UNIVERSITY OF SOUTHERN CALIFORNIA
MARSHALL SCHOOL OF BUSINESS

FBE 533
Spring 2014

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CEO PAY, CORPORATE GOVERNANCE, AND THE POLITICS OF FINANCE
(a.k.a. "CEO Pay, Incentives, and Corporate Governance")

COURSE DESCRIPTION

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The ongoing attack on wealth and income inequality have left many to question the legitimacy of profits made by both large corporations and the executives who run them. FBE 533 analyzes the objectives of corporations, and the role of corporate governance and incentive arrangements that help or hinder achievement of these objectives. The key players in the emerging drama include: shareholders, primarily interested in increasing shareholder value (sometimes at the expense of other stakeholders); (2) executives, primarily interested in increasing their own utility; (3) directors, elected by but not perfect agents for shareholders; and (4) influential outside parties such as the government, labor unions, and the media with agendas far removed from shareholder-wealth maximization. The course traces how pay practices have evolved in response to economic, institutional, and political factors, and examines how the evolution has served to either increase or decrease the inherent conflicts of interest among the various players.

Particular attention is paid to analyzing problems with (and developing solutions for) top-executive compensation, including defective bonus plans and equity plans, the complacency of the board and compensation committee, misguided government policies (and the political process leading to them), and a general ignorance, confusion or indifference about how value is created and destroyed. Topics covered include throughout the course include conglomerations and diversification, leveraged buyouts, downsizing, private equity, earnings management, taxes rules, and accounting policies. In addition, we consider whether Wall Street pay practices led to excessive risk taking that triggered the recent financial crisis, and also focus on the cost, value and incentives from executive and employee stock options.

PREREQUISITES

This course requires only introductory finance and is open (and accessible) to both finance and non-finance majors.

EDUCATIONAL OBJECTIVE

Narrowly, the objective of this course is to provide a general framework for analyzing compensation, incentives, and governance in organizations. All organizations have explicit or implicit incentive systems. My objective is to stress the importance of these systems in predicting organizational behavior, with particular focus on understanding (and correcting) systems that generate dysfunctional or unintended incentives or results.

More broadly, I use “compensation and incentives” as a platform to talk about a wide variety of topics and to develop and test your economic intuition. You should not expect to leave the course with a “cookbook” set of solutions or with an encyclopedia of institutional facts (though there will be plenty of these), but rather with a general way of thinking about organizational incentive problems and their solutions.

CAREER FOCUS

FBE 533 is particularly relevant for students pursuing careers in accounting, consulting, corporate finance, and general management, as well as for prospective owners and entrepreneurs.

REQUIRED AND RECOMMENDED READINGS

Copyrighted required readings and cases for the course are available in either “Reading Packet” from the USC Bookstore. Non-copyrighted or publicly available required readings – as well as supplemental “recommended readings” – are available for you to download from the class “Blackboard” website.

TEACHING PHILOSOPHY

My approach to teaching is to emphasize open classroom discussion and de-emphasize lectures. Cases and shorter “caselettes” will comprise about one third of the required readings. Additional assignments include notes, articles from the academic and business press, and computer exercises. Also, I will be distributing additional material such as problems, notes, relevant articles and examples when appropriate.

Because the course is discussion-oriented, it is critical for you to keep up with the readings, and to come prepared to each class. To assist in your preparation, discussion questions for each class session will be distributed weekly and posted on the class website. In the event that preparation levels sag, I reserve the right to resort to other “preparation facilitators” such as cold-calling. The first several sessions develop the basic theoretical “building blocks” used throughout the course. The material in the course is cumulative, so it is important to attend class, keep up with the readings, and take careful notes.

After the first few class sessions I would like you to sit in approximately the same seat each day. This helps me keep track of participation, and makes it easier for you to interact with each other during class discussions. I will create a seating chart after the class roster is fixed.

An environment for effective learning is one in which people are free to discuss energetically all relevant issues and ideas. As the instructor, I take responsibility for helping guide the discussion and, in particular, for limiting discussion of topics that will take us too far off track. Productive discussions often involve emotional commitment, energy, and disagreements with the ideas of others (including the instructor's). There is a clear distinction between disagreeing with another person's ideas and criticizing him or her as a person. We all have responsibility for preventing the latter; it blocks learning and is therefore inappropriate for the classroom.

GRADING

The course grade will be based on homework assignments, class participation, a midterm examination, and a final examination. The weights for the final grade are:

Homework Assignments	25%
Class Participation	10%
Midterm Exam (March 10 or 12)	25%
Final Exam (May 7)	40%

Homework Assignments. Written responses to homework questions will be due at the beginning of most class sessions. These questions – which will be distributed in class and available on Blackboard – generally involve calculations or issues related to the course discussion for that day, and are used to facilitate your preparation. Grading for the "discussion" questions will be predictably lenient: I'm looking for evidence of a thoughtful response, and not necessarily for the "right" answer (even if there is one). If you cannot attend class, you may e-mail the homework assignment to receive credit. Homework will be graded and returned within two weeks of the due date. I will consider accepting late homework under special circumstances, but cannot promise to grade and return late homework on a timely basis.

I will drop the lowest six homework scores (out of approximately 24 assignments). Also, although you are welcome to compare ideas and results with classmates, I expect students to hand in their own assignments.

Class participation. Because this is a discussion-oriented class, I expect all students to prepare and actively participate in classroom discussions. Participation scores will be based on both the quantity and quality of your classroom contributions. The "quantity" of participation will be determined objectively based on my (imperfect) recollection following each class. The "quality" dimension is based on both my subjective assessment and peer assessments of how your participation contributed to classroom learning. High quality participation does not necessary mean providing the right answer or "cracking" the case, but rather presenting views or analyses that provoke debate and stimulate additional discussion.

Examinations. The midterm and final examination will consist of short essay questions. Sample "practice questions" will be available on the course website.

OFFICE HOURS

I will generally be available after class Mondays and Wednesdays; additional office hours will be announced preceding exams. I will also attempt to answer questions via e-mail (kjmurphy@usc.edu) on a timely basis; this is usually the best way to get in touch with me.

STATEMENT FOR STUDENTS WITH DISABILITIES

Any student requesting academic accommodations based on a disability is required to register with Disability Services and Programs (DSP) each semester. A letter of verification for approved accommodations can be obtained from DSP. Please be sure the letter is delivered to me as early in the semester as possible. DSP is located in STU 301 and is open 8:30 a.m.–5:00 p.m., Monday through Friday. The phone number for DSP is (213) 740-0776.

STATEMENT ON ACADEMIC INTEGRITY

USC seeks to maintain an optimal learning environment. General principles of academic honesty include the concept of respect for the intellectual property of others, the expectation that individual work will be submitted unless otherwise allowed by an instructor, and the obligations both to protect one's own academic work from misuse by others as well as to avoid using another's work as one's own. All students are expected to understand and abide by these principles. Scampus, the Student Guidebook, contains the Student Conduct Code in Section 11.00, while the recommended sanctions are located in Appendix A: http://www.usc.edu/dept/publications/SCAMPUS/gov/. Students will be referred to the Office of Student Judicial Affairs and Community Standards for further review, should there be any suspicion of academic dishonesty. The Review process can be found at: http://www.usc.edu/student-affairs/SJACS/.

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CEO PAY, CORPORATE GOVERNANCE, AND THE POLITICS OF FINANCE SYLLABUS

Session 1 *January 13*

THE POLITICS OF PAY

Kevin J. Murphy, "The Politics of Pay: A Legislative History of Executive Compensation," Chapter 1 in Randall S. Thomas and Jennifer G. Hill, editors, *The Research Handbook on Executive Pay*, Edward Elgar Publishers, 2012.

Session 2 *January 15*

THE GOVERNING OBJECTIVE

Steve Denning, "The Dumbest Idea in the World: Maximizing Shareholder Value," *Forbes* (November 28, 2011).

Milton Friedman, "The Social Responsibility of Business is to Increase its Profits," *New York Times Magazine* (September 13, 1970).

James M. McTaggart, Peter W. Kontes, and Michael C. Mankins, "The Governing Objective," Chapter 1 from *The Value Imperative: Managing for Superior Shareholder Returns*, The Free Press, New York, 1994. **(RP)**

*Michael C. Jensen, "Value Maximization, Stakeholder Theory, and the Corporate Objective Function" (October 2001).

Session 3 *January 22*

AGENCY COSTS OF EQUITY AND DEBT

Michael C. Jensen and Kevin J. Murphy, "CEO Incentives: It's Not How Much You Pay Them, But How" *Harvard Business Review*, May/June 1990, reprint #90308.

Harwell Wells, "U.S. Executive Compensation in Historical Perspective," Chapter 2 in Randall S. Thomas and Jennifer G. Hill, editors, *The Research Handbook on Executive Pay*, Edward Elgar Publishers, 2012.

*-denotes "recommended" (rather that required) readings. Readings designated (**RP**) are available in the course reading packet; all other readings are available on Blackboard.

Session 4 — TAXES AND THE (FIRST) RISE AND FALL OF STOCK OPTIONS

January 27

Kevin J. Murphy, "Executive Compensation: Where we are, and how we got there," Chapter 3 in George Constantinides, Milton Harris, and René Stulz (eds.), *Handbook of the Economics of Finance*. Elsevier Science North Holland (forthcoming 2013), Sections 3.1 – 3.4.

Session 5 — PAYING FOR PERFORMANCE

January 29

Carlton, Jim, "Commission Clash: A Real-Estate Chain Riles Competitors By Breaking the Rules," *Wall Street Journal* September 10, 1991.

Kevin J. Murphy and Michael C. Jensen, "CEO Bonus Plans and How to Fix Them," Section 2, Working Paper (November 2011)

Session 6 — BUDGETS AND BONUSES

February 3

Kevin J. Murphy and Michael C. Jensen, "CEO Bonus Plans and How to Fix Them," Sections 3-4, Working Paper (November 2011)

*Michael C. Jensen, "Paying People to Lie: the Truth about the Budgeting Process," *European Financial Management*, Vol. 9(3), 2003.

*Kevin J. Murphy, "Performance Standards in Incentive Contracts" *Journal of Accounting and Economics* (2000)

*Robert Gibbons and Kevin J. Murphy, "Relative Performance for Chief Executive Officers," Industrial and Labor Relations Review, Vol. 43 No. 3 (February, 1990), pp. 30-51.

Session 7 — HOW MUCH IS TOO MUCH?

February 5

Michael C. Jensen and Kevin J. Murphy, "Compensation at Lexerd Systems." HBS Case N2-494-066. **(RP)**

Steve Swartz, "Why Gary Gilligan Stands to Qualify for Guinness Book," *Wall Street Journal*, March 31, 1989.

Excerpts from James B. Stewart, *Den of Thieves*, Simon & Schuster, 1992, pp. 48-67, 527-529. **(RP)**

Session 8 *February 10*

THE RESTRUCTURING OF CORPORATE AMERICA

Daniel Fischel, "The Restructuring of Corporate America" Chapter 1 from *Payback: The Conspiracy to Destroy Michael Milken and his Financial Revolution*, Harper Business, 1995. **(RP)**

Kevin J. Murphy, "Executive Compensation: Where we are, and how we got there," Sections 3.5–3.6.

*Michael C. Jensen, "The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems," *Journal of Finance*, July 1993, pp. 831-847.

Session 9 *February 12*

TAKEOVERS AND THE MARKET FOR CORPORATE CONTROL

Michael C. Jensen, "The Takeover Controversy: Analysis and Evidence," Midland Corporate Finance Journal, 4(2) (Summer 1986).

Session 10 *February 19*

LEVERAGED RECAPITALIZATION AND BUYOUTS

"Dividend News: Sealed Air Plans Special Cash Dividend Totaling $40 a Share," *Wall Street Journal*, April 28, 1989.

Michael C. Jensen and Brian K. Barry, "Gordon Cain and the Sterling Group (A)." HBS Case 9-492-021. **(RP)**

Session 11 *February 24*

THE ECLIPSE OF THE PUBLIC CORPORATION?

Prologue from Bryan Burrough and John Helyar, Barbarians at the Gate: The Fall of RJR Nabisco. Harper & Row, New York (1990) **(RP)**

Michael C. Jensen, "Eclipse of the Public Corporation," *Harvard Business Review,* September/October, 1989. HBR Reprint #89504. **(RP)**

Session 12 *February 26*

VALUE-BASED COMPENSATION

Chasan, Emily. "Stock Loses Some Sway on Pay," *Wall Street Journal* (October 30, 2012), B4.

Shawn Tully, "The Real Key to Creating Wealth," *Fortune*, September 20, 1993. **(RP)**

Session 13 *March 3*

MEASURING PERFORMANCE

Kevin J. Murphy and Michael C. Jensen, "CEO Bonus Plans and How to Fix Them," Sections 5-6, Working Paper (November 2011)

*Kerr, Steven, 1975, On the Folly of Rewarding A, While Hoping for B, *Academy of Management Journal* 18, 769-783.

Session 14 *March 5*

GENEROUS DYNAMICS

Kevin J. Murphy and Jay Dial, "Compensation and Strategy at General Dynamics (A)." HBS 9-494-048. **(RP)**

Session 15 *March 10*

INCENTIVES TO DOWNSIZE

Kevin J. Murphy, "The Executive Compensation Controversy and the Modern Industrial Revolution," *International Journal of Industrial Organization* (1997).

Kevin J. Murphy, "CEO Pay and Downsizing: The Social Consequences," in *CEO Pay: A Comprehensive Look*, American Compensation Association, 1997.

Session 16 *March 12*

MIDTERM*

*May be moved to March 10th, depending on course progress.

Session 17 *March 24*

THE GREAT OPTION EXPLOSION

Kevin J. Murphy, "Executive Compensation: Where we are, and how we got there," Section 3.7.

Session 18 *March 26*

STOCK OPTIONS AND THE BLACK-SCHOLES FORMULA

Kevin J. Murphy, "Primer on Stock Options and the Black-Scholes Formula"

Stock Option Valuation Exercise *(Excel spreadsheet downloadable from class website)*.

Session 19 *March 31*

STOCK OPTIONS FOR UNDIVERSIFIED EMPLOYEES

Stock Option Valuation Exercise, Part II. *(Excel spreadsheet downloadable from class website)*.

Peter Coy, "Funny Money, or Real Incentive?" *Business Week* (January 15, 2001), p. 71-72.

Brian J. Hall and Kevin J. Murphy, "Option Value Does Not Equal Option Cost," *WorldatWork Journal*, Second Quarter 2001.

*Hall, Brian J. and Kevin J. Murphy. 2002. Stock Options for Undiversified Executives, Journal of Accounting and Economics, 33(1), 3-42.

Session 20 *April 2*

TOO MANY OPTIONS TO TOO MANY PEOPLE?

Flanigan, James, "It's Time for All Employees to Get Stock Options," *Los Angeles Times* (April 21, 1996).

Brian J. Hall and Kevin J. Murphy, "The Trouble with Stock Options," *Journal of Economic Perspectives,* Vol. 17(3) (Summer 2003), 49-70.

Session 21 *April 7*

ACCOUNTING FOR THE OPTION EXPLOSION

Kevin J. Murphy, "Executive Compensation: Where we are, and how we got there," Section 3.7.

Session 22 *April 9*

THE EARNINGS MANAGEMENT GAME: ARE OPTIONS TO BLAME?

Michael C. Jensen and Kevin J. Murphy, "The Earnings Management Game. Working Paper, December 2011

Session 23 *April 14*

OPTION OPPORTUNISM AND THE RISE IN RESTRICTED STOCK

Kevin J. Murphy, "Executive Compensation: Where we are, and how we got there," Section 3.8.

Fried, Jesse M., 2008. Option Backdating and Its Implications. Washington and Lee Law Review, 853-886.

*Yermack, David, 1997. Good timing: CEO Stock Option Awards and Company News Announcements, *Journal of Finance*, 52(2), 449-476.

*Aboody, David and Ron Kasznik, 2000. CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures, *Journal of Accounting and Economics*, 29(1), 73-89.

*Lie, Erik, 2005. On the Timing of CEO Stock Options Awards, *Management Science*, 51(5), 802-812.

Session 24 — WHY DID CEO PAY INCREASE SO MUCH?

April 16

Lucian Arye Bebchuk and Jesse M. Fried, "Executive Compensation as an Agency Problem," *Journal of Economic Perspectives*. 17(3) (Summer 2003): 71-92.

Frydman, Carola, and Dirk Jenter, "CEO Compensation," (MIT Working Paper, November 2010).

Kevin J. Murphy, "Executive Compensation: Where we are, and how we got there," Section 5.

*Bengt Holmstrom and Steven N. Kaplan, "The State of Corporate Governance: What's Right and What's Wrong?" *NBER Working Paper 9613*, April 2003.

*Bebchuk, Lucian A., Jesse M. Fried and David I. Walker, 2002. Managerial Power and Rent Extraction in the Design of Executive Compensation, University of Chicago Law Review, 69(3), 751-846. Available from the Social Science Research Network eLibrary at: http://papers.ssrn.com/abstract=316590.

*Kevin J. Murphy, Explaining Executive Compensation: Managerial Power versus the Perceived Cost of Stock Options The University of Chicago Law Review, Vol. 69, No. 3 (Summer, 2002), pp. 847-869.

*Kevin J. Murphy and Ján Zábojník, "CEO pay and turnover: A market-based explanation for recent trends." *American Economic Review* (May 2004).

*Gabaix, Xavier, and Augustin Landier, 2007, Why Has CEO Pay Increased so Much? Quarterly Journal of Economics.

Session 25 — BANKING BONUSES AND THE FINANCIAL CRISIS

April 21

Kevin J. Murphy, "Pay, Politics, and the Financial Crisis," in *Economic Lessons from the Financial Crisis*, Russell Sage Foundation (2012).

Kevin J. Murphy and Michael C. Jensen, "CEO Bonus Plans and How to Fix Them," Section 7, Working Paper (November 2011)

*Kevin J. Murphy, "Compensation Structure and Systematic Risk," Testimony to the U.S. House of Representatives (June 11, 2009).

*Fahlenbrach, Rudiger and Rene M. Stulz, "Bank CEO Incentives and the Credit Crisis," Ohio State University working paper (January 13, 2010).

Session 26 **REGULATING PAY IN BAILED-OUT BANKS**
April 23

Kenneth R. Feinberg, Testimony to the Congressional Oversight Panel (October 21, 2010).

Kevin J. Murphy, "Executive Pay Restrictions for TARP Recipients: An Assessment," Testimony to the Congressional Oversight Panel (October 21, 2010)

Session 27 **THE DODD-FRANK CEO PAY REFORM ACT**
April 28

The Dodd-Frank Wall Street Reform and Consumer Protection Act

Kevin J. Murphy, "The Politics of Pay: A Legislative History of Executive Compensation," in *The Research Handbook on Executive Pay*, Edward Elgar Publishers (2012).

Session 28 **WRAP-UP AND REVIEW**
April 30

May 7 **FINAL EXAMINATION (11:00AM-1:00PM)**