CEO Compensation: Evidence From the Field
Practitioner Report

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This is a Practitioner Report on our study. The full academic paper can be found at:
https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3877391

Abstract

We survey directors and investors on the objectives, constraints, and determinants of CEO pay. 67% of directors would sacrifice shareholder value to avoid controversy on CEO pay, implying they face significant constraints beyond the theoretical ones of retaining and motivating the CEO. These constraints lead to lower pay levels and more one-size-fits-all structures than boards consider to be optimal. Shareholders are the main source of constraints, suggesting that directors and investors disagree on how to maximize shareholder value. Both directors and investors believe intrinsic motivation and reputation to be stronger motivators than incentive pay. Pay matters to CEOs not to finance consumption, but because it affects perceptions of fairness. The need to fairly recognize the CEO's contribution explains why annual pay responds to performance, even though CEOs' equity holdings already provide substantial financial incentives, and why peer firm pay matters beyond specific retention concerns. Fairness also matters to investors and stakeholders, with shareholder returns an important reference point. This consideration explains why CEO pay is affected by external risks beyond the CEO's control, in contrast to theories of optimal risk sharing, which suggest that pay should be adjusted for the impact of any risks beyond their control.

1. Introduction

1.1 Executive pay as a first-order decision

How to design executive pay is a first-order decision for every firm. Pay is critical for attracting and retaining the right CEO in a competitive labour market, as well as motivating her[1] to maximise firm value. Pay affects the wider company beyond the CEO – high pay can demotivate employees and damage a company's reputation among customers. Even more broadly, CEO pay across the economy influences the public's perception of capitalism. As a consequence, CEO pay receives more attention than nearly every other routine corporate decision. Boards have dedicated remuneration committees, investors have a special "say-on-pay" vote, and pay is highly regulated.

Due to the importance of CEO pay, it is critical to understand how it is set. Academics typically study this question through building models and testing their predictions. While a great deal has been learned through these methods, they also have limitations. First, data only documents the outcome of decision making and not the process that led to it. Even if it is consistent with a given model, a quite different model may have generated that data. For example, a model of incentives will predict that pay-for-performance should be used to motivate the CEO, but instead it may be to ensure that the CEO shares risk with investors and stakeholders. Second, many key ingredients of compensation models are difficult to measure and thus test, such as a CEO's intrinsic motivation or risk appetite.

1.2 Motivation for the study

This survey lies at the intersection of academic research and practitioner experience, drawing from the author team's mixture of academic and practitioner expertise. These complementary perspectives have several advantages. First, while a principal goal of the study is to understand what determines CEO pay in practice, academic research helped us structure the available responses. This ensured that the survey questions tested clear hypotheses rather than being a "free-for-all", in turn leading to meaningful conclusions. Second, and relatedly, a hallmark of academic research is to identify multiple competing hypotheses for a particular practice. We tested these alternative explanations and uncovered several ways in which directors and investors view the world differently, in turn suggesting potential topics for future dialogues to address the underlying sources of disagreement that sometimes cloud pay negotiations. Third, academic research has guided many innovations in the practice of executive pay. For example, the use of relative performance measures,

[1] In this report we use the pronoun "she" when talking about CEOs and "he" when talking about survey respondents whether investor or director.

the lengthening of pay horizons (e.g. as recommended by the 2018 UK Corporate Governance Code), and the emerging replacement of LTIPs with restricted stock, all have a strong academic grounding. However, the recommendations of academic research cannot simply be taken "off-the shelf" and be immediately put into practice. Academic models often overlook considerations that are first order in the real world. The survey thus also helped uncover which theories have practical relevance in their present form, but also which important considerations they omit – thereby informing and improving the relevance of future academic research.

1.3 Differences in board and investor perspectives

Although this is principally an academic study, the results reveal insights that we believe are useful for practitioners and policymakers alike. The purpose of this Practitioner Report is to draw out the key findings for these audiences in more digestible form than the full academic paper. In this Practitioner Report we have focused on our conclusions. Complete datasets, detailed reasoning, academic references, and methodological descriptions can be found in the full academic paper.

Perhaps the most striking finding for practitioners is how differently investors and directors view the world. Investors believe that pay is too high and boards are weak. Investors believe boards should be much tougher on the level and design of executive pay. Directors believe that investors are uninformed about the realities of retaining and motivating CEOs. They believe that investors themselves are the source of constraints that prevent value being maximised. These constraints are perceived to be widespread, with around three quarters of directors saying that they had offered a level or structure of pay that was not optimal from a shareholder value perspective. Directors believe that getting the right CEO in place is the most important consideration and that labour market pressures in achieving this are real. By contrast, investors place more weight on the importance of structuring incentive contracts correctly to deliver the right behaviour and performance. If investors are right, then boards are paying too much for CEOs and not aligning their incentives well enough with long-term shareholder interests. If directors are right, then investors risk driving the best CEOs away from our listed companies either to other countries or, perhaps more realistically, into the arms of private companies.

Our survey cannot determine who is right and who is wrong in this debate. But the extent of the differences suggests there could be real value from better dialogue between directors and investors on these issues. There are few forums that bring boards and investors together on governance topics outside of the, sometime heated, circumstances of individual company consultations.

For academics, the survey findings provide a treasure trove of opportunities for enhanced model specifications or creative empirical designs. The idea of a single "principal", an investor-aligned board, is seriously undermined. The reality of non-financial constraints in the pay setting process is exposed. The importance of intrinsic factors and fairness considerations in the motivation of executives and design of pay systems is emphasised. Some of the more arcane features of academic models do not find support.

1.4 Organisation of the study

We organise our findings under four headings below:

- Objectives and constraints
- Pay levels
- Pay structure
- Who sets pay?

The richness of the results requires some length of exposition to do them justice. We have therefore summarised the key findings at the start of each section. A quick overview can be obtained by reading this introduction, each key findings summary, and the conclusion.

We engaged in a two-year consultation process to refine our survey questions before launching the survey. The consultation process involved presenting them at multiple academic conferences, sending them to experts in either executive pay and/or the survey research methodology, and beta-testing them live with directors, investors, and compensation consultants. We distributed the survey in November and December 2020, receiving responses from 203 non-executive directors of FTSE All-Share companies and 159 investors in UK equities. Many of the questions were asked on a five-point scale from "strongly disagree" through to "strongly agree" (or "not at all important" through to "very important", etc). In this paper, we focus on reporting the percentage of respondents who agreed or strongly agreed with a given option, as this is the most intuitive way to understand many of the results. The full breakdown of responses together with mean responses and data on the number of responses can be found in the full paper. To help ensure that we interpreted the responses correctly, we included free-text fields for nearly every question, and conducted detailed post-survey interviews with several directors and investors.

Our findings were remarkably consistent across different cuts of the data. Portfolio managers and governance specialists had world views that were closer than we had expected, as did asset owners and asset managers. Differences by company size and the nature of the investor base were second-

rather than first-order. Therefore, in this Practitioner Report we report only the aggregated results, not demographic subsets.

Participation triggered funding for a total donation of £25,000 made to NHS Charities Together at the start of this year. We would like to thank everyone who made this possible, especially the participants in the survey.

2. Objectives and constraints

Key findings

1. Directors view attracting and retaining the right CEO as the most important goal of pay, while investors believe that motivating the CEO is most important. Both believe that reducing the quantum of pay is less important.
2. Boards feel that constraints – the need to avoid controversy – hinder them from designing pay to maximise long-term shareholder value. 67% of directors would sacrifice shareholder value to avoid controversy, and 56% of investors would tolerate directors doing so.
3. These additional constraints matter. 77% of directors report that constraints led to them offering a lower level of pay than they would have done otherwise. In 20% of cases this led to the CEO leaving or them hiring a less expensive CEO, while 42% stated that it reduced the CEO's motivation. 41% of directors believe that lower pay had no adverse consequences. In standard theories, the level of pay should not affect incentives (which are determined by pay-performance sensitivity). Instead, this is consistent with perceived fairness being a source of motivation.
4. 72% of directors report that constraints led to them offering an inferior structure of pay. This typically involved less tailoring and a lower upside for good performance.
5. The biggest constraint reported by directors was avoiding controversy with investors, suggesting that boards and shareholders disagree on the contract that would maximise shareholder value. Directors also view proxy advisors as a significant constraint; both directors and especially investors view avoiding controversy with employees as important.

Our first question asked respondents to rank the importance of three goals when setting CEO pay.

Table 1: Rank the importance of the following goals when setting CEO pay

	Directors			Investors		
Importance	**Most**	**Second**	**Least**	**Most**	**Second**	**Least**
Attract/retain the right CEO	65%	32%	4%	44%	48%	8%
Design a structure that motivates CEO	34%	61%	5%	51%	42%	7%
Keep the quantum of pay down	1%	8%	91%	5 %	10%	85%

65% of directors view attracting the right CEO as most critical, while 34% prioritise designing a structure that motivates the CEO. For investors, these figures are 44% and 51% respectively. This reversal reflects a theme that recurs throughout our survey – directors view labour market forces, and thus attraction and retention considerations, as more important than investors, who prioritise setting the right incentives. Only around 10% of directors and 15% of investors have keeping the quantum of pay down as their primary or even secondary goal. This is consistent with CEO pay being a small percentage of firm value, while hiring a subpar CEO or providing bad incentives has potentially large effects.

However, boards feel restricted by far more than the economic constraints assumed by standard models. Directors perceive the need to avoid controversy with several parties, such as proxy advisors, employees, and customers. 67% of directors are willing to sacrifice shareholder value to avoid controversy and 56% of investors tolerate this sacrifice. As many as 23% of directors and 16% of investors are willing to accept a moderate or large sacrifice in shareholder value to avoid controversy.

Whom are boards and investors wanting to avoid controversy with?

Table 2: How important is it to avoid controversy with the following parties?

	Proportion agreeing or strongly agreeing	
	Boards	Investors
Investors*	88%	44%
Employees	63%	82%
Proxy advisors	48%	30%
Customers	44%	75%
Policymakers	32%	65%
Media	29%	43%

*For investors, this option was "avoid controversy from other investors"

Surprisingly, the most severe constraint perceived by boards is the need to obtain investor support, even though this should be automatic if boards are setting pay optimally. By setting the contract that maximises long-term shareholder value, the board should automatically obtain investor support. Thus, this response suggests that directors and investors view the world quite differently. These constraints matter. 77% of directors report that constraints have led to them offering a lower level of pay than they would have done otherwise, and 72% an inferior structure. Paradoxically boards believe that shareholder guidelines on pay harm shareholder value.

Directors and investors also disagree on the importance of the views of other stakeholders in the pay setting process. Investors are very concerned about avoiding controversy with employees, customers, and policymakers; directors less so. One potential reason is that investors are more concerned about the general narrative on executive pay, and the extent to which it is a source of concern in the public's mind. As they deal with hundreds of pay cases each year, some of which are controversial, investors may have a heightened sense of the potential for controversy. Directors' views may reflect the fact that, at the individual company level, pay is rarely a source of serious controversy with either employees or customers. This is consistent with findings in the Edelman Trust Barometer that while trust in business overall is rather low, employees' trust in their own employer tends to be high. In practice, for directors, it is the constraint of shareholders' views that is more relevant.

These results indicate that directors and investors disagree on the optimal CEO contract. One interpretation is that boards are more informed about the difficulties of attracting and retaining a CEO in a competitive labour market, whereas shareholders underestimate them and push for changes to pay that would demotivate the CEO or cause her to leave. A second interpretation is that directors overestimate the effects on CEO motivation and retention of adopting shareholders' preferences on pay, and so fail to adopt changes that would create value. To help disentangle these interpretations, we ask the directors that were forced to offer lower or suboptimal pay about the consequences.

Table 3

Panel A: Have any of the following ever caused you to offer a lower quantum of CEO pay than you would like? (Y/N)

Panel B: Did this lower quantum ever lead to the following consequences?

Panel A – cause of lower quantum	
	Yes
Risk of investor opposition	60%
Risk of "vote against" recommendation from a proxy advisor	53%
Restrictions from our existing approved pay policy	44%
Risk of controversy with employees, the media, customers, or policymakers	37%
Unwillingness to deviate substantially from how we have paid in the past	28%

Panel B – consequence of lower quantum	
	Yes
The CEO was less motivated	42%
There were no adverse consequences	41%
We hire a less expensive CEO	13%
The CEO left	7%

These results reinforce the finding that shareholders (and their advisors) are the primary inhibitor for boards doing what they believe to be optimal. While 7% report that the CEO left, and 13% that they hired a less expensive CEO, 41% admit that there were no adverse effects. This result is meaningful, since any self-serving bias would discourage this response. Thus, at least in some cases, boards overestimated the negative consequences of taking tough decisions on CEO pay. However, 42% reported that the CEO was less motivated, suggesting that the level of pay affects incentives, in contrast to standard theories.

The fact that 41% say there were no consequences to cutting pay could be taken as support for shareholders' view that boards are weak on pay. However, from a board's perspective, a broadly 50:50 chance of adverse consequences doesn't make for great odds. Moreover, some of the cases relate to the recent pressure on executive pensions in the UK. Initially boards were reluctant to break executive contracts in isolation. But when the whole market moved in response to investor pressure, the consequences were less severe.

As one director said about the consequences of a lower quantum of pay, "[the CEO] was navigating in a highly volatile and complex situation. He still did the job, but his morale was affected negatively." Another wrote: "There is first a test of pay fairness by the CEO, then after that, for most CEOs, it is about building reputation for the company and latterly themselves" – reputational concerns incentivise CEOs to perform, but only if they first believe their pay to be fair.

We next study the effect of controversy on the structure of pay.

Table 4

Panel A: Have any of the following ever caused you to offer an inferior structure of CEO pay to what you would like? (Y/N)

Panel B: Was the structure inferior in the following ways?

Panel A – cause of inferior structure	
	Yes
Risk of "vote against" recommendation from a proxy advisor	54%
Risk of investor opposition	54%
Restrictions from our approved pay policy	40%
Restrictions from regulation or governance codes	36%
Risk of controversy with employees, the media, customers, or policymakers	29%
Unwillingness to deviate substantially from how we have paid in the past	16%
Adverse tax, accounting, or disclosure implications	10%
Panel B – nature of inferiority	
	Yes
We followed market practice more	69%
We offered less upside for good performance	65%
We used (more) performance conditions	57%
We made incentives more long-term	40%
We made incentives more short-term	13%

Again, it is shareholders and their advisors that directors view as being the biggest barrier to adopting the design they believe is optimal. The most common negative consequence is being constrained to follow market practice as opposed to a tailored approach. In free-text fields and during interviews, several directors and investors explained that they would prefer to pay CEOs like owners, where they are given large equity stakes, small annual bonuses and no LTIPs. Such a contract involves unlimited upside for good performance and no performance conditions, violating some of the above constraints. One director, when interviewed, pointed out that large equity stakes are used successfully within private firms. However, when a company goes public, it immediately gets benchmarked against other public firms, and thus has to offer the model of bonuses and LTIPs "because this is what everyone else does". Another wrote that "we have held off changing from LTIPs to share award schemes for some of the above reasons". Several investors stated that they would like CEOs to be

paid in restricted shares to achieve maximum alignment, but that other investors or proxy advisors would object because such a scheme does not fit their standard models.

These disagreements highlight a new perspective that contrasts the two prevailing academic paradigms. Most models assume that pay is set by a single principal: a shareholder-aligned board. The main alternative perspective is often referred to as “weak boards” – directors allow CEOs to dominate the pay-setting process to benefit themselves at the expense of shareholders. Our results suggest a third view – directors aim to maximise shareholder value and are misaligned with shareholders not because they are captured by the CEO, but because they view the world differently. This difference in turn may stem from two sources. One is “uninformed investors”. Investors may underestimate important considerations such as labour market pressures, the difficulty of the CEO job, the value created by a CEO, or the effect of the level of pay on CEO motivation. Boards may be aware of these issues, particularly since most directors have executive experience. The second is “uninformed boards” – directors underestimate their latitude to restructure pay, or the depth of the CEO labour market even if a restructuring causes the current CEO to leave.

A number of responses to questions throughout the survey, including free text fields, suggest that boards and investors each think that they are trying to maximise value but the other party is uninformed (or, in the case of investors’ view of boards, weak). The most common circumstance in which boards and investors interact on pay is a company-specific consultation. This inevitably has an element of negotiation about it, which may harden the attitudes revealed in this study. Creation of forums to enable investors and boards to enter into dialogue about executive pay (and other governance issues) outside the crucible of a company-specific consultation could well be beneficial.

3. The level of pay

Key findings

1. Directors believe that significant cuts to the level of pay would markedly worsen the quality and motivation of the CEO. The level of pay affects motivation through affecting perceptions of fairness, in contrast to standard models where it plays no role. Free text comments particularly highlighted concerns about the increasingly less favourable positioning of listed companies compared with private competitors.
2. In contrast, many investors believe that there would be few adverse consequences of pay cuts, even if made to one firm in isolation and even if significant ($1/3^{rd}$ reduction). Instead, they view a CEO transition as an opportunity to reset the level of pay. 77% of investors believe that pay is too high, mainly because they view boards as insufficiently challenging.
3. Both investors and directors believe that good recent performance can justify increases in pay, even though most CEOs have substantial incentives from their equity holdings. This is consistent with the importance of incentives playing a role in recognition, fairness and reputation.
4. Directors view themselves as not starting from a blank sheet of paper. It is difficult to increase pay, and even more difficult to decrease pay, in response to firm-specific changes or changes in CEO's other employment options. In contrast, investors believe that such factors should drive both increases and decreases in pay.
5. Ability is the most important determinant of a new CEO's pay. The (dis)utility of a CEO job is another important driver, suggesting there should be significant cross-sectional variation in pay levels.
6. Pay in peer firms affects new CEO pay even more than the pay at the new CEO's prior position and alternative employment options. This suggests that peer firm pay matters because it affects what is viewed as fair, rather than purely for recruitment considerations.
7. The level of pay is affected by internal considerations. There should be a gap with other top executives, but the gap to the wider workforce should not be too high.

Our second set of results concerns the level of pay. Here, our survey demonstrates significant differences between investors and directors.

3.1 Overall levels of pay

Perhaps most strikingly, one third of investors believe there would be no adverse consequences from cutting the pay of the next CEO by 1/3 compared to its current level as compared with around 10% of directors. By the same token, while 59% of directors believe that such a cut would result in recruiting a lower-quality CEO, only 18% of investors concur.

Table 5: If your firm (investor: a firm) reduced the target quantum pay of its next CEO by 1/3 compared to its current CEO, what might happen?

	Proportion agreeing or strongly agreeing	
	Directors	Investors
We (investor: the firm) would recruit a lower quality CEO	59%	18%
The CEO would be less motivated	46%	24%
It would create undesirable pay compression between the CEO and other executives	51%	16%
We (investor: the board) would have a strained relationship with the CEO	45%	12%
It would send a negative signal about CEO quality to the market	49%	23%
There would be no adverse consequences	10%	33%

Many investors believe that, even if the board ends up recruiting a different CEO, she would be less materialistic rather than less capable. A fund manager claimed that "CEOs should not just be motivated by quantum of compensation – that suggests they have the wrong person"; a governance specialist stated that "[the CEO] might have a hissy fit … then the board should reconsider if this person is appropriate for the role". For directors this is unrealistic. One said: "The idea that quantum could be reduced by such a large percentage presumes that it is happening across-the-board. Because if it happens only selectively, it will be difficult to recruit the quality leader that the business needs since the rest of the world would still be paying CEO's at the higher level and hence we would be recruiting someone who did not have the option to be leading a company elsewhere."

Fewer than a quarter of investors agreed with each of the negative consequences that we suggested. Many investors thus believe that a change in CEO provides the opportunity to reset the level of pay: "Where things have previously escalated to an unsustainable/inappropriate level it seems irrational to continue embed the problem with successive CEOs"; "this race to the bottom has to stop". But a director countered: "[We] could only avoid adverse consequences if the overall

competitive market backdrop changes. Otherwise the best candidates would not be attractied at such a significant discount to "market" rates."

This investor sentiment is reflected in their views on the overall level of CEO pay. 77% of investors believe it is too high, and fully 86% say this is because boards are ineffective at lowering it even though they should. There was no significant difference between the responses of portfolio managers and governance professionals. In sum, investors believe that pay levels are too high and attribute this in part to weak boards.

Table 6: Question asked of investors only

Panel A: Do you believe the overall level of CEO pay is too low, too high, or about right?

Panel B: How strongly do you agree with the following statements for why the overall level of CEO pay is so high?

Panel A: level of pay	
	Proportion too high or far too high
Do you believe the overall level of CEO pay is too low, too high, or about right?	77%
Panel B: causes	
	Proportion agreeing or strongly agreeing
Boards are ineffective at lowering it even though they should	86%
Investors have insufficient power over boards to lower it	56%
Investors focus their engagement on more important topics than the level of pay	36%

56% of investors agreed that pay is too high in part because "investors have insufficient power over boards to lower it". This is surprising given that shareholders have a binding policy vote, which places legal constraints on directors' freedom to set pay contracts. Indeed, the pension reductions in 2019-20 shows that co-ordinated shareholder action can cause boards to lower pay.

3.2 Pay increases

Boards and investors are generally aligned on what could justify increases in the target level of pay. Good recent CEO performance is the most supported reason by some margin.

Table 7: What causes you to increase (investors: support an increase in) the target quantum of pay for an incumbent CEO?

	Proportion agreeing or strongly agreeing	
	Directors	Investors
Good recent CEO performance	76%	75%
Increase in firm size	46%	45%
Increase in pay at peer firms	44%	27%
Increased threat of CEO leaving	43%	30%
Changes in attractiveness (e.g. prestige, risk, complexity) of CEO job at the firm	44%	45%
Other changes that reduce the attractiveness of the pay package (e.g. holding periods)	28%	30%
Changes in attractiveness (e.g. prestige, risk, complexity) of CEO jobs at other firms	19%	16%

It is surprising that good performance should be seen as a reason for increasing target pay. Most academic models argue that pay is used to provide "consumption incentives" – the CEO is motivated by the prospect of superior performance increasing her wealth and thus her potential consumption. CEOs have substantial equity holdings which increase in value in line with good performance; indeed, such increases normally dwarf any realistic change in target pay levels. Thus, the fact that both directors and investors believe that good recent performance should increase the level of pay, despite the sufficient consumption incentives already provided by the CEO's equity holdings, suggests that pay has a second role – to provide "ex-post recognition". One reason for ex-post recognition is fairness – it is fair to reward good performance ex post, even if ex ante the prospect of a pay rise is unlikely to provide incremental consumption incentives over and above the CEO's equity holdings.

While commonly referenced in pay discussions, "fairness" is often a vague concept – and indeed some interviewees deliberately avoided using this term for this reason. Our survey results allow us to be more concrete on what fairness means. Fairness is pay relative to a set of reference points, and one reference point is the CEO's perception of her contribution to firm performance (future questions will uncover other relevant reference points). A fund manager explained in an interview that pay rises are important to acknowledge good performance, and that no talented person stays in a job where she

does not feel appreciated by her employer. Another explained that a pay rise is so small compared to firm value that it costs the company very little. Thus, if the CEO is denied it, she infers that the board and shareholders do not value her highly. Relatedly, one interviewee noted that CEOs have annual appraisals to evaluate their performance. However, a positive appraisal is viewed as meaningless unless it is accompanied by an increase in pay: "pay is putting your money where your mouth is".

A CEO may not view a higher stock price as recognition because it occurs automatically and is not a consequence of any board evaluation. In contrast, a pay rise requires a discretionary decision or active judgement by the board and must be approved by shareholders in the implementation vote. As one investor pointed out, "pay is a measure of how much they're worth". Another stated that the revaluation of equity is a reward for contributing capital, but a pay rise is a reward for effort – thus, the latter is required to recognise good performance.

A second reason for ex-post recognition is to boost the CEO's reputation. Several interviewees explained that a pay rise is a more public endorsement for good performance than the revaluation of her equity holdings, since it is disclosed as part of the "single figure". Both of the above reasons suggest that pay incentives and portfolio incentives are not fungible, in contrast to standard models where only total financial incentives matter. Pay incentives have a special role because they provide immediate recognition.

Some free-text fields and interviewees argued that size may matter because of complexity. Others argued that CEOs benchmark their pay against peers of similar size to assess whether their pay is fair. Thus, if a firm ascends from the FTSE-250 to the FTSE-100, the CEO expects to be paid similarly to FTSE-100 firms. As one director argued, "benchmarking gives comfort that there's fairness, transparency, and objectivity to the level of pay." While academic theories highlight many other determinants of pay, e.g. CEO ability and the complexity of the job, firm size plays a particularly important role because it is observable.

Directors ranked "increases in pay at peer firms" (44%) significantly higher than investors (27%), with a similar difference for "increased threat of CEO leaving". This is again consistent with directors perceiving labour market pressures to be stronger. Some investors were strongly opposed to responding to increases in peer firm pay. Both sets of respondent considered peer firm pay a far less important determinant of changes in pay for an incumbent than for the pay of a new CEO. This is consistent with evidence from Nobel Laureate Daniel Kahneman on the reference point an employee uses to assess whether her pay is fair – peer firm pay if she is a new hire, and last year's pay if she is an incumbent.

What particularly came out of the free-text fields is that it is surprisingly difficult to increase the level of CEO pay by a significant amount. This may be due to increases risking controversy from investors or stakeholders, unless there has been a visible change to the size and complexity of the firm. Director comments included “It is pretty much impossible to increase the target pay of an incumbent CEO in the UK. It might be possible with a large acquisition that changes the scale and complexity substantially”; “substantial increases would only come if the job gets markedly bigger/more complex, or there is large market shift in the way such jobs are valued” and “basically only when ‘the market moves’ and/or when the job has become obviously more demanding.”

3.3 Pay decreases

We now turn to decreases in pay. Only 23% of directors said they had ever materially reduced CEO pay. We interviewed directors to understand why pay cuts are so infrequent. One explained that a pay cut communicates that the board has downgraded its assessment of the CEO’s worth. Another said that, as a consequence, cutting a CEO’s pay is effectively firing her. A third stated that if there were ever a justification for cutting the CEO’s target level of pay, you would instead fire her.

65% of investors responded “Yes” to the analogous question “Have you ever requested significant decreases to the target quantum of pay for an incumbent CEO?”[2] To the respondents who answered that they had reduced CEO pay, we asked “What caused you to decrease the target quantum of pay for an incumbent CEO?”.

[2] This 65% is not directly comparable to the 22% response from directors, since investors hold stakes in many companies and so are more likely to have requested decreases in at least one firm.

Table 8

Panel A: Have you ever significantly decreased (investor: requested significant decreases to) the target quantum of pay for an incumbent CEO?

Panel B: What caused you to decrease (investor: request decreases to) the target quantum of pay for an incumbent CEO?

Panel A – prevalence of decreases		
	Directors	Investors
Have you ever significantly decreased (investor: requested significant decreases to) the target quantum of pay for an incumbent CEO?	23%	65%

Panel B – causes of decreases		
	Directors	Investors
External pressure to reduce pay (e.g. from investors, the media, policymakers)	46%	27%
Your firm encountering financial constraints	51%	58%
The CEO requesting it*	41%	N/A
Poor recent CEO performance	34%	70%
Decrease in firm size	17%	24%
Decrease in pay at peer firms	12%	11%
Change in attractiveness (e.g. prestige, risk, complexity) of CEO job at your firm	10%	16%
Change in attractiveness (e.g. prestige, risk, complexity) of CEO jobs at other firms	5%	9%

*Only directors are asked this question.

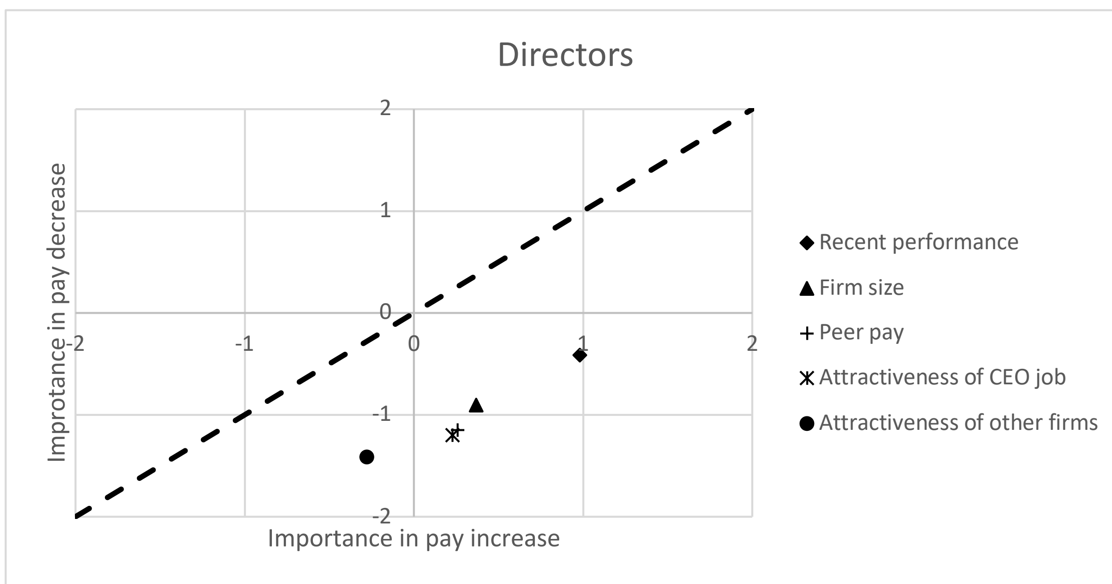
Here, unlike for increases in pay, there are significant discrepancies between investors and directors. The five factors that theories predict should drive changes in pay (poor CEO performance, decreases in firm size, changes in attractiveness at your firm, changes in attractiveness at other firms, decreases in pay at peer firms) are the five least popular options for directors. The levels of support from directors for these factors is significantly lower than for these same factors when applied to increases in pay. This suggests that directors treat increases and decreases in pay asymmetrically. Some asymmetry is also found in investor responses, but much less so. Investors believe that these factors, and in particular CEO performance, should drive both increases and decreases in pay, just as theory predicts. Note that this is the only question for which investors believe labour market forces are more important than directors – if they can be used to rationalise decreases in pay, which they generally view as too high.

The charts below plot this asymmetry using the mean of responses recorded on a five point scale from -2 (strongly disagree) to +2 (strongly agree). Panel A displays how directors believe these five

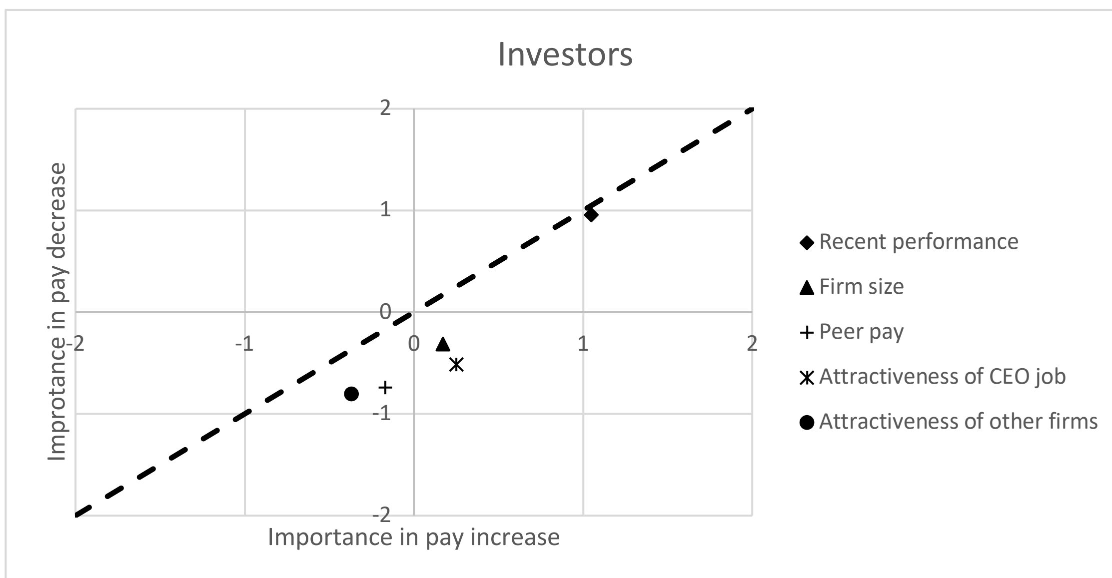
factors should affect increases (on the x-axis) and decreases (on the y-axis). All factors lie significantly below the 45 degree line, suggesting that they should have a greater effect on increases. This asymmetry is striking since directors are only posed this question if they answered that they have materially cut CEO pay on at least one occasion, i.e. they do view it as possible to decrease pay. Panel B plots the results for investors, and all factors lie closer to the 45 degree line, although some asymmetry persists, other than for performance.

Figure 1: Comparison of justifications for pay increases and decreases

Panel A - Directors



Panel B - Investors



One potential explanation for this asymmetry in director responses is the motivation or retention consequences of pay cuts. 70% of investors see poor CEO performance as justification for a pay cut, but a cut for such reasons may demotivate the CEO if last year's pay is a reference point. CEOs may also see a pay cut for changes in market conditions (e.g. pay and attractiveness at peer firms), or her own job getting easier, as being unfair as these changes are out of her control. Recall, however, how directors view that improvements in market conditions or the job getting harder are valid justifications for pay increases.

Instead, the three most common responses for directors had no analogy in the question about increases. The most popular response was "your firm encountering financial constraints" (52% for directors, versus 58% for investors). A second response (46%, versus 27% for investors) was "external pressure to reduce pay". The free-text field highlighted two recent external pressures – the COVID-19 pandemic, and the downward pressure on pensions. Standard economic models, such as those of Nobel Laureate Bengt Holmstrom, suggests that financial constraints caused by factors outside the CEO's control should not affect CEO pay – pay should only be linked to the CEO's own performance. However, the role of financial constraints can be justified if fairness matters and a relevant reference point is the experience of investors and stakeholders, who suffer when a firm is financially constrained. Taken together, if a pay cut can be attributed to external pressures or financial constraints, or is requested by the CEO, it does not affect her sense of her worth. This may explain why these are seen as plausible reasons for reducing pay.

3.4 Pay for a new CEO

"The new CEO's ability" is the most commonly cited determinant of pay for a new CEO for both directors (85%) and investors (90%), consistent with talent-based pay.

Table 9: How important are the following factors in determining the target quantum of pay for a new CEO?

	Proportion important or very important	
	Directors	Investors
The new CEO's ability	85%	90%
CEO pay at peer firms	66%	49%
How attractive our firm is to run (e.g. prestige, risk, complexity)	67%	61%
The new CEO's other employment options	58%	43%
The new CEO's pay in their previous position	42%	23%
How financially motivated the new CEO is	37%	24%
The outgoing CEO's pay	32%	14%

Potentially more surprising are the high responses to "how attractive our firm is to run (e.g. prestige, risk, complexity)", where prestige and complexity aim to capture the net disutility[3] from working for the firm. This was the second most popular option for investors and third for directors. Many critics of high pay believe that the CEO job involves little disutility, and so it should not be a driver of pay. While a governance specialist wrote that "We need to frame CEO pay in terms of the privilege it is to lead global corporations and to factor in the non-monetary benefits that flow from the prestige of being a CEO" and a CIO pointed out that "running a FTSE100 company is prestigious in itself", most other respondents highlighted the importance of disutility. One director warned that "covid and the extraordinary demands placed on CEOs over a prolonged period may lead to some deciding to leave sooner than otherwise." In interviews, several directors stressed how difficult the CEO job is – involving extremely long hours, being constantly in the media, and facing additional pressures not faced by other executives (such as having to waive bonuses during COVID).

"CEO pay at peer firms" was the second most popular response for directors and third highest for investors. Notably, both sets of respondent ranked it higher than "the new CEO's pay in their prior position" and "the new CEO's other employment options". In economic models, pay only needs to

[3] "Complexity" is the practitioner equivalent of the academic term "disutility" and "prestige" represents "utility".

be enough to persuade the new CEO to leave her current position and choose the firm over alternative opportunities. Instead, the results suggest that the pay of a peer firm is relevant even if the CEO could not get a job at that firm, e.g. due to there being no vacancy. This relevance could arise because peer pay determines what the CEO views as fair and is thus a relevant reference point. Several interviewees argued that peer firm pay affects what a CEO believes that she is "worth". One noted that a CEO interacts with CEOs of competitors, customers and suppliers, and her sense of worth is eroded if she is paid much less. Investors viewed all three of the above determinants as less important than directors, consistent with them placing less weight on labour market conditions and viewing the talent pool as deep.

Finally, "the CEO's financial motivation" and "the outgoing CEO's pay" were viewed as least important. The free-text field highlighted an additional determinant of pay absent from most models – internal equity considerations. One director highlighted the importance of "the multiple of the CEO pay to the average within the company"; another responded that "The CEO sits at the top of a pyramid where at each level pay must be externally competitive and internally proportionate. At the top there is not really a well-functioning labour market, so internal proportionality is most important." Several investors made similar statements.

4. Structure of pay

Key findings

1. Directors and investors consider intrinsic motivation and personal reputation to be the most important sources of incentives for CEOs.
2. While the primary reason for variable pay is to motivate the CEO to improve long-term shareholder value, the main channel is not that the CEO consumes the additional pay from good performance. Instead, she views it as fair to be rewarded for good performance, incentives provide recognition, and such rewards boost her personal reputation.
3. How much the CEO can affect firm performance is the main determinant of the proportion of pay that is variable. However, directors view peer firm practice and investor or proxy advisor expectations as important constraints, hindering them from tailoring pay to the specifics of their company – even though investors themselves say they do not consider following peer practice as important. Firm risk and CEO risk aversion are less important.
4. In general, investors strongly believe that lengthening the horizon of CEO incentives would improve decision making, with few adverse consequences. Directors disagree. Some directors are concerned about the attraction/retention effects of making such a change in isolation; others believe that incentives are already sufficiently long-term and further lengthening would reduce their effectiveness.
5. The majority of directors and, in particular, investors, believe that use of relative CEO performance measures (like relative TSR) should not be universal. One reason is that it is fair for CEO pay to mirror the shareholder experience. A second is that, for some companies, it is practically difficult to define an appropriate peer group or obtain information on peer performance.

4.1 Sources of motivation

There is significant agreement on what motivates CEOs.

Table 10: What motivates your CEO (investor: CEOs) to perform strongly?

	Proportion agree or strongly agree	
	Directors	Investors
Intrinsic motivation	92%	91%
Personal reputation	91%	96%
Incentives from bonuses, LTIPs, equity, or future pay increases	76%	68%
Industry competition	61%	67%
The quantum of pay	55%	37%
The potential to move to a bigger firm	18%	46%
Risk of being fired	11%	25%

Both boards and shareholders believe financial incentives are relevant but of secondary importance. Instead, the CEO's intrinsic motivation and personal reputation are most important, even though they are absent from nearly all academic theories. Directors in particular view career concerns as third-order: fewer than 20% view either the risk of being fired or a move to a larger firm as an important motivator.

The free-text responses suggest that financial incentives may overlap with ex-post recognition, and thus intrinsic motivation and reputational concerns (we use "intrinsic incentives" as an umbrella term for these two motivators). The CEO values pay not so much because she needs it to afford consumption – as one investor stressed, "all CEOs are going to take care of most human needs in terms of finances" – but because it is recognition that she has performed well. One director stated that "primary motivation comes from inside, but pay is important as a signal to the CEO and the market of the value placed on them by the board". Another wrote that "relative competition (why does he earn more than me?) is very significant as an issue of pride".

4.2 Rationale for offering variable pay

Both boards and investors believe that motivating the CEO is the main reason for offering variable pay – despite viewing financial incentives as second order to intrinsic motivation.

Table 11: Why do you offer the CEO (investor: why should CEOs be offered) variable pay?

	Proportion agree or strongly agree	
	Directors	Investors
To motivate the CEO to improve long-term shareholder value	89%	87%
To attract/retain a high-ability or hard-working CEO	87%	69%
So the CEO shares risks with investors and stakeholders, even if out of CEO's control	84%	79%
To motivate the CEO to improve outcomes other than long-term shareholder value	52%	53%
To match peer firm practice	49%	15%
Because investors or proxy advisors require it*	31%	N/A
So that the quantum of pay can be justified	27%	25%

*Only directors are asked this question.

Free-text fields and interviews suggest that this is for two reasons. First, even though intrinsic incentives are powerful, they still may not be sufficient. As one interviewee explained, only a "superhuman" CEO would be willing to perform at her very best without financial incentives. The second is that intrinsic incentives may lead to the CEO taking actions that may not increase firm value, such as increasing the scale of the business, engaging in R&D for scientific curiosity even if not commercially motivated, or designing the highest-quality product even if a low-cost strategy would be more effective.

A second reason why variable pay is needed is because employees are offered variable pay. One director pointed out that "variable pay is organisation wide practice … difficult to think of CEO scheme in isolation from executive board and firm as a whole." Another noted that "a high proportion of variable pay runs through all levels of the organisation (commission at lower levels, annual bonuses at higher levels) and it therefore feels appropriate and a cultural alignment for the CEO to have a high mix of variable pay." While internal equity comparisons are typically seen as concerning the level of pay (e.g. the recent disclosure of pay ratios), the comparison of pay structures receives less attention.

Third, while the value of the CEO's equity is tied to the stock price, variable pay can be based on other performance criteria. One director explained how CEOs are set business plans with key performance indicators ("KPIs"), and tying pay to these KPIs holds management accountable. He

pointed out that the CEO's actions have a greater effect on these KPIs than the stock price, which is affected by factors outside her control. When asked whether intrinsic incentives would be sufficient to motivate the CEO to achieve publicly-announced KPIs, he explained that "my world is one where you set targets and pay according to whether you hit them. It has always been my world and I've never questioned it."

Another director pointed out that the company's KPIs may only be credible to employees and investors if they are incorporated into the CEO's contract. Thus, even if KPIs ultimately improve the stock price, and so the long-term stock price is a comprehensive measure of CEO performance, there is value to including KPIs in the contract to create a performance culture within the firm. He thus used the term "variable pay" rather than "incentives", since pay is not used to provide ex ante incentives for the CEO (although it may be for the rest of the organisation). He also explained that non-C-level employees are paid according to KPIs, since they have little effect on the stock price. The CEO should be paid according to the same KPIs so that the whole firm is working towards the same goals.

Very popular among investors (79%) and directors (84%) was a response strongly contradicted by theory: "so that the CEO shares risks with investors and stakeholders, even if out of the CEO's control". While this represents inefficient risk-sharing (recall the Holmstrom model), respondents believe it is unfair to insulate CEOs from a downturn while others are suffering. While theoretically a board could argue "we're not cutting the CEO's pay in the pandemic because she's risk-averse; by insulating her from downturns outside her control, we were able to offer a lower target level of pay", investors and stakeholders are unlikely to accept such an argument – particularly since they do not see the counterfactual contract that would have been offered without this insurance. Thus, shareholder returns appear to be a relevant reference point that directors and investors use to assess fairness.

Indeed, many free-text fields emphasised the importance of "shareholder alignment" or "to mirror shareholder experience", which is affected by external factors. One investor, in an interview, said that CEOs should be co-owners with other shareholders as they will be "there for the journey"; in a downturn, "it's not fair that I have to take the pain and you don't". He argued that a board that wishes to insulate the CEO from a downturn views the CEO as an employee, not a co-owner. A director emphasised the importance of sharing risk with stakeholders – "in distress … the execs must lead by example and step up to take cuts, or smaller base pay rises than the rest of staff." Even though the CEO's equity holdings will already decline in a downturn, respondents believe that CEO pay should also fall due to its salience.

4.3 How much variable pay?

We asked directors and investors how pay mix is determined.

Table 12: What determines the split between fixed and variable pay?

Investor: What should determine the split between fixed and variable pay?

	Proportion important or very important	
	Directors	Investors
How much the CEO can affect firm performance	62%	75%
Investors or proxy advisor expectations*	60%	N/A
The split between fixed and variable pay in peer firms	49%	10%
CEO intrinsic motivation	49%	39%
The desire to avoid excessive pay outcomes	50%	47%
CEO personal risk appetite	22%	20%
How risky our firm is	16%	47%

*Only directors are asked this question.

The lowest responses were "CEO personal risk appetite" (22% for directors and 20% for investors) and "how risky our firm is" (16% for directors and 47% for investors) – even though these variables are predicted in theory as being important. The highest response was to "how much the CEO can affect firm performance", which is in accordance with theory – but for different reasons. Economic models argue that, if the CEO has a greater effect on firm performance, it is efficient for the board to incentivise her to work harder and it does so by offering greater financial incentives. In reality, the CEO may already be working hard due to intrinsic motivation. Instead, it is fair to reward her more for improved firm performance if she had a greater role in that improved performance.

The next two most popular responses for directors are not predicted by classical theories: "investor or proxy advisor expectations" and "the split between fixed and variable pay in peer firms". Thus, directors do not set pay-performance sensitivity entirely from first principles but partially follow market practice. Free-text responses included "The benchmark seemed to be set at roughly a third for each of salary, bonus & shares. 'This is what everyone else does'"; "RemCos are being increasingly forced to 'fit' genuine motivational adjustments to pay into a rigid framework which is essentially governed by superficial numerical comparisons with other companies"; and "The 'rules' are very

clear and laid out by external parties". Again, this is surprising given that investors state that they dislike benchmarking and do not consider peer practices as relevant.

4.4 "Suboptimal" pay practices

Finally, we study the reasons for apparently suboptimal pay practices (at least according to academic theory). The first apparently suboptimal practice is the short-term nature of many pay incentives. Here, directors' and investors' views differ very significantly.

Table 13: What would happen if you made the CEO's incentives more long-term? (-2=very unlikely outcome, 2=very likely outcome)

Investor: What would happen if companies made CEO incentives more long-term?

	Proportion agree or strongly agree	
	Directors	Investors
The incentives would lose their effectiveness	44%	5%
We would have to pay the CEO more, which would outweigh any benefits	38%	6%
We would be unable to attract/retain the CEO we want	39%	5%
The CEO would make better decisions	21%	78%

78% of investors believe the CEO would make better decisions if incentives were more long-term. Fewer than 6% agree with each of three potential concerns – that long-term incentives are less effective motivators, would jeopardise CEO retention or recruitment, or would require a costly compensating adjustment in pay level. As one fund manager wrote, "This would be a win win win win win. It would weed out CEOs that are in it for a quick buck, it would focus on long-term outcomes, and it would align CEOs with shareholders. If I could have a single bullet to improve corporate governance, this would be it." Another said that "we would get better alignment between CEO and owners. It is ridiculous that industries with a 5, 10, 15 year business/product cycle have a 1 and 3 year incentive program." Two investors stated that the CEO would need to be paid more, but the benefits would outweigh the costs.

Directors view the world very differently. They view incentives as already being sufficiently long-term, and only 21% believe that further lengthening would improve decisions. Instead, they view all three above concerns as important. Some directors already view incentives as being sufficiently long-term and thus further lengthening would reduce their effectiveness: "the current vesting and holding periods mandated by the governance bodies are already onerous". This is consistent with the

importance of ex-post recognition. Others pointed to the shortening CEO tenures as a barrier: "The global average tenure of the CEO is maybe 5 years(?). Long-term does not make any sense, if the right to dismiss is exercised"; "Shareholders have driven a reduction in CEO tenure. If the incentives do not match the tenure, then they lose reality." Others argued that shareholders would object to longer-term incentives: "problem is also that investors [are] still watching ST returns"; "a preference for short term cash rewards runs through our industry sector". This mismatch between investors' stated preferences and directors' assumptions over investor preferences is interesting, and echoes the mismatch on investors' preferences for tailoring.

Again, the results emphasise the different world views of investors and directors. Investors believe that the benefits of longer-term incentives would far outweigh the costs, but directors disagree. Do directors underestimate the extent to which they could reframe incentive packages to align with long-term shareholder interests without damaging CEO motivation? Or are investors ignorant of the complex reality of motivating business leaders, and the competitive pressures faced in attracting and retaining them? These may be fruitful topics for director-investor dialogues outside of a specific pay negotiation. The second practice predicted by theory but less seen in reality is the use of relative performance evaluation. Theory suggests that performance should be benchmarked against peers, to filter out fluctuations caused by external factors. Doing so would reduce the CEO's risk, allowing the board to offer lower pay.

Boards suggest three reasons, absent from all theories, why they do not filter out industry conditions from all performance measures. The most popular answer among directors is that "the CEO should benefit from an industry upswing, since investors and stakeholders do." This response contradicts theoretical models of efficient risk-sharing, but is consistent with notions of fairness in two ways. First, if investors have benefited from windfalls due to good market conditions, it is deemed fair for the CEO to also benefit. Second, not benchmarking on the downside means it is fair not to do so on the upside. One director explained that "the opportunity to give normal rewards in upturns provides some cushion for lesser rewards in downturns"; another noted that "shareholder alignment requires you to reduce pay in cyclical downswings … fairness requires a mirror image on the upside." Several shareholders expressed the same sentiment.

The other two reasons limiting use of benchmarking performance are practical – it can be difficult to define an appropriate peer group, or to observe peer performance for some performance measures. Explanations proposed by other theory models, such the CEO being responsible for industry choice, receive little support.

5. Who sets pay?

Key findings

1. Fewer than 5% of investors believe that shareholders as a whole have high influence on CEO pay, which is perhaps surprising given the binding policy vote in the UK. 37% of directors believe that investors have more influence than they should. Some shareholders view their fellow shareholders as not influencing pay in the right direction.
2. Both directors and investors believe that each other's advisors (compensation consultants and proxy agencies, respectively) have more influence than they should – in part due to excessive benchmarking and insufficient tailoring to company specifics.
3. Investors view the CEO as having too much influence on pay, as do directors, albeit it to a lesser degree. Both sets of respondents believe that the HR director, and employees, the media, customers, and policymakers (collectively) have approximately the right level of influence.
4. Investors view the say-on-pay vote as partly an evaluation of the CEO's performance, and thus may be reluctant to vote against, even if they do not support all aspects of the pay proposals.

Our final questions ask respondents who influences CEO pay, compared to the optimal level.

Table 14: How much do the following influence CEO pay compared to the optimal level? (-2=much less than they should, 0=about right, 2=much more than they should)

Panel A - Directors

	Mean	-2	-1	0	1	2
Proxy advisors	1.01	1%	6%	21%	35%	36%
Investors	0.38	2%	4%	57%	29%	8%
Pay consultants	0.32	2%	4%	64%	22%	9%
CEO	0.24	1%	4%	68%	24%	3%
Employees, the media, customers, or policymakers	0.08	2%	15%	59%	19%	4%
Board	-0.06	4%	9%	76%	8%	2%
HR director	-0.18	6%	12%	76%	5%	1%

Panel B - Investors						
	Mean	-2	-1	0	1	2
Proxy advisors	0.33	1%	17%	39%	34%	9%
Investors	-0.65	11%	51%	30%	7%	1%
Pay consultants	0.97	2%	4%	23%	36%	35%
CEO	0.80	1%	2%	33%	45%	19%
Employees, the media, customers, or policymakers	-0.11	8%	27%	38%	23%	5%
Board	-0.11	2%	30%	48%	15%	5%
HR director	0.04	5%	14%	60%	14%	7%

While directors view investors' advisors (proxy agencies) as having the most excessive influence, investors think the same about directors' advisors (compensation consultants). The free text fields suggest that each blames the other's advisors for similar behaviour – excessive benchmarking to peers and insufficient tailoring to a particular situation. Starting with director concerns about proxy advisors, one argues that "the proxy advisors have a disproportionate amount of power in the market and in some cases are rules based in their approach which makes it challenging to risk controversy if the shareholder register follows them blindly, as a number of investors do." Turning to investor concerns about consultants, responses include: "Compensation consultants have built a business on this needless benchmarking"; "As an investor, it is hard to get a board to pay less for a CEO. They hide behind the pay consultants".

Investors also think that the CEO has more power than they should, with 63% of investors believing the CEO has too much or much too much influence. Directors are slightly more likely to think that CEO's have too much rather than too little influence, but view this as a less significant issue than investors do. Boards think investors have too much influence over how pay is set, whereas investors themselves believe they have too little, which is perhaps surprising given the binding and advisory voting regime in the UK.

Overall, investors' general dissatisfaction with boards' setting of CEO pay seems surprising since average say-on-pay support consistently exceeds 90% in the UK. For example, in 2020, average support for the implementation vote exceeded 93% for both the FTSE 100 and FTSE 250. We explored this discrepancy in interviews. Several investors responded that say-on-pay is often viewed as a vote on the CEO's performance, rather than the CEO's pay, since it is the vote most related to the CEO (other votes are related to directors, auditors, and special resolutions). Thus, if the CEO has

performed well, the investor will support her pay even if it is high. If governance specialists recommend voting against, fund managers may oppose this if the CEO has performed well. A second reason is that many investors generally follow proxy advisors, and will almost automatically vote for if the proxy advisor recommends it; due to resource constraints, they will focus their attention on the cases with negative recommendations. Third, long-term investors wish to have a constructive relationship with management. Voting against is seen as "kicking off" and may sour that relationship. Indeed, some investors may prefer to address concerns with pay through engagement rather than voting against. Fourth, if an investor has voted against, the company will repeatedly ask to meet with the investor in the future to seek its approval before proposing a pay package, imposing a significant time cost. This concern is the opposite of the problem typically voiced in the literature – that voting against management may restrict investor access.

6. Conclusion

This paper surveyed directors and investors on the objectives, constraints, and determinants of CEO pay, to help evaluate existing models and to guide future theoretical and empirical research. Our results show that many standard assumptions of executive pay models do not describe how CEO pay is actually set, and we suggest alternative assumptions to bring them closer to reality.

Boards believe that constraints hinder them from maximising long-term shareholder value, frequently causing them to offer lower levels of pay and more one-size-fits-all structures than they would prefer. The most severe constraint is the need to obtain shareholder approval, suggesting that directors and investors disagree on how to maximise shareholder value. Investors in particular perceive the need to avoid controversy with employees, customers, and policymakers as important additional constraints. It may be that investors face constraints that affect their own economic incentives (for example reputation and fund flows) that are not aligned with shareholder value.

Even for the standard constraints of retention and motivation, there is significant disagreement on their importance. Investors believe that the incentives can be sharpened and made more shareholder-aligned, and that there is scope to cut pay without harming recruitment and retention. They want boards to take a tougher stance on pay. In contrast, directors believe that recruitment and retention concerns are real. They feel that investors underestimate the difficulties of attracting and retaining CEOs in the managerial labour market, and that implementing investors' wishes would demotivate the CEO or precipitate her departure, and make it less possible to recruit a qualified replacement. Concerns about the attractiveness of listed versus private companies for CEOs are widespread.

Turning to the determinants of pay, we find that fairness concerns appear to play an important role in both the level and structure of CEO pay. Starting with the level of pay, investors and especially directors believe that the CEO should be paid at competitive levels, even absent any recruitment or retention concerns, because the failure to do so may be viewed as unfair and undermine intrinsic motivation. Both types of respondent also believe that the level of CEO pay, and changes to this level, should take into account the level and changes in employee pay – even though the CEO and employees compete in different labour markets.

Moving to the structure of pay, both directors and investors argue that pay should be linked to performance, even though they also believe that financial incentives are less important drivers than intrinsic motivation and personal reputation. One explanation is that financial incentives interact with these other motivators – visibly rewarding the CEO for good performance improves her reputation, but not doing so may be seen as unfair and undermine intrinsic motivation. This channel implies that

incentive pay is valuable because it provides not only consumption incentives, but also ex-post recognition. This in turn suggests that changes in pay may play a special role over and above changes in wealth (from existing equity holdings), since they lead to greater recognition, whereas existing research views these two sources of consumption incentives as interchangeable

In addition to ex-post recognition, two other fairness considerations justify the link between pay and performance. One is that CEOs are expected to share external shocks with investors and stakeholders, in contrast to optimal risk-sharing. A second is that, if employees' pay is linked to their performance, it is fair for the CEO's pay to be similarly sensitive. Overall, our results suggest that CEOs evaluate their pay relative to a set of reference points, such as the pay of other CEOs, their past pay, and their perceived contribution to the firm. Directors and investors evaluate CEO pay relative to a set of potentially different reference points, such as the pay of other CEOs, their past pay, the pay of employees and other top executives, and shareholder returns.

Our results point towards a considerably more complex but also more interesting model of CEO pay than currently used in the academic literature. A more realistic model of CEO pay needs to account for the numerous constraints faced by boards and for the complex relationship between boards and investors as well as broader fairness criteria that they apply. It needs to be based on more realistic understanding of how CEOs value pay. As a result, our findings suggest a number of potential directions for future research.

Starting with theoretical research, the standard assumption of a single principal – a shareholder-aligned board – does not capture the complexity of the pay-setting process. The opposite assumption of the board maximising pay, implicit in the "weak boards" view, also seems unrealistic. Instead, pay is set by a board that aims to maximise shareholder value, but also must obtain the approval of shareholders who have different information or beliefs. Separately, our results provide a foundation for developing models where pay is influenced by fairness concerns, felt by investors, directors, and CEOs, with fairness being measured relative to a multitude of potential reference points. Future empirical analyses might further distinguish between the "weak/uninformed boards" and "uninformed investors" explanations for the disagreement between directors and investors. For example, researchers could study how deep the labour market for CEOs actually is, and what are the consequences (either for CEO retention or firm performance) of changes to the level or structure of pay that make the contract less attractive.

Turning to practitioner implications, our survey highlights the underlying differences of opinion that may be the root cause of disagreements on pay packages. Investor engagement often focuses on

the aspects of the contract itself, but initiating dialogues on the deeper disagreements may ultimately lead to more fruitful conversations on executive pay. A number of the results suggest that mutual understanding could be improved. For example, investors and boards blame each other's advisors for some of the problems in the pay setting process. Investors think that CEOs have too much influence whereas boards believe that investors interfere too much. Investors think boards could be much tougher in their treatment of CEOs, whereas boards think this would have significant costs in terms of motivation and the ability to attract and retain CEOs. These differences of view may reflect mutual disagreements on the depth of the labour market and the sources of a CEO's motivation.

All of the above suggests that establishing ways for boards and investors to have dialogue on these issues outside the context of company-specific consultations could be very fruitful. A number of areas would be worthy of such exploration: the depth of the CEO labour market, referencing difficulties in attracting CEOs as well as the risk of losing them; the span of the competitive market, in particular the role of private company markets, which a number of directors referenced as being increasingly important; the drivers of CEO motivation; the role of pay in providing recognition as well as financial incentives; and the role played by each other's advisors.

Moreover, even though our survey does uncover differences of opinion, there may be more consensus on some aspects than otherwise thought – pointing to potential paths forward. For example, directors are concerned that investors prevent them from tailoring the contract and have a preference for short-term returns, yet investors would like directors to tailor more and make incentives more long-term. There is support from both investors and some directors for paying the CEO like a long-term owner, i.e. with restricted shares rather than bonuses and LTIPs.

Another consensus is that, while directors are concerned about reducing CEO pay at their firm in isolation, they are more open to doing so in response to market-wide shifts (although in this context, for directors, 'market wide' would need to include private as well as public firms). While investors are concerned that other investors are not using their power to reduce pay, the responses suggest that most investors believe that some downward pressure on pay levels would be warranted. Given the commonality in beliefs, investors may have greater power to work together to exert such pressure than often believed, as the recent reduction in pensions have shown, and such market-wide movements may attenuate the retention and motivation effects of singling out particular companies in isolation. However, given that boards identified negative consequences, most commonly reduced motivation, on more than half of occasions they reduced target levels of pay, investors would need to be sure that it is boards, and not investors themselves, who are uninformed.