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Ethical Finance Research Series

Challenges to Executive Compensation

Challenges to Executive Compensation

This booklet summarizes the results of presentations and panel discussions of the conference "Challenges to Executive Compensation". The conference was held on 2 November 2004 at the University of Zurich as the second event in the Ethical Finance Research Series.

Ethical Finance Research Series

The Ethical Finance Research Series provides a forum for fostering intellectual exchange among academics and practitioners on issues affecting today's financial industry with a focus on ethical concerns. The general purpose of this series is to provide professionals with comprehensive knowledge on current academic research and to stimulate ethical discussions between academics and practitioners. For more information, see www.nccr-finrisk.ch/ethicalfinance

The Series is jointly organized by the CCRS, the Center for Corporate Responsibility and Sustainability at the University of Zurich, and the National Centre of Competence in Research "Financial Valuation and Risk Management" (FINRISK). It is supported by the Swiss Banking Institute, the Center of Competence Finance in Zurich, and the University Research Priority Program "Finance and Financial Markets" at the University of Zurich.

The conference organizers highly appreciate the continuous support of the President of the University of Zurich, Professor Hans Weder.

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The Swiss National Science Foundation (SNSF) launched the **National Centre of Competence in Research "Financial Valuation and Risk Management"** at the end of 2001. FINRISK is an academic forum that fosters cutting-edge finance research, education of highly qualified finance specialists at the doctoral level and knowledge transfer between finance academics and practitioners. It is managed from the University of Zurich and includes various academic institutions from Basel, Geneva, Lausanne, Lugano, Neuchatel, St. Gallen and Zurich. FINRISK's long-term goal is to develop a Swiss Excellence Centre in Finance. For more information see www.nccr-finrisk.unizh.ch

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Rajna Gibson

The conference "Challenges to Executive Compensation" was organized and sponsored by the University of Zurich, and the National Centre of Competence in Research "Financial Valuation and Risk Management". It was the second in a series of conferences in ethical finance organized at the University of Zurich. The first one in November 2003 focused on combatting money laundering. Our goal with the launching of this series of conferences in ethical finance is to promote open, high level academic debates on practices in the finance industry, in particular those practices that the public regards as controversial or even morally outrageous.

The press has recently reported on large excesses in the level of executive compensation, including the retirement benefits of the former CEO of General Electric, Jack Welsh, and the deferred compensation of the former CEO of the NYSE, Richard Grasso. Similar uneasiness was felt in Switzerland recently, when some CEOs received large equity-based compensation soon after their companies announced the firing of a large number of employees.

However, extreme cases may distract our attention from the big picture. The question of executive compensation in a corporation has been with us for a long time. The modern corporation proliferated in western countries in order to enable a very large and dispersed shareholder ownership base to finance investments of unprecedented scale at the dawn of the industrial revolution. As a consequence, the corporation separated control from ownership. Thus, it became possible for the controllers (the board of directors and managers) to act in their own interests, rather than the interests of the owners (the shareholders). Hence, the question of an executive compensation model that aligns the interest of the managers and of the firm became central to the efficient management of modern corporations.

Rajna Gibson is Professor of Finance at the University of Zurich and Honorary Professor of Finance at the University of Lausanne.
Rajna Gibson is Director of the National Centre of Competence in Research "Financial Valuation and Risk Management" (FINRISK).
She is a member of the Board of Directors at Swiss Re and of the scientific councils of TCIP and FAME, two teaching and research organizations located in Switzerland.
She holds a Ph.D. in economic and social sciences and a graduate degree in business administration from the University of Geneva.

The first part of this conference focused on the sharp rise in executive compensation over the last decade while the second part examined whether current forms of equity-linked compensation, in particular stock options, are optimal from the stakeholder and manager perspectives.
Some of the most important messages obtained during the conference can be summarized as follows:

First, it is indisputable that we have reached excesses over the last two decades in managerial compensation levels. In particular, executives received too many options due to the fact that companies did not grasp the true economic cost of those option grants.

Second, any meaningful executive compensation policy should be consistent with the goal of maximizing the long term value of the corporation. This proposition should determine the design and implementation of sound executive compensation practices; more specifically, those practices that will attract, retain and motivate controllers (both managers and boards of directors) to act in the long-term interests of the firm stakeholders.

Finally, optimal compensation design is not sufficient to achieve long-term value maximization and we need to rethink corporate governance. Indeed, the responsibilities and the incentives of the board of directors need to be revisited. Moreover, the shareholder-monitoring of managers needs to be re-examined. But are shareholders able to take a more pro-active monitoring role? Do they have the relevant information and authority to do so? Empirical evidence on shareholder activism in Europe shows that this movement is still in its infancy.

We very much hope that you will enjoy reading this summary of the talks and panel discussions and benefit from the many economic, social, ethical and psychological considerations invoked by our speakers to both explain the current level and form of executive compensation, as well as to explore possible corporate governance reforms to enhance the pay-performance efficiency.

Kevin Murphy, E. Morgan Stanley Chair in Business Administration, is the Vice Dean for Faculty and Academic Affairs at the USC Marshall School of Business, professor of finance and business economics at the Marshall School, professor of business and law in the USC Law School, and professor of economics in the USC Economics Department. He is an internationally known expert on executive compensation, and is the author of more than forty articles, cases, or book chapters relating to compensation and incentives in organizations.

Executive Pay: Is Europe Catching Up with the U.S.? Should Europe Catch Up with the U.S.? Kevin Murphy

The above questions were addressed by Kevin Murphy. He reviewed recent trends in executive compensation in Europe and offered several explanations of these developments. Murphy established various facts about executive compensation in Europe. First, average CEO pay in 2003 was the highest in Switzerland, followed by Germany, Italy, and the U.K. Secondly, in all (Western) European countries, the fraction of firms with long-term incentive plans increased significantly over the last seven years and had reached 100% in almost all European countries by 2003. Thirdly, the share of stock-based pay ranges from 21% in the U.K. to 11% in Sweden. Despite the fact that executive compensation has been increasing in the last years, it is still way behind average compensation of U.S. executives.

A major trend in executive compensation in the last decade was the increasing share of stock-based pay of total compensation. This is equally true for the U.S. and Europe. In fact, the escalation of option grants was not restricted to CEOs or even top-level executives. It has occurred across a wide range of industries, but is especially pronounced in the so-called "New Economy" firms related to computers, software, the Internet, telecommunications or networking.

One explanation for the excessive increase in executive pay is, according to Murphy and his co-author Brian Hall, the fact that in the last decade the ratio of outside hires to total CEO hires increased significantly. Usually, hiring executives externally requires a premium. Furthermore, Murphy claimed that the remuneration committee of the board is often incompetent when it comes to negotiating executive compensation. He suggested that the remuneration committee must take control of process, policies, and practices with regards to executive recruitment and compensation. Most importantly, directors should not see themselves as employees of the CEO.

His explanation for the increasing fraction of share options in executive compensation packages is what he calls the "perceived cost hypothesis". Board members and managers alike think that share options are free. In other words, board members and managers perceive the cost of stock options as being low, as there is no accounting cost, no cash outlay, and a tax benefit upon exercise. However, stock options do give rise to economic costs, most importantly in the form of dilution. In fact, the economic cost of an option is typically higher than the value of an option to the employee which in turn is higher than the perceived cost of the option. As decisions are supposedly based on perceived cost rather than on economic cost, too many options were granted to too many people. Murphy pointed out that, at the beginning of the 1990s, options were still granted with good intentions. Firms wanted to focus on shareholder value maximization and aligned CEOs´ incentives by granting stock options. The bull market in the late 1990s seemed to prove decision makers right. This success brought increased pressure to push options down further in the organization. No approval was usually required for broad-based plans.

As it now seems, the bull market was a cause for the rise of stock options but it was not an effect of it. Retrospectively, the option grants do look excessive.

Murphy then addressed the question of how such excesses can be avoided in the future. He demanded that boards understand and communicate the full cost of equity-based compensation plans. The cost of a plan should be derived from its opportunity cost, which should be computed by the Black-Scholes formula. The cost should be recognized as expense on the firm´s accounting statement. Furthermore, boards need to understand the dangers of "fixed share" plans as well as the cost and benefits of pushing options down the hierarchy.

Murphy concluded with the question whether Europe should indeed catch up with the U.S. when it comes to executive compensation. He suggested that the answer to this question is partly determined by taste. In addition, he pointed out that the U.S. has it wrong in that decisions about compensation plans should be based on economic costs, not on perceived costs. He mentioned that due to changes in accounting rules and to the drop in the stock market, fewer options will be granted at U.S. firms, concentrated on top executives, and that firms will move towards restricted shares. He concluded that Europe should not catch up with the U.S. but learn from its mistakes.

Hans Widmer is Chairman of the board of directors and majority shareholder of Schweiter Technologies. Previously, he was chairman of the board and CEO of Oerlikon Bührle. Prior to that he was chairman and CEO of Tecan. He worked for McKinsey&Company for 12 years, most recently as McKinsey's executive in charge of Switzerland.

5 Board Dynamics Hans Widmer

Another explanation for the current excessive levels of executive compensation was offered by Hans Widmer. He claimed that excessive levels of compensation can be explained by the dynamics of boards of directors. He pointed out that executive compensation is determined by the board of directors of firms, and that boards at many companies do not function the way they should. He did not attribute this to incompetence of board members, but to the group dynamics of boards. He distinguished between emotional problems and organizational problems caused by group dynamics. Emotional problems include the fact that board members hesitate to deviate from the behavior of the group, and usually tend to be supportive of management. Organizational problems include the fact that boards are typically "managed" by the CEO and that board meetings are often "orchestrated".

Widmer proposed several measures to improve the functioning of boards. First, he suggested that a board constitutes itself, that board members meet extensively, and that board members meet regularly without management. Secondly, he proposed that the agenda of a board meeting be set by the chairman. Thirdly, he put forth that the board should manage the CEO, and not vice versa, that is, the board sets the CEO´s objectives, assesses his strategies, and monitors performance. Furthermore, Widmer demanded that the chairman of a board be employed part-time and act as a representative of shareholders, not of the company. That is, the chairman should focus on controlling management.

Widmer claimed that such a board structure would remedy current problems with executive compensation: "(executive compensation) would be geared to the market, not to those ridiculous rankings that CEOs use to wangle incredible incomes out of their boards. In plain language, it would be geared to expectations of the CEO´s role, to what the candidate is required to deliver, and to how he ultimately performs."

Armin Falk is Professor of Economics at the University of Bonn and Research Director of the Institute for the Study of Labor in Bonn. Research interests include the economic importance of reputation, asymmetric information and incomplete contracts, social interaction at the work place, network formation, and social capital. He is a research affiliate of CEPR, a fellow at CESifo, and a lecturer at the Central European University in Budapest.

The Hidden Cost of Control Armin Falk

An important problem in modern corporations is the separation between ownership and control. On the one hand, the owners of a company – the shareholders – should be able to control the board of directors who, on the other hand, should be able to control and monitor the firm's executives. How does this decision to control affect motivation and performance? Is control associated with a hidden cost by signalling distrust, thus resulting in lower motivation and performance?

In an experiment by Armin Falk and Michael Kosfeld, the authors showed that a manager's distrust in the voluntary performance of an employee has a negative impact on the employee's motivation to perform well. Before the employee chooses his performance, the manager in the experiment decides whether he wants to restrict the employee's choice set by implementing a minimum performance level for the employee. Since both parties have conflicting interests, restriction is optimal for the manager whenever the latter expects the employee to behave opportunistically. Falk and Kosfeld find that most managers in their experiment do not restrict the employee's choice set but trust that the employee will perform well voluntarily. Managers who trust induce, on average, a higher performance and hence earn higher payoffs than managers who control. The reason is that most employees lower their performance as a response to the signal of distrust created by the manager's decision to control and thus limit their choice set. These experimental results shed new light on dysfunctional effects of explicit incentives as well as on the puzzling incompleteness of many economic contracts.

Rudolf Volkart is the Director of the Swiss Banking Institute and Professor of Finance and Banking at the University of Zurich. His research interests include corporate finance, value management, value based management compensation, and selected topics in banking. He holds several board positions.

David Shirreff joined The Economist in March 2001 as Capital Markets Editor and in September 2003 moved to Frankfurt to cover German business and finance. Previously he has written for Euromoney, Risk, The Wall Street Journal and Middle East Economic Digest.

Panel Discussion: How Can We Explain Current Levels of Executive Compensation?

Armin Falk, Kevin Murphy, David Shirreff, Rudolf Volkart, Hans Widmer

The discussion of this panel focused on conflicts of interest within boards as a key determinant for excessive executive pay and explored the question of the "right" level of executive compensation. In addition, the panelists assessed the consequences of government disclosure rules for individual executive pay on the level of executive compensation.

Determinants of excessive executive pay – conflicts of interest

Recent cases of excessive executive compensation are difficult to explain by traditional determinants of executive pay, such as the firm's performance, its size, its institutional affiliation, or the level of executives' human capital. The panel explored a key determinant of excessive executive pay – conflicts of interest within boards. It was made clear that incentives of executives of publicly-held companies have to be aligned with the preferences of shareholders through appropriate compensation arrangements that primarily reward executives for firm performance.

Members of the board of directors, under their fiduciary duties of care and loyalty, have to serve as agents of the shareholders and monitor and motivate the managers in an effort to alleviate the conflict of interest between the shareholders and the managers. Therefore, boards should design rules that give appropriate incentives to the executive to act in the best interest of the shareholder. To a large extent it is this design of pay structures that should provide the necessary financial incentives to engage executives in activities that increase the long-term market value of a firm. Existing conflicts of interest for members of the board of directors or, in particular, members of the compensation committee of a board of directors, seem to be an important factor to explain recent cases of excessive executive pay. For example, CEOs that equally serve as board chairman, large boards that consist of a great fraction of outside directors that are directly appointed by the CEO, or boards whose agenda is set by the CEO, may well have an inflationary effect on the level of executive compensation.

The question has to be asked, whether governance systems must be changed so that board members can reduce their conflicts of interest and fulfill their duties in the best way possible in line with the interests of the shareholders. The problem with conflicts of interest within the board is that they are generally difficult to manage. Boards often fail to negotiate at arm's length with the executives they are meant to oversee. Mr. Widmer made clear that governance problems can be reduced by separating the chairman and the CEO, by letting the board constitute itself, or by letting the chairman set the agenda, but in the end a company's board will always remain an imperfect animal where deep psychology is at work.

What is the right level of executive compensation?

The panel members cast serious doubt on the recent discussion about the appropriate level of executive compensation. One of the suggestions that repeatedly arises in the media and that has been criticized by the panelists is some legislated maximum of CEO compensation relative to some benchmark, such as the lowest paid employee in a firm or the average worker pay. Recent discussions in Switzerland and Germany to limit executive compensation schemes to a deliberate multiple of a non-CEO average salary, led to the question of what should be regarded as excessive and what level would be appropriate.

Several participants argued that focusing simply on the level of pay is the wrong way of looking at the problem. It might well be acceptable for a company to give the executive two percent of the increase in wealth that the CEO creates for its shareholders. It cannot be viewed as excessive, when executive pay is correlated with the long-term wealth that he creates for shareholders. Hence, instead of discussing how much you should pay executives – the right level of compensation relative to some benchmark salary – it is how remuneration is structured that really matters. The focus should be on the structure of pay leading to practices that do not distort managers' incentives.

A key problem in determining the right levels of pay resides in the difficulty to assess the marginal contribution of a CEO to firm value. By simply looking at the development of stock prices in order to set the level of executive compensation, it is implicitly assumed that the CEO is responsible for creating any volatility of a company's share price. By taking the share price as a reference, executive compensation might be determined to a large extent by luck or external events rather than by pure measure of individual performance. Nevertheless, Kevin Murphy argued that the share price currently represents the best measure for evaluating the contribution of top executives.

It has been criticized that peer groups and performance benchmarking in setting executive compensation levels has so far rarely been used and that there exists a strong opposition against this approach within the industry. One positive example that has been cited is Lufthansa. Lufthansa only grants benefits to their top executives when their share price is outperforming a basket of other airlines. This policy provides two very strong signals: First, executives only receive a bonus when they achieve something outstanding and second, it conveys a signal of confidence to the investor community that the company was able to beat its competitors.

Effects of disclosure on levels of executive pay

The panel examined how disclosure rules will affect the level of compensation paid to chief executives. While government disclosure rules may improve the pay-performance relationship by increasing shareholder scrutiny of managerial pay contracts, it might also affect workers' motivation and performance negatively. In terms of the average level of executive pay, it was strongly argued that the regulatory impact of individual executive compensation disclosure will substantially increase the level of executive pay schemes.

On the one hand, it was referred to a study made at the University of British Columbia which looked at the effects of the '92 amendments by the SEC towards disclosure of executive compensation in the U.S. This study came to the conclusion that disclosure of individual executive pay might turn out to be value increasing for the company and shareholders. In fact, shareholders benefits were the highest in terms of stock price and operating performance in those firms that were lobbying most against disclosure of compensation. The reason is that increased shareholder scrutiny allowed for better results in the contracting process.

The argument was raised that in European countries like Switzerland and Germany, such effects could even turn out to be stronger. On the other hand, the disclosure of levels of compensation bears a strong risk from the perspective of workers' motivation. At a time when executives' salaries are 300 to 500 times higher than that of an average worker, and knowing that motivation is one of the key problems in any company, disclosure might negatively affect the motivation and performance of workers. Kevin Murphy, however, argued that if Germany enforced disclosure of executive pay, one could expect that not only may performance go up but so will compensation levels. One of the best natural experiments is the case of Canada. Before 1993, Canada had virtually no disclosure at all. In 1993, government introduced a fully-fledged U.S. style disclosure of compensation policies. The new disclosure regulation required Canadian public companies to reveal pay levels of their top executives. This apparently helped executives to negotiate raises to bring compensation in line with counterparts at other companies, leading to a general increase in compensation levels. Murphy would expect similar developments to follow in Germany and Switzerland.

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Integrity, Compensation, and Managing the Tension Between Two Cultures

Michael C. Jensen

Raising the question whether there is an optimal compensation model, Michael Jensen provided substantial recommendations for reforming current executive compensation systems. While making clear that no solution will eliminate the agency problems between managers and shareholders, and between board members and shareholders, he stressed that the objectives should be to mitigate these problems by well-designed pay packages on one side and well-designed corporate governance policies and processes on the other. The following is an excerpt of the highlights of his recommendations and guiding principles as contained in his paper:

1. Companies should embrace "enlightened value maximization" and "enlightened stakeholder theory" in which creating firm value is not one of many objectives, but the firm's sole or governing objective. And this governing objective must be complemented by a statement of corporate vision and strategy that guides and motivates the organization in creating value.
   Properly understood, enlightened value creation makes use of much of what is generally called "stakeholder theory", but insists on long-term value as the firm's governing objective.

2. Remuneration committees should develop a "remuneration philosophy" that reflects and is consistently faithful to the governing objective, and to the corporate vision and strategy.

3. Remuneration and audit committees should pay careful attention to ensuring that their managers cannot benefit from short-term increases in stock prices that are achieved at the expense of long-term value destruction.

4. Audit committees and boards should establish regular communication with substantial short sellers of the company's stock.

Michael C. Jensen, Jesse Isidor Straus Professor of Business Administration, Emeritus, joined the faculty of the Harvard Business School in 1985. He joined the Monitor Company in 2000 as Managing Director of the Organizational Strategy Practice.
He founded the Managerial Economics Research Center at the University of Rochester in 1977 and served as its Director until 1988.
Professor Jensen is the author of more than 60 scientific papers, in addition to numerous articles, comments, and editorials published in the popular media on a wide range of economic, finance and business-related topics.

5. Remuneration committees must take full control of the remuneration process, policies and practices.

6. Employment contracts for CEOs and top managers should be discouraged. When they do exist they should not provide for compensation when the contract is terminated for incompetence or a similar cause.

7. The cost to the corporation of granting an option to an employee is the opportunity cost the firm gives up by not selling the option in the market, and that cost should be recognized in the firm's accounting statements as an expense. Stock options to CEOs and managers should not be given free of cost but should be sold to them at their opportunity cost to the firm.

8. If a company's stock price starts to become overvalued, management must make sure that it is communicating to the markets the information regarding the firm's current and long-run health and prospects. Management must work to make the organization far more transparent to investors and to the markets.

9. Companies should change the structural, social and psychological environment of the board so that the directors are no longer governed by the CEO.

10. Senior managers must communicate with the capital markets. They must understand what drives value in their organization and align internal goals with those drivers, not with analysts' expectations.

11. Business educators, while teaching students the desirability of maximizing value, must also teach them about the dangers of overvaluation. Maximizing firm value does not mean maximizing the price of the stock.

Herbert J. Scheidt has been CEO of Vontobel Group since October 1, 2002. Prior to joining Vontobel Group he held various positions at Deutsche Bank (1982 to 2002) in Germany, New York, Milan and ultimately as head of private Banking International in Geneva. Previously he was deputy CEO of GGK Grundstücksgesellschaft, Kettwig.

Aspects of the Principal-Agent Conflict – A Case Study

Herbert J. Scheidt

Possible solutions to the principal-agent conflict through a compensation model were presented by Herbert Scheidt. He explained the executive compensation model recently adopted by Vontobel Group, a large Swiss private bank. While being applicable to all employees, this model is compulsory for all executives. It has two components: 50% of the compensation is being payed in cash whereas the remaining 50% is composed of bonus shares with a three-year blocking period and another part of performance shares. This latter part provides long-term incentives and is linked to the average ROE achieved over a period of three years, and to the BIS Capital Ratio. This allows the bank to combine the ROE with its risk propensity and thereby enhances entrepreneurship and solidity of the bank. Thus, the performance share-part of the model aligns the interests of managers and of stakeholders by focusing on the long-term incentives of management.

However, Herbert Scheidt made it clear that no compensation system is able to address by itself the multi-dimensionality of value creation in a company. There are many other issues that have to be worked on in order to establish those values that form the entrepreneurial responsibility of management. Finally, no compensation system can make up for dishonesty and lack of integrity.

Maurice J. Zufferey is a member of Spencer Stuart's Financial Services Practice, which he heads in Switzerland. He focuses his activities on wealth management, investment banking and legal positions for international companies. He also conducts assignments for the Industrial, Consumer Goods & Services and Financial Officer practices.

Previously, Mr. Zufferey was CEO of the Ecole Hôtelière de Lausanne, and held various management positions at UBS.

Executive Compensation in Switzerland: Some Observations on Recent Market Trends

Maurice J. Zufferey

Executive compensation levels in Switzerland were reviewed by Maurice Zufferey. The ratio of chairman, CEO or senior executive pay to employees has grown in Switzerland from around 30-50 to 1 to a ratio of around 180-250 to 1 in the last 10 to 15 years. While the creation of shareholder wealth is the most important measure of top executive performance also in this country, some companies do not consider shareholder value as a sufficient measure of top executives' performance. Beyond pure financial performance, they attach high value to qualitative criteria such as customer loyalty, service quality, employee satisfaction, operational stability, and sustainable growth. These criteria play an increasing role in executive compensation strategies.

Since markets are the driving forces in decisions on executive pay, it is important to remember that in Switzerland as a small country, personal relationships between CEOs and board members can play a significant role in deciding about compensation levels, particularly when they reciprocate in sitting on each other's boards. Market analysis conducted by Mr. Zufferey's firm suggests that executive pay in Switzerland ranks amongst the highest in Europe. This country has by far the highest proportion of foreigners on boards of directors and executive committees. As a result, in the past, the levels of compensation needed to be aligned with those of their country of origin in order to create incentives.

Beat Gygi is the Business Editor of Neue Zürcher Zeitung (NZZ). He has been with NZZ since 1990 serving in various positions including Economics Editor and Economics and Financial Correspondent in Paris and Bonn.

Doris Leuthard is a member of the Swiss Parliament and President of CVP. Her political work focuses on various issues in economic, foreign, and social security policy. She also works a as lawyer and holds various board positions at private and public instutions.

Panel Discussion: Is There an Optimal Compensation Model?

Dominique Biedermann, Beat Gygi, Michael C. Jensen, Doris Leuthard, Herbert J. Scheidt, Maurice J. Zufferey

The question focusing on the existence of an optimal compensation model was addressed by a group of academics and practitioners. Dominique Biedermann, representing 80-85 pension funds, spoke in the name of an important category of shareholders. He advocated full transparency not only of the remuneration packages but foremost of the policy mechanisms to fix remuneration. He raised the question of whether shareholders should vote at the general assembly on remunerations and their mechanisms. In the UK, shareholders do have the right to vote on this topic at the general assembly. Even if the vote is not binding, it has a signalling effect on the management and the board. In the Netherlands, the vote exists as well and it is binding. Mr Biedermann would favour voting on remuneration and on its mechanism in Switzerland as well.

Doris Leuthard focused on the current revision of the Swiss corporate law. The draft law's objective is to bring full transparency on each board member's individual compensation package and the highest management salary paid at listed companies. Payments made to persons closely connected to the board or the management and loans to high ranking employees must be made transparent as well. A further revision of corporate law should bring additional transparency in management and supervision of listed companies.
Rajna Gibson questioned the role of stakeholders' activism. Michael Jensen stressed that a firm cannot create long-term market value if it ignores its stakeholders. He gave the following recommendations:

Dominique Biedermann is Chairman of Ethos Investment Foundation. He was Executive Director of the Canton of Geneva Pension Fund from 1994 to 1998, and Deputy Executive Director between 1991 and 1994. Since 1994 Mr. Biedermann is a member of the National Commission Justitia & Pax of the Swiss Roman Catholic Bishop Conference. He is also member of the Editorial Committee of the Swiss pension fund's Review "Schweizer Personalvorsorge".

Companies should never again issue a standard executive stock option. Instead they should issue stock options that have two features:

1. Their exercise price should be indexed to the cost of equity capital. With the standard stock option we destroy shareholder value and reward the executive, which gives a dangerous incentive.
2. Jensen would never give stock options or performance shares to a manager again, he would sell them. If we sell the option, the managers will reveal to us how much confidence they have in their own strategic plans. If a manager refuses to buy a stock option, the board will know whether it wants to keep that person in management. "Get the managers to reveal whether they really believe in their plans."

A participant raised the following question: How is it possible to assess the performance of a CEO if it will only be realized in 5 or 10 years? Dominique Biedermann suggested to include criteria other than financial ones in the evaluation, for example, job creation, company reputation etc. When jobs are being destroyed, higher remuneration of the executive seems to be a reward for failure. Michael Jensen recalled the recommendation given earlier on the missing concept of governance. We must make sure that managers do not get paid for failures just because of a misspecification of the remuneration packages.

The presentation of Herbert Scheidt was mentioned as a good example of transparency and a good model of remuneration. Herbert Scheidt himself would in no case recommend discussion of such models in the general assembly. As he said, it was difficult enough to reach agreement on the Vontobel model within the board and the management. But he strongly advocated to discourage short-termism. We should think at least in five-year terms. He would encourage more explanatory dialogue with the stakeholders and not more regulation. Michael Jensen reminded the audience of the negative effect of the US Congress' vote on limiting golden parachutes. This entailed an abuse of managers quitting the company and taking the golden parachute that had been limited by Congress to one million U.S. dollar.

Marc Chesney is Professor of Finance at the University of Zurich. He has published several articles and books in the area of quantitative finance. He has begun to focus on the subject of ethics and finance. In addition, he is an external expert with the World Bank.

Should the System of Executive Compensation Be Reformed? Marc Chesney

The interesting presentations at this conference seem to corroborate the idea that the system surrounding executive compensation should be reformed in order to correct the excesses reached over the last two decades. Proposals to impose an accounting charge for option grants could close the gap between perceived and economic costs and consequently might reduce incentives to grant stock options. Moreover, the need for more transparency regarding executive compensation seems to be an important feature of new accounting rules that are now being introduced in the European Union and the U.S.
A university is truly an appropriate place for considering and discussing all the dimensions of the managerial compensation question - financial, legal, and ethical. It is also a place where possible solutions can emerge. In any case, this has been the objective of the University of Zurich and of the organizers of this conference. We hope we have contributed to that objective.

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