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# Peer group ties and executive compensation networks

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ABSTRACT

Publicly traded firms in the US typically determine C.E.O. compensation by benchmarking the pay of their C.E.O.s against the pay of C.E.O.s in "peer" firms. Consequently, executive compensation is influenced not only by firm-level characteristics, but also by the selection and actions of the firm's immediate peers as well as by the structure of the executive compensation network overall. Analyzing compensation peer group choices made by the same 1183 firms for F.Y. 2007, 2008 and 2009, we find that while the typical compensation peer is similar in size and industry to the firm that chose it, deviations from this norm are common, especially among larger firms, and tend to be towards larger firms with better paid CEOs. Further analysis shows that firms who pay CEOs well relative to the pay that would be predicted from their revenues, return on assets, and industry tend to have greater aspiration bias in their group of named peers.

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## 1. Introduction

Between 1980 and 2004, the adjusted average compensation of a chief executive officer (C.E.O.) at a large public corporation in the United States rose from $625,000 to $9,840,000, an annual growth rate of 12.2% (Bogle, 2008). In contrast, during the 30-year period prior to the mid-1970s, median executive compensation is thought to have generally remained flat (Frydman and Saks, 2010). For every $1 earned by an average household in 1993, US C.E.O.s running S&P 500 companies earned on average approximately $80; by 2006, S&P 500 C.E.O.s were earning approximately $225 for every $1 earned by an average household (Kaplan, 2008).[1] In 2005, median annual pay to C.E.O.s at S&P 500 firms exceeded $8 million and C.E.O. pay at the top 100 US firms in recent years has exceeded $15 million (Terviö, 2008). One recent estimate pegs the rate of 2005 total company sales spent on C.E.O. compensation at the largest 1000 US companies at 0.07% (Walsh, 2008).[2]

While C.E.O. pay has flattened of late (Kaplan, 2008), the dramatic rise and size of executive compensation these statistics describe has generated extensive public policy and media attention, and has been studied and debated within and across a variety of disciplines (see Devers et al. (2007) for a recent review). Research in the fields of management, finance, economics, law and sociology have focused on what the rise means in terms of the value of managerial labor and the functioning of executive labor markets (Himmelberg and Hubbard, 2000; Murphy and Zábojník, 2004); optimal contracts and the relationship between pay, performance, and shareholder value, issues of corporate governance and the functioning of boards of directors (Core et al., 1999; Bebchuk and Fried, 2005; Bebchuk et al., 2002), shareholder rights, changes in the social norms that govern pay, and general trends in US income inequality, which has been aggravated by increasing compensation levels in elite occupations (Piketty and Saez, 2003).

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[1] In the peak year of 2000, they earned more than $300 for every $1 earned by an average household (Kaplan, 2008).

[2] Using data collected by Frydman and Saks (2010) and Nagel (2008) estimates the ratio of C.E.O. pay to average pay of the top three executives grew from 1.22 in the 1970s to 1.67 in the early 2000s.

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Scholarship on the rise in executive compensation largely comprises an unsettled and occasionally contentious debate between two primary sets of explanations: *market forces* (i.e., C.E.O.s are generally paid for performance, and executive pay packages reflect optimal contracting) vs. *managerial power* (i.e., C.E.O. pay reflects rent extraction, often produced by managerial entrenchment) (Murphy, 1999; Bebchuk et al., 2002; Gabaix and Landier, 2008).[3] While differing substantively in their premise, proponents of pay for performance and managerial power theories typically explain rising executive compensation at a common level of analysis. First, they tend to analyze correlates of executive pay (e.g., firm performance, board governance) as opposed to the specific processes that produce executive pay (Frydman, 2008). Second, in doing so, they typically use firm- or executive-level characteristics to predict executive-level compensation and firm-level policies. Such an approach treats firms as atomistic (independent) actors, a somewhat paradoxical orientation in light of the prevailing practice by companies to benchmark their executives' pay against the pay of counterparts at "peer" organizations (Faulkender and Yang, 2008; Bizjak et al., 2011).

In this paper, we report findings from a large-scale multi-year data collection project on executive compensation in the United States. The project takes advantage of recent changes in US Securities and Exchange Commission (S.E.C.) compensation disclosure requirements to study directly the empirical behavior of a sample of 1183 firms for which we have now repeat compensation peer group measures for F.Y. 2007, 2008, and 2009[4] as they select peers and construct peer groups to benchmark their executives' pay. Our focus is the firm-to-firm economic network that emerges from (and influences) the selection of compensation peers by individual firms, and its consequences for executive compensation and trends in compensation for firms and networks. Peer group and compensation consultant reports were collected through researcher-developed software algorithms that identify the relevant compensation disclosure text in company S.E.C. filings, and match the unstructured company names used in the disclosure with structured company names in a look-up table.

Using as our universe the companies traded on either the NYSE or Nasdaq for which compensation and peer group data are available, we answer a fundamental question of network processes: What factors explain tie formation? While firms generally choose peers similar in size and industry (i.e., homophily [McPherson et al., 2001]), deviations from this norm are common, especially for larger firms. When companies go outside their "natural" peer population, their choice is structured: they tend to choose peers larger than themselves. Large companies in particular are more likely to choose companies from a different industry group, a finding that differs from that of at least one recent compensation peer group study (e.g., Bizjak et al., 2011). Firms also have a tendency to selectively sample from the structural locations from which they draw peers, and, consistent with other recent studies based on fewer years and smaller samples (Faulkender and Yang, 2008, 2013; Bizjak et al., 2011), we find that the selective sampling amounts to "cherry-picking"; CEOs who have relatively high compensation are more likely to be named as peers net of the characteristics of their firms. The upward bias in median benchmark values produced by peer groups is greater for total compensation (33% in F.Y. 2007, declining to 29% in F.Y. 2009) than cash compensation (10% in F.Y. 2007 and F.Y. 2009). Our simulations confirm that the observed upward bias is above and beyond the random variation in pay benchmarks that would be expected from a firm sampling from all possible normative peers. While our finding that reported peer groups produce inflated pay levels is generally consistent with other recent research (Bizjak et al., 2011), our results suggest a larger bias than previously reported for total compensation. Generally speaking, the size of the bias corresponds with the extent to which a CEO is overpaid relative to the pay that would be predicted from revenues, return on assets, and industry sector.

## 2. Background

Two broad sets of explanations for the rise in executive compensation dominate academic research on the topic. Proponents of market-based explanations argue that the rise in executive compensation reflects the growing size and complexity of firms over time (Gabaix and Landier, 2008), changes in the productive relationship between managerial ability and "scale of operations" (Himmelberg and Hubbard, 2000; Terviö, 2008), the increased value and transferability of general management skills (Murphy and Zábojník, 2004), the related development of a "superstar" executive labor market (Rosen, 1981), and the trend towards more direct benefit from firm equity growth as a way of better aligning management and shareholder interests (Hall and Liebman, 1998; Holmstrom and Kaplan, 2001). They note trends such as greater board independence, preferential treatment of outsiders over presumably C.E.O.-friendly inside board members (Murphy, 2002; Murphy and Zábojník, 2004), and increased C.E.O. turnover (Kaplan and Minton, 2012) as contradicting claims of managerial power. They point to similar compensation trends among occupations not affected by managerial entrenchment dynamics, and empirical findings on the positive relationship between compensation and firm-level characteristics such as size and performance as support for their view (e.g., Hall and Liebman, 1998; Himmelberg and Hubbard, 2000; Kaplan and Rauh, 2009; Gabaix and Landier, 2008).[5]

[3] Explanations that do not fit cleanly into these two buckets include Murphy's (2002) "perceived-cost" view, which focuses on the design of compensation packages, in particular the greater use of stock options.

[4] Proxy filings are made after the close of a F.Y., so the years of the filings analyzed are 2007–2010.

[5] Proponents of market explanations do not necessarily disagree with a need for corporate governance reforms or moderation of pay levels, rather they argue that as an empirical matter, managerial power does not preclude optimal contracting (Core et al., 2005) and market factors best explain the rise in executive compensation.

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