Equity-Based Remuneration for Swedish CEO's

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Abstract

This study examines the underlying reasons for observed relative differences in the use of equity-based remuneration for Swedish CEO's. Adopting a qualitative approach, the empirical foundation of the paper is interviews with key decision-makers in the area, namely directors of large public firms and institutional shareholder representatives. Descriptive data regarding the composition of CEO compensation in Swedish large cap firms between 2006-2011 is also provided. The theoretical basis of the investigation is a combination of agency theory, managerial power theory and institutionalism. Contrasting theory with previous research, secondary observations and – most importantly – a rich set of qualitative primary material we make several observations regarding how equity incentives are designed in the context of large public corporations in Sweden. We find that agency theoretic perspectives can potentially explain some observed variations in CEO equity incentive practices, but argue that economic theories must be extended to include influences from institutionalism to fully understand how compensation is constructed in reality. Among other things, we suggest that a coercive isomorphism of practice resulting from the Leo Act inhibits the use of equity-based pay.

Keywords: Executive Compensation, Long-Term Incentive Programs, Share-Based Remuneration, Agency Theory, Managerial Power Theory, Institutionalism, Qualitative

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1. Introduction

The first section begins with a brief background, exploring the research topic and historical developments within the field of executive compensation research. Implications of recent developments and how Sweden differs in the use of equity based remuneration to CEO are also touched upon. A brief overview of remuneration legislation and practices as well as the current situation in Sweden is followed by our purpose, problem discussion, research question, scope and delimitations.

1.1 Background

Executive compensation in general, and CEO compensation in particular, has been the subject of frequent debate among academics, practitioners, shareholders, the media and the general public during the past few decades, with the intensity of the discussion regarding compensation reaching new levels during the recent financial crisis and its aftermath. Whereas the public debate has often focused on the level of compensation, i.e. *how much* executives are paid, academics, shareholders and regulators have for a long time also directed equally as much attention on *how* executives are remunerated and what incentives different forms of compensation create. As a recent example, the Swedish government instituted an outright ban on all forms of variable compensation (cash bonuses and equity-based incentives) for senior executives in state-owned firms in the aftermath of the financial crisis, purportedly to curb excessive risk-taking (Bergström, 2012).

In the U.S., from where much of the research on compensation has emanated, radical changes within pay practices were undertaken during the 1990's (Murphy, 1999). While chief executives previously had been accused of being paid as "bureaucrats", with a high proportion of fixed salary that supposedly created "weak" incentives (Jensen & Murphy, 1990), U.S. CEO's instead started receiving a large amount of their compensation in the form of stock options issued free of charge (Frydman & Saks, 2010). The U.S. government at the time, unlike the current Swedish government, appeared to favor variable pay as they implemented a change to the corporate tax code that limited the deductibility of "non-performance based pay" (e.g. salary) to $1 million per executive while allowing unlimited deductions for various types of variable pay such as executive stock options (Bergström, 2012). A subsequent surge in executive option programs, coupled with strong equity market returns, led to a veritable explosion in CEO pay levels during the 1990's (Frydman & Saks, 2010). During the following decade stock options fell out of favor somewhat, but in their place U.S. corporations instead started issuing larger grants of restricted stock, resulting in a continued dominance for equity-based pay versus other forms of executive compensation (e.g. salary and cash bonuses) that has continued to this day (Fernandes et al., 2011).

Interestingly, developments in the U.K., which is considered to have a legal, ownership and governance structure that is very similar to that of the U.S., did not follow the same patterns. Instead, the proportion of CEO compensation that consists of equity-based pay historically trailed that of their American counterparts and still does (see e.g. Conyon & Murphy, 2000; Fernandes et al., 2011). Further, U.K. firms have rarely granted their CEO's any options or stock free of charge without attaching performance requirements such as an EPS or TSR target that must be met for any allotment to be made, unlike their U.S. peers (Bruce et al., 2003; 2005). The U.K. trend towards self-regulation within executive compensation, which had its roots in various scandals such as supposedly frivolous stock option grants in recently privatized utilities, has arguably shaped the remuneration landscape in Britain as both compensation governance codes (i.e. the 1995 Greenbury Code) and directives from influential institutional investors (the Association of British Insurers) have explicitly recommended against free executive stock options (Conyon & Murphy, 2000; Bruce et al., 2003). In light of the aforementioned demands on British firms, share-based so called Long-Term Incentive Plans (LTIPs) were popularized in British corporations from 1995 and onwards (Ibid). Typically, these programs require executives to purchase a certain amount of shares that are later matched with free shares at the end of the programs to the extent that performance targets (e.g. TSR relative to a peer group) are met[1].

Contrary to the U.S. and the U.K., very little data exists with regards to the relative importance and characteristics of equity-based pay for Swedish CEO's. This has been pointed out by numerous researchers who have tried to examine different aspects of executive compensation and equity-based pay in Sweden (see e.g. Bång & Waldenström, 2009; Randoy & Nielsen, 2002; Samani, 2012). An important reason for this has historically been a lack of disclosure regarding the terms of equity incentive programs (Bång, 2006). Disclosure has however improved in recent years, and Fernandes et al. (2011; 2012) sketch a picture of how Sweden, the U.S., the U.K. and other European countries compare in terms of the level and composition of executive compensation.

Three stylized facts emerge from this data: Swedish CEO's had roughly the same amount of cash bonus as a percentage of total compensation compared to both their European and American peers in 2006, but a vastly lower proportion of equity incentives and, furthermore, lower relative levels of total compensation. This is corroborated by the consulting firm Halvarsson & Halvarsson (2009), which compared CEO compensation in the largest Swedish firms with peers in large European and Nordic firms between 2006 and 2008, finding a radically lower proportion of equity compensation, but only slightly lower bonus percentages and levels of total compensation. Bång (2006) further presented a similar picture for a random sample of 20 large listed Swedish firms between 2003 and 2005. The three studies

[1] As will be demonstrated in Section 1.3, this share-based LTIP has also become the dominant form of equity-based compensation in larger Swedish corporates.

are summarized in Table 1. While the findings vary somewhat, e.g. due to methodology and sample, all three suggest that equity-based compensation appears to play a limited role in the compensation of Swedish chief executives. In addition, the proportion of equity-based compensation is remarkably lower than other countries, both in the Nordics, Europe and America.

	Hallvarsson&Halvarsson (2009) 2006-2008			Fernandes et al (2011) 2008			Bång (2006) 2003-2005
Country	Sweden	Nordic	Europe	Sweden	US	Europe	Sweden
Base Salary	72%	55%	28%	61%	29%	50%	48%
Variable Salary	18%	14%	28%	16%	20%	21%	20%
Equity-Based Remuneration	**7%**	**29%**	**37%**	**1%**	**46%**	**19%**	**3%**
Other Benefits	3%	2%	7%	22%	6%	10%	-
Pensions	-	-	-	-	-	-	29%

Table 1: Summary of previous studies on the composition of executive compensation in different countries

1.2 Legislation and the Code

Sweden has some country specific laws, rules and practices concerning director remuneration. Firstly, the Swedish governance system is based on a strictly hierarchical structure, illustrated in Figure 1, where the shareholders meeting is the supreme governing body. The shareholders elect the board at the general meeting. The board in turn, has as one of their main duties to elect and remunerate the CEO.

One unique feature in the Swedish corporate governance system is the use of nomination committees. Rather than being a subcommittee of the board, as is common in most other developed markets, Swedish nomination committees are appointed by shareholders at the GM and typically consists of the largest owners or their representatives. The primary task of the committee is to nominate board candidates.

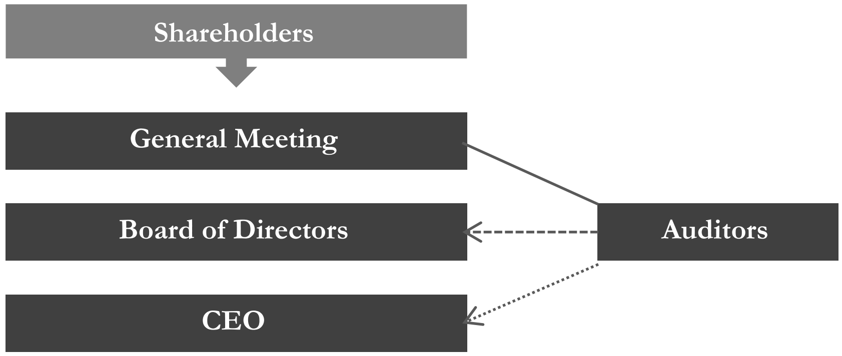

Figure 1: The Swedish Corporate Governance Model

As a complement to Swedish law, the Swedish code of Corporate Governance "The Code", defines a norm for good governance at a more ambitious level than the minimums specified in the Companies Act and other statutory regulations (The Code, 2010). The Code has an entire section advising on executive remuneration issues including some guidance regarding equity-based pay. Companies choosing to comply with the code are to establish a remuneration committee with the main task to prepare principles for remuneration and monitoring of executives as well as evaluation of current established guidelines (The Code, 2010). Moreover, the Code stresses, in accordance with existing compensation theory, that variable remuneration is to be linked to predetermined performance criteria and that share-related remuneration in particular is to be designed with the aim of achieving an increased alignment between the interest of the participants and the shareholders (ibid.).

Shareholders represented at a Swedish GM are further entitled to vote on a firms proposed remuneration guidelines, a document outlining the company's pay principles to the CEO and key executives (so called say-on-pay). In order to be accepted, the guideline document requires a simple majority, 50% of the votes at the GM, and unlike in many other developed markets, the content of the guidelines are legally binding. It is the responsibility of the board of directors of listed companies to draft the guidelines and to make sure they are followed. The guidelines should also state if the companies use any share-based remuneration, i.e. the transfer of securities and/or the granting of rights to acquire securities from the company in the future, which often occurs via so called "LTI programs" or "LTIPs". The different components of the total remuneration package are specified in detail in Table 2 below and normally consists of five different parts, base salary, variable pay, other benefits, LTI-programs and pensions, all though content, particularly with regards to LTI programs, varies between firms.

Ilustration of components included in a remuneration guidelines document	
Fixed Salary	Base salary
Variable Salary	Pay connected to results on short to medium term (1-3 years), paid in cash often with a cap of 50-100% of fixed salary
LTIP	Benefits linked to objectives of longer term results (3+ years) in the form of cash, allocation or purchase of shares, options and/or other financial instruments
Other Benefits	Perquistites like company car, housing, health insurance and such
Pensions	Pensions are classified either as defined contribution or defined benefit, depending on the economic substance

Table 2: Example of components in a CEO remuneration package

Due to legislation, different compensation packages require different degrees of shareholder involvement depending on whether they include equity-based remuneration. Decisions regarding fixed and variable salary, bonus, cash-based LTIPs and other benefits require a simple majority at the AGM through the say-on-pay vote. However, as soon as compensation proposals involve an issuance of shares, convertibles, warrants or a buy-back of shares (as equity-based LTIPs do) they are regulated under the so-called Leo Act which has more stringent criteria than say-on-pay[2]. Firstly, the Leo Act requires all decisions regarding share issues and transfer of shares to related parties (e.g. the CEO) to be made separately at the GM. Secondly, the Leo Act requires a 9/10th majority. A GMs decision on equity-based remuneration is thus only valid if it carries support from at least 90% of the shares represented at the GM. The Leo Act is unique for Sweden and came into force to protect minority shareholders after the Leo-affair in 1986[3].

[2] See Chapter 16 Swedish Companies act.
[3] Corporate scandal in 1986, shares were issued to board members and employees in the company LEO.

1.3 Current Situation

Public data on executive compensation levels and structures in Sweden has been very limited in the past, as previously mentioned. However, in July 2006 new legislation came into force regarding the disclosure of compensation to executives (Svenskt Näringsliv, 2006). The new rules required expanded disclosures to be presented in a note to the financial statements. As such, from 2006 it has been possible to get breakdowns of remuneration to CEO and other senior executives in publicly listed Swedish companies.

This new law allowed us to set up a database for the purpose of this study in order to get a reliable indication of current levels and recent developments of share-based pay in Sweden. It was also a way for us to gain a deeper knowledge in the structure, design and use of different share based programs. The database consisted of manually collected data from annual reports for all firms that have been, and currently are, listed on large cap in Sweden between the years 2006-2011. The total sample included 64 firms totaling 301 CEO-observations, and firms not headquartered in Sweden or otherwise not following IFRS were excluded[4]. We only included large cap companies as they were believed best suitable for the purpose of this study (see further 1.5 Scope and Delimitation).

The figures disclosed by companies with regard to LTI programs represent the estimated cost for the executive remuneration for a particular year. When companies issue equity-based LTI programs, they follow the standards in IFRS 2, share-based payment, to estimate the amount to be allocated for the program each year. The standard involves complex valuation issues and requires all equity based-payments to be recognized based on fair value at grant date. It is therefore relatively common that companies recognize an expense even if the employee receives no benefit (the program does not vest). Due to this, the given cost for equity-based LTI programs should be seen as an estimate and results from the archival data are treated as an *indication* of the current composition of CEO pay in Swedish large caps. The main purpose was to use the data for sample selection and problem formulation and not as a primary source of empirical data.

The collected data revealed that costs for equity-based LTI-programs made up 3,5-7,4% of the total costs for CEO remuneration in Swedish large cap companies between 2006-2011. The average for the period was 6,2% (see Table 3). We have chosen to separate equity-based and cash-based LTI programs in this study as our focus is on equity-based remuneration. The remainder of this thesis will solely discuss equity-based remuneration, the term LTI-program will thus refer to equity-based LTI programs conclusively.

4 Companies were only included the years they were actually listed on large cap.

Separating out equity-based LTIPs also makes the figures comparable to the research provided in Table 1. When comparing our findings with those presented in Table 1, we observe a similar pattern suggesting that levels of equity-related pay (LTIP) in Sweden appear relatively low if compared to other Nordic countries, Europe and the US.

	2006	2007	2008	2009	2010	2011	Average 2006-2011
Sample	All firms listed on Sthlm Large cap between 2006-2011, a total of 62 companies						
Base Salary	44.6%	44.1%	44.0%	50.4%	45.4%	50.0%	46.3%
Variable Salary	23.9%	22.7%	15.8%	19.0%	23.8%	18.8%	20.7%
Equity-based LTIP	**3.5%**	**7.4%**	**7.3%**	**5.7%**	**5.9%**	**7.1%**	**6.2%**
Cash-based LTIP	1.5%	1.3%	0.3%	0.3%	0.7%	0.9%	0.8%
Other Benefits	1.9%	2.4%	3.8%	1.7%	3.4%	1.9%	2.5%
Pensions	22.8%	21.9%	27.6%	24.5%	21.3%	22.5%	23.4%

Table 3: Composition of CEO remuneration at OMXS Large Cap

Share or option awards under equity-based LTI programs are in general linked to predetermined performance criteria like growth in EPS, TSR, ROCE, ROE etc. Data regarding the nature and occurrence of LTI programs in our studied sample was also collected and compiled in order to see developments and possible trends in the use of different equity-related plans (see Figure 2 below).

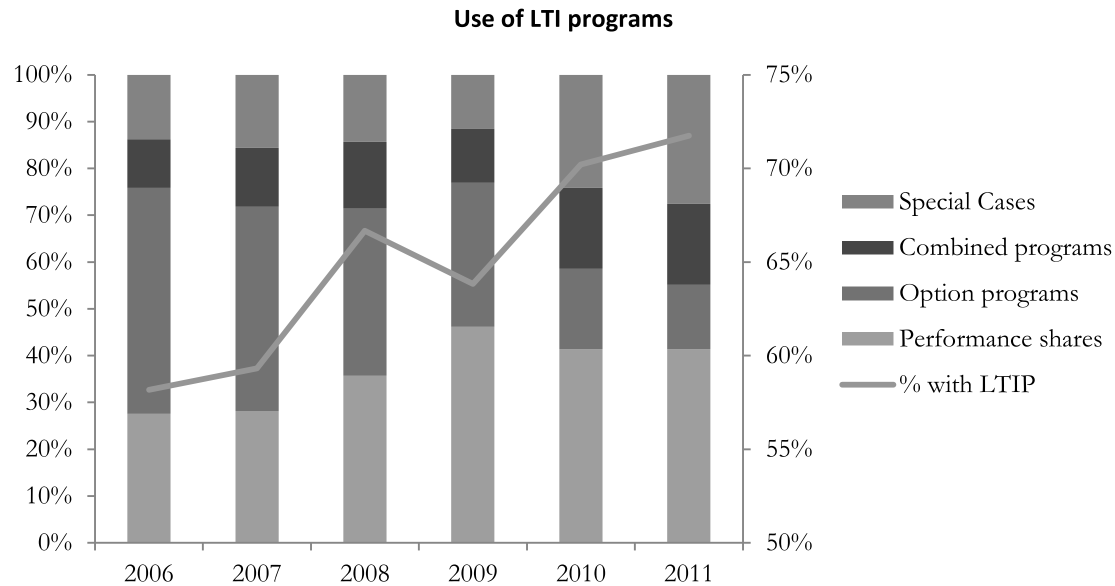

Figure 2, Left axis: Distribution of type of equity-based program, Right axis: percentage of companies with LTIP

Companies using some kind of LTI program have increased from 58% in 2006 to 72% in 2011 (right axis). In addition, as illustrated by the graph above, there is a multitude of different LTI programs currently in use in Sweden. (A more detailed explanation of the different equity-related LTI programs specified in Figure 2 can be found in Appendix 1)

The most recent trend when it comes to LTI programs in Sweden is the increased use of performance programs. We have experienced a clear shift from option programs to the use of performance shares, combined programs and other special cases of LTI programs as demonstrated in the graph. The latter programs often appear rather complex and wide-ranging, with each company having uniquely designed programs including different performance metrics. In order to demonstrate this, and to provide a better understanding of the design and use of performance share programs, the 2012 LTI-programs covering Ericson's CEO is briefly described as an illustrative example, below:

The CEO of Ericsson is covered by two different LTI programs. The first one covers all employees and is called *The Stock Purchase Plan*. Under this program, the CEO is given the opportunity to save up to 10% of his gross fixed salary for purchase of Class B shares at market price during a period of 12 months. If he keeps the shares and remains employed for at least three years, these initial shares will be matched with a matching number of shares by Ericsson. The second program, *The Executive Performance Stock Plan*, covering the CEO as well as other key executives, gives CEO the opportunity to receive up to an extra nine shares if he fulfills performance criteria on three different operational targets: sales growth, operating income and cash conversion rate during the three-year period. The actual amount of shares awarded is determined by how well the performance criteria are met.

1.4 Purpose and Problem Discussion

The foundation of this thesis is our desire to better understand compensation practices in Sweden in general and variable equity-based components in particular. Due to the prominent role that equity-based pay has in the compensation literature, where it is ascribed the potential to create superior incentives vis-à-vis other forms of remuneration both by mainstream researchers (e.g. Murphy, 1999) as well as critics (e.g. Bebchuck & Fried, 2004), we find it highly interesting to investigate the observation that equity incentives play a relatively small role in Swedish CEO's compensation packages. Previous compensation research, which will be presented in the next section, offers only anecdotal or limited explanations regarding country-level differences in compensation composition and equity incentives, something which has further motivated us in our research. Furthermore, previous empirical research on equity incentives in Swedish companies is very limited, despite the obvious need to better understand practice in this domain.

This thesis aims to develop a better understanding regarding the processes involved when large Swedish corporations make decisions regarding equity-based pay by adopting a broad theoretical framework and a qualitative approach. More specifically, we try to answer the question: *Why do Swedish CEO's receive less equity-based compensation as a proportion of total pay than their European and American peers?*

1.5 Scope and Delimitation

This thesis focuses on the equity-related component of executive compensation. While equity-based pay is by no means the only part of a compensation package that has incentivizing effects, we believe it is more interesting to investigate for a number of reasons. Firstly, the incentive effects of equity-based compensation has for a long time been ascribed larger importance than that of cash-based bonuses in the compensation literature. Secondly, we have not observed the same differences between Sweden and other developed markets when it comes to the prevalence of cash bonuses. Thirdly, the body of research on equity pay is much less developed than that for cash-based incentives, e.g. due to disclosure issues and a lack of systematic data.

We have further chosen to focus on Swedish firms listed on the Large Cap section of Nasdaq OMX Stockholm. This has been done both because the level of disclosure is higher among these firms, but also, and more importantly, because firms listed there are more comparable to listed firms in other countries in terms of e.g. size, complexity and degree of internationalization.

Finally, the focus of our study is on corporate boards and shareholder representatives. While these are by no means the only actors involved in compensation decisions, they are the ones with the formal authority to propose (in the case of the board) and decide upon (in the case of shareholders) the CEO's equity-based incentive programs under the Swedish governance model.

1.6 Definitions

(A)GM: (Annual) General Meeting of Shareholders

EPS: Earnings per Share

Institutional Shareholder: A shareholder (typically, a pension, mutual or investment fund) that invests client funds rather than their own and is subject to fiduciary duties.

IPO: Initial Public Offering

Large Cap: Nasdaq OMX Stockholm Large Cap

Leo Act: Swedish Law requiring a 90% majority approval at a GM in order for equity issuances to CEO.

LTI Program (LTIP): Three year period program covering the CEO and awarding him/her equity-based instruments, typically depending on the attainment of performance conditions. Cash-based programs excluded.

Nomination Committee: Swedish shareholder-elected organ that nominates directors.

Pay-performance sensitivity: Relation between change in CEO's wealth and firm value i.e. the change in a CEO's payoff that is associated with a given performance of the company he/she leads share price. Can be measured in a variety of ways, most commonly as a one $/£/SEK increase in the CEO's pay-off associated with a 1,000 $/£/SEK increase in the firms market capitalization.

Remuneration Guidelines: Document of "remuneration principles" the Board of Directors shall each year propose to the AGM to decide on.

Restricted Stock Plan: A program under which executives are awarded company shares free of charge after a certain timeframe has elapsed (the vesting period).

Say-on-pay: Shareholder vote on remuneration guidelines at GM.

Share-based LTI-program: see LTI program

Stock Option Program: A program under which executives are awarded stock options either free of charge and subject to no performance conditions (base American case) or subject to other performance criteria such as growth in EPS (typical U.K. case). Subject to a vesting period.

TSR: Total Shareholder Return

1.7 Disposition

The rest of the thesis is structured as follows:

- **Theoretical framework:** This section will present and discuss relevant research within the field of executive compensation, focusing on the theories and previous findings that are particularly relevant to our chosen research topic. Agency theory, managerial power theory and institutional factors are all examined.
- **Methodology:** Section three is intended to carefully present the methodology of choice, the research process as well as sample selection and quality of the study.
- **Empirical Findings:** The fourth section will describe and explore the empirical results revealed from the qualitative data collected during the interviews. The section is thematically divided into seven main headings based on recurring subjects and issues discussed the during interviews.
- **Analysis and Discussion:** Provides a thorough analysis and discussion of the empirical findings based on the theoretical framework and relevant previous research findings in order to explore and provide answer to the research question
- **Conclusions:** Summarizes the analysis and discussion and answers the research question based on findings from analysis and discussion
- **Avenues for Further Research:** Implications and suggestions for further research are presented.

2. Theoretical Framework and Literature Review

This section will present and discuss relevant research within the field of executive compensation, focusing on the theories and previous findings that are particularly relevant to our chosen research topic. Agency theory, managerial power theory and institutional factors are all examined at length. Due to the comprehensiveness of the review, the section ends with a brief summary; we also provide a shorthand overview of the key research findings in Appendix 2.

2.1 Background

An often repeated cliché within compensation research is that the only thing that has grown more rapidly in the past few decades than executive pay itself is the body of literature that examines it. As such, structuring the volumes of available research has been crucial in order to create a link between previous studies and this thesis. Devers et al. (2007) outline four central questions that have guided compensation research: how pay affects behavior and performance as well as how performance and behavior affects pay. While all four questions are key to understanding executive compensation, the research question in this thesis is most heavily linked to the determinants of pay, i.e. how behavior and performance affects compensation, and therefore this is the main focus of this review. However, discussing equity pay is fairly uninteresting without also explaining why equity-based incentives are believed to lead to certain types of behavior and performance. With this in mind, as well as the critique outlined in Devers et al. (2007) regarding the fact that previous research has often been too narrowly focused, some research relating to the latter two questions is briefly discussed as well. Moreover, the two theoretical perspectives most usually employed in answering the aforementioned questions, agency theory and managerial power theory, which tend to be tested by quantitative analysis of archival data, have been criticized for ignoring contextual factors and being under-socialized (see e.g. Tosi et al., 2000). As this study is heavily context dependent, focusing on a relatively small market with characteristics that arguably differ from the traditional Anglo-Saxon markets where most research has been undertaken, contextual influences on pay have also been given prominence through the use of institutional theory. As follows, this review begins with outlining the dominant research regarding what makes equity pay different from other forms of compensation, followed by the main concern of this thesis: how performance, behaviors and contextual or institutional factors influence pay.

2.2 Agency Theory and Optimal Contracting

Agency theory has its roots in the observations made by Berle & Means (1932) regarding how a dispersion of ownership in publicly held corporations had led to a separation of ownership and control between diversified shareholders on the one hand and managers on the other. Jensen & Meckling (1976) furthered this notion, and formalized the modern principal-agent framework. Under the framework, the interest of shareholder-principals differs from that of manager-agents as shareholders are assumed to be concerned solely with increasing the wealth of their investment while managers may have other priorities (e.g. NPV-negative pet projects, shirking, perquisite consumption). Further, principal and agent interests are thought to differ with regards to the appetite for risk as shareholders are diversified and risk neutral, contrary to less diversified and relatively risk-averse managers (Jensen & Meckling, 1976; Jensen & Murphy 1990). This agency problem, and how pay practices affects its magnitude by reducing self-serving behavior by managers (so called *moral hazard*), has been the focal point of a large portion of modern research regarding executive compensation (see e.g. Devers et al., 2007; Murphy, 1999).

The central tenet of optimal contracting is the possibility for shareholders to design rational and effective compensation contracts for executives so that agency costs are minimized (see e.g. Core & Guay, 1999; Murphy, 1999). Ideally, this would be done by drawing up contracts that reward executives for the actions they take (e.g. building a plant) or, in the second instance, for achieved outcomes that inform shareholders about the actions taken by the manager (e.g. increased profits resulting from a plant being built) (Holmström 1979; Murphy 1999). However, due to the fact that executive actions in many cases are impossible or prohibitively expensive to monitor; that managers by definition have better information about which actions maximize shareholder value; and that executives possess an unlimited repertoire of possible actions (including expending their effort on manipulating accounting performance), rewarding them for anything but achieving the shareholder's ultimate objective, i.e. increases in shareholder wealth, are only rarely considered beneficial (Murphy, 1999). In sum, as it often is impossible for shareholders to isolate the CEO's "marginal contribution to firm value", it becomes more appropriate to reward them for the development of the firm value itself under the theory (Jensen & Murphy, 1990, pp. 243).

In line with this, optimal contracting theory focuses on creating the best possible link between executive compensation and changes in shareholder wealth (Jensen & Murphy, 1990). This link is typically captured by so called *pay-performance sensitivities*, defined as the relationship between the gains received by executives both from annual flow compensation (salary, bonus, perquisites, LTIPs, share and option grants) and stock compensation (appreciation in shares and options held as well as already outstanding LTIPs and option plans) to the change in value of the firm (see e.g. Core & Guay, 1999; Frydman & Saks, 2010; Jensen & Murphy, 1990). Equity related incentives are by far the most important contributors to this pay-performance sensitivity as they provide a direct link between compensation and shareholder wealth development as opposed to the indirect link provided by e.g. cash bonuses (Jensen & Murphy, 1990; Hall & Liebman, 1998). Central to examining whether the level of pay-performance sensitivity is sufficient in any one firm are three things: the magnitude of information asymmetries, the notions of executive risk-aversion and wealth constraints (Ibid). Managerial risk-aversion limits the feasible upper bound of pay-performance sensitivities (or the acceptable amount of equity incentives) as executives do not have the same risk attitudes as diversified shareholders, and wealth constraints limits it because executives cannot feasibly be expected to risk their entire personal wealth solely on the share price development of the firm (Ibid). As these factors are not directly observable, optimal contracting theorists usually consider and test a range of proxies in order to understand levels of pay-performance sensitivities in different firms. These proxies include, but are not limited to, size (to capture executive wealth-constraints), stock price volatility (risk-aversion) and growth opportunities (information asymmetries) (see e.g. Core & Guay, 1999; Murphy, 1999). To simplify, the appropriate amount of executive equity incentives in a firm is thought to vary with, among other things, the size of the firm and the volatility of the firms stock (Ibid).

The first major empirical study examining whether existing incentives were "sufficient" according to theory, and indeed what later became the benchmark against which other optimal contracting theorists measured their results, was Jensen & Murphy (1990). Studying a large sample of U.S. CEO's between 1974 and 1986, the authors found an average pay-performance sensitivity of $3.25[5] for a $1,000 change in firm value. This led the authors to conclude that CEO's were paid like "bureaucrats", as incentives were generally much weaker than predicted by theory even when considering potential effects from information asymmetries, risk-aversion and wealth constraint factors. To illustrate the implications, they posited that a CEO with the median total pay-performance sensitivity of $3.25 would have incentives to adopt a project with a negative NPV of $10 million so long as his or her private benefits exceeded $32,500.

In a subsequent follow-up study, Hall & Liebman (1998) found that U.S. pay-performance sensitivities had more than doubled between 1980 and 1998, going from $2.50 to $5.30 per $1,000, largely due to the dramatically increasing use of stock options during the 1990's (Ibid). Around the same time Aggarwal & Samwick (1999) also showed that pay-performance sensitivities increased substantially, to over $14 per $1,000, if the volatility of the firm's stock (as a proxy for risk) was explicitly accounted for. Core & Guay (1999) went further and constructed a two-step model predicting both the optimal level of executive equity incentives in a firm and whether U.S. firms' between 1992-1997 had issued more equity if actual incentives deviated from the predicted optimum. Optimal incentives were determined by looking at firm

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[5] Out of the $3.25 a mere 30 cents, or less than ten percent, resulted from cash compensation such as salary and bonus (Jensen & Murphy, 1990, pp. 232).

size, risk and growth opportunities as well as other agency theory proxies[6], and the propensity to issue more equity was corrected by variables that may reduce a firm's willingness to do so, such as tax effects, the firm's cash position and other factors[7]. From their findings, the authors concluded both that firms manage the CEO's actual incentives with regards to what is optimal under agency theory and that they issue new equity grants to the CEO to correct for some, but not all deviations.

Conyon & Murphy (2000) compared large samples of similar U.S. and U.K. CEO's and found, after controlling for typical agency proxies[8], that levels of total annual compensation and pay-performance sensitivities were significantly higher in the U.S. As these differences would have to depend on U.S. CEO's being relatively less risk-averse; more productive than U.K. CEO's; or alternatively that U.K. performance is measured with more noise, neither of which has any empirical basis, the authors concluded that optimal contracting cannot properly account for the country-level differences. Instead the authors pointed to the differing corporate tax regimes (particularly the U.S. favorable treatment of options) as well as other economic, cultural and political factors. Conyon, Core & Guay did a follow up study in 2011, matching the 1997 set of U.S. and UK firms with the same firms in 2003. They found that, after controlling for typical factors[9] that influence pay, and risk-adjusting the total pay received by separating out the payments that hypothetically arise due to risk-averse executives being compensated for holding large equity incentives in their firms, U.S. CEO's did not appear to be overpaid in 2003. The authors pointed to the importance of risk when comparing pay levels, as it has the potential of explaining differences in absolute pay to a large extent, and suggested that future research should be focused on why the *composition* of pay and incentives differ between countries instead of total pay *levels*.

In the Swedish setting, Bång (2006) measured the pay-performance sensitivities in a random sample of 20 large firms and found a median of SEK 1.74 in CEO compensation for a 1,000 SEK change in firm value, equivalent to sensitivities at levels half of those found by Jensen & Murphy (1990) in the U.S. during the 1980's. Fernandes et al. (2011) found that Swedish CEO's held approximately ten times less stocks and options relative to annual cash compensation than their American counterparts and that cash compensation (including bonuses) lacked any correlation to stock returns. Combined with the previously

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[6] E.g. the existence of a free-cash flow problem, CEO tenure and industry dummies.
[7] E.g. size, growth opportunities, stock returns, whether or not firms were earnings/dividend constrained and industry dummies.
[8] These factors include size, industry dummies, risk, growth opportunities, CEO age, and whether or not the position of CEO and board chairman is combined.
[9] These factors include both governance and economic variables, such as: size, industry, leverage, growth opportunities, percentage of shares that are closely held, and whether the board and chairman role is combined. Governance variables are explicitly discussed in Section 2.3.

reported finding from Fernandes et al. (2011), that equity grants constituted around two percent of total compensation, this further implied that Swedish CEO pay had a very low exposure to stock price.

2.3 Managerial Power Theory

Managerial power theory, formalized by Bebchuck & Fried (2003; 2004) conceptualizes executive compensation partially within the agency theory framework, but considers how a relative power advantage possessed by self-interested executives versus boards of directors and shareholders in widely-held firms may produce compensation contracts that are less than optimal. Further, managerial power theory argues that boards' may lack the ability or willingness to impose optimal contracts. In general, these issues result from the CEO being able to influence board elections; the dynamics of the board room; the size and make-up of the board[10]; a lack of economic incentives for directors; information disadvantages, as the CEO exerts a large amount of control over what information and which proposals reach the boardroom; the fact that compensation consultants that design compensation proposals are frequently hired by the CEO or his/her subordinates (e.g. the HR-department); and because directors usually lack the time and expertise required to scrutinize proposals and craft counter-proposals (Bebchuck & Fried, 2003;2004).

These departures from arm's length bargaining, coupled with factors that limit the markets ability to correct inefficiencies (e.g. anti-takeover provisions that limit the market of corporate control, insulating entrenched executives), allows self-interested executives not only to extract more compensation than what is optimal (rents), but also to do so in less risky forms than what would be the case under optimal contracting. It is theorized that the largest costs to shareholders result not from the rents extracted by managers, but from the weakened and in some cases perverse incentives that can arise from inefficient contracts. For instance, the costs accrued from whatever additional salary an entrenched CEO can extract from a firm is hypothesized as smaller than the cost incurred by the empire-building activities that same entrenched CEO can engage in in order to create a larger, more prestigious and well-paying firm to run as there are no proper mechanisms in place to discourage such behavior (Bebchuck & Fried, 2003; 2004)

Under the theory, the main restriction on how high executive compensation can rise, and how distorted incentives can become, is whether or not the compensation practices gives rise to *outrage* among relevant outside groups such as shareholders, the business community, industry press and employees. It is also

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[10]E.g. inefficiently large boards, interlocking directors, non-independent directors and combined board chairman-CEO roles.

posited that executives are less entrenched when there are one or more large outside shareholders (block holders) and a larger concentration of institutional owners, as they tend to monitor executives more closely. Empirically, managerial power studies focus on examining how conditions that increase the entrenchment and relative power of executives adversely affect firm performance and compensation practices both by weakening incentives and increasing levels of total pay (Bebchuck & Fried, 2003; 2004; Bebchuck et al., 2002).

Core et al. (1999) was one of the seminal studies examining the impact of ownership and governance structures on CEO entrenchment. They studied US firms, investigating whether weak governance led both to inferior pay practices and subsequently poor firm performance. Their results showed that, even after controlling for standard agency determinants of CEO compensation (e.g. firm risk, size and performance), board-of-director inefficiency variables such as board size; whether the CEO also held the position as chairman; whether outside directors were appointed by the CEO or considered gray[11]; whether directors were busy[12]; and director age had a significantly positive effect on CEO pay. Further, ownership variables, i.e. the CEO's ownership stake and the existence of a block holder, had significantly negative impacts on CEO pay. To test for whether the observed differences in pay were the result of an entrenched CEO the authors also examined whether the board- and ownership variables were correlated with future firm performance, measured by ROA and stock returns. The results indicated that poorly governed firms not only paid their CEO's more but also suffered poor subsequent performance.

Bertrand & Mullainathan (2001) demonstrated that a sample of U.S. CEO's total compensation responded as much to a "lucky" dollar, i.e. one depending on an observable shock to performance beyond the CEO's control, as to a general dollar in terms of shareholder value increases, which they considered incompatible with optimal contracting. The authors proposed that this was due to entrenched CEO's capturing or "skimming" the compensation process. They found that entrenchment and skimming was less prevalent in well-governed firms, with the strongest influences being whether or not large shareholders are present on the board and board size.

Bruce et al. (2003) studied a sample of U.K. firms during 1997-1998, a few years after LTIPs were first introduced as a replacement for stock option programs there. The authors argued that while LTIPs do have the potential to preserve shareholder interests by increasing pay-performance sensitivity, there are several specific issues with these types of plans vis-à-vis options. First, there are skimming opportunities

[11] Grey directors are outside directors who receive compensation in excess of their typical board fees, e.g. for consulting engagements and other business with the firm.
[12] Busy is defined as serving on a large number of boards simultaneously.

resulting from how performance is measured under the plans. Second, the overly complex nature of plans can prevent accurate evaluation by outsiders and an insufficient understanding of the incentives created. Third, the prevalence of "flat-spots" in the plans, i.e. levels of performance for which no pay-out is made, weaken incentives under exceptionally low or high performance. By studying a large sample of executives, while controlling for a range of typical factors such firm size, the author's found that the presence of an LTIP had a significant and positive effect on compensation, increasing it by 34.7 percent. Interestingly, and in line with managerial power theory, they also found significantly *lower* pay-performance sensitivity in firms' that used LTIPs. The authors noted that the link between rewards and share price development had been somewhat weakened by the use of non-share price related and relative performance criteria in LTIPs, as well as the previously described flat-spots in these programs.

Hartzell & Starks (2003) studied the relationship between institutional ownership concentration and executive compensation in a sample of U.S. firms, to test whether institutional ownership was a safeguard against CEO entrenchment. They found that institutional ownership had a strong positive correlation with pay-performance sensitivities. The relations they found were very solid[13], even after testing for wide variety of control factors. They simultaneously studied levels of pay and found a negative correlation between institutional ownership and levels of pay, even after controlling for firm size, industry, investment opportunities and performance. Additionally, they found that changes in institutional influence were followed by changes in executive compensation. In sum, their results provided support to the hypothesis that U.S. institutional investors influence the structure of executive pay by both lowering pay and making it more dependent on share price development. Almazan et al. (2005) added to these findings by examining whether the intensity of monitoring is different across different types of institutional investors. They found that increases in pay-for-performance sensitivity were positively related to increases in the concentration of active institutions, such as investment companies and investment managers, but found no relation with the concentration of other, more passive institutions, such as pension and mutual funds.

[13] An increase of one standard deviation in the percentage of the top-five institutional investor shareholding was associated with an estimated 20% increase in the sensitivity of total compensation to shareholder wealth.

Combining optimal contracting and managerial power approaches, Samani (2012) studied the determinants of compensation in all OMX Stockholm-listed Swedish non-bank companies between 2005 and 2009. While controlling for agency and governance factors, the author tested the relation between executive compensation and different variables[14] related to the specific ownership and governance structure in Sweden, specifically comparing firms with dominant owner-families with non-family owned firms. Limited by data constraints, the study investigated equity compensation through a yes/no dummy variable. The author found that non-family firms tended to pay their CEO's more (in cash), that a larger percentage of cash compensation was variable and that equity pay was more prevalent in those firms. In line with theory, it was also found that the total capital held by the largest owner has a negative and significant correlation with total pay, pay variability and equity incentives. Further, CEO's that belonged to a firm's owner family received lower total compensation. The presence of a CEO on the board as well as the proportion of board members that were dependent of the firms' largest owners showed no correlation with the studied compensation characteristics. Lastly, the proportion of the board constituted by employee representatives had a significant and negative correlation with the prevalence of equity pay.

Using a previously unavailable dataset, Frydman & Saks (2010) analyzed the long-run development in pay levels and composition for the highest paid executive of the 50 largest U.S. firms between 1936 and 2005. While they found relatively stable pay levels and pay-performance sensitivities from 1930 to 1970-1980, rapid increases occurred after that – particularly due to the increasing use of executive stock options. The authors tested a range of possible explanations provided by optimal contracting and agency theory in order to explain the radical changes in pay practices during later decades, questioning many central notions within theory. First, CEO entrenchment and rent seeking was called into question by pointing out that pay had been stagnant at low levels for the first decades of the studied period during which time corporate governance practices were arguably weaker. Second, while ownership concentration did decrease during the period (by five percent on average), which could explain poorer compensation practices; changes in pay were far more radical (median CEO pay increased fivefold). Third, size increases, which are a common explanation for rising pay and shifting pay practices within agency theory, only correlated strongly with compensation during the last 35 years studied. The authors also argued that this may be due to an independent simultaneous increase in both variables, questioning the causality between size and pay. Finally, the authors critiqued the standard principal-agent model by pointing out

[14] These factors include the total capital held by the largest owner, the prevalence of a non-controlling blockholder, the size of the disparity between voting and cash-flow rights due to stock with differentiated voting rights, the prevalence of a CEO on the board, whether the board has a compensation committee and the proportion of the board that is constituted by employee representatives.

that the inclusion of unobservable parameters, such as managerial risk aversion, makes it virtually untestable. Even under very strong assumptions, however, they found illustrative evidence to suggest that the increase in compensation risk resulting from a shift towards larger equity incentives (higher pay-performance sensitivities) could not completely explain rising pay levels. To conclude the authors suggested other hypothetical explanations for shifting pay practices, including but not limited to changes in societal norms with regards to compensation.

2.4 Institutionalism and Institutional Factors

The legal and regulatory environment that a firm operates in has shown to effect governance practices, including executive compensation, greatly (see e.g. La Porta et al., 1999). According to institutional theorists such as Meyer & Rowan (1977), DiMaggio & Powell (1983) and Scott (2001) legal and regulatory institutions and the pressure they exert are, however, only a part of a larger totality of institutional influences that together determine how a firm is structured and what types of practices it engages in. Two key notions within institutional theory are credibility and legitimacy, it is hypothesized that organizations are inclined to act in certain ways based on whether or not the their chosen actions make them appear credible and legitimate in relation to their peers (Meyer & Rowan, 1977; DiMaggio & Powell, 1983). More specifically, institutional scholars predict an *isomorphism* of firm practices, where firms are pressured to adopt behaviors that have become legitimized in their specific environment (Ibid).

DiMaggio & Powell (1983) identify three separate isomorphic pressures that shape firm behavior: *coercive* isomorphism, *mimetic* isomorphism and *normative* isomorphism. Within the executive compensation domain, coercive isomorphism can be understood as regulatory pressures to adopt certain practices, mimetic isomorphism as firms essentially copying practices from successful peer firms and normative isomorphism as firms' more or less uncritically following normative prescriptions from consultants (see e.g. Bender, 2003). Under institutional theory, firms are loath to innovate on their own, as these coercive, cognitive and normative influences and the fear of appearing illegitimate or lacking credibility create a great deal of inertia and social embeddedness (Scott, 2001). When change does occur, it is usually due to one or more key drivers: political pressures that arise from shifts in interests or power distributions among existing institutions, social pressures from interest groups that have conflicting priorities and/or apparent deficiencies in performance (Oliver, 1992). Within the compensation domain, specifically, Bruce et al. (2005) identifies e.g. the need for a firm to gain access to international capital, the internationalization of the market for executives and changes in the influence of different stakeholder groups as drivers of institutional change. Chronologically, it is predicted that organizational innovations and new practices will initially be adopted by firms due to their technical or economical salience, but that widespread adoption over time is more driven by concerns of appearing credible rather than due to functional concerns (Meyer & Rowan, 1977).

When taking a firm's institutional environment into account, CEO compensation decisions depart from the rational-functional reasoning applied within economics in general and agency theory in particular (Bruce et al., 2005). Instead, firm decision making with regards to executive pay becomes just as much dependent on rules of thumb and generally accepted notions regarding what is appropriate in any one setting at any one point of time (Ibid). Eisenhardt (1988) provides a useful summary of the radically different perspectives provided by agency theory and institutionalism, summarized in Table 4, but stresses like many other researchers that the two should be seen as complements rather than substitutes. Further, the author cautions against considering institutionalized decision making, or satisficing, irrational: "the use of structures and processes that are legitimated by an environment can be sensible because it implies responsible management, pleases external others, and avoids potential claims of negligence if something goes wrong" (Eisenhardt, 1988, pp. 491).

	Agency Theory	**Institutional Theory**
Key idea	Organizational practices arise from efficient organization of information and risk-bearing costs	Organizational practices arise from imitative forces and firm traditions
Basis of Organization	Efficiency	Legitimacy
View of people	Self-interested rationalists	Legitimacy seeking satisficers
Role of environment	Organizational practice should fit environment	A source of practices to which organizations conforms
Role of technology	Organizational practice should fit technology employed	Technology moderates the impact of institutional factors or can be determined institutionally
Problem domain	Control problems (vertical integration, compensation, regulation)	Organizational practice in general
Independent variables	Outcome, uncertainty, span of control, programmability	Industry traditions, legislation, social and political beliefs, founding conditions that comprise the institutional context
Assumptions	People are self-interested, rational and risk averse	People satisfice and conform to external norms

Table 4: Agency vs. Institutional Theory (Adapted from Eisenhardt, 1988)

A direct product of satisficing and the strive for organizational legitimacy within institutional theory is *de-coupling*, where firms symbolically adopt certain practices to signal credibility, but in reality do little or nothing of substance to alter the way they actually operate (Meyer & Rowan, 1977). Westphal & Zajac (1994) studied the role that legitimacy and de-coupling plays within executive compensation by examining the adoption and subsequent use or disuse of equity-based incentive programs among a large sample of U.S. CEO's between 1972 and 1990. The authors suggested that firms were inclined to propose equity-based incentive programs since doing so symbolized a legitimate practice (aligning executive and shareholder interests), but that certain firms would subsequently fail to adopt or adopt only minimal actual equity incentives (Westphal & Zajac, 1994). Specifically, and in line with both institutional theories of change and managerial power theory, they hypothesized and found that the gap between formal adoption and actual equity issuances increased over time, with larger discrepancies among late adopters with influential CEO's. Additionally, the authors demonstrated that firms with poor performance, which under the principal-agent model have a greater need for strong incentives, were initially more likely to both propose and use equity-based compensation plans but that this effect diminished over time, with later firms being more inclined to use plans only symbolically (Ibid).

Conyon et al. (2011) examined institutional isomorphism and hypotheses related to managerial power theory. Looking at a sample of the largest U.K. firms' during 2003 the authors found that, even after controlling for typical factors[15] predicted to influence pay under both optimal contracting and managerial power theory, the shared use of consultants among firms led to converging pay practices, i.e. normative isomorphism; that simultaneous director and consultant interlocks led to increases in total pay, in line with both managerial power theory as well as normative and mimetic isomorphism; and that the level of total compensation in a firm increased if a compensation consultant also provided other services to the firm, as predicted by managerial power theory (Ibid).

Departing from the heavy dependence on quantitative studies of archival data in compensation research, Bender (2003) interviewed key decision-makers in two large listed British utilities in order to shed new light on the determinants of pay packages. The author specifically examined the institutional concepts of legitimacy and isomorphism, and found evidence of such reasoning among the individuals that influenced compensation practice. Moreover, agency theoretic conceptualizations regarding compensation design at times appeared out of step with organizational reality. Specifically, and directly in conflict with optimal

[15] These factors include firm size, performance (shareholder returns), growth opportunities, whether the role of chair and CEO is combined, the fraction of directors that are outsiders and the capital held by the largest owner (Conyon et al. 2011).

contracting theory, the author noted indications that directors were uncomfortable with "punishing" executives for poor performance under long periods of time and that incentive programs which did not result in payouts were viewed as problematic even if this was due to "poor" performance (Ibid, pp. 210). The author further examined how British firms made the decision between executive option programs versus LTIPs, finding suggestive evidence that coercive isomorphism (in the form of the self-regulatory Greenbury report which heavily criticized the use of options in 1995) and mimetic isomorphism (attempts to determine what was in "favor" at the moment) influenced compensation choices. The author also queried one director with regards to the observation that the LTIP of the utility where he served was very similarly designed to one in another, radically different, company where he also held a directorship, noting suggestions of normative isomorphism: "[The director] pointed out that the two companies share a remuneration consultant, and suggested that perhaps was the other obvious place to look as regards similarities in schemes." Moving on, the author found that practically all interviewees implied that there were no a priori truths regarding levels of pay or caps on how much pay should be variable, but rather that these decisions were made by looking at "comparative" firms to determine what was appropriate in any one setting, suggestive of isomorphic pressures, satisficing and legitimacy-seeking behavior. It was also indicated by firm representatives that it was appropriate to use consultants for this purpose (determining "market practice"), as their supposed neutrality conferred legitimacy (Ibid, pp. 214).

Bender (2004) sought to further examine the underlying motivations for using performance-related pay, interviewing key decision-makers at twelve large British firms'. Querying interviewees regarding whether they believe that performance contingent pay incentivized and motivated executives garnered mixed results, with several responses indicating that they did not believe this was the case (directly in contrast with agency theory) and no respondents indicated that they believed that the point was to make executives work more or harder (Ibid, pp. 526). Turning specifically to LTIPs, the author honed in on the fact that "long-term" almost always equaled three years in the British setting, finding heavy indications of isomorphism: the respondents appeared to suggest that there was no business logic involved in defining "long-term" as a three year period, but that this was simply due to the fact that it had become the accepted definition (Ibid, pp. 529). The author also found that the need to adhere to "best practice" and "good corporate governance", i.e. a need to appear legitimate, was a central motivator for many decision-makers when deciding to implement LTIPs – in the words of one respondent: "[…] a third of the total remuneration is "performance related". So you can write that down in the report and accounts, and when anybody questions you, you say: "we're complying with best corporate governance of the moment, and we have a substantial part of pay which is variable and subject to performance, etc. etc." (Ibid, pp. 530). In sum, the author concluded that the need for legitimacy and coercive as well as mimetic isomorphism had visible implications for how decision-makers approached variable pay: "By following market practice in structuring their executive packages, the companies are not standing out from the crowd, and are likely to draw support from relevant constituencies, in particular the institutional shareholders." (Ibid, pp. 531)

In a further study illustrating institutional isomorphism in executive compensation practice, Main et al. (2008) interviewed 22 directors serving on the remuneration committee of a total of 35 large UK corporations. Like Bender (2003; 2004), the authors found notable skepticism regarding the motivational aspects of equity incentive schemes among respondents (Main et al., 2008, pp. 230). Also prevalent was a concern among directors regarding how proposed programs would be interpreted by relevant outsiders, particularly institutional investors (Ibid). In general, the authors found that interviewees struggled with achieving both "performance", i.e. designing a scheme that would fit roughly under the tenets of optimal contracting on the one hand, and "conformance", i.e. proposing schemes that would be acceptable to outsiders on the other. One particularly prevalent example of conformance-seeking was the way in which companies chose performance conditions for their executive stock option or LTI programs: directors often could not motivate the chosen metrics in any way other than that they thought they would please institutional shareholders (Ibid). This was attributed as one possible reason for the curious observation that out of the 22 firms employing LTI programs in the sample, 19 had chosen the exact same performance metric (relative TSR) – the same metric preferred by the Association of British Insurers (ABI) (Ibid, pp. 230-231). Further, the authors found little evidence of any active management of the total level of incentives or pay-performance sensitivities, as suggested by Core & Guay (1999) and others, noting instead that plans tended to be viewed in isolation, with much more attention devoted towards ensuring that new equity plans were in conjunction with outside demands. In the authors words, and in direct conflict with optimal contracting: "Each year's reward tended to be treated on its own as a separate event, rather than as the opportunity to "rebalance" the executive's "reward portfolio" in the light of recent developments" (Ibid, pp. 233).

2.5 Research Summary

As this review demonstrates, a vast body of research related to executive compensation has emerged since Jensen & Meckling (1976) first theorized about how dispersed shareholders could prevent opportunistic behavior among self-interested managers via pay structures. Among optimal contracting theorists, incentives have been regarded as either too "low" (Jensen & Murphy, 1990), "satisfactory", particularly in recent decades (Frydman & Saks, 2010) or almost perfectly aligned with theory (Core & Guay, 1999). Various measures of size, risk, growth opportunities and other economic variables have been debated as explanatory variables for the appropriate structure of pay and levels of equity incentives. Managerial power theorists have further proposed that governance failures have resulted in ineffective, even harmful, compensation arrangements, demonstrating this by showing how measures of weak governance such as ineffectively large boards, combined chairman and CEO roles, the lack of monitoring block or institutional shareholders and other factors relate to both poor compensation practices and performance. In the Swedish setting, Bång (2006) and Fernandes et al. (2011) have shown exactly how much "weaker" equity incentives are for Swedish CEO's compared to their American, or even European, counterparts and Samani (2012) has, moreover, given initial clues as to how economic and governance variables specific to the Swedish setting might influence its relatively unique pay structure.

Few answers, except anecdotal accounts, have emerged within the economic research streams to explain observed differences in equity incentive levels between different countries, with the extremely influential researchers Conyon & Murphy (2000) and Conyon, Core & Guay (2011) providing perhaps the best examples of this in their comparisons of US and UK CEO's. Research adopting an institutionalist perspective has, however, been able to give indications on how time and place can affect pay practices by demonstrating how coercive, normative and mimetic isomorphic pressures confine and guide the behavior of corporations in this regard. Both quantitative (e.g. Conyon et al., 2011), but also rich qualitative data (e.g. Bender, 2003; 2004) has indicated how external influences define the appropriateness of compensations structures, particularly with regards to equity incentives, and demonstrated the incompleteness of agency theoretic a priori prescriptions in how pay is structured and determined.

3. Methodology

This section will initially present and explain the methodology of choice, followed by a description of the process design with focus on sample selection of an exploratory character. Subsequently, type of interviews and execution will be touched upon as well as a critical discussion of the study's quality.

3.1 Choice of Study Method

A qualitative, exploratory approach with semi-structured interviews has been used for the purpose of this research in order to explore the composition of executive compensation in a Swedish setting. More specifically, the purpose was to develop a better understanding regarding the processes involved when making decisions on executive compensation, equity-based pay in particular in Sweden. Archival data on CEO compensation for all companies listed on Stockholm large cap has been hand-collected from annual reports between the years 2006-2011 and used for the purpose of sample selection.

Historically, executive compensation research has been focused on archival data where pay-performance sensitivities and other quantitative measures have been studied to draw conclusions on optimal levels and composition of pay (Tosi et al., 2000). This is particularly true in the US where access to detailed data on executive compensation has been long available through extensive databases[16]. Several attempts have been made to quantitatively explain changes in composition and levels of executive compensation. Despite this, the findings are widespread and often contradicting, unable to provide clear answers (see e.g. Frydman & Saks, 2010). O'Neill (2007) provides an explanation to the lack of convergence in executive compensation research outcomes and mentions methodological dogmatism as one of the reasons. He argues that traditional research methodologies (quantitative methods) are problematic in several ways. Firstly, the possibility of spurious correlations is leading to doubtful claims of causality (see Frydman & Saks, 2010). Secondly, as already touched upon, the archival data sources are often unreliable due to the dynamic effects of time-frames of LTI programs and the "leaps of faith" required to draw conclusions from archival data used as proxy variables.

The method of choice in this thesis, the qualitative interview study, was adopted as it was deemed the most suitable method providing a chance to explore this complex subject from different theoretical perspectives. Firstly, qualitative studies are more suited to answer *why* questions, in particular one seeking to explore an issue that has not been fully addressed in any previous studies. Secondly, the available data

16 Most quantitative research in the US is based on input from ExecuComp, a database providing detailed breakouts of compensation data of US CEOs.

on executive compensation in Swedish companies is not comprehensive enough for a high quality quantitative study. Several assumptions regarding option pricing for the purpose of valuation as well as number of shares allotted under LTI programs would have to be made, weakening the validity and quality of potential findings. In addition, as there are no databases readily available on Swedish executive compensation it would require too much effort to conduct a quantitative study, unrealistic for the size and time constraints of this particular study. Thirdly, a qualitative study on this subject should be a greater contribution to the existing academia as most current executive compensation research focuses on price-performance sensitivities and other statistical measures but lack the ability to capture soft issues like societal norms and other contextual factors that might impact the Swedish remuneration practices.

Moreover, it is an exploratory study, an appropriate approach in this area as most previous studies have analyzed archival data and there is very little in the existing body of literature that discusses determinants of executive compensation practices (Bender, 2003). The Swedish practice with regards to LTIPs in particular, has to our knowledge not been subject for any qualitative research at all. The exploratory study is therefore an attempt to open up research questions around the context of this issue that earlier analyses have ignored or overlooked. Another advantage of using this method was the possibility to modify the research question if new interesting angles and problems occurred as the study progressed.

3.2 Sample Selection

In terms of the interview design process, there are many decisions that must be carefully considered, such as who to interview, what questions to ask, how many interviewees will be required and what type of interview to conduct (Qu, Dumay, 2011).

A total of 13 interviews were conducted with people in positions to provide insights in the researched subject, 12 of them were included in the empirical sample. Silverman (2010) describes this as a purposive sample and respondents were selected on the basis of the groups the research addressed. The first interview was a pilot-interview, conducted with a compensation consultants for the purpose of testing the research question and hone the interviewing skills of the researchers. The following 12 were conducted with key decision makers within executive compensation practice in Sweden: board members and institutional owner representatives.

Vital for the study was to choose a sample of individuals in key positions to understand and influence the decision making of executive remuneration policies in Sweden. Given the chosen study question and scope of the study, the group of people deemed most suitable to interview initially was board members in Swedish large cap companies. Not only do board members have a lot of experience on executive pay setting, they are often present in several boards at the same time and many of them have also acted as CEO's in their previous careers.

An apparent problem when choosing a sample of board members in large cap companies is obtaining access. Due to this, it is difficult to avoid a certain amount of opportunism in the selection of interviewees (Silverman, 2010). To avoid subjectivity when establishing the sample, the archival hand-collected data of levels and composition of executive compensation for CEO's in Swedish large cap companies was used. The companies were ranked based on level of share-based payment and divided in three groups (high, medium, low) with respect to cost for LTI programs in relation to total cost for CEO remuneration. Two companies in each group were identified and their board members contacted. Due to the difficulty of reaching this group of people, we initially approached board members in companies were we had a weak established contact. A total of six interviews were conducted with board members in companies with high, medium and low levels of equity-based pay.

Early in the interview process it was discovered that large Swedish institutions, e.g. pension-, life- and mutual funds, seemed to have a large impact on the pay setting process in Swedish large cap companies. With regards to the exploratory character of this study a choice was made to investigate this path further by including a sample of institutional owners in the interview sample. Six of the largest institutional shareholders with holdings in the large cap companies included in the initial sample were contacted and asked to participate in the study. A table summarizing the 12 interviews can be found in the end of this section (Table 5).

The respondents were contacted by email or phone. All of the approached respondents agreed to participate in the study after the research question was briefly described. The researchers did not have a direct relationship with any of the participating respondents, however they had established a relationship with some of the board members during the work with their bachelor thesis in 2010. The institutional representatives on the other hand seemed to find the subject very interesting and relevant and were positive to participate. Given the scope of the study, it is difficult to generalize to an overall population from this work. However, given that all the respondents agreed to participate when asked, without any close relationships, bias toward people or companies taking a certain stand in the specific issue was limited to some extent (positive or negative towards LTI programs).

3.3 Interview Structure

The interviews were of a semi-structured character and involved prepared questioning guided by theory-related themes in a systematic manner. Semi-structured interviews are capable of disclosing important and sometimes hidden facets of human and organizational behavior. It can often be one of the most effective and convenient means of gathering information (Kvale & Brinkmann, 2009). Relatively open questions and loosely structured interviews are suitable if there is little knowledge and an explicit need in exploring an issue (Flick, 2009). In addition, it enables a good qualitative analysis of the respondents' answers and is in line with the exploratory nature of this study. One problem that may arise when interviewing senior people like board members is their habit of leading conversations and focusing on topics and issues that they are passionate about (Andersen, 1998). This was something the researchers kept in mind to ensure that the interviews preceded within the confines of the formulated questions and to the extent it was possible, avoided to spend too much time on details that were outside of the study's purpose and problem area.

When it comes to the interview questions, they were initially tested in the pilot interview and later modified in two versions, one for the board members and one for the institutional owner representatives. Research that is informed by previous theory and research is described as inductive (Rowley, 2012). In line with inductive research the interview questions was derived from economic theories commonly used in executive compensation theory (optimal contracting theory and managerial power theory) and from institutional theory.

3.4 Quality of the Study and Data Analysis

Reliability and validity are two commonly used terms in quantitative research when discussing quality and credibility of a study. While the credibility in a quantitative study depends highly on instrument construction, the main instrument in a qualitative study is the interviewer (Patton, 2002). The qualitative research is therefore more dependent on the ability and efforts of the researcher. Terminology that encompasses booth validity and reliability, such as quality, rigor, credibility and trustworthiness are more appropriate in a qualitative paradigm (Golafshani, 2003).

The concept of triangulation has risen as an important methodological issue in qualitative approaches (Mathison, 1988). The method has been used in this thesis as a strategy for promoting and strengthening the quality and rigor of the research. Triangulation can be adopted in several ways; in this study mainly two methods have been used. Firstly, quantitative archival data was used to choose the initial sample of interviewees with the purpose to include individuals representing companies with different approaches to equity-based pay (high-, medium-, low levels of LTIP). Secondly, by using different theoretical perspectives (optimal contracting, managerial power and institutional theory) the issue could be studied from several angles and a wider picture of the phenomenon was likely to be captured. In addition, involving two researchers with different theoretical-methodological backgrounds (accounting and management) is also an example of triangulation and was used as a strategy for improving quality (Flick, 2009).

Moreover, as mentioned above interview-based research is highly dependent on the interviewer's capacity to collect and analyze data in an objective way. To avoid biases and improve trustworthiness and credibility of the research, two different groups of respondents were chosen with different perspectives and decision making authority in the issue. In addition, the board members in the sample represented companies with different levels of share-based remuneration and type of LTI programs to get a fair view of the process. All of the respondents were promised to be fully anonymous in order to assure an open discussion during the interviews with no fear of revealing their actual personal opinions. At the start of each interview permission was sought to record the interview, in addition, notes were taken by both researchers in case of technical problems, which occurred at one occasion, resulting in a total of 11 recorded interviews and one were we had written notes. The records were later transcribed resulting in an extensive amount of data that was systematically analyzed. The material was initially divided into different topics based on central issues touched upon during the interviews. It was subsequently coded in order to systematically analyze important issues in an effort to really understand what the respondents had told us with the purpose to answer the research question.

Interviews	**Date**	**Position relevant for this study**	**Use of LTIP low-high**	**Comments**
Director 1	15/Oct/12	Board member, Large Cap	Low-LTIP	-
Director 2	22/Oct/12	Board member, Large Cap	Medium-LTIP	MD insurance fund and serves in several nomination committees
Director 3	25/Oct/12	Chairman of the board & remuneration committee, Large Cap	High-LTIP	Retired as Chairman 2011
Director 4	25/Oct/12	Chairman of the board & remuneration committee, Large Cap	Medium-LTIP	Retired as Chairman 2011
Director 5	26/Oct/12	Board member, Large Cap	High-LTIP	-
Director 6	6/Nov/12	Board member, Large Cap	Low-LTIP	-
Representative 1	31/Oct/12	Institutional owner representative, Head of Corporate Governance	Pension fund	Serves in several nomination committees
Representative 2	9/Nov/12	Institutional owner representative, Managing Director	Mutual fund	Serves in several nomination committees
Representative 3	9/Nov/12	Institutional owner representative, Head of Corporate Governance	Pension fund	Serve in several nomination committees
Representative 4	22/Nov/12	Institutional owner representative, Head of Corporate Governance	Pension fund	Serves in several nomination committees
Representative 5	23/Nov/12	Institutional owner representative, Director	Mutual fund	Serves in several nomination committees
Representative 6	27/Nov/12	Institutional owner representative, Director	Mutual fund	Serves in several nomination committees

Table 5: Interviews

4. Empirical Findings

This section will describe and explore the empirical results revealed from the qualitative data collected during the interviews. The section is thematically divided into seven main headings based on recurring subjects and issues discussed during the interviews.

4.1 The Effect of Equity-based Compensation on Performance and Behavior

The main argument stated for setting a competitive remuneration package to the CEO according to the Swedish Governance Code is to attract, retain and motivate him or her to make the best possible job with maximizing shareholder wealth in the long run. This reasoning also repeated in the studied companies remuneration guidelines. Philosophies regarding how various forms of equity based-compensation helped achieve this goal varied among respondents. Most interviewees voiced opinions regarding how current LTI programs affect performance and behavior, particularly regarding its motivational effect and whether it serves to further the alignment of interests between the CEO and shareholders.

A clear majority of the board members shared the perception that variable pay in general and equity pay in particular is theoretically sound in order to create the right drive and motivation for a CEO, often referring to the "competitive instinct" that exists among CEO's. Half of them, however, cautioned that it was not possible for CEO's to work any harder than they already do, indicating that motivation may mean something else than inducing the chief executive to avoid "shirking" in this context. Further, an issue voiced by many was the difficulty involved in implementing incentive plans that achieved the desired theoretical effects in practice. A poorly constructed program was seen by most board members as having clear demotivating effects. Specifically, one director cautioned against too strict incentive plans with low allotments or misguided performance conditions:

> "If the owners place too high demands on performance conditions or include factors that the CEO cannot influence, there is a quite large risk that the outcome from the programs will be zero. In these cases, the programs can instead become very demotivating for top executives." (Director 1)

A recently retired chairman of a company where LTI-programs stated further:

> "A key driver to the use of share based-programs is that the absence of them is highly de-motivating, [The use of LTI programs] is a self-generating process." (Director 3)

The risk of plans becoming overly complex, resulting in a situation where plan participants do not understand conditions, was also brought up by several of the respondents as an example of where the motivational effects are lost. This is something that will be discussed at length later. Despite having a positive view of equity incentives in general, two of the directors had an underlying perception that in reality it is non-pecuniary factors that motivate most CEO's to do a great job. A board member in a company that has previously used strong option-based incentives illustrated this by stating:

> "Although it is not an opportune thing to say, I do not think these people [CEO's] perform better just because they get paid more through generous LTI programs." (Director 5)

The view of equity programs as motivators was equally ambiguous among the institutional representatives. While several of them indicated that they believed that they had motivational effects, many caveats were brought forward. Two representatives made specific references to a number of CEO's who had performed well in their positions and concurrently been very well remunerated for this exceptional performance, but suggested that their motivation would not have been any lower in the absence of monetary incentives above and beyond their base salary. Specifically, one of them stated:

> "What is most important for these people? Remember, we are talking about people [CEO's] who already earn millions in salary. Is it not other factors, like their reputation and public perception that matters?" (Representative 2)

Another representative had opposing arguments, stating that equity incentives could indeed have quite powerful effects on motivation, but – and in a similar vein as some of the directors – that many LTI programs were simply too weak or poorly constructed to achieve this in practice:

> "You see quite a lot of programs that do not result in any awards […] When the programs result in no or a very small award it will not change anyone's behavior or have any motivational effects […] The program has to be properly constructed. The CEO's economy must be dependent of the firms' development for it to give any effect." (Representative 6)

A second aspect discussed with the respondents was whether equity programs in general and LTI programs in particular achieved an alignment of shareholder and CEO interests. A clear majority of respondents were theoretically in favor of CEO's owning shares in their companies in order to align interests and get a synchronized agenda. Contrasting this with motivation, one board member likened share-based LTI-programs to an educational tool, stating that a CEO would not work harder because of the plans but more focused and more in step with shareholders. However, there were discrepancies in philosophies of how the allocation of shares to the CEO should be achieved. The current common practice, where the CEO receives shares or options for free if she or he fulfills certain performance criteria, was criticized by both board members and an institutional representative who argued that the alignment of interest might improve if they instead purchased all of the shares or options themselves in the market. While stressing that the appropriateness of share-based incentives vary between firms, one director stated:

> "It should be clear that the shareholders and the CEO have the same agenda […] The best way to achieve this is to induce the CEO to purchase shares. Take out a mortgage on your home and buy shares." (Director 2)

When queried about why e.g. shareholding requirements hadn't replaced LTI programs as a means to promote CEO shareholding and interest alignment, references were made to the fact that CEO's may in some cases simply not afford to purchase the requisite amount of shares. This argument, however, was not considered valid by one of the institutional representatives:

> "We are not talking about supermarket check-out salaries here, the CEO and other senior executives can afford it. If you want the CEO to hold shares, make him buy them." (Representative 2)

Another institutional representative, working for a pension fund, believed that some plans observed in practice failed to achieve alignment. This was exemplified by the LTI program in one major Swedish company, where the CEO has the opportunity to receive nine shares free of charge for every share purchased if requisite performance is achieved:

> "The fact that the CEO gets a 90% discount according to this program is completely unreasonable. Too generous programs, like this one, tend to amount to a transfer of wealth rather than being an instrument for control." (Representative 3)

It is worth noting, however, that many respondents tended to have a pragmatic attitude towards existing LTI programs, even if they were not considered ideal. As one mutual fund representative stated:

> "As long as there is clarity, long-term thinking and measurability in these programs, they have a positive effect. They are beneficial as shareholders and the board can move the CEO in a certain direction by making them focus on particular goals, for example EPS." (Representative 5)

Finally, one director, who was positive to LTI programs in general, cautioned against ascribing unreasonable importance to equity-based incentives and their potential to align interests, invoking parallels to the U.S. and the financial crisis:

> "Look at Lehman Brothers, where executives held enormous equity stakes. It is fascinating that these Harvard MBA's still did not understand what they were doing […] The condition that the CEO holds a lot of shares is not a good enough factor for the board to abdicate. American literature [on compensation] is from a completely different world. A lot of these theories are gibberish." (Director 3)

In sum, respondents appeared to believe that equity-incentives and LTI programs had a role to play, particularly regarding the alignment of interests or inducing the CEO to prioritize certain outcomes. However, interviewees painted an ambiguous picture of how this should be achieved, and expressed some skepticism with regards to observed practices.

4.2 Contracting Compensation

4.2.1 Board-CEO Negotiation

In order to get an initial feel for how compensation contracts are drawn up, respondents and particularly directors, who tend to be more involved at this stage, were queried about the initial stages of the process. Particularly, we focused on whether there tended to be intense negotiations between the board and the CEO, with each party trying to preserve their own self-interests. Little systematic evidence of this emerged in the interviews. Rather, several directors said that while there were "some" negotiations, they were seldom particularly fierce. In the words of one director:

> "You listen to the CEO to get a feel for what he wants in order to be content, but there are no rough negotiations involved." (Director 6)

When negotiations did occur, it tended to be with newly appointed CEO's, those that had been in their position for a long period of time appeared to do so very seldom. As one director stated:

> "In my experience, negotiation processes very rarely occur, particularly if the CEO has held his or her post for a while." (Director 5)

This director also stated that it was important for the CEO to be content with the remuneration package, but that it was equally important that it did not "appear eye-catching". Another one pointed out that while he did once have a CEO that was very keen to negotiate; this was the exception rather than the rule:

> "In [Company 3] I did negotiate with one CEO, who was a very strong-spirited individual. It is however much more common that no such negotiations take place." (Director 3)

Several institutional representatives were quite critical to what they observed as a lack of negotiation. Two of them argued specifically that newly appointed CEO's had a great advantage over the board, as they tended to decide upon one specific candidate first and leave compensation matters as an afterthought . To illustrate how matters can sometimes get out of hand, with CEO gaining undue influence, a representative of a large pension fund shared this example:

> "I was in a meeting once, together with another institutional owner representative as well as a very high-profile board chairman, in order to discuss a certain clause in a LTI-program that we weren't satisfied with. The clause had been proposed by the CEO of one of the chairman's companies. After a long discussion we were able to reach an agreement to amend the clause. The next time I met this particular chairman, he came up to me and thanked me for helping him stand up against his CEO. This made me terrified." (Representative 1)

Finally, while discussing poorly constructed LTI programs, one institutional representative gave the following comment in reply to our question about why ill-conceived plans were implemented if they did not create value for shareholders:

> "I guess the board simply does not know how to negotiate." (Representative 3)

4.2.2 Compensation Consultants

In further discussions regarding the pay-determination process, almost all respondents identified that compensation consultants were involved in one way or another. Several of the interviewees also indicated that the use of consultants had increased in recent years, with one board member pointing out that it had become a major business for large banks and accountancies. One institutional representative argued that a major cause of increased consultant use was the aftermath of the IT and telecommunications crash in the early 2000's, when a lot of executive stock options became useless as the market crashed. This spurred a need for alternative solutions in equity-based pay, e.g. LTI programs, which the consultants were able to provide. Half of the board members stated further that they used consultants in order to benchmark the fairness of potential compensation packages and to indicate whether total CEO compensation was in line with market practice.

Several respondents further indicated that consultants were used specifically as a means to design LTI programs that were likely to be considered acceptable, and expected to stand up to scrutiny e.g. prior to a shareholder vote. One board member illustrated this with the following comment:

> "One of the reasons to engage external advisors is […] that they know what programs will pass through an AGM and which will not." (Director 1)

Two institutional representatives pointed out that Swedish LTI programs had become increasingly similar to British plans, which was explained by two main factors. First, when demand started to increase for consultants in Sweden, British firms were used in particular. Second, Swedish Corporate Governance is in several respects similar to that of the UK, making it easier to export practices. One of the institutional representatives illustrated this effect with the following comment:

> "Predominantly British firms have been used. […] The fact that Swedish LTI programs have become so similar to British programs is definitely due to consultants." (Representative 3)

The notion that consultants influenced the design of LTI programs was touched on by several respondents, who believed that external advisors had a homogenizing effect. To quote one of them:

> "Sometimes when you look at an LTI program, you can almost guess [which consultancy] designed it" (Representative 4)

This impression was most prominent among the institutional representatives, with one of them further stating that they also tend to push for specific proportions of fixed, variable and share-based remuneration. Two of the directors, meanwhile, implied that practices in incentive program use and design on the contrary were more likely to be spread between board members that are active at several boards at the same time rather than by consultants. One of them stated:

> "Consultants can lead to similar compensation levels as we use them to benchmark pay. But I do not believe they induce us to use the same LTI programs as other firms […] Rather, [the use of equity incentives] is more likely to be influenced by board members who bring with them experiences from other firms, which they in turn discuss with other directors." (Director 3)

The question of which party hires the consultant was also brought up during the interviews. One board member explained that while in the past it was usual that consultants were hired by management rather than by the board, this was no longer common practice. Another director added that today, in his experience, an LTI program work group is often set up consisting of the CEO, the HR-executive, the board chairman and the remuneration committee which together hire consultants as needed. The institutional representatives were slightly more concerned with current practices. One of them claimed that it appears to be far too common that programs are developed by management in collaboration with consultants and only subsequently presented to the board. Another stated that his impression was that consultants tended to have executive interests closest to heart. A further practice some institutional representatives considered inappropriate was that consultants, rather than the board, sometimes presented the LTI programs at the general meeting:

> "The board has to prove that they understand the program and have been involved in the development and design of it, it looks extremely bad to send out a consultant to present the proposal." (Representative 1)

Consensus among the institutions that this was commonplace on contemporary AGMs did however not exist, with one representative clearly stating that this was mostly a thing of the past and another claiming not to have observed it at all. Finally, one respondent offered the following reply when asked about whether companies referred to their consultants in order to legitimize their LTI program proposals prior to shareholder votes:

> "Yes, we see a lot of this. They like using British or American consultancies which provide them with a battery of acronyms to refer to when discussing proposals." (Representative 5)

To summarize, almost all respondents acknowledged the use of consultants, both to gauge whether compensation practices were appropriate in general but occasionally also more specifically when dealing with equity-based incentives. A clear majority was also positive to their use, or at least not directly critical, claiming that they had an essential role to play in compensation matters due to the complexities involved. In several cases it was identified that consultants appeared to have direct influences on how LTI programs were designed, and some institutional representatives were critical towards how companies dealt with them in practice.

4.2.3 A Global Market for CEO's?

Digging deeper into the compensation contracting process, the avenue regarding the internationalization of the labor, or in our case CEO, market was explored. A majority of the respondents argued that even though the world has become increasingly globalized, there is still a primarily domestic, or in some responses Nordic, market for CEO's. Swedish companies in general, indeed even the largest ones which are covered in this study, were seen as primarily recruiting from a Swedish or Nordic base. Consequently, most director-interviewees explained that they looked almost exclusively to other Nordic peer companies when benchmarking the reasonability of a CEO's compensation program. As a result, they had developed extensive knowledge about how pay practices look in other regional, and particularly domestic, firms. One director expressed this very clearly:

> "Sweden is basically an isolated country. You look to other Swedish or perhaps Nordic firms when benchmarking compensation programs, an international comparison is irrelevant [...] I do not believe in a global market for CEO's." (Director 4)

The retired chairman, who had been on the board of one of Sweden's largest firms, contrasted this viewpoint to some extent by arguing that a company with operations in several countries, comparable in size with other multinationals, should probably look outside the Nordics:

> "What is a proper benchmark for a company of this size really? We are far larger than our closest competitors in Sweden and despite this our CEO's compensation is constantly compared to these [smaller] firms in the media [...] compared to similar firms in Europe we are still in the very lower end when it comes to remuneration [...] Compensation should be decided with the Swedish setting in mind, but a European perspective should also be included." (Director 3)

Indeed, this was reflected in the LTI program of Company 3, which unlike many other Swedish firms included a pool of European competitors when determining CEO performance and subsequent share allotment under their plan. Two of the institutional representatives, who while believing that the CEO market was indeed domestic expressed concerns regarding a perceived isolation, suggesting that a lack of globalization could be negative for Sweden in the long run. Specifically, one of them stressed that Swedish compensation practices may make it difficult to attract foreign talent in the future. The other representative articulated similar worries:

> "The job as CEO is just as hard in Sweden as anywhere else [...] There is a clear risk if you deviate to much from the international norm [...] We have to be able to attract international talent to our major companies." (Representative 2)

This concern departed somewhat from the general perception of the board members and the rest of the institutional representatives who seemed slightly less concerned. The reverse situation was also discussed, i.e. whether there was a risk that potential Swedish-born CEO's would simply leave for greener pastures. This was not seen as an issue by most respondents. The two most common arguments presented to this end were that Swedish CEO's simply aren't as attractive abroad as in the domestic market, and that they lacked a strong interest in moving somewhere else. One institutional representative in particular indicated that Swedes were not very coveted abroad, but not stressed that this was not because they were incompetent or inferior in any way. Rather, cultural aspects and relationships were critical factors:

> "A company is not just the product, it is the culture and the people […] It is much more difficult for a Swedish CEO to assert himself in, for instance, an American firm […] Corporate culture is important when making a career." (Representative 3)

One director further argued that Swedish CEO's tend to be "very Swedish" and that they have their families and an established way of life here. It was a common belief that non-pecuniary factors had a larger impact on where a CEO chose to work. Two of the board members presented the same poignant example with regards to the differences between the Swedish and American market for executives: that companies with an American subsidiary almost always pay their regional American director more than their Swedish CEO. This was explained in market terms by one director:

> "The American director almost always gets paid more. People accept it because they know there are totally different pay structures and norms in the US […] It is simply a market pricing of CEO's." (Director 2)

4.3 Influences from the Swedish Governance Model

4.3.1 The Leo Act and Say-on-Pay

A explained in Section 1, Sweden has a relatively unique way of voting on executive compensation in general and equity-based incentive plans in particular. Or, alternatively, as expressed by one of the respondents: a very "Swedish" way. All companies in our sample comply both with Swedish law and with the remuneration section of the Swedish Code of Corporate Governance, and LTI programs under which shares are issued to the CEO must as such be accepted by shareholders in two separate votes. First, the use of LTI programs should be mentioned in the binding remuneration guideline document which requires a majority vote on each AGM to come into effect. Second, the issuance of equity to anyone employed by the firm must pass a $9/10^{th}$ majority vote at a GM in order to be legal.

The general perception among respondents was that the guideline document, requiring a majority vote, was very non-specific and boilerplate in terms of content. Dialogue with the owners prior to the AGM regarding the executive remuneration guidelines was also very uncommon. One of the institutional owner representatives explained that the "say-on-pay" vote was more of a formality: firms' guideline documents were very similar and not particularly controversial. One of the directors stated further:

> "The guideline document says nothing really. It is very general and most board members, including myself, add a standard-phrased paragraph in the end making it possible to deviate from the guidelines if the board finds it necessary to do so" (Director 4)

As such, say-on-pay appeared to have little or no direct implications on the use of LTI programs. A single exception to this general rule, however, became apparent during our interviews. One of the studied companies had seen their remuneration guidelines voted down on a recent AGM by its largest owner: the Swedish state, which – in line with its own guidelines on pay – required that all forms of bonuses and LTI programs be excluded from the binding document, together with any references to board discretion.

With the exception of that outlier, the Leo Act was considered far more consequential among respondents. Whenever new equity-based programs or large amendments to old ones were being planned, there were almost always informal contacts between directors and their larger shareholders, due to the 9/10th majority requirement. All participating institutional representatives often met with companies to discuss plans prior to shareholder votes and explained that it was common practice for institutions to get an opportunity to give feedback on proposed programs. Both groups of respondents stated in no unclear terms that the Leo Act created a need for dialogue between the company and its shareholders.

One institutional representative and one board member stated that as shares represented at any one AGM were usually at roughly 50% of the total, the real majority required to stop an equity-plan proposal was at 5-6% of outstanding shares. Another director further stated that it was "tremendously easy" to block a program. In spite of this, it was considered extremely rare for LTI plans to be voted down, particularly among larger companies. Two of the directors indicated that a no-vote was simply unacceptable, with one further implying that it in effect was a no-confidence vote for the board. A major reason presented for the absence of no-votes was due to the aforementioned process of "clearing" plans with larger shareholders in order to avoid any surprises. According to several respondents, this feedback process allowed large minority owners to effectively block proposals which they did not like before they were even presented at meetings. The director who also serves as an institutional representative explained:

> "Throughout the years loads of proposals have been stopped before they even reach the AGM, as companies usually check in with important shareholders before presenting them." (Director 2)

One of the institutional representatives further stated:

> "I have rarely, if ever, voted no to a proposal. This is due to the fact that companies amend or simply withdraw proposals if they believe that shareholders will not support them." (Representative 5)

A natural follow-up inquiry became what effects the Leo Act had on observed equity-compensation levels in Swedish companies. Many interviewees, both directors and representatives, stated that it had effected the use of LTI programs. In fact, only two of the twelve respondents, both directors, expressed the belief that the Leo Act did not have any implications on the existence and design of LTI-programs. One of the institutional owners elaborated on its perceived effects:

> "I think that the 90-percent rule [i.e. the Leo Act] has had a large impact on the number of share-based programs and their size. […] If we only had a 50-percent rule we would not have seen similar developments." (Representative 1)

Most of our respondents were sympathetic to the purpose of the Leo Act, defined as elevating protection to minority shareholders when moving large values out of the company, but critical to some of its implications. One of the institutional representatives argued that contrary to current practice, the board and not the shareholders should be responsible for LTI programs:

> "The Leo-act is a way for the Board of Directors to free themselves from responsibility. This is wrong and results in that no one takes direct responsibility for the programs […] theoretically, it seems like a good idea, but if you have been to a shareholders meeting, you will know it doesn't work in reality. I do not even think that everyone understands what they are voting on. It is wrong to place the responsibility at the GM." (Representative 3)

One board member had a similar line of argument, stating that the Leo Act itself is good but that it has become extremely expensive and difficult for large companies to gain acceptance for their programs as it requires the board to address and explain the LTI programs to every single large minority shareholder in advance. Another one stated that a two-thirds majority, as in the case of directed share issuances, would suffice. Yet another director noted that while there had been attempts to remove the 90 percent voting requirement from equity-based incentive plans, the effects of the law were in fact "very benign."

In sum, a rather clear pattern emerged during discussions about the Leo Act. With its $9/10^{th}$s voting requirement, it was seen as inducing dialogue between companies and their shareholders. This dialogue, in turn, tended to award the latter some influence over the content and extent of LTI program proposals.

4.3.2 Nominating Committee's and other Aspects

Other relatively unique aspects of Swedish Governance were also discussed with board members, such as the shareholder-elected nominating committee. Mostly, the respondents spoke about the nominating committee in general terms, describing it as an illustration of strong shareholder influence. All the institutional respondents disclosed that they tended to participate in the nominating committees of their larger holdings. One of the representatives further stressed that the work in nominating committees eases company-shareholder collaboration on compensation issues:

> "Companies and owners have met before [in the nominating committee] and there are thus established channels for discussions on compensation issues" (Representative 5)

This impression was also brought up by one of the board members. Another one mentioned that he thought that nominating committee's had led to lower compensation levels as shareholders are directly involved in the nomination of directors, unlike in other developed markets. Several respondents discussed the fact that boards are by and large non-executive, unlike in many other markets, as another example of strong shareholder influence over management. Finally, one of the board members mentioned that the lack of poison pills, i.e. measures to block hostile bids or takeover attempts, in Sweden as having an effect on the power balance between owners, boards and the CEO:

> "The fact that we do not have poison pills […] leads to a weaker bargaining position for the CEO" (Director 5)

4.4 Institutional Investor Behavior

4.4.1 Influence, Voice and Negotiations

All institutional representatives in this study stated that they engaged with larger companies as active owners and involve themselves in governance issues, particularly CEO compensation. One institutional representative explained:

> "The large [Swedish] institutions are more or less required to have large holdings in major Swedish companies, the size of their funds makes it inevitable […] this makes them long-term owners automatically and involvement in the governance of their companies becomes a natural element." (Representative 5)

As indirectly indicated in the prior section about the Leo Act, Swedish institutions tend to involve themselves in the drafting of executive compensation and incentive plan proposals. The institutions in this study engaged did so in two main ways. First, they engaged directly by meeting the companies under informal circumstances. Second, they tended to have policy documents where they specified opinions and directives about the incentive plan proposals. Directors also confirmed that they engaged with their institutional shareholders. Several respondents pointed to the failure of Ericsson to garner support for their LTI program in a Leo Act vote during their 2007 AGM as the triggering event for more intense informal contacts between institutional shareholders and companies:

> "After Ericsson missed a proposal, this became a great concern for the companies."' (Representative 1)

> "Ericsson was a clear failure. Everyone is being courted now to avoid such embarrassing events. […] It was obvious that they had forgotten to clear their program [with shareholders]." (Representative 3)

Institutional shareholders appeared to make specific demands when discussing plans with companies. Several respondents, both directors and representatives, indicated that share dilution was one of the major concerns put forward by institutions with regards to equity plans – it was considered important that the number of shares issued under any one program did not excessively dilute the institutional holdings. Two institutions also preferred that LTI programs required executives to purchase shares themselves in order to be awarded any under the plans. Several respondents, including half of the institutional representatives, also indicated that institutions had preferences with regards to what type of performance conditions (e.g. EPS or TSR) the plans should contain in order for the CEO and other participants to receive any awards. A representative for a mutual fund stated that institutions' demands were well understood by companies:

> "All parties involved are aware of what is considered acceptable […] All major companies have a clear picture of what the institutions are going to accept and not." (Representative 6)

A picture emerged were institutions appeared to have large sway over how the LTI programs put forward by large companies were designed, something which was confirmed by both directors and representatives. One institutional representative commented:

> "All programs might not fulfill all our specific directives perfectly, but they have become much better compared to three - four years ago […] this is partly thanks to the diligent work done by the institutions." (Representative 4)

To the specific question regarding what prevented strong equity incentives among Swedish CEO's, one director responded:

> "There is a large resistance towards strong incentive programs, particularly among institutions […] there are some good and some less good reasons for this resistance […] but it is largely due to the institutions." (Director 1)

Illustrating a perceived difference between Sweden and other developed markets, one institutional representative made the following comments:

> "Influential institutional owners in Sweden, for example [Institution 1] work actively to keep compensation at a low level compatible with Swedish norms […] Abroad, the boards tend to run the companies themselves and have a much easier time when implementing large incentive programs […] Shareholders have very little say […] This is a fundamental difference towards how it works in Sweden." (Representative 6)

Two board members had a strong impression that there needed to be a balance between the dilutive properties of the equity programs and their effect on plan participants when designing LTI programs. One of them commented:

> "The institutions do not want to be diluted […] and the board has a responsibility to make sure that this is not the case. The dilution must be in the magnitude that the value increasing effects can plan make up for it." (Director 3)

Finally, while discussions heavily centered on the behavior of Swedish institutions, three of the directors also made specific references to Institutional Shareholder Services (ISS) which organizes foreign, predominately Anglo-Saxon institutions, in Swedish governance matters and GM voting. In of the few consequential remarks regarding their influence, one director noted:

> "There are enormous demands regarding precision [in the LTI programs] from foreign institutions. It is important that you have a company like ISS on board. I always check in with them prior to shareholder votes." (Director 3)

4.4.2 Institutional Collaboration

To further get a feeling for how institutions behave and influence compensation, the extent and effects of any eventual collaboration between Swedish institutional shareholders was discussed. All participating institutional representatives, except one, acknowledged some kind of collaboration with other institutions. Descriptions regarding the extent, however, varied. Two quotes illustrate the different experiences:

> "It should be made absolutely clear that there is gigantic activity behind the scenes [among institutions]. I know everyone at the other institutions and simply pick up the phone if I want to discuss a certain proposal." (Representative 3)

> "There are some discussions with other institutions. There are some people you can trust [at other institutions], who can give clues regarding the salience of different incentive plans." (Representative 6)

Two representatives stated specifically that the cooperation between institutions emanated from the compensation scandal at Swedish insurance giant Skandia in the early 2000's. In the words of one of the representatives, from a mutual fund:

> "If you go back in history, it is probably the merry band of directors and executives at Skandia who started this whole process […] Skandia was a company with no real guidance from owners at all, the directors simply created an extremely generous incentive program with no caps at all […] We [the institutional representatives] then felt that it was time to end the madness." (Representative 6)

One representative, with a certain amount of queasiness, brought up a formal forum for collaboration:

> "There is an organization, which we gave a very complicated name [*Institutionella ägares förening för regleringsfrågor på aktiemarknaden*] in order for it not to become well-known. It is tasked with, among other things, appointing members to the Swedish Corporate Governance Board [which drafts the Swedish Code of Corporate Governance] and other regulatory matters […] We meet formally a few times per year, which also makes more informal inter-institutional collaboration easier." (Representative 1)

However, several representatives brought up that the fact that the institutions were heterogeneous, particularly with regards to their client base (pension funds, mutual funds, life insurance). This was thought by several respondents to lead to a large number of differing and sometimes contradicting demands being brought forward with regards to LTI proposals. One representative commented:

> "You basically have fifteen institutions entering the room with fifteen different demands." (Representative 1)

Another had an opposing line of argument:

> "A certain view has been established among all institutions regarding how the plans should be designed, consensus. Everyone has similar demands regarding performance conditions etc." (Representative 6)

A second pension fund representative struck a middle ground between these perspectives, stating that while the institutions did indeed have varying priorities as manifested, for example, in their very different policy documents, their combined efforts had impacted incentive program practices to some extent:

> "It has decreased the amount of outliers and improved the quality of information provided […] It has also lowered the levels of compensation, predominantly with regards to equity pay." (Representative 4)

Finally, only one director (Director 1) commented on the potential effects of institutional collaboration, stating briefly that institutions had the power to block any LTI program in a major Swedish company if they chose to work together.

4.5 Other External Influences on Pay

4.5.1 Values, Politics and the Government

Executive remuneration in Sweden in general and share-based grants in particular, appears rather modest if compared to the US, UK and other European countries, as described in Section 1. Among respondents, Swedish culture, heritage and history was described as having partially affected this development. One of the directors explained that Sweden has no real history of executive largesse and is one of the countries in the world with the smallest pay differences between chief executives and employees, but despite this still has a lively debate about CEO compensation. Another director mentioned the Swedish norm system, and stressed the importance of CEO remuneration packages being in line with what is considered acceptable in society. Several of the respondents indicated that Swedish culture espouses values that probably have an inhibiting effect on CEO compensation, it was indicated that earning vast sums of money way to some extent socially inappropriate. The Swedish compensation culture was said to differ in particular from that of America, a board member explained:

> "It is considered suspicious to make too much money in Sweden, unless you win at the lottery or do it as a successful entrepreneur. America is different in this sense; there you are considered accomplished and successful if you earn a lot of money." (Director 4)

Two representatives pointed specifically to equity-incentives, stating that Sweden lacked a history and tradition of strong incentive programs. One also added legal aspects, mentioning the US tax rule where fixed salary is only tax deductible up to $1 million as a possible reason for different levels of equity-pay:

> "This is historically motivated […] In the US for example, they introduced a cap on most non-equity pay [during the 1990's] that probably affected the proportions […] Swedes are also not used to bear a large risk in their income, this is probably a reason why we have so little equity pay here." (Representative 4)

Several representatives explained that societal aspects must be considered when making compensation decisions due to the ease with which their investors (members of the public) can withdraw their funds if they are unhappy with the representatives' decisions, particularly in mutual-funds where the investments are more liquid. One pension fund manager elaborated on this issue:

> "There is a brand risk here that can be directly translated to a financial risk […] there is an intense legitimacy discussion, they [equity-programs] have to be considered acceptable by society at large in order to avoid harming the brand name." (Representative 1)

Three directors expressed discomfort with what they saw as politically motivated behavior among some institutional owners. Two of their comments are provided below:

> "At the moment it is politically opportune to be against it [variable remuneration]. I believe the Swedish institutional owners want to be in sync with the political debate. It would however be more appropriate for them to focus on maximizing shareholder value than acting out of political opportunism." (Director 1)

> "You might expect the institutional owners to be politically neutral, but this is not always the case. A lot of the time you are talking about pension funds, and pension funds must be more aligned with what is considered politically correct if they are to be successful." (Director 5)

The director representing a large cap company where the Swedish government had blocked all variable and equity-based programs to the CEO and top-management via the AGM say-on-pay vote expressed some discomfort with the implications of this decision:

> "All contracts had to be re-negotiated and none of them [CEO and senior management] signed a new agreement in which they felt they weren't compensated for their loss of variable pay […] Whether this was better or cheaper for the company is clearly debatable." (Director 1)

Several directors and one institutional representative criticized the government's policy to attempt to ban all variable compensation in firms' where they owned shares in fairly harsh terms. In the wording of one director and one institutional representative:

> "It is clearly bullshit, the government's corporate governance practices. What have they achieved with this policy? Take for example Company 1, a standout example of bullshit: [the CEO of Company 1] has his variable compensation replaced by the same amount of fixed salary, which is completely risk-free." (Director 5)

> "It [the ban] is insane, complete madness, it raises fixed pay. […] Companies will be negatively affected as talent goes elsewhere […] they are fanning the remuneration debate only to score points with the public." (Representative 3)

Several institutional representatives stressed that they and their colleagues did not act in politicized manner. As an example, three of them pointed to the fact that the major Swedish public pension funds, the so called "AP-funds", had actively resisted attempts by the government to implement on them their ban on variable pay. One of the mutual fund representatives elaborated further on the political issue:

> "In general, institutions have not been affected by the political debate to any large extent. Most of us [institutions] are positive to variable and equity pay, and state this clearly in our policy documents. I do think, however, that this [variable compensation] has become a political issue." (Representative 6)

4.5.2 The Media

The media in general, and the business press in particular, tend to report quite extensively on CEO compensation. Among respondents, this reporting was perceived to have some implications with regards to compensation and incentive practices. However, the majority of respondents were of the opinion that the media did not have a large outright impact on levels of share-based pay. Rather, the impact appeared more indirect, as coverage gave indications of what acceptable levels of pay were and increased awareness of being monitored. Two representatives elaborated on the media's role in measuring public opinion:

> "The media has some effect [on compensation practices]. It can be used as a tool to understand the public opinion, which is basically our customer base." (Representative 5)

> "Media has an enlightening role and affects both those who construct compensation and those who receive it. […] The media has an influence but it is not crucial. Rather, the influence rests in the public opinion." (Representative 3)

The media was described by one board member as one of the main reasons why companies make sure to anchor proposals on equity-programs prior to the GM:

> "Companies want to avoid the negative publicity arising from losing a shareholder vote." (Director 2)

One director stood out by voicing a fairly strong opinion about media coverage:

> "The media has a very large impact [on CEO compensation], constantly fanning the remuneration debate […] *Dagens Industri* [A large financial daily], for example, is Sweden's largest gossip rag and completely obsessed with CEO pay." (Director 4)

4.6 Complexity in LTI programs

The general complexity of many LTI programs was a recurring theme throughout the interviews. All respondents commented on the fact that the plans, on average, appeared more or less overly complicated. Many differing and at times conflicting explanations for the causes of this perceived complexity were provided by interviewees. The effect of having very complicated program structures was also discussed.

Several respondents from both categories posited that demands from institutions were one major reason for how plans had come to appear in practice. Specific requirements on e.g. performance criteria had forced the companies to adapt the design of the programs to please their institutional owners, partly by requiring a larger number of performance conditions. One representative explained:

> "We [the institutions] all want very measurable programs. This has required more parameters [performance conditions] and as a result, the programs have become more complex." (Representative 6)

When queried about the rather complicated nature of his company's LTI program, one director stated that complexity was a reflection of being cautious:

> "The complexity shows that you have left nothing to chance. The more careful you are, the more you add to this patchwork." (Director 4)

One representative further stated that current programs arose from a desire to depart from less complicated programs that only depended on one criterion, as this often led to a lack of awards:

> "We have seen that some of the simple programs resulted in no payout at all in bad years […] This has resulted in programs with more parameters [performance conditions], to make a payout possible even in bad years." (Representative 6)

A desire for less transparency was attributed to the increasing complexity by one respondent:

> "I think that the complexity is due to a desire to decrease transparency. Sometimes I don't even understand the programs myself, but you think twice before bringing that up." (Director 5)

As stated, a wide variety of perceptions existed about the reasons for complexity. A final one was provided by an institutional representative:

> "We saw a large amount of option programs that did not produce any awards, and then the programs disappeared for a while. The crises that led to programs not producing any

> awards led companies to look at other models with the help of consultants […] who tend to produce far more complicated programs. These consultants have definitely contributed to making present programs more complex.” (Representative 3)

Turning instead to the effects of program complexity, several respondents pointed to the risk of diluted incentives. When the programs become too complicated, the CEO and other plan participants might not fully understand how they can affect awards and their purpose diminishes. Both board members and institutional representatives expressed clear worries on the recent development and its effects:

> “Worst of all is when participants in the plans don’t understand them. This is a huge problem; they must not become too complex. We communicate this to boards that tend to agree. In many cases the boards don’t understand them [the programs] themselves.” (Representative 1)

> “All of the parties involved do not understand, if everyone’s wishes are to be incorporated the programs can become unbelievably complicated and therefore not have the desired effect on participants. A trade-off situation occurs.” (Director 1)

> “A lot of people want to re-model the LTI programs because the participants do not understand them. If nobody understands, they have almost no value.” (Representative 2)

One board member and one representative described the complexity as a nuisance for shareholders:

> “The complexity has increased and many times annoys shareholders. The general meetings are not hostile to the programs themselves, but to their complexity.” (Director 4)

> “The programs have become so horribly complicated, if they [companies] keep making them this complicated it will become easier for us to simply vote no. This [the complexity] is very controversial.” (Representative 2)

To follow up on his comment, we queried the representative regarding whether the programs would be easier to evaluate and find acceptable if they only covered the CEO, receiving an answer in the affirmative. Another representative elaborated on the fact that the plans covered more participants than the CEO:

> “Especially in larger companies, you often blame it [the complexity] on the fact that you are a global company that needs a globally viable plan. Ericsson, for example, has a hard time getting everyone to participate in their programs. Americans, for example, want their shares for free. It is ruled by tradition.” (Representative 3)

In sum, while respondents agreed that programs were often perceived as too complex, a plethora of explanations for this emerged. However, less ambiguity existed with regards to fact that participants appeared to view these developments unfavorably. Most importantly, many of the respondents answers seemed to imply that programs were not created in a vacuum: a lot of both internal and external perspectives had to be taken into account when designing them.

4.7 Incentive Differences in Public vs. Private Corporations

While particular study is clearly delimited to large public firms in Sweden, it was hard not to touch upon remuneration practices in non-public firms as well, since several respondents drew parallels to private firms, private equity-owned ones in particular, to make illustrative arguments about executive incentives. The overall belief among those who did so was that it was less suitable for CEO's in large listed firms to have the same opportunities to receive large payouts, e.g. through strong equity incentives, that many private-equity CEO's can. Two main reasons for this were mentioned. First of all, public companies operate under the assumption of a going concern. It was thus considered difficult to decide which time frame to ascribe a certain CEO and subsequently remunerate him for. In the words of one director:

> "Private equity firms have strong incentives as their model and it works very well in that industry, where you have a clear investment start and end date." (Director 1)

Secondly, rapport with shareholders was mentioned as an important factor. A board member explained that it was much easier for a company with one or a few strong majority owners to make a decision to give away a certain share of the company to management with the belief that they would act in their interests. This was further supported by one of the institutional representatives who stressed that he managed "other people's money", and couldn't make decisions to give away shares in portfolio companies without breaching his fiduciary duties. Another representative contradicted this, however:

> "I do not have a problem with huge equity incentive programs per se […] just as long as we get something out of it." (Representative 4)

Several respondents stated that differences between private and public firms in Sweden could have implications for the latter. One of the board members stressed that it has become increasingly complex for companies to act in a public environment, particularly with regards to executive compensation:

> "This [the executive remuneration] issue is infinitely more complicated in a listed company compared to a private one. It is one reason why successful mid-size private firms choose not to go public. It adds a completely different amount of complexity and limitation regarding an issue like this." (Director 1)

An institutional representative stated that competent potential CEO's were increasingly likely to work for non-public firms due to differences in compensation. Another director contrasted this by stating that while potential CEO's did indeed have better opportunities to make money in e.g. PE, many were interested in the spotlight granted to the CEO of a large public firm. A second director agreed:

> "Very few public CEO's have a desire to go to PE [private-equity owned firms], even if they are paid more. The status effect of being the CEO of a public company is much greater, it is many peoples dream." (Director 5)

5. Analysis and Discussion

In this section, we contrast our empirical findings with the theoretical framework and other previous research presented in our review in Section 2. We begin by discussing optimal contracting and agency theory with its predictions with regards to CEO incentives, honing in on how theoretical conceptions connect with Swedish practices. Thereafter we examine the explanatory power of managerial power theory in the Swedish setting. Finally, we discuss the Swedish institutional landscape, isomorphism and legitimacy-seeking in the context of Swedish chief executives equity-based pay.

5.1 Optimal Contracting and Swedish CEO Incentives

Optimal contracting theorists, by way of agency theoretical constructs, make fairly strong predictions regarding both the beneficial effects that CEO compensation, and particularly equity-based incentives, can have on the behavior and performance of chief executives as well as the different factors that can affect the salience of various types of compensation arrangements and CEO incentives in any one firm.

Starting with the effects that pay which is highly sensitive to performance has on executives, many of our respondents appeared to express disbelief in the notion that increasing incentives would induce agents (CEO's) to work harder[17]. Indeed, ambiguity existed among interviewees whether equity incentives had any specific motivational influences on CEO's. A caveat here is however that it was difficult to separate the definition of "motivation" from that of "alignment" (between shareholders and executives), with many respondents being skeptical to the former but clearly believing equity-incentives achieved the latter – e.g. by making references to the need for a "shared agenda." Some respondents were however a lot less vague in this regard, as they implicitly or explicitly stated that they did not believe that CEO's of large public companies were primarily motivated by pecuniary factors, a perception which more or less invalidates the optimal contracting perspective as it is heavily reliant on monetary incentives.

The most interesting observations regarding the incentivizing effects of LTI programs were however not their theoretical effects but rather that many respondents appeared displeased with what they witnessed in practice. It is very hard to explain deviations from the "ideal" under the rational lens of optimal contracting and agency theory, especially in the seemingly large and systematic ways that became obvious in interviews. One particularly salient example of this was the view among several respondents that

[17] Bender (2004) identified the same tendencies among the 22 remuneration committee members she interviewed in that study.

current share-based plans had become so overly intricate as to lose almost all effect, motivational or otherwise, on their agent-participants – a development which seemed less than rational or optimal.

Further, from an optimal contracting perspective, the evolution over time of equity-based compensation practice for Swedish CEO's appears a bit puzzling. Similar to the developments in the U.K. described by Bruce et al. (2003), LTI programs with a less direct relation to share-price development and an often lower pay-performance-sensitivity (e.g. due to the use of relative or non-share price related performance conditions) have become the dominant form of equity-based compensation, replacing stock options that are rarely relative, always more or less directly dependent on stock price developments and *inter alia* tend to produce greater pay-performance sensitivities. This point deserves to be repeated. Many Swedish LTI programs, including those employed by the companies in this study, award shares based on performance which is not directly related to share price development because they use multiple, bespoke or accounting-based conditions that are not solely dependent on the trajectory of the firms stock. Further, while they do award participants shares in the firm, which increases the pay-performance sensitivity, they do so at the end of the three-year life of the plan and typically lack any provisions that require the CEO to hold the shares afterwards. This is markedly different from the executive stock option plans or restricted share plans used in the U.S. which permeates the optimal contracting theory literature. That these plans are less alike the "ideal" form of equity-based compensation preferred by optimal contracting theorists could be further seen in responses which stated that modern-day multi-performance condition plans had emerged from a desire to avoid past single-performance condition plans or executive option programs that made no awards in "bad" years. This line of reasoning is strikingly similar to what Bender (2003) referred to as an unwillingness to punish executives, regardless if the this was for poor performance, which she described as directly in conflict with a principal-agent view of incentives.

That plans in practice appeared so complicated as to appear annoying to shareholders further seemed to undermine the notion that rational and self-interested principal-shareholders are able to produce effective remuneration contracts for CEO's in the Swedish setting. The notion of rational incentive design, and particularly the very strong assumptions made by Core & Guay (1999) who stated that equity-incentives for CEO's were either aligned with optimal contracts or bound to become so due to the continuous rebalancing of incentives by boards, further appeared somewhat disconnected from the reality of the two respondents who stated that directors themselves at times do not even understand the LTI programs they are proposing. The discussions regarding private firms were also somewhat counter-intuitive from an optimal contracting view, as they basically amounted to a perception that private firms with fewer and more closely involved shareholders tended to provide stronger incentives than public peers. How this can be understood from an optimal contracting and agency theory perspective, which states that firms with a more dispersed shareholder base have larger agency costs and a greater need for monitoring and/or executive incentives is an open question that cannot be understood by heterogeneous wealth constraints or differences in risk aversion. The comment by one director that the "complexities" in compensation decisions increase to such a large extent when going public that some firms are hesitant to IPO appears equally bewildering from a strict optimal contracting perspective.

It is unfortunate that optimal contracting theorists such as Conyon & Murphy (2000) and Conyon, Core & Guay (2011) have been unable to develop a coherent narrative inside the agency theoretical framework for the observed incentive or pay-performance sensitivity differences between the U.S. and the U.K. as well as other countries since such contributions could have helped explain the reasons for our initial observations regarding the relatively low proportion of equity-based pay as well as the markedly lower (vs. e.g. the U.S.) pay-performance figure found by Bång (2006) in large Swedish firms better from their perspective. Instead, optimal contracting theorists, including the aforementioned as well as Jensen & Murphy (1990) and Frydman & Saks (2010) have put forward varying hypotheticals, including but not limited to references to differences in regulations, cultural factors and societal values which seem to fit better under the lens of institutionalism, to argue why pay may sometimes appears to be less sensitive to performance than their theories predict in any one setting or point in time. Taken together with the many observations made in this study, where very influential compensation decision-makers in Sweden more or less contradict theory, it is hard to see how optimal contracting can, on its own, fully account for the "why" in the research question of this thesis. Of course, it would be very inappropriate to dismiss it completely: it is not implausible that incentive differences to some extent depend on that large cap CEO's in Sweden differ in terms of information asymmetries, risk-aversion and wealth constraints. Indeed, some respondents provided support to the latter two notions when they implied that Swedish CEO's were not used to holding a very large risk in their income or alternatively could not afford to hold large equity stakes (something which one respondent, however, contradicted). Differences in ownership concentration, which in Sweden is a lot higher than particularly Anglo-Saxon markets, can also provide explanations to why there tentatively would be less need for executive incentives in Sweden under agency theory. Frydman & Saks (2010) have, however, already studied this hypothesis in an econometric agency model and found that decreasing ownership concentration provided a rather weak and incomplete explanatory value for U.S. compensation developments. In sum, it is easy to be somewhat skeptical to the idea that differences in these factors are so large as to singlehandedly explain why pay-performance levels in Sweden that are dramatically lower than in the U.S., as reported by Bång (2006) and, more crucially, why equity-compensation proportions are so very much lower than elsewhere in Europe or even the Nordics. Instead, in line with Eisenhardt (1988) and similar to the U.K. findings of Bender (2003; 2004) it appears that the observations in our study and the determinants of compensation are best understood if allowing extending agency theory to include influences from institutionalism.

5.2 Managerial Power Theory in the Swedish Context

Managerial power theory, in essence, suggests that systematic failures, particularly in the U.S. setting, has led to pay practices that diverge from optimal contracting. The divergences are said to be apparent in the very high amounts of compensation awarded to executives, and the fact that their pay packages provide weak or distorted incentives. Overly powerful, or entrenched, CEO's are seen as the main cause for failure and CEO's can become entrenched because of weaknesses in, among other things, corporate governance practices. "Outrage" in relevant groups, such as shareholders and the media are, however, said to provide some limits on how derailed CEO compensation practices can become in practice.

Before discussing our observations regarding managerial power theory, some initial caveats regarding the applicability of the theory in the Swedish setting need to be discussed. First of all, a cornerstone of managerial power theory is that shareholdings are dispersed and that shareholders have very little influence over the compensation process or indeed the appointment of directors to the board. Secondly, an equally important notion is that CEO's have compensation packages that are somehow egregious or amount to executive largesse. Superficially, it is not particularly controversial to posit that this appears somewhat out of step with Swedish practices with binding say-on-pay votes, the Lex Leo Act, shareholder-elected nominating committees, relatively concentrated ownership via family-owned investment firms and relatively low levels of compensation compared to other developed markets. It is also important to point out that while managerial power researchers are positive to "strong" incentives, they tend to, in contrast to optimal contracting researchers, have an inconsistent view of how incentives should be designed. Some have been critical of U.S.-style executive stock option and equity plans that lack other performance criteria than share price development because they reward executives for "luck", while others have taken a stance that is much closer to optimal contracting researchers.

Perhaps the strongest indication of CEO entrenchment among our respondents where how they described the board-CEO negotiation process, which as managerial power theory posits seemed to be out of step with intense arms-length bargaining. Many institutional representatives seemed particularly concerned that his led to less than optimal outcomes from the remuneration contracting process, with one specifically indicating that it had led to poor practices as regards LTI programs. Whether or not these negotiation failures had led to escalating pay and rent extraction from CEO's, as managerial power theory suggests, is however debatable considering that Swedish CEO's did not appear to be overly generously compensated. In fact, understanding why an entrenched CEO that has captured the pay-setting process would allow an American subordinate to receive a higher salary than him or herself, which several respondents indicated was a common phenomenon, seems slightly out of step with theory. Further, the illustrative remark by Representative 1 regarding his interaction with a well-known board chairman also implied something else about board-CEO negotiation failures: shareholders appeared to have an ability to empower boards to stand up to CEO's. Indeed, shareholders were systematically described as far from powerless in the Swedish setting, specifically because they had the power to appoint directors but more importantly because the Leo Act allowed them to block generous equity-pay outs with relative ease. That the say-on-pay mechanism on the contrary was dismissed as a "formality" with little implications for pay-setting, except in one instance, is however also worthwhile to note.

Understanding our observations with regards to equity-incentives through the lens of managerial power theory is far from clear-cut. Hartzell & Starcks (2003) predict that institutional shareholders push not only for lower pay levels but also higher pay-performance sensitivities, i.e. a large stock-price sensitivity in compensation, which runs counter to many of our observations. In our findings, it appeared as if institutions were on average somewhat skeptical to very strong incentives, that many interviewees viewed them as having an inhibiting effect on the size (or, interchangeably, dilution) of equity-based plans and that institutions, as stated, pressed for LTI programs with criteria other than only-share price development as opposed to single-criterion option or share programs with larger sensitivities. Almazan et al. (2005) found that only "active" institutions – a definition which excluded the pension and mutual funds included in our sample – seemed to have the sensitivity increasing effect noted in Hartzell & Starcks (2003), but our findings run counter to the logic that the pension and mutual funds are "passive" in the Swedish setting. In fact, they appeared heavily involved and influential in determining incentives.

The "outrage" criterion, which posits that outside groups such as shareholders and the media can prevent particularly eye-catching departures from optimal or reasonable compensation practices appeared somewhat relevant in our discussion with respondents about the Swedish context, with several respondents indicating that pay levels had been prevented from spiraling out of control to due to outside influence. Again, however, the incentive question is difficult here. The media did not appear to have any direct implications for the composition of pay, only an indirect influence on levels, and institutional and other large minority shareholders appeared to circumscribe the use of LTI plans rather than pushing for lower levels of fixed pay and more incentives (be it LTI programs or stock options), as predicted by theory. Much of the latter of course depended on the influence awarded to shareholders via the Leo Act. "Outrage" could potentially partially explain the expressed view that private firms could pay their CEO more and provide them with stronger incentives as they are less scrutinized by the media, but managerial power theory – being as highly related to agency theory as it is – cannot properly explain why incentives were described as stronger for private firms with more closely involved shareholders in the first place.

The use of compensation consultants, further, has been described as having the possibility to award CEO's greater power over their own remuneration – particularly if they are hired by the CEO or management or otherwise work to further their interests. Only limited evidence of such practices emerged in our findings, however. "Inappropriate" practices with regards to consultants appeared mostly to be a thing of the past, and most of the directors and representatives indicated that they thought they provided useful and valuable services in the compensation process. With regards to LTI programs it also hard to see how a consultant would be able to produce a lax executive-friendly plan even if they (theoretically) were in the CEO's pocket and the CEO had a very large sway over the board, since shareholders appeared to monitor proposals with such diligence.

Being an U.S. theory developed for U.S. circumstances, translating managerial power theory to the Swedish context is a fragile process. Many of its arguments seem out of line with practice both because many of the perceived weaknesses in governance and shareholder influence do not exist but also because CEO's do not appear to receive "inappropriately" large amounts of pay. In terms of executive incentives, one could possibly hypothesize – under very strong assumptions – that the reason that Swedish CEO's have a relatively low stock-price sensitivity in their compensation is because they, being the risk-averse, self-interested and entrenched agents they are, have shifted their pay to less sensitive forms. It is however hard to completely buy into this hypothesis in light of the observations in this thesis, particularly as LTI programs to a large extent appeared to be heavily influenced by shareholder demands; because there was, in practice, little direct evidence of CEO entrenchment; and finally due to the fact that few indications emerged of non-incentive pay being "inflated" or otherwise much larger than might be reasonably expected in absolute terms as a result of CEO's relatively low equity-based pay.

5.3 Institutionalism, Isomorphism and Legitimacy in Swedish LTI Programs

Executive compensation practices, viewed through the lens of institutionalism, can to some extent be explained by firms' desire to appear legitimate in their particular context. Specifically, an isomorphism of practice is expected, where external influences from regulators, peer companies, consultants and other external actors impact the salience of design choices. From this perspective the components of a particular LTI program, for instance, is determined not only in the basis of functional aspects but also due considerations of whether it will appear acceptable in its larger institutional environment.

In line with previous qualitative studies of the determinants of executive compensation (e.g. Main et al., 2008), more or less overt influences from institutionalism were at times evident in the responses of the compensation decision-makers interviewed in this study. One of the strongest examples of isomorphic influences on processes and practice with regards to LTI programs or equity-based pay were the coercive effects of the Leo Act. Respondents more or less unanimously indicated that the Leo Act had induced companies to engage more with shareholders in compensation issues than they would have in the absence of regulation. Further, it appeared that the law exposed companies to pressure from shareholders when designing LTI programs, and all but two respondents implied that the Leo Act had served to inhibit the use of equity-based incentives due to its 9/10th majority requirement. It also became clear from our interviews that the law had set the stage for institutional investors to assume a rather large role in the design of LTI incentives, which is discussed at length below. Perhaps unsurprisingly, the binding remuneration guidelines which also include non-equity pay did not appear to have had an equally strong coercive influence, except for the firm with a very large government ownership stake, purportedly due to the fact that it only has a simple majority requirement. In terms of coercive isomorphism, it becomes interesting to compare the policies of the U.S. and Swedish government in the area of executive incentives. Many researchers, including but not limited to optimal contracting scholars such as Conyon & Murphy (2000), (and indeed one of our respondents) have indicated that a 1990's U.S. tax law which limited deductions for most non-equity based pay for executives served to make executive stock option plans and other forms of equity-based pay wildly popular there. While no legislation exists in the area in Sweden, it appeared more or less clear that the Swedish government, with their no-tolerance policy for variable pay in partially or wholly state owned firms, had a directly contrarian standpoint vis-à-vis the U.S., which they went as far as to try and induce publicly owned institutional investors to adopt.

Moving on, indications of normative isomorphism by way of compensation consultants, as suggested by e.g. Conyon et al. (2011), appeared in our findings. Many firms employed consultancies to benchmark pay practices, and consultants seemed to influence what was considered "normal" or "market practice" in terms of pay levels in the eyes of many respondents. Several interviewees also indicated that consultants had direct implications for the design of LTI programs, suggestive of a normative isomorphism of practice. Specifically, consultants were cited by different respondents as producing plans that were more complex, more alike U.K. LTI programs as well as plans that were more in tune with shareholder demands and as such more likely to pass through Leo votes at GM's. Interestingly, one institutional representative seemed to imply that the specific influence of different consultancies could be sometimes be observed in LTI programs; another one implied that consultancies influenced companies to set certain pre-defined proportions of salary, bonus and LTI incentives; and, in line with Main et al. (2008), yet another stated that companies seemed to refer to consultants to legitimize proposals. Turning instead to cognitive influences, two directors made remarks that directly implied a mimetic isomorphism of practice, stating that directors (rather than consultants) tended to transport "best practices" in equity compensation between firms: it was believed that directors had a tendency to repeat incentive practices they had believed worked well in other firms. Moreover, respondents seemed to imply that firms extensively "benchmarked" practices and were very up to date with what other similar Swedish (in some cases Nordic, in one case European) peer companies were doing in terms of executive compensation when they determined CEO pay and incentives, to some extent suggestive of mimetic isomorphism. That one director remarked that the CEO's remuneration shouldn't be "eye-catching" further hinted that a certain amount of thought went into replicating or mimicking the behavior of peer companies.

Institutional investors undoubtedly appeared as one of the most important external actors in the institutional environment of Swedish public firms, particularly the larger Swedish mutual funds, pension funds and insurance companies. It became clear during interviews that these institutions were involved to some extent in almost every large cap corporation. Apart from proposing suitable director-candidates through the nominating committee, executive compensation and incentives stood out as the area where the institutional investors had most sway over firm practices, to some extent effectively setting the standard for what was legitimate and acceptable practice. That contacts between institutions and companies were claimed to have increased after Ericsson's 2007 LTI program failed serves as a poignant anecdote: it appears that companies then even to a larger extent than before became aware of the need to craft proposals that appear legitimate to shareholders in general and institutional ones in particular. The feedback provided by institutions both through informal private contacts and their formal public policy documents seemed to circumscribe the repertoire of possible actions available to boards in the equity-compensation area in two main ways. Firstly, it appeared to have an inhibiting effect on total incentives as most institutions seemed hostile to very large and dilutive plans. Secondly, institutional shareholders appeared to have preferences for both the existence of and choice of performance conditions in their portfolio companies.

One representative further informed us that many of the institutions collaborated formally in an organization that seemed to have influence over policy-making in the compensation area, among other through appointing candidates to the body which drafts the Swedish Code of Corporate Governance, indicating that they also had influence over coercive isomorphic pressures in the compensation arena. However, unlike the Association of British Insurers (ABI) which organizes many British institutional owners and which has specifically stated that they want their portfolio companies to use LTI programs with relative TSR as the performance condition, Swedish institutions did not appear to have any collective agreement on what the "gold standard" for performance conditions was. Rather, it appeared to be decided on an ad hoc basis: one representative indicated this by stating that you had "15 institutions entering the room with 15 different demands". Another representative, however, implied that the institutions together had reached a form of consensus regarding how plans should be designed to be legitimate. In terms of performance criteria, the former statement seemed more correct: the review of LTI programs presented in Section 1.3 revealed almost as many combinations of performance conditions as there were firms. The lack of a mutual agreement in the form of a quasi-regulatory document (the ABI guidelines) can help us understand why, unlike in the U.K. (Main et al. 2008), there appears to be no isomorphism of practice in practice with regards to the specific performance criteria used in Swedish LTI programs, only in the fact that such performance criteria should in fact exist (unlike in e.g. the U.S.). That institutions together limited the "generosity" of LTI programs appeared clearer, one of the directors even stated outright that resistance among institutional investors was the reason that Swedish public CEO's lacked "strong" incentives. In other words, the tacit regulation of LTI programs with regards to dilution and size of plans seemed to achieve an isomorphism of practice in this area.

Institutional involvement appeared far from uncontroversial to directors. That several of them overtly accused institutional shareholders of being politicized and several institutions implied that they at times took took cues from public opinion (albeit strongly renouncing any political considerations) appears particularly notable in this context, considering the strong opinions voiced about the government's policy of banning all variable compensation for executives and suggestions of public hostility against variable pay. Remarks such as "they [equity-programs] have to be considered acceptable by society at large in order to avoid harming the brand name" and others made by institutional representatives, appeared to somewhat undermine the common "line of defense" regarding societal and political influences among institutional representatives, that the public AP-funds had resisted the government's measure. It is not presumptuous to suggest that some (but not all) institutional representatives themselves seemed to make decisions in the basis of (societal) legitimacy rather than strict agency theoretic "maximizing shareholder wealth"-rationality. Considering the large sway that the institutional shareholders appeared to have over firms in terms of equity-based compensation, it does further not require very strong assumptions to imply that this legitimacy-based decision making or satisficing made its way into firms' LTI programs by way of the institutions.

One of the observations with regards to LTI programs that appeared as the most counter-intuitive from an agency perspective were that plans at times seemed to lack any effect on plan participants (including CEO's), other than being a very expensive lottery, due to their complexity. Even in less extreme cases, there were strong implications that plans had to designed with more interests than the incentivizing or aligning effects on participant-agents in mind, which arguably cannot properly be explained by optimal contracts or agency theory either. This however is less puzzling when introducing an institutionalist logic, as firm's then, as stated, are seen as making decisions not only due to their functional aspects but also because they believe them to please relevant external others. Main et al. (2008) referred to this as making a trade-off between "performance" (that plans were in line with optimal contracting theory) and "conformance" (making sure that plans are perceived as legitimate among relevant constituencies). Swedish LTI programs, as described by participants in our study, seemed to exhibit both performance and conformance, particularly with regards to the demands of institutions but also due to various other isomorphic pressures. Even if a director wanted to introduce an equity-based incentive scheme that was highly "performance"-oriented, the findings of our study suggest that this was to a large extent simply not possible due to the pressure to "conform" to what appeared legitimate in the Swedish setting, e.g. in terms of the scope of the plan.

Bruce et al. (2005) has hypothesized that the internationalization of the labor market for CEO's can lead to shifting institutional contingencies, in effect leading to changes in what constitutes a viable practice in terms of executive compensation and incentives. From this perspective, the general perception among our respondents that Swedish CEO's, even in large companies, to a large extent were part of a domestic or regional labor market (and conversely that Swedish firms to a large extent recruit in their home market) is relevant as this suggests that a lack of internationalization may serve to further conserve the inertia and social embeddedness of Swedish public firms in terms compensation practice. Conversely, it is also in line with the notion among a minority of respondents that Swedish firms may at some point in the future have to push for changes in compensation practices in order to converge with firms in other developed markets if they are to attract talent. Under institutional theory, this is however unlikely to occur until the functional pressures become so great as to overcome the institutional inertia blocking change. One remark deserves to be repeated in this context for illustrative purposes, namely that made by Representative 3 about Ericsson's program, where American executives were seen as shunning participation because it unlike U.S. tradition required both a personal buy-in and did not award shares automatically, but rather only after the attainment of a range of performance conditions. If Swedish firm's suddenly developed a widespread need for U.S. CEO's or other high-level executives, it is hard to see how they on a large scale would allow legitimatized, but in this case not rational-functional, LTI programs to persist without pushing back against the isomorphic pressures that define what is acceptable in the Swedish context., e.g. by attempting to influence public discourse in the domain or stepping up their efforts to reform the voting requirements of the Leo Act.

A final point regarding the impact of the institutional environment on incentive practices in large Swedish public firms observed in our findings deserves to be made, namely that of observed differences in the practices of private and public firms. A previously mentioned, the impression among some respondents that private firms with more closely-held shares appeared to both pay more and have stronger incentives seemed confusing from an agency perspective, particularly the comment by one director that the limitations placed on public firms in the compensation domain made some successful firms hesitant to pursue an IPO. Applying an institutionalist logic, however, these observations make almost perfect sense: private firms have a much smaller constituency of external others demanding that practices be legitimate, and are as such much more free to "perform" rather than "conform" in the words of Main et al. (2008). If shareholders and directors in these firms prescribe, as some decision-makers appear to do, to a very American optimal-contracting view of incentives, then they have very few obstacles towards instituting such a policy. A public firm, which in the terminology of draws resources and legitimacy from a very wide constituency, including a dispersed shareholder base with pension and mutual funds and to some extent the public, is conversely much more likely to satisfice and "conform", in the words of Eisenhardt (1988). An equivalent hypothetical argument to the one made about the internationalization of the labor market can also be made here: if a strong functional pressure would build, e.g. if a large group of potential CEO's would depart for private firms and deplete the market for potential chief executives, push-back against isomorphic pressures would likely occur and contingencies may indeed shift. As remarks by two of our board members suggest, however, this is perhaps not yet the case: contemporary public CEO's appeared more than happy to work for less monetary rewards but a greater deal of public acclaim.

In sum, the predictions and results of researchers applying an institutionalist perspective such as Conyon et al. (2011) regarding the normative isomorphism of consultants as well as Bender (2003; 2004) and Main et al. (2008) about the isomorphic determinants of variable pay practices appear in line with many of our findings. Specifically, it appears that consultants to some extent impact both levels of pay and the design of equity incentives, that some indications exist of mimetic isomorphism and, most importantly, that coercive isomorphic pressures, particularly by way of the Leo Act, appear to impact the use of equity-incentives greatly. As in the latter three studies, institutional shareholders appear to have a large sway on both the size and general design of equity incentives, perhaps even more so than in the U.K. due to the very strong coercive influence of the Swedish Leo Act. It was further suggested that institutional shareholders for various reasons may be prone to seek legitimacy themselves, by attempting to act in tune with societal values. Evidence and arguments were also provided for why isomorphic pressures in the area of CEO incentives have been allowed to persist, namely that it appears as if the functional push-back against them has, as of yet, not become large enough.

6. Conclusions

In this section, we provide a range of tentative answers to our research question with a basis of our quantitative and qualitative findings as well as our analysis of previous research in the area.

Optimal contracting theorists predict, *a priori*, that shareholders will be favorable to equity-based pay as it increases the willingness of self-interested CEO's to work towards furthering their interests, narrowly defined as increases in shareholder wealth, instead of their own. Further, they predict that the only factors that mitigate the extent of those incentives are the relative magnitudes of information asymmetries as well as CEO wealth constraints and risk aversion. Under this theoretical lens, the answer to our research question, i.e. why Swedish CEO's appear to have relatively weaker equity incentives than their peers in other developed markets, must as such be that Sweden differs in one or all three of these respects. Some of our findings do indeed seem to suggest this. References were made to Swedish CEO's as being particularly disinclined to having risk in their income and being cash-constrained. Sweden's divergent ownership structure, or indeed other proxies for the unobservable parameters in the agency model, that are more suitable for future econometric studies in the Swedish setting may also provide explanations as to why CEO's receive a lower amount of equity compensation.

However, based on our findings, we do not believe that the agency or optimal contracting framework can provide us with all the answers. A number of reasons for this emerged. First, while our respondents seemed to agree with agency theory in as much as that equity incentives created an alignment of interests, they were much more ambivalent regarding whether it served to motivate the CEO – particularly with regards to working harder. Second, several respondents implied more or less directly that they thought that CEO's in large Swedish public were not primarily motivated by pecuniary factors. Third, the framework cannot properly explain several observed practices, including why there appears to exist incentive plans that participants do not understand or why directors would choose less stock-price sensitive LTI programs over U.S. style stock options or deferred shares. Fourth, descriptions of incentive differences between widely-held public and closely-held private firms, where they were described as being greater in the former than in the latter, offered by respondents appear to run counter to agency logic.

We argue that institutionalism, specifically legitimacy-based rationalizations or satisficing among compensation decision-makers and a coercive, normative and mimetic isomorphism of practice explains many of the aforementioned divergences from agency logic in Sweden as well as other observations regarding CEO incentive-design. The most important external pressure on companies, we suggest, arises from the coercive isomorphism of the Leo Act. This law exposes company decision-makers (directors) to the whims of shareholders with regards to CEO equity incentives to a much larger extent than in other

U.S., U.K, other European or even Nordic countries which lack equivalent legislation. The observation that these shareholders, which often are institutional investors such as pension funds, mutual funds or other firms with the public as their main client-base, at times appear to have a different agenda than what is predicted by agency theory, particularly in terms of how equity incentive plans should be designed, can further explain why Sweden stands out in comparison to other countries in the compensation domain. Specifically, we argue that pressure from institutional investors has led legitimacy-seeking companies to adopt plans that are both smaller in scale and contain more performance conditions than they would have without the coercive effects of the Leo Act, something which *inter alia* leads to weaker equity incentives.

Further, we found some evidence of a normative and mimetic isomorphism of practice through the use of consultants and mimicking of "best practices" that can explain director behavior to in the context of compensation and incentive design. We also believe that the currently observed lack of an internationalized CEO market in Sweden serves to conserve the status quo and path-dependence of large public Swedish firms in terms of compensation. We also argue that our observations with regards to private firms having stronger equity incentives and higher pay can be understood from an institutional perspective as these firms have a smaller constituency of relevant others demanding conformance with their demands. Conversely, we also suggest that institutional contingencies may shift over time, for example due to an increasing international mobility for CEO's, which could lead to different practices.

Through the lens of institutionalism, our research question and problem area becomes a lot less puzzling than if considered solely from an agency perspective. Understanding why U.S. CEO's that are active in a market where regulation de facto promotes the use of stock options and restricted share programs have more share-price sensitivity in their compensation than Swedish CEO's, who operate in a context where legislation in no way limits fixed pay and effectively outsources equity compensation decisions to shareholders with varying priorities, for instance, is in fact rather straightforward. In line with this and other arguments presented above, we suggest, like Bender (2003; 2004) and Main et al. (2008) that it is impossible to completely understand compensation practices in different contexts without including institutional perspectives. Further, we believe that our observations regarding institutional pressures provide a very plausible indication of why Swedish CEO's of large public companies may receive lower equity-based compensation than their peers.

Finally, a few remarks regarding managerial power theory deserve to be made. As outlined in the analysis, we do not find any strong indications of systematic CEO entrenchment or de-railed compensation practices as the theory suggests. In fact, it translates rather poorly to the Swedish context. The perhaps most consequential argument that can be presented is related to our initial observations about compensation practices for the CEO's of large public firms in Sweden: they do not appear to be "over-paid". Rather, the opposite picture emerged both when comparing archival data with peer CEO's in other countries and when taking the qualitative accounts of our study participants into consideration. The fact that equity incentives are "weak" by comparison, is further not likely to depend on CEO entrenchment as it would imply that some other form of compensation was artificially inflated, of which we find few indications. CEO entrenchment, which implies a great deal of autonomy for the chief executive, is also not compatible with our interpretations of the institutional environment for Swedish large cap CEO's.

7. Avenues for Further Research

In line with the exploratory nature of this study and the lack of previous studies examining equity-incentives for Swedish CEO's through a combined agency and institutionalist perspective, our thesis can to some extent in its entirety be considered a very comprehensive indication of potential avenues for further research.

The first such study we would suggest is a two-step study taking an econometric approach to modeling pay-performance sensitivities with typical agency and governance variables in order to, with quantitative precision, understand exactly how Swedish CEO incentives differ in the language of optimal contracting and managerial power theorists. The second step of such a study would, we suggest, also include institutional factors such as the ones suggested here, e.g. institutional investor influence, the effect of consultants and so forth. Preferably, care would be taken to exclude proxies, such as firm size, which have been suggested as only spuriously correlated with executive compensation. If any abrupt shifts in institutional contingencies were to occur within the Swedish context, such as a reform of the Leo Act, it would also be highly interesting to examine the "before and after"-effects of that on compensation practices, particularly with regards to equity pay.

Just as Main et al. (2008) and Bender (2004) suggested that their combined agency and institutionalist qualitative studies would be interesting to repeat in other settings (as done here, to some extent) we also believe it would be informative to conduct further research with similar angles as ours in other contexts: be it in other countries or types of firms. It would of course also be highly interesting to conduct cross-country qualitative studies that simultaneously examine the institutional influences of two different contexts, e.g. by comparing the reasoning of compensation decision-makers in Sweden and the U.S.. Replicating our study with a different set of decision-makers would also, we believe, be informative.

Finally, one of the most desperately needed types of studies in the executive compensation area are ones that first-hand examine the reasoning, behavior and characteristics of CEO's themselves. One of the most interesting such studies we can imagine would be one that attempts to examine the two CEO-related unobservable parameters of the agency model: risk-aversion and wealth constraints, preferably by contrasting CEO's in different contexts. Such studies could potentially provide a vast range of implications for future compensation research.

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Appendix

A1. Equity-related plans

Definition of equity-based plans (Figure 2)	
Combined Programs	Any combination of cash, share-based programs and or option programs with or without performance criteria
Option Programs	Executive receives option grants or synthectic options with or without performance criteria
Performance Shares	Executive invests part of salary and receives free matching shares (or options) and/or free performance shares based on certain performance criteria (or with no performance
Special Cases	All programs not covered by any of the definitions above

A.2. Summary of Previous Literature

A.2.1 Optimal Contracting Theory

Researchers	Data	Findings	Conclusions
Jensen & Murphy (1990)	2,213 US CEO's between 1974-1986	CEO pay-performance sensitivity, due to flow and stock compensation as well as sensitivities resulting from the risk of dismissal, was $3.25 for a $1,000 change in firm value	Executive incentives are, in general, weaker than they should be
Hall & Liebman (1998)	478 CEO's of largest U.S. firms between 1980-1994	Pay-performance sensitivities in the U.S. more than doubled between 1980 and 1994, going from $2.50 to $5.30 per $1,000, largely due to the increasing use of stock options	CEO's may be properly incentivized, new measures of pay-performance sensitivity
Aggarwal & Samwick (1999)	ExecuComp Database (S&P 500, Mid-Cap, Small-Cap), 1993-1996	Pay-performance sensitivities increase substantially (to over $14 per $1,000) if the volatility of the firm's stock is accounted for	Pay-performance studies that don't account for risk are biased towards 0
Core & Guay (1999)	Non-financial firms in ExecuComp Database, 1992-1997	Constructed 1) a model to determine optimal level of incentives in a firm 2) a model to determine if new equity grants reduce deviation from optimal incentives. Found this was the case.	Firms set optimal levels of pay and manage the levels by varying new incentive grants
Conyon & Murphy (2000)	510 largest UK firms vs. 1,666 largest US firms	Levels of total annual compensation, cash compensation and pay-performance sensitivities are significantly higher in the U.S. than U.K. even after controlling for size, growth opportunities etc.	Optimal contracting cannot properly account for the differences, point to cultural, social and economic differences
Conyon, Core & Guay (2011)	177 and 214 UK firms, 1,372 and 1,511 US firms from 1997 and 2003 respectively	Compare risk-adjusted CEO pay in UK and US, find that US CEO's have higher pay but bear much higher risk stemming from equity incentives	U.S. CEO's did not appear to be overpaid in 2003
Bång (2006)	20 randomly selected listed Swedish firms held by 1st AP-fund	Average pay-for-performance sensitivity was SEK 1.74 for a 1,000 SEK change in firm value	Share based remuneration imply additional cost for CEO/senior exec. remuneration
Fernandes (2011)	1,500 US & 900 EU firms over six years	US CEO's are paid only modestly more than European counterparts after controlling for risk	Pay more tightly linked to performance in US

A.2.2 Managerial Power Theory

Researchers	Data	Findings	Conclusions
Core et al. (1999)	1982-1984 (pre-governance debate) sample of 495 U.S. firms	Positive effect on total pay: Large board, CEO = Chair, % Grey/Interlocked/Busy/Old directors; Negative effects on total pay: % CEO ownership, large external or internal block holders; "Poor" pay practices lead to negative performance effects (ROA & stock)	Poor/excessive pay practices are due to weak governance, as evidenced by subsequently deteriorating performance
Bertrand & Mullainathan (2001)	792 large U.S. corporates 1984-1991; 51 largest U.S. oil firms 1977-1994	CEO pay is just as sensitive to increases in performance that result from "luck" (e.g. external shocks in oil price/exchange rates) as general performance increases; Worse in poorly governed firms (a large shareholder on the board decreases pay-for-luck by 22-33%)	Poorly governance leads to skimming (executives capturing the pay-setting process) and pay-for-luck, which cannot be explained by optimal contracting
Bruce et al. (2003)	287 UK firms between 1997-1998 (just after LTIPs were introduced)	Presence of an LTIP significantly increases total pay by 34.7% while also lowering pay-performance sensitivities (£1.36 vs. £1.06 per £1,000) as measured by pay sensitivity to TSR	Link between pay and performance has decreased while total compensation has increased, which may be evidence of managerial skimming.
Hartzell & Starks (2003)	1500 US-firms 1992-1997	Institutional ownership has a strong positive correlation with pay-for-performance sensitivities; negative correlation with levels of total pay	Institutional investors influence the structure of executive pay and help reduce agency problems between managers and shareholders
Almazan et al. (2005)	1500 US-firms 1992-1997	Active institutional ownership has a strong positive correlation with pay-for-performance sensitivity; Both significant for total pay	Active institutions monitor more closely than passive institutions, which in turn monitor more closely than regular ones

A.2.3. Combined Theoretical Approaches

Researchers	Data	Findings	Conclusions
Samani (2012)	All listed non-bank firms in Sweden 2005-2009	Equity pay more prevalent in non-family firms. Less prevalent with increase in shares held by largest owner and with employee representatives. Family CEO's receive less total pay. CEO on board and dependence of directors on owners has no effect	Less equity pay in firms with employee representatives and higher ownership concentration may be due to lower agency costs
Frydman & Saks (2010)	50 largest US firms between 1936-2005	Governance was weaker but pay was lower and less sensitive to performance 1950-1970. Size and pay increases may be unrelated. Hypotheses regarding risk cannot be proven	Argues that common perspectives on determinants of executive pay need to be re-examined in light of new data

A.2.4 Qualitative Theoretical Approaches

Researchers	Data	Findings	Conclusions
Conyon et al. (2011)	232 largest UK firms during 2003	Shared use of consultants lead to converging pay practices and simultaneous director and consultant interlocks lead to increases in total pay. Level of total compensation also increased if a compensation consultant provided other services to the firm	Findings are in line with theories of institutional isomorphism and managerial power
Bender (2003)	Interviews in two listed UK utilities in 2001-2002	Findings on how directors pay is set, level and structure of remuneration were clearly influenced by the market, and highlight the problems of determining a suitable comparator market	Institutional theory influences identified in level and structure of pay
Bender (2004)	Interviews with 35 individuals in 12 UK companies (FTSE 100 & 250)	Companies adopt performance related pay despite a belief that money doesn't motivate. Reasons relate to best practice in HR management and legitimizing factors (variable pay seen as a symbol for directors success)	Can be explained by institutional theory. Legitimacy important for how decision-makers approached variable pay
Main et al. (2008)	22 interviews members of remuneration committees in UK	Concerns with legitimacy push remuneration committees towards an institutional isomorphism in process and practice	Neo-institutionalism, Performance metric chosen to please institutional investors