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Setting CEO Pay: What Pitfalls Should We Avoid?

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Problem of practice

For ages, boards have set CEO pay using market benchmarks, variable compensation, and aligning incentives with the company's stock: this seems like a no-regret move, right? Yet, in far too many cases, CEO pay has not correlated well with the performance of the companies they lead. There are also concerns that their compensation, driven largely by equity, has become disproportionately and inequitably high relative to that of other employees. This raises questions about the measures used to determine CEO compensation and the governance process by which it is approved. To address the concerns, research by Pierre Chaigneau, Alex Edmans, and Daniel Gottlieb makes a case for performance-vesting equity, where rewards are earned only after company performance crosses preset thresholds.[1] They suggest this compensation model "can induce effort for free" because CEOs are motivated by being fairly rewarded for the value they create, rather than by what others receive. However, its effectiveness depends heavily on board oversight, the performance measures used, and the size of the equity grants themselves. We identify the contexts in which performance-vesting equity may be effective and the various pitfalls that limit its effectiveness

[1] The article 'A Theory of Fair CEO Pay' by Pierre Chaigneau, Alex Edams and Daniel Gottlieb, featured in Volume 7, Issue 3 of the *American Economic Review: Insights*, examines how CEOs' perceptions of fair pay influence motivation, arguing that performance-linked compensation can reward value creation and encourage effort even when executives are already financially secure

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Why excessive CEO pay matters

How high has CEO compensation reached? In 2024, average annual CEO pay was US$17.2 million, compared with US$35,570 for the median worker at the top hundred S&P 500 firms, representing a CEO-to-worker pay ratio of 632-to-1.[2] The CEO-to-worker ratio for the 350 largest publicly traded companies has increased from 31-to-1 in 1978 to 281-to-1 in 2024, with equity-based compensation now accounting for 79% of CEO pay.[3] Such a steep increase cannot be explained by improvements in productivity or company performance alone. *What has changed is the CEO's power in setting their own pay.*

We should worry about this because excessive CEO compensation creates various organisational distortions. Very high CEO pay effectively takes small or often not-so-small amounts of money from other stakeholders, particularly other shareholders and employees, and gives it to the CEO. For other workers, seeing the CEO walk off with huge payouts can be demoralising. In fact, some research calls excessive compensation a "misuse of corporate assets".[4]

More insidious is the effect on managerial incentives. Many studies have shown that excessive compensation,



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which leads to high wealth levels over time, can increase risk-seeking behaviour. This reduces the CEO's true 'skin in the game', contrary to the traditional corporate finance view that larger equity rewards necessarily improve incentive alignment. After several years in the role, CEOs who have accumulated substantial wealth will be less affected personally if things go wrong.

Even though not all CEOs fall prey to these effects, the unintended distortions resulting from excessive pay policies warrant attention and appropriate remedy.[5]

Where performance equity may work

Research by Chaigneau and team argues that CEOs are motivated not only by their material rewards but also by whether they believe they are receiving a fair share of the value they create, as measured by firm value. The authors state that the fairness motive is more important than wealth accumulation, since "CEOs are typically wealthy and most of their consumption needs are already met". In their model, this fairness preference can make a performance-contingent contract optimal: compensation becomes payable once firm output crosses a threshold, after which the CEO receives a share of the value created. This logic helps explain the appeal of performance-vesting equity, which is already commonly used in CEO pay contracts. The practical challenge, however, is whether boards can identify performance thresholds and measures that accurately reflect the CEO's contribution rather than broader market, industry, or organisational forces.

Apple Inc.'s 2024 equity award to Tim Cook illustrates how performance conditions can be built into CEO compensation. The pay package consisted of 75% performance-based restricted stock units and 25% time-based restricted stock units.[6] The performance-based portion vests over three years based on Apple's relative total shareholder return compared with the S&P 500, with payouts ranging from 0% to 200% of the target. This pay structure partially reflects the fairness argument: the CEO receives a larger reward only if the stock performs well enough.

In a similar vein, more than 95% of Microsoft CEO Satya Nadella's FY2025 annual target compensation was performance-based, with a substantial portion awarded



through performance stock awards.[7] American defence company Lockheed Martin's performance stock units are based on three metrics: 50% relative total shareholder return, 25% return on invested capital, and 25% free cash flow, with payouts ranging from 0% to 200% of target.[8]

Misaligned CEO pay

In contrast to these positive instances of performance-vesting equity, the following examples highlight the dangers of tying CEO pay to stock prices and the disconnect between CEO pay and firm performance.

Dave Calhoun, CEO of a US-based aircraft manufacturer, Boeing, presided over a deeply troubled period from 2020 to 2024. His tenure was marked by falling sales, multi-billion-dollar losses, negative cash flows, and a decline in market capitalisation. Yet, he was awarded US$20-25 million in annual compensation (much of it as stock awards).[9]

David Zaslav, CEO and president at the US-based media and entertainment company Warner Bros. Discovery, provides another example. Zaslav's tenure, which began in April 2022, saw the company report multi-billion-dollar losses and a substantial drop in market capitalisation. Yet Zaslav's annual pay exceeded US$30 million.[10] Furthermore, he left with a golden parachute – or displacement package – worth US$887 million, even after cashing out US$114 million in stock.[11] In a non-binding advisory vote in April 2026, this package was rejected by 82% of shareholders.[12]

> Move to rewards that vest only with predetermined, measurable improvements in operating performance rather than stock price. Three such measures are of prime significance: revenue growth rate, net income margin, and free cash flow, adjusted for acquisitions and divestitures

These examples raise two important concerns: why does large compensation packages persist despite weak firm performance, and how do large equity awards affect managerial incentives as CEOs become wealthier?

The second concern is addressed by research on a 'house money effect', which suggests that executives are

more likely to display risk-seeking behaviour after experiencing gains.[13,14] Further research found that when personal wealth increases, CEO's risk aversion decreases and risk tolerance increases.[15] In the banking context, research shows that equity-based compensation rewards can be similarly seen as a leveraged bet on the banks' asset value, since losses from the realisation of risks are shared among all other stakeholders, whereas gains are not.[16] Although the extent of this effect varies across sectors, it highlights a broader limitation of relying heavily on equity to align CEO incentives.

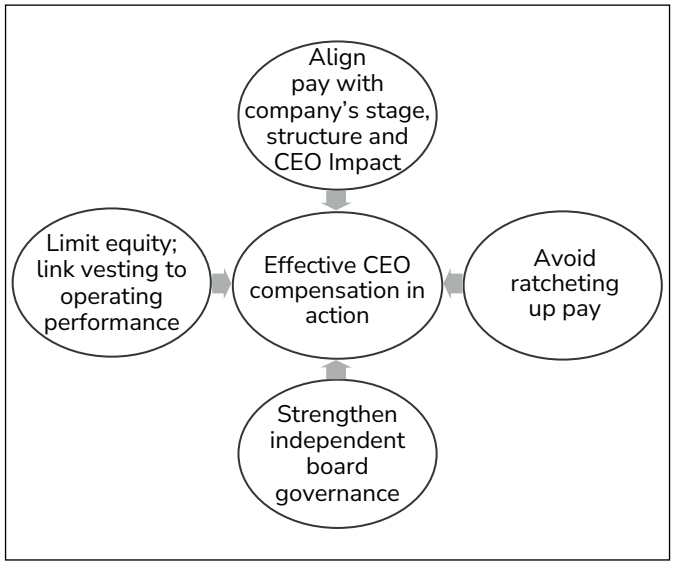
Common measures such as advisory shareholder votes on compensation, use of restricted stock awards and increased director oversight and independence 'cannot eliminate the identified problem'.

The practical question, then, is how boards should design a CEO pay package to create and preserve incentives while appropriately limiting such distortions.

Getting insight into practice

Effective CEO compensation design requires careful attention to governance, incentive design, and the measures used to assess performance (see **Figure 1**).

Figure 1: Effective and fair CEO compensation design



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1. **Get board governance right:** A perennial issue is the board's independence and its role in executive compensation policies. Research by Elson puts it rather bluntly, "there was no easier way to get fired from a board than by acting independently".[17] He contends that there is "*no real bargain when an executive negotiates with a board that is effectively beholden to the executive*". A study describes flawed compensation arrangements as "widespread, persistent and systemic", arising from structural weaknesses in governance and a sharp decoupling of both equity and non-equity awards from CEO performance.[18] To strengthen governance, we recommend two shifts for boards and their compensation committees:

The fairness-based argument for CEO pay is strongest when the CEO's contribution to output is large, as in startups, founder-led firms, or turnarounds. It is less persuasive in large, mature, diversified, or regulated firms, where performance is harder to attribute to a single person.



a) **Build significant ownership in the firm:** Meaningful director ownership can strengthen independence by giving directors an economic stake in the consequences of the compensation decisions they approve.

b) **Shift away from large equity grants:** Large equity awards that make CEOs substantially wealthier over time leave them with less to lose personally. If their decisions go wrong, it weakens the very 'skin in the game' that equity compensation is meant to create. In addition, they create adverse incentives, such as selling shares by timing the release of material information.

The above two shifts will go a long way towards genuine arm's-length negotiation between the board and the executive.



2. **Resist the 'ratchet up' trap:** When boards rely heavily on peer CEO pay data, it becomes difficult not to pay their CEO at the 50th percentile or higher. The result is a self-reinforcing ratcheting up of CEO pay: as boards target median-or-higher pay, the median itself keeps going up over time. Performance-based incentives can help counter this ratchet-up, but only if the performance measures are well-designed and tied to genuine improvements in operating performance rather than to stock prices.
3. **Move away from stock price to operating performance:** Move to rewards that vest only with predetermined, measurable improvements in operating performance rather than stock price. Three such measures are of prime significance: *revenue growth rate*, *net income margin*, *and free cash flow*, adjusted for acquisitions and divestitures. Avoid rewards linked to firm size, as they can encourage value-destroying acquisitions.

Company culture and other factors

Berkshire Hathaway, a publicly traded American holding company, illustrates an important qualification of the research findings. The company relies less on performance-based equity because alignment of the CEO's interests with long-term company performance comes from outside the compensation contract. Warren Buffett's compensation was modest for decades, with an annual salary of US$100,000 and total compensation of about US$389,000 in 2025.[19] His successor, Greg Abel, will receive a much higher annual cash salary of US$25 million as CEO beginning in 2026.[20] This approach may work because Abel already owns substantial Berkshire stock, Buffett remains the chairman and a major shareholder, and Berkshire's culture places unusual weight on reputation, decentralisation, and long-term capital allocation. In other words, where ownership, governance, and organisational culture already create strong alignment, performance-vesting equity may add less value.

This highlights an important boundary condition. The fairness-based argument for CEO pay is strongest when the CEO's contribution to output is large, as in startups, founder-led firms, or turnarounds. It is less persuasive in large, mature, diversified, or regulated firms, where performance is harder to attribute to a single person. It depends more on organisational capabilities, prior investments, market conditions, and regulations.

Family-controlled firms raise a related point: ownership, reputation, and long-term stewardship may substitute for formal performance equity, although such structures can also create conflicts between controlling and minority shareholders.

Beyond stock prices

Looking more broadly, we believe these recommendations can alleviate the distortions associated with periodic, large stock grants. Stock prices are forward-looking measures, heavily influenced by market sentiment and irrationalities that can persist for extended periods. When all is said and done, if the company cannot grow revenue, increase net margins, or generate more free cash flow, has the company's performance really improved, even if the stock price is higher?

One counterargument is that stock prices reflect expectations about future operating performance. However, this relationship is strong only over the long term; stock prices can deviate substantially from the underlying firm value for extended periods. Furthermore, granting equity and eventually the ability to sell that stock is a bit like putting the cart before the horse. Superior firm performance may not have been realised yet, and in some cases is never realised (leading to an eventual decline in the stock price), but the CEO may already have cashed out by selling large tranches of the stock.

Getting the board, top management team, and shareholders to adopt the above shifts is no easy task. It would require trust-building among stakeholders, an examination of evidence linking firm performance to executive compensation, and a phased approach. We believe the journey is worth it, as companies seek stronger performance, greater efficiency, and true incentive alignment.



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