NY: W.W. Norton.
[13] Walt Disney 10-K405 filed 12/19/96 for the period ending 9/30/96.
[14] Walt Disney Company proxy statement, January 9, 1997, p. 10.
[15] Investors willingly pay a premium over the perpetuity value of a company's current earnings because they expect growth in economic profit. Acquisition accounting says that a company is performing poorly if it doesn't immediately earn a current cash return on the premium—which makes no sense. See Young, S. David, and Stephen F. O'Byrne. 2001. *EVA and Value-Based Management*, 236–47. New York, NY: McGraw-Hill.
[16] The plan defined net income growth as [EPS – threshold EPS] × shares outstanding used for the EPS calculation where threshold EPS was average EPS for 1997–98 (but not less than $2.75 nor more than $3.25) increased by 7.5% per year for each year after 1998. Disney proxy January 9, 1997, p. 22.
[17] Walt Disney Company proxy statement, January 9, 1997, p. 23.
[18] Walt Disney Company proxy statement, January 5, 2000, p. 13.
[19] Walt Disney Company proxy statement, January 12, 2001, p. 15.
[20] "CEO Bonus Plans," p. 27.

Mike and Kevin were fans of the consulting firm Stern Stewart & Co., and their bonus chapter gratefully acknowledges the "valuable comments and suggestions" of Al Ehrbar, Joel Stern and Bennett Stewart of Stern Stewart & Co. As the head of the firm's compensation practice from 1992 to 1998, I led the firm's efforts to improve the Eisner type plan—that is, fixed sharing in EVA—efforts that, by 1994, had produced a new, or "second generation" of Stern Stewart bonus plans. Since these plans are not mentioned in Mike and Kevin's chapter, I thought I'd provide a brief look at them here and show how they represented an advance over the plans blessed by Mike and Kevin.[21]

The second-generation Stern Stewart bonus plans began by making the bonus earned equal to the sum of a target bonus plus and a fixed share not of the performance measure (EVA), or even of the increase, or "improvement," in EVA. Instead, we came up with a measure that we called "excess EVA improvement." Stated as briefly as possible, excess EVA improvement was the amount by which a manager or business unit increased its EVA after subtracting from it the amount of expected EVA improvement built into its stock price (or other estimate of its current market value).[22]

After being calculated and declared in accordance with this formula, the bonus earned was then credited to a bonus "bank" to determine the bonus actually paid out. The bonus paid was the bonus bank balance, up to the target bonus, plus just a third of any excess above the target bonus. The other two thirds of any excess was deferred and at risk if future earned bonuses were negative.

What were these second-gen EVA-based Stern Stewart plans meant to accomplish? The basic idea was this: If a manager succeeded in producing just the expected increase in EVA projected in its current valuation, the manager would earn a target bonus—no more no less—designed to match labor market norms at the time (the kind of thing that could be readily provided by the HR departments). But to the extent the manager either outperformed (or underperformed) this market-based benchmark, his or her reward (or penalty) would be a fixed share of that unexpected outcome.

Viewed in this light, the aim of the Stern Stewart bonus plan can be seen as providing the fixed-sharing framework for an equitable partnership between a company's employees and its investors. Employees received competitive pay in the labor market if and only if investors received a competitive return in the capital markets.

So, unlike the formulas at Expeditors and Disney, the new Stern Stewart bonus plan design explicitly incorporated market levels of pay, making it possible to provide average pay for average performance and to avoid excessively high (or low) pay that results from the growth of the capital base, not superior performance. At Disney, for example, the targets for Eisner's expected improvement in economic profit could easily have adjusted for acquisition goodwill in a fair way, recognizing his contribution to Disney's longer-run profitability and value.

The new Stern Stewart EVA bonus was used by several hundred companies at its peak, but few companies currently use EVA in their bonus plan. Many companies dropped the Stern Stewart bonus plan after industry downturns led to significantly negative bonus bank balances.[23] Although the expected EVA improvement concept provides a mechanism to adjust for industry performance, few EVA companies were willing to accept the complexity of a formula-driven industry adjustment that would have preserved uncapped fixed sharing in a performance measure with a name like "excess improvement in EVA net of industry."

As Mike and Kevin tell the story, EVA's vogue ended up a brief one mainly because consulting firms like Stern Stewart competed "by touting the superiority of their uniquely complex renditions and accounting adjustments"—which in turn caused companies to focus "on the adjustments rather than on the simple compelling logic of EVA.[24] My own view of the EVA bonus plan's limited run is quite different. It begins by focusing on the absence of general agreement on best methods of measuring incentive strength and alignment. Without such agreement, it became a hugely difficult task to convince directors, compensation consultants, and proxy advisors that the complexity needed to maintain uncapped fixed sharing was well justified by the expected gains in incentive strength and alignment. Which brings us to the second of Mike and Kevin's unfinished major undertakings vis-a-vis CEO pay: developing a good measure of incentive strength.

TOWARD A BETTER MEASURE OF INCENTIVE STRENGTH

"Unless directors recognize the importance of incentives," they wrote in their much-cited *Harvard Business Review* article on CEO pay, "large companies and their shareholders will continue to suffer from poor performance."[25] Mike and Kevin's measure of incentive strength was the change in executive wealth associated with a $1000 change in shareholder wealth. Their measure was based on a very comprehensive analysis that broke down an executive's change in wealth into five components: changes during the past year in (1) current salary and bonus; (2) the present value of expected future salary and bonus; (3) expected future pay resulting from an increase in the probability of dismissal; (4) the value of stock options; and (5) the value of company stock. For 430 US public companies, they ran individual company regressions to estimate the change in current salary and bonus, and another set of individual company regressions to estimate the change in the present value of expected future salary and bonus. They also constructed a logit model that made use of information about the careers of 2505 US public company CEO careers to estimate, at any given time, the probability of dismissal and its sensitivity to company performance.

One conclusion of Mike and Kevin's analysis was that the wealth of the median CEO of the 250 largest companies in their study changed by only $2.59 for every $1000 change in shareholder wealth. What's more, almost three-quarters of that change came from the CEOs' stock and stock options. And as we noted

[21] O'Byrne, Stephen F. 1994. "EVA and Management Compensation." *ACA Journal* 3(2, Summer). The ACA Journal was the American Compensation Association Journal. It later changed its name to the WorldatWork Journal.

[22] The expected improvement was the increase in EVA required for investors to earn just the cost of capital on the market value of their investment.

[23] See O'Byrne, Stephen F., and S. David Young. 2009. "Why Capital Efficiency Measures Are Rarely Used in Incentive Plans: And How to Change That." *Journal of Applied Corporate Finance* 21(2, Spring).

[24] "CEO Bonus Plans," p. 34.

[25] "CEO Incentives – It's Not How Much You Pay, But How," p. 149.

earlier, they described the "most important leaders" of "corporate America" as paid "like bureaucrats."[26]

Mike and Kevin's work on incentive strength has been very widely used in academic research. In 2023, JSTOR listed 10,458 citations of their companion paper in the *Journal of Political Economy*. But it's also been widely criticized, in part because it seems to suggest that a large company CEO could never—at least given then prevailing pay levels—have a strong incentive to increase shareholder wealth.

Some of these same early critics argued that a better measure of incentive strength was the dollar change in executive wealth associated not with a $1000 increase, but rather with each 1% change, in shareholder wealth.[27] And other, somewhat more recent critics have argued that the best measure of incentive strength is the *percentage* (not the dollar) change in executive wealth associated with a 1% change in shareholder wealth—a measure that is my own favorite, and that I refer to as "wealth leverage."[28]

Unfortunately, neither users nor critics of Mike and Kevin's careful analysis of the sensitivity of expected future pay to changes in shareholder wealth have managed to advance and gain a wider audience for it. The users have seized on Mike and Kevin's finding that stock and options accounted for 75% of the median CEO's incentive and decided that there was little value in trying to duplicate Mike & Kevin's extensive analysis of the sensitivity of expected future pay to current performance.[29]

I agree with the critics who have argued that the ratio of the percentage change in executive wealth to the percentage change in shareholder wealth is a better measure of incentive strength than Mike and Kevin's measure.[30] Let's look at an example to appreciate the differences between the two approaches. In a 2010 paper, David Young and I estimated the wealth of Exxon-Mobil CEO Rex Tillerson at the end of 2006 at $208 million, consisting of $42 million in stock and option holdings, $16 million in current year incentive pay, $133 million in the present value of expected future incentive pay, and $18 million in current and projected future salary.[31] Based on these numbers, we also estimated that Tillerson's wealth leverage was 0.35. In other words, we expected each 1% change in Exxon-Mobil shareholder wealth to increase Tillerson's wealth by 0.35%, or $728,000. We also showed that his wealth leverage was at the 25th percentile of S&P 1500 CEOs—which was well below the median wealth leverage of 0.66—and that switching a quarter of his equity compensation to fixed-share grant guidelines would raise his wealth leverage to 0.5.

Mike and Kevin's approach, by contrast, would have focused on Tillerson's dollar wealth change of $728,000 as a percentage of the Exxon-Mobil shareholder wealth gain. A 1% increase in shareholder wealth at the end of 2006 would have increased Exxon-Mobil shareholder wealth by $4.5 billion, suggesting that Tillerson was getting just 16 cents for each $1000 of shareholder wealth gain (and putting him at just the 4th percentile of Mike and Kevin's 1990 ranking).[32] And switching a quarter of Tillerson's equity compensation to fixed share grant guidelines, and thereby raising his wealth leverage to 0.5, would have increased his wealth gain to only 23 cents for each $1000 of shareholder wealth and to the 6th percentile of the Jensen-Murphy rankings.

I have little doubt that Tillerson would have been highly motivated by a business strategy that promised to double shareholder wealth if his pay plans ensured that it would also double his own wealth—even if, as Jensen-Murphy's analysis was telling us, he could only expect to receive 46 cents for each $1000 of shareholder wealth gain.[33] At the same time, it's also reasonable, as critics have argued, to assume the dollar impact of his decisions increases with the size of the company.

But despite this case for introducing a measure of wealth leverage, the academic critics of Mike and Kevin's "dollar-dollar" measure, with a single exception,[34] have never tried to replicate Mike and Kevin's idea of a survey of "who's paid the best."[35]

Both groups abandoned Mike and Kevin's careful empirical work assessing the sensitivity of expected future pay to current performance. With no one following their lead on this, few academics noticed as operating companies and proxy advisors increasingly embraced "competitive pay policy," the notion that companies should provide competitive pay regardless of past performance. And as I have spent the last two decades trying to demonstrate,[36] competitive pay policy has had the unintended, and largely unnoticed, effect of making the expected future pay and wealth of US public company CEO pay largely independent of current performance.

The cumulative net effect of such policy has been a significant reduction in US CEO pay-for-performance. For example, my own recent study with Shiva Rajgopal and two other accounting professors suggests that the rise of competitive pay practices in US public companies during the past 30 years has completely offset

[26] Jensen, and Murphy. 1990. "CEO Incentives – It's Not How Much You Pay, But How." *Harvard Business Review*, 138.

[27] Hall, Brian J., and Jeffrey B. Liebman. 1998. "Are CEOs Really Paid Like Bureaucrats?" *Quarterly Journal of Economics* 113(3).

[28] Edmans, Alex, Xavier Gabaix, Tomasz Sadzik, and Yuliy Sannikov. 2012. "Dynamic CEO Compensation." *Journal of Finance* LXVII(5). O'Byrne, Stephen F., and S. David Young. 2010. "What Investors Need to Know About Executive Pay." *Journal of Investing* (Summer).

[29] For example, in one study Charles Himmelberg and Glenn Hubbard ignore the present value of expected future equity compensation and use three times current cash compensation as a "crude proxy" for the present value of expected future cash compensation. Himmelberg, Charles P., and R. Glenn Hubbard. "Incentive Pay and the Market for CEOs: An Analysis of Pay-for-Performance Sensitivity." available at ssrn.com/abstract = 236089.

[30] A year after Mike and Kevin's study, I published a study showing that typical US public company CEOs had wealth leverage of only 0.4, that is, a 1% change in shareholder wealth resulted only in a 0.4% change in CEO wealth, including the present value of expected future pay. And I showed how fixed share bonus plans and equity grant guidelines could be used to raise wealth leverage to 1.0. See O'Byrne, Stephen F. 1991. "Linking Management Performance Incentives to Shareholder Wealth." *Journal of Corporate Accounting and Finance* (Autumn): 91–99. In a mid-1990s visit to the Stern Stewart EVA Institute, Mike expressed enthusiasm for the wealth leverage concept.

[31] O'Byrne, Stephen F., and S. David Young. 2010. "What Investors Need to Know About Executive Pay." *Journal of Investing* (Summer).

[32] Jensen, Michael C., and Kevin J. Murphy, Full Survey and Technical Appendix to "CEO Incentives – It's Not How Much You Pay But How." Working Paper MERC 90-05, Simon Graduate School of Business Administration, University of Rochester, table 2.

[33] He would get 23 cents per $1000 with wealth leverage of 0.5, so he would get 46 cents per $1000 with wealth leverage of 1.0.

[34] The one exception is my co-author S. David Young of INSEAD. See Young, S. David, and Stephen F. O'Byrne. 2001. *EVA and Value-Based Management*, 364–75. New York NY: McGraw-Hill.

[35] Alex Edmans and his co-authors, in their brilliant paper on Dynamic CEO Compensation, show the calculation of wealth leverage only for a hypothetical example where a CEO's expected future pay is known and deposited in a trust account. See Edmans, Alex, Xavier Gabaix, Tomasz Sadzik, and Yuliy Sannikov. 2012. "Dynamic CEO Compensation." *Journal of Finance* LXVII(5).

[36] For an account of my career-long efforts to establish a standard measure of wealth leverage and demonstrate the drop in US CEO pay for performance stemming from "competitive pay policies," see Chew, Don. "The Perennially Vexing Question of U.S. CEO Pay, and Steve O'Byrne's Quest for the Perfect Pay Plan." In Don's forthcoming book, *The Making of Modern Corporate Finance*. Columbia Business School Press.

the positive incentive effect of the remarkable rise in percentage of pay in equity—from 40% in 1995 to 65% in 2023—during the same period, and often attributed to Mike and Kevin's 1990 article.[37] In other words, using measures like Edmans's DIA incentive and my own concept of wealth leverage, one would reach the dispiriting conclusion that US public company pay practices have not progressed nearly as much as even most finance scholars seem to believe—that the worst-performing US CEOs have been getting paid too much, while the best continue getting too little… while receiving and accepting offers to move to private equity.

As my work on wealth leverage also suggests, private equity remains a bastion of strong management and director incentives, continuing to rely heavily on pay practices that Mike hailed some 35 years ago in his most cited and famous *Harvard Business Review* article, "Eclipse of the Public Corporation."[38] The remarkable rise and continued success of what has become a global private equity movement is perhaps the best proof of Mike and Kevin's conviction that "compensation policy is one of the most important factors in an organization's success."[39]

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CEO pay, cumulative performance, incentive strength, wealth leverage

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[37] Ferrari, Mascia, Stephen O'Byrne, Shivaram Rajgopal, and Francesco Reggiani. "Competitive Target Pay Practices for CEO Compensation." forthcoming revision to be available at ssrn.com/abstract = 4180660.

[38] Jensen, Michael C. 1989. "Eclipse of the Public Corporation." *Harvard Business Review*.

[39] "CEO Incentives-It's Not How Much You Pay, But How," p. 139.