How Much Sunlight Does it Take to Disinfect a Boardroom? A Short History of Executive Compensation Regulation*

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Abstract:

This paper reviews the history of executive compensation disclosure and other government policies affecting CEO pay and surveys the literature on the effects of these policies. CEOs are almost exclusively in the top 1 percent of the pay distribution, and regulation of their pay is seen as a well-targeted way of reducing income inequality. Mandatory disclosure of executive compensation has increased nearly uniformly since 1933. A number of other regulations, including special taxes on CEO pay and rules regarding votes on some pay packages have also been introduced, particularly in the last 20 years. However, there is little solid evidence that any of these policies have had any substantial impact on pay. I also review limited evidence from overseas on "Say on Pay," recently proposed in the US, which would allow nonbinding shareholder votes on CEO compensation. The experiences of other countries have been positive, with tighter linkages between pay and performance and improved communication with investors. Mandatory say on pay would be beneficial in the United States, both increasing shareholder value and making CEO pay fairer, thus reducing the likelihood of passage other legislation to reduce income inequality, such as higher taxes on the rich.

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1. Introduction

Over the last 20 years, there has been renewed public interest in executive compensation. Especially beginning in the early 1990's, there was substantial outcry over rising pay packages for CEOs while the wage of the average worker was stagnating. Inequality has increased since 1980 by almost any measure. Moreover, the income of the highest paid workers has continued to pull away from that of the remainder of the work force. The rise in inequality has led to calls for reform. Some propose simply raising top marginal tax rates (e.g. Dew-Becker and Gordon, 2005), but there are also proposals for more targeted reforms. The purpose of this paper is to review the policies used in the United States to regulate executive compensation and shed light on their exact effects.

Gordon and Dew-Becker (2007) discuss the literature on income inequality. Through the 1980's, the incomes of the 90th and 10th percentiles diverged dramatically, and for a variety of reasons: increased trade and immigration, a fall in the real minimum wage, and a decline in unionization all helped increase income inequality. However, between 1980 and 2000, inequality above the 90th percentile also increased dramatically. Piketty and Saez (2003) find that the top percentile's share of total income has more than doubled since 1980 from 10 to 23 percent by 2006, while the share of the 90th to 95th percentiles has stayed roughly constant at 11 percent. The top 1 percent has pulled away from the rest of the top decile.

Kaplan and Rauh (2007) study the composition of the top 1 percent of the income distribution. Combining data from the IRS and SEC filings, they find that only 7 percent of CEOs have incomes below the 99th percentile. While executives comprise only a small portion of top incomes, they have incomes almost exclusively in the highest tier. Therefore reforms affecting executive pay have the benefit of being focused on a relevant group.

Frydman and Saks (2008) study changes in executive compensation going all the way back to the beginning of the SEC in 1933. They find that executive compensation in a sample of large firms actually fell in real terms between 1936 and 1950. It subsequently grew slowly, at only 0.8 percent per year (versus economy wide wage growth of 1.2 percent). It was only after 1975 that executive pay began to pull away from that of the average worker; CEO pay grew much faster than average income since 1975, while the income of the median worker grew less than average.[1]

There are concerns that CEO pay is set inefficiently. Rather than being purely market driven, as with major sports stars and entertainers, executive compensation is set by boards of directors whose interests may often align with the CEO himself rather than shareholders. Bebchuk and Fried (2004), for example, review substantial evidence on board capture by CEOs. Regulating executive pay may then achieve two goals: both lowering income inequality and increasing shareholder value.

By the early 1990's, executive pay packages looked especially unreasonable when compared to those in Japan, a country that, at the time, had far superior economic performance. Therefore, in 1992 Congress enacted two major changes to the way executive compensation is treated. First, mandatory disclosure of executive pay was expanded dramatically, with far more detailed explanations of precisely what executives are paid and why they are paid it. Second, the tax code was changed so that all pay above $1 million that is not tied to performance is now deemed "excessive" and is not eligible to be deducted from corporate income for tax purposes.[2]

The 1992 laws are perhaps the best known changes in policy regarding executive pay, at least among economists. However, the government treatment of executive pay

[1] See Gordon, 2009, for a discussion of the gap between mean and median wages.
[2] The SEC also allowed shareholder proposals on executive compensation to be added to proxies. I discuss this change in section 5 below.

has changed drastically over a much longer period. This paper provides a short history of policies regarding executive pay since the 1930's. In particular, I look at disclosure rules, tax rules, and the effects of changes in legal liability. There has been substantial research on the determinants of executive pay but surprisingly little on the policies that are used to control pay. Throughout the paper, I try to note any available research on the effects of policy changes. It is evident, though, that much more work could be done. Policies that affect executive compensation are actively changing, with at least 5 major laws having been enacted over the past 16 years. We know surprisingly little about their effects.

What will become clear is that the United States currently has a sensible set of disclosure rules. The SEC has spent over 70 years fine-tuning the policies, and it is now difficult to find any major flaws that should be rectified. The presence of good disclosure policy, however does not imply that corporate governance overall is perfect. Rather, there is a lot we could do to improve the performance of boards of directors.[3] One recent proposal to improve governance is mandatory "Say on Pay." Under this plan, publicly traded companies would be required to put their CEO compensation plan up for a non-binding vote at each annual meeting. Research on the effects of similar policies in other countries finds generally positive results. Say on pay would be especially useful in light of recent legal developments that have limited the ability of shareholders to question the decisions of boards.

The remainder of the paper is organized as follows. Section 2 gives a short discussion of the standard theory used to understand compensation practices. At its heart, regulation of executive compensation is about improving the interactions between shareholders, boards, and CEOs. In section 3 I review the history of disclosure rules, showing that they have followed a nearly continual trend towards more thoroughness.

[3] See, for example, the work of Lucian Bebchuk.

Section 4 discusses how various government policies have affected the composition of executive pay, rather than just its level. Tax changes since 1992 have caused substantial changes in the incentives for firms to use different forms of compensation. Section 5 examines corporate governance. While disclosure rules have continually moved in favor of shareholders, many recent changes in corporate governance have gone in favor of boards.

In section 6, I ask whether say on pay proposals are sensible and what effects we might expect them to have. In general, say on pay will bring some power back to shareholders and help improve their relationships with boards of directors. Finally, section 7 concludes. Improvements in governance and shareholder-board relations will help make CEO pay more fair and increase shareholder value. If the goal is to increase egalitarianism, these policies will not help. But if one wants to ensure CEOs are paid what they are worth, the history reviewed in this paper shows the US has been moving in that direction over the past 15 years, and that say on pay would be a smart improvement.

2. Theory

At its heart, the problem of setting the level of executive compensation is a so-called principal-agent problem. The principals are the shareholders, who hire an agent, the CEO, to run their firm for them. They want to pay the CEO as little as possible, but also provide sufficient incentive for him to work hard. If the shareholders observe everything the CEO does, then they can write a contract that defines exactly what the CEO must do in order to be paid. The problem is that they do not observe the actual work that he does. The CEO might shirk his responsibilities, or he might skim profits, say, in the form of undisclosed perks. The standard solution to this problem is an incentive contract, under which the CEO's pay depends on the profits of the firm. The CEO then has more incentive to work in the best interests of the firm (though these contracts do not, in general, lead the CEO to work as hard as the shareholders might want).

In the real world, the board of directors forms a second layer through which this interaction takes place. The shareholders delegate their power to the board, which is supposed to monitor the CEO and set up a pay package. If the board's incentives are perfectly aligned with those of the shareholders, then they will write an efficient contract for the CEO and monitor his behavior. However, if the board's interests conflict with those of the shareholders, then we have another principal-agent problem, this time between the shareholders and the board.[4]

In any company, the board of directors has a contract that governs their interactions with the shareholders. In exchange for monitoring the executives of the firm, they are paid in the form of a fixed salary and an incentive scheme, usually consisting of stock or stock options (though obviously their pay may include any number of other components, such as perks). By giving them a share of the profits (in the form of stock), the shareholders align the board's incentives with their own. Nevertheless, the board may still not behave exactly how the shareholders want. I discuss these conflicts further in section 5.

If shareholders and directors' incentives are not perfectly aligned, there may be a place for regulation. First, mandatory disclosure helps shareholders monitor directors and ensure that they are creating good contracts for the CEO. As in the basic principal-agent problem, if the shareholders can define exactly what the board is expected to do, and then monitor it perfectly, then there is no longer a conflict of interests and the board will act in the shareholders best interests. More disclosure gives more information, which should lead to better behavior by the board. On the other hand, mandatory

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[4] Singh, 2007, provides a model with this second layer of interaction, and also reviews principal-agent theory as applied to executive compensation.

disclosure may impose costs on the company for collecting information or reveal trade secrets.

Regulation can also directly affect how the shareholders and the board interact. In the past, shareholders delegated all of their authority on setting pay to the board. More recently, shareholders gained a limited ability to vote on nonbinding resolutions on pay. The nature of the interaction between shareholders and the board determines the freedom of the board to both help and hurt the shareholders, say, by finding the best CEO available, or paying her too much. An argument against more shareholder influence, though, is that some shareholders may push for actions that bring only short term gains, while the board is better placed to ensure the long term strength of the firm.

Last, the government may try to directly manipulate pay through various taxes. The overall level of the tax will affect CEOs' incentives to work, and shareholders may just end up paying more in total salary. But the variation in taxes across different types of compensation can lead the board to using a more efficient contract. Specifically, if boards tend to use inefficiently low levels of performance-based pay, then taxes relatively weighted towards salary motivate more efficient contracts. It is not obvious how to determine the optimal level of incentives, though.

In the remainder of the paper, I study these types of regulations of executive pay, among many others. At their heart, these regulations are about resolving conflicts of interests, either between shareholders and the board, or between the board and the CEO.

3. Disclosure Rules

The Beginning of Mandatory Disclosure

The first requirements for disclosure by publicly traded firms were enacted in 1933 with the Securities Acts.[5] All firms making a new offering were forced to register with the Securities and Exchange Commission (SEC) and release a prospectus detailing the financial condition of the firm. Firms listed on exchanges also had to send out proxy statements before annual meetings or shareholder votes. The proxy was intended to give shareholders the necessary information to make informed votes about any proposals. It had to contain information on the qualifications of nominees for the board of directors, any transactions they had with the firm, and their holdings of company stock. Furthermore, companies could recover the profits if any insider bought and sold stock within a 6-month window. In other words, in the very first disclosure requirements, the SEC was already dealing with the possibility of directors acting in their own interests, rather than those of the shareholders.[6]

In 1938, the SEC first required firms to disclose executive compensation. The new proxies, along with the rules from 1933, began the systematic media scrutiny of executive pay. In 1942 for the first time, the SEC required companies to disclose executive pay in a table, rather than just in narrative form. The tabular disclosure was expanded also in 1952 to include pensions and deferred compensation. By moving to tables, the SEC was helping to increase the transparency of disclosure, even if the actual amount of information disclosed was the same.

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[5] See Greenstone, Oyer, and Vissing-Jorgensen (2006) for an extensive explanation of these laws and subsequent amendments. My description relies on their work.

[6] La Porta, Lopez-de-Silanes, and Shleifer, 2006, study the cross-sectional relationship between disclosure laws, among others, and financial development in a large international sample. They find that greater disclosure is related to greater financial development along a number of dimensions.

Tabular disclosure is easier to grasp than a narrative. It allows easy comparisons across firms and keeps firms from obscuring facts with accounting jargon. However, since they are only required to disclose specific types of pay rather than the total pay package, firms can disguise pay simply by using vehicles that are not required to be disclosed, such as perks. Moreover, tabular disclosure necessarily forces firms to oversimplify their pay packages. For example, investors are probably much more willing to pay a CEO a bonus when it is tied to some specific performance goal. Kole (1997) studies the complexity of CEO compensation packages and finds that there are numerous relevant dimensions along which contracts can be adjusted above simply total compensation and whether it is performance-based or not. For example, a firm can vary vesting periods for options, the performance measure for earning rewards, and whether or not the executive has voting rights on restricted shares. These facets of the contract are not included in simple summary numbers in compensation tables.[7] Throughout its history, the SEC has tried to balance transparency and detail.

The 1960's and 70's

The last major expansion of the firm coverage of disclosure rules was in 1964. Essentially, it extended coverage to nearly all OTC firms. There is evidence that prior to this disclosure, much of securities fraud, at least in terms of the raw number of offenses, was concentrated in these relatively unregulated firms (see Greenstone, Oyer, and Vissing-Jorgensen, 2006, and Seligman, 1995). The majority of OTC firms did not even tell shareholders the names of the directors, let alone their qualifications or possible conflicts of interest. 30 percent of OTC firms did not even send out proxy statements before annual meetings. Greenstone, Oyer, and Vissing-Jorgensen also note that people

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[7] Even in 19th century Germany, firms were setting up contracts with incentive plans. Burhop (2004) finds that while they began simply with incentive schemes that were linear in profits, they quickly introduced nonlinearities similar to modern options packages. These packages were vastly simpler than those described by Kole, 1997, however.

at the time believed that firms did not list themselves on stock exchanges precisely so they could avoid the disclosure requirements. However, it is noteworthy that by severely limiting their disclosure, these firms probably opened themselves up to far higher risk of litigation than firms listed on exchanges (a topic to which I return below).

Greenstone, Oyer, and Vissing-Jorgenson (2006) provide one of the cleanest analyses of the effects of disclosure rules. Prior to 1964, two equally sized firms with identical financial characteristics could have totally different disclosure requirements simply depending on whether they were listed on an exchange or not. The 1964 rule changed that. Using a variety of methods, Greenstone, Oyer, and Vissing-Jorgensen find that the firms to which the new rules applied had substantial excess returns. During the 18 months over which the new rules were considered and passed, these firms had excess returns of 10 percent. If the rules helped solve an agency problem due to imperfect monitoring, then this value was largely newly created. On the other hand, it is possible that the rise in stock prices constituted simply a transfer of wealth from insiders to shareholders. The authors note that they cannot test this possibility. Nevertheless, it is clear that the effect is large and shareholders were left better off.

Throughout this period, the Internal Revenue Service (IRS) required that executives pay taxes on any perks that they received that were not available to all employees of their firm. McGahran (1988) notes that the rule was not enforced until 1977. In that year, a line was added to corporate income tax returns requiring disclosure of management perks, but companies said that they did not have the information necessary to report the value of perks. In 1978, the SEC substantially expanded disclosure rules, requiring the summary compensation table in the proxy statement to cover all forms of compensation, including perks, contingent compensation, and the value of stock options and stock appreciation rights. The IRS then expanded its Audit

Technique Handbook in 1979 to inspect perks more closely.[8] McGahran (1988) studies these changes and finds that when perks became more expensive to executives due to the new tax treatment, they tended to shift compensation more towards salary.

The Pendulum Swings Back

By the late 1970's, essentially all major forms of compensation were being reported in tables. Perks were included in the summary compensation table, and perks valued at more than $25,000 or 10% of the executive's salary (based on the incremental cost to the company) was reported in a footnote.[9] But in 1983, the SEC turned on its heel and markedly reduced disclosure. The summary compensation table now only included cash compensation, and firms no longer had to report contingent compensation, interest on deferred compensation, or dividends paid on restricted stock (even though they still had to pay taxes on this money). Moreover, the number of officers covered by disclosure was limited, and perks below the value of $25,000 no longer had to be reported anywhere. Essentially, prior to 1983, all compensation that would show up somewhere on financial statements (though aggregated with other data) was to be reported in the proxy statement. After 1983, this was no longer the case; there were substantial opportunities to obfuscate the true cost of compensating executives.

Between 1938 and 1982, the SEC followed a path of only increasing disclosure. Bebchuk and Hamdani (2006) note this same trend as a part of generally increasing Federal regulation of securities markets. Corporate law originated in state law, but through the 20th century, the Federal government expanded its regulation of corporations as they became more national in character. In 1983 though, the SEC reduced disclosure in

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[8] This section draws much from McGahran, 1988, who provides an extensive and clear explanation of the changes in the late 1970's.
[9] See the US Federal Register, Vol. 43, No. 240, pp. 58183–58184.

the name of simplification, transparency, and reduced compliance burdens. This change fits with the general trend towards deregulation under President Reagan in the 1980's.

The Current Regime

The current disclosure regime began in 1992 with an overhaul of how executive pay is treated in proxy statements. Disclosure was expanded from the three most highly paid executives to the CEO and the other 4 most highly paid executives.[10] Firms now had to report salary, bonus, perks, and long term compensation going back 3 years. The SEC added a performance chart to the proxy that compared the firm's stock return to a reasonable benchmark so that investors could see the relationship between pay and performance, and a compensation committee report was required to identify explicitly the performance measures used to determine pay and the general goals of the compensation package. In addition, a number of new tables were added to the proxy statement meant to disclose many of the vehicles that firms had been using to disguise the total value of pay. For example, firms had to disclose the value of retirement plans and severance packages over a certain threshold.[11] The one reduction in disclosure was that perks no longer had to be reported below $50,000, instead of the former $25,000 limit, which was justified simply by inflation.

Firms also had to begin to report the value of stock options granted, unlike under the 1983 rule when just the number of shares was reported. They had three choices: the Black-Scholes method, or calculating the potential value of the options assuming 5 or 10 percent annual stock appreciation. Murphy (1996) examines firms' reporting choices and

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[10] Disclosure was also extended somewhat to cover directors, though the disclosure is still not as extensive as it is for executives.

[11] The rule was slightly expanded in 1993. Previously, if an executive retired, his or her compensation was not reported in that year, encouraging the use of massive payments on the date of retirement. As of 1993, firms had to report the pay of any executive who left the firm but was among the 5 highest paid employees prior to leaving.

finds that they tended to use whatever valuation method gave the smallest value for the options.

Lo (2003) studies the effect of the 1992 rule on stock returns. She considers firms that submitted comments to the SEC criticizing expanded disclosure, and assumes that those firms were the ones who likely had some sort of agency problem. That is, if they were against disclosure, it was probably because they had something to hide. She finds that these firms had excess returns of approximately 6 percent during the 3 month period over which the new rule was considered and saw improvements in returns on both assets and equity.

In 1993, Canada expanded disclosure in a manner similar to the US. Because there is so little direct evidence on the impact of disclosure in the US, studying other countries' experiences is critical. In Canada, firms were not only required to report current compensation, but also the previous three years.[12] Park et al. (2001) and Craighead et al. (2004) study this change. Park et al. (2001) find that disclosure actually raises pay, which they argue is due to executives' increased bargaining power when they have better information about the pay of their peers. Craighead et al. (2004) argue, on the other hand, that Park et al. (2001) find increased pay because their sample of firms changes over time and because they do not properly control for the effects of accounting performance on pay. Craighead et al. (2004) use a subtler identification strategy, arguing that disclosure should have different effects on closely held versus widely held firms. In closely held firms, monitoring should be effective even in the absence of mandatory disclosure. Thus, they find that following disclosure, pay becomes more closely tied to performance in widely held firms.

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[12] This was also true in the US following 1992, but it was phased in so that no new information on, e.g., 1991, was ever reported.

The 2006 Rule

The final change to disclosure occurred in 2006. After the SEC proposed new rules in January, it received 20,000 public comments, more than any other SEC proposal in history. The 1992 change garnered only 900 comments (still more than the 1983 and 1978 rules combined). The 2006 rule has been viewed as a huge change in how pay is reported, even though it looks outwardly very similar to the prior regime, in the sense that the summary compensation table is retained, along with familiar tables detailing options grants, pensions, etc. The major difference in the 2006 rule, as noted by Brown (2007), is that it is "principles-based" rather than "rule-based." That is, in the past, disclosure rules have been "rule-based" in the sense that firms are given specific rules to follow for how to disclose different types of pay. This means that when firms come up with new forms of compensation, such as loans with below-market interest rates, there may be no specific provision for disclosure. As of 2006, the SEC wants every component of compensation to be disclosed, regardless of whether there is a specific provision for it. Firms are supposed to disclose thoroughly what their total liabilities are to the CEO, including severance packages, pensions, and deferred compensation. Extending principles-based disclosure to the proxy statement fits with recent general trends, including the Financial Accounting Standards Board's new rules for stock option valuation (see below).

To an economist, the 2006 rule looks like a triumph of common sense. It is designed to tell investors the change in what the firm owes an executive over the past year. For example, in the past, firms were required just to report payments from long term compensation packages. Now they are required to report the change in what they actually owe to the executive. The SEC also pushed much harder for plain English disclosure of what the firm is actually trying to accomplish with its pay package, rather than allowing firms to continue their use of complex accounting terminology. This brings compensation disclosure in line with the financial statements, which require the same sort of plain English reporting.

To be more specific (though by no means exhaustive), the new rules expanded disclosure in the following ways: [13]

- All components of compensation must be measured in dollar terms
- Add a new table summarizing the pay of directors
- Deferred compensation is now included in the summary compensation table
- Disclosure of severance and retirement packages is substantially enhanced
- Add disclosure of specific targets and the range of potential payouts for incentive plans
- Perks must be disclosed if they are worth more than $10,000 (as opposed to 1992's $50,000 limit)
- "All other compensation," which includes components of pay not included in salary, bonus, or stock, must be disclosed in a separate table listing any individual component worth more than $10,000
- Eliminates flexibility in disclosure of the value of options (firms have to follow the current financial accounting standard – the Financial Accounting Standards Board's rule 123R)
- When options are repriced, the incremental change in their value is reported in the proxy, instead of treating them as new grants (or not reporting them at all) as in the past

As noted above, these changes are all designed to allow investors to see the total amount of money that can potentially be paid to executives. The changes to reporting for severance and retirement packages are possibly the most important. Firms are now required to exhaustively list the possible payments if executives are terminated or there is a change in control. They also have to explain precisely what executives stand to receive in annual benefits from retirement plans. Previously, these two types of packages were what caused some of the largest outcries because they were often only revealed after

[13] Brown, 2007, has a useful table listing the changes from the 1992 to the 2006 rule.

executives were fired. For example, Disney had to spend millions of dollars fighting off a lawsuit that arose almost entirely due to a severance package paid to an executive who worked for only a year.

Bebchuk and Jackson (2005) find that, prior to the 2006 rule change, substantial amounts of compensation were being effectively hidden in retirement plans. The median CEO had a pension worth twice what she earned in salary during her entire tenure. Bebchuk and Jackson also find that if previous studies had included the value of pensions in total compensation, they would have found pay to be far less connected to performance. Moreover, by paying CEOs through pensions, firms are able to avoid certain tax liabilities associated with salaries over $1 million.[14]

There is as yet little research on the results of the 2006 changes. Beucler and Domat-Connell (2007) provide a review of investor opinions on the changes that gives at least anecdotal evidence on how disclosure has changed in practice. In some respects, they are optimistic. They find that disclosure is genuinely more extensive, with the disclosure of retirement benefits and director pay being two of the more effective improvements.

On the other hand, they find that firms still are not being as transparent as the SEC had predicted in the text of their 2006 rule. The Compensation Discussion and Analysis (CD&A), is one major area of concern. While the SEC encouraged plain English disclosure and had envisioned the CD&A only requiring 1,000 words, the median length in 2007 was 4,726 words. Moreover, Beucler and Domat-Connell do not see the CD&A as in any way transparent to the average investor. An important question is whether the length and opacity of the CD&A is due to firms trying to mislead investors or

[14] See the discussion of IRC section 162(m) in section 3 below.

simply because firms are being careful due to the new liability associated with the CD&A, which I discuss below.

The other major shortfall that Beucler and Domat-Connell find in the 2007 proxy statements involves the disclosure of the value of equity compensation. As noted above, the SEC now requires principles-based disclosure of equity compensation, rather than requiring a single valuation method, but Beucler and Domat-Connell find that 54 percent of companies do not report their valuation methodology.[15]

In the end, it is clear that the new rule is a major step in the right direction, and that disclosure now covers all changes in liabilities to the CEO (including both current compensation and expected future payments). Nevertheless, as is common with new standards, some guidance from the SEC is probably necessary in order to help clarify expectations.

4. Taxes and the Composition of Pay

Around the same time that the SEC was decreasing mandatory disclosure, the Congress passed the Deficit Reduction Act of 1984. This law included a new set of taxes on severance packages. While severance packages were not enormously common at that time, congress acted to limit their use by limiting when they could be deducted from corporate income taxes and imposing a 20 percent excise tax on any severance package deemed "excessive."[16] The technical definition of excessive here turned out to be three times average annual pay over the previous 5 years. Jensen, Murphy, and Wruck (2005) claim anecdotally that this new law if anything encouraged the use of severance

[15] However, they do not say whether they looked for a description of the valuation methodology in the 10-k. Since valuation of equity awards is now supposed to be consistent across the proxy and financial statement, it seems possible that firms just list their valuation methodology once in the financial reports.
[16] Note that the 20 percent tax is not a marginal tax. That is, it applies to the full value of the severance package only if it is above the limit. So if an executive has a $1 million salary, then he pays no tax on a $3 million severance package, but would pay $600,000 on a $3,000,001 package, netting him only $2.4 million.

packages. It was interpreted as a congressional endorsement of packages up to three times annual pay as "reasonable."

In 1993, again, just after a change in disclosure rules, Congress passed a major change to the tax code. A new section, 162(m), was added to the Internal Revenue Code (IRC) which says that all compensation over $1 million that is not performance-based is deemed excessive and does not qualify to be deducted from corporate income.[17] For income to qualify as performance-based, it has to be associated with specific targets with a horizon of at least 12 months, be approved by a compensation committee composed of at least two independent directors, and be put up for a shareholder vote.[18]

Firms that pay salaries less than $1 million have strong incentives to shift towards performance-based pay, which should be a positive development, and they pay no extra taxes. On the other hand, the vast majority of firms now pay salaries above $1 million. The tax still makes incentive-based pay relatively cheap, but firms are also paying a large amount of new taxes, which come out of profits. Even if firms are willing to pay salaries above $1 million, though, 162(m) should still have an effect since a dollar of compensation paid as salary is more expensive to a corporation than a dollar paid that is performance-based.

A number of authors have studied the effects of the 1992 tax and disclosure changes. Vafeas and Afxentiou (1998) find that after 1992, compensation committees included noticeably fewer insiders, and compensation seems to be more closely tied to performance. These two effects are to be expected both from the 162(m) and the SEC

[17] The 1992 rule was pushed for not only by political interest groups but also by large institutional investors such as the California and New York City Public Employees Retirement Systems, see Dodell, 1993. In general, institutional investors very consistently say that they do not want to interfere with the determination of "reasonable" salaries. Rather, they push for independent boards and strong incentives for CEOs. See Pagano and Volpin, 2001, for an interesting review of the political economy of the regulation of financial markets.

[18] "Independent" was defined as more than not being an employee of the firm, but also not receiving any pay from the company for, e.g., a consulting relationship.

rule. Perry and Zenner (2001) confirm that pay was increasingly sensitive to performance. They also say that firms paying salaries slightly above $1 million prior to 1992 tended to reduce them after, but that firms paying higher salaries were largely unaffected.

The legal and consulting community, to some extent, has argued that 162(m) is not nearly as stringent as it sounds. First, companies and executives had a one-time opportunity to avoid tax charges by shifting income from 1993 (when the law first applied) into 1992. Moreover, by awarding salary but then deferring payment until retirement, firms could completely avoid the $1 million cap (see, e.g., Kroll, 1998).[19] The rules about pay being tied to performance are also easily skirted. Suppose the compensation committee says that the CEO receives 1 percent of total sales above some level as her bonus. If, at the end of the year, they try to increase the bonus for some other subjective reason, then the entire bonus no longer counts as performance-based, and the firm pays taxes on it. Suppose, on the other hand, the firm says that its official policy is to set the bonus to 2 percent of sales, but then it just revises the bonus downward at will to meet whatever value it deems appropriate. This alternative package will then likely pass muster with IRS. So even though 162(m) gave firms greater incentive to use performance-based pay, it also gave them incentive to make the targets relatively easy to achieve (see Salwen and Laarman, 1993). That said, a firm's pay package will look suspicious to both the IRS and investors if it involves a massive payout for performance that is then revised downwards every year, so there are limits to this strategy.[20]

After 1992, there was an enormous rise in the use of stock options (see, e.g., Bryan, Hwang, and Lilien, 2000). Some firms have even made standing offers to

[19] Nusbacher and Johnston, 1993, note that deferred compensation may not be very attractive to corporations. The compensation shows up on current financial reports but does not provide a tax deduction until it is paid. Moreover, they have to pay taxes on all of the investment earnings.
[20] Kroll, 1998, and Nusbacher and Johnston, 1993, discuss issues associated with 162(m) from the perspective of the legal and compensation consulting communities.

executives that allow them to trade salary for (non-qualified) option grants. The tax treatment of stock options was made even more attractive with the Taxpayer Relief Act of 1997 and the IRS Restructuring and Reform Act of 1998. These acts lowered the maximum capital gains tax rate from 28 to 20 percent, which had an immediate impact on executive pay. Under the new laws, if an executive receives an incentive-based stock option (also known as a qualified option), they never pay income taxes on it as long as they do not exercise it within two years of the grant date. The entire value is treated as a capital gain. This makes qualified options much more attractive to executives, and even more so after the further reduction in capital gains tax rates that occurred in 2003.

5. Corporate Governance: "Care and Loyalty"

While changes in the 1990's affected the composition of pay, changes in the late 1980's may have had a substantial effect on its level. Following the Supreme Court's decision in *CTS v. Dynamics Corp.*, states were allowed to write laws making hostile takeovers much more difficult.[21] Delaware, the state in which more than half of firms are incorporated, enacted its anti-takeover legislation in 1988. This was a business combination law that worked mainly to inhibit leveraged buyouts. Bertrand and Mullainathan (1999) provide an extensive discussion of the history of these laws. They then exploit the cross-state variation in the laws to measure their effects on executive pay. They find that pay tended to rise in firms affected by the new laws.

Interestingly, they also find a rise in pay for performance in these same firms. This is consistent with the hypothesis that because agency problems increased, firms had to increase the incentives for good performance. Moreover, because compensation became riskier, its expected value had to rise in order for executives to get the same value

[21] Bertrand and Mullainathan, 1999, provide a detailed description of the various laws and their history. Until fairly recently, most corporate law operated at the state level. Corporations exist as creations of states, rather than the federal government. Therefore, a very large part of the statutory and case law originates in the states.

– CEOs' average income rose. What is worrisome is that the increase in pay for performance only occurred in firms with a large shareholder. Firms without a large shareholder must have then had an increase in agency problems without an attendant change in pay structure to mitigate them.[22] The changes in executive pay following changes in the ease of takeovers are an example of the market for corporate control acting as a monitoring mechanism (see Jensen, 1993).

More recently, the Sarbanes–Oxley Act of 2002 covered a diverse set of issues related to corporate governance. A few of its provisions directly affect executive compensation. First, it disallows loans from corporations to their executives, a type of compensation heavily criticized by Bebchuk and Fried (2004). Second, since the CEO and Chief Financial Officer must now personally certify financial statements, if those statements are materially revised, the CEO is required to give the company back 100 percent of his or her performance based compensation. Third, it requires that the board be made up of a majority of independent directors, and that the nominating and compensation committees be entirely independent. At the same time, the three major stock exchanges, the NYSE, NASDAQ, and AMEX, made their definitions of independence more stringent. The independent directors on the board are also now required to meet in executive session without the insiders at least once a year. These changes further enhance the rules applying to compensation committees in 162(m).

Chhaochharia and Grinstein (forthcoming) study the effects of the provisions of Sarbanes–Oxley related to board independence on CEO compensation. They find that firms that were affected by this policy decreased compensation paid to their executives by 17 percent more than the change in pay by firms that were unaffected. Their analysis is one of the few available studies of the effects of board composition on executive pay.

[22] Shleifer and Vishny, 1986, first showed the relationship between large shareholders and the quality of corporate governance.

Interestingly, they find that the majority of the decline in pay came from options, rather than cash. This implies that rather than options being used as a way to solve agency problems, if anything, they were used to inflate pay.

One of the major concerns in the comments to the SEC about the 1992 and 2006 rules was that it could open the board of directors to new kinds of lawsuits. In particular, firms were worried that they could be sued over the content of the compensation committee report if it contained even a minor mistake. In the 2006 revised regulations, the compensation committee report was somewhat downsized and replace with the "Compensation Discussion and Analysis (CD&A)." Since the CD&A is officially filed with the SEC, it could conceivably be used as part of a lawsuit.[23] Firms also worried that the increased disclosure might bring more frivolous lawsuits and that it might force them to reveal trade secrets. The same sort of concerns arose around the time Sarbanes-Oxley was passed. These concerns seem to have been unfounded, at least with relation to executive pay. Over the years, it has proven essentially impossible to successfully sue corporations over pay packages. The new rules, in particular the compensation committee report, the required independence of the compensation committee, and the requirement in 162(m) that pay packages be approved by shareholders, make suits over executive pay even less likely to succeed than in the past.[24] Moreover, the Private Securities Litigation Reform Act of 1995 made it more difficult for shareholders to sue firms, thus weakening even further the power of shareholders.[25]

[23] This is as opposed to the compensation committee report which is only "furnished," and opens firms to less risk of liability.
[24] See, for example, the discussion in Olson, Mueller, and Rogers, 1993.
[25] Johnson, Kasznik, and Nelson, 2000, find that for a sample of high-technology firms, the PSLRA increased the market value of firms most likely to be involved in securities litigation. They note, however, that the benefit of limiting litigation is weaker when other governance mechanisms are also weaker.

The fiduciary duties of boards of directors can be divided into a duty of care and a duty of loyalty.[26] When shareholders sue corporations over pay packages, they generally allege a violation of these fiduciary duties. The duty of loyalty says that directors must act in the best interests of the shareholders, rather than themselves. The duty of care says that directors must take due care in their decisions, gathering all relevant information and keeping abreast of all developments. Under a principle called the business judgment rule, courts are generally unwilling to question the decisions that boards make; rather, they will only look at the process at which the board arrived at the decision. As long as the process looks to have been duly deliberative and the board had no personal stake in the decision, courts will not question whether it was actually a good idea.

The combined effect of the SEC's 1992 and 2006 rules, IRC section 162(m), and Sarbanes-Oxley is to make all three types of claims more difficult than in the past. Because the compensation committee is now fully independent and the definition of independence is more strict, duty of loyalty claims are more difficult. Outside directors are generally given the benefit of the doubt with relation to self-dealing, whereas the burden of proof can be on inside directors to prove that they are not violating the duty of loyalty. The compensation committee report also makes duty of care claims more difficult than in the past. When the committee explicitly explains its motivation for the pay package, it is showing that it took care in determining pay. Finally, because many pay packages are subject to shareholder approval, courts are unlikely to rule them wasteful. The logic is, if a reasonable person would not approve of this pay package, the definition of waste, then why would the shareholders have voted for it? Whether this logic makes sense (many shareholders probably do not read proxies carefully, and many do not even vote at all), it is the current state of affairs in the courts.

[26] This section draws heavily on Pinto and Branson, 2004.

Regulation of the relationship between shareholders and the board has thus gone in multiple directions. The SEC moved in the direction of more shareholder control of the board when it allowed resolutions on pay to be voted on at annual meetings and when it added the CD&A in which the board must directly defend its pay practices. Sarbanes–Oxley also required more independent directors, making the board more representative of outside shareholders, rather than insiders. On the other hand, the PSLRA and court decisions limiting takeovers reduce the ability of shareholders to use the law to keep boards of directors under their control. If CEO pay setting can be improved, it is probably then through corporate governance, rather than ore disclosure. Say on pay is one possible avenue for improvement.

6. Say on Pay

In recent years, there has been an increased movement within the ranks of corporate governance activists, institutional investors, and even legislatures, for corporations to accept "Say on Pay." Standard say on pay rules require that companies submit executive compensation packages to the shareholders for a nonbinding advisory vote. Even though say on pay is not yet mandatory, there has been a recent push among institutional investors to force companies to accept it. In 2007, 51 such proposals came up for votes, getting an average of 43 percent of shareholders voting in favor.[27] By May of 2008, 30 more proposals were voted on, drawing nearly identical support (Tse, 2008). In general, companies have been strongly against these proposals. Their main argument is that companies will no longer be able to attract the best talent because they will have to keep salaries low. Supposing this is true, it simply means that we should mandate say on pay for all companies. That way no individual firm will be at a disadvantage.

[27] As of the writing of this article, a measure has passed the House of Representatives, but has not yet come up for a vote in the Senate.

Our theoretical understanding of the effects of say on pay rules is very limited. The closest model is that of Singh (2006), who argues that firms may tailor their pay packages in order to signal that they are responsible. Alternatively, they might be able to signal their quality using the adoption of a say on pay measure. For example, suppose say on pay has the cost that it keeps a firm from hiring the very best CEOs, but it also keeps boards from overpaying their CEO. In that case, all boards would find it somewhat costly to adopt say on pay, but the boards who were the most beholden to the CEO would find it most costly, and hence we might find a separating equilibrium in which high quality board adopt say on pay and low quality boards do not.

In terms of empirical results, the say on pay measures are so new that we only have very limited evidence. Johnson and Shackell (1997) study a related rule change from 1992. In that year, the SEC expanded the list of topics about which shareholders make submit proposals that can come up for a vote at the annual meeting. These proposals are often related to corporate governance, but the board can block any proposal that relates to the firm's "ordinary business." In 1992, the SEC stated that the ordinary business exclusion no longer related to executive compensation. Johnson and Shackell (1997) study proposals relating to executive compensation from 1992 to 1995. These proposals are similar to say on pay in that they involve shareholder resolutions on compensation. Johnson and Shackell find no evidence that these proposals have any effect on the level of pay. However, they do find that proposals relating to the independence of the compensation committee, in particular those submitted by institutional investors, often do lead to changes in the independence of that committee.[28]

Deane (2007) examines the results of mandatory say on pay in other countries. Five countries, the UK, Netherlands, Australia, Sweden and Norway, have instituted

[28] Johnson and Shackell, 1997, also cite Karpoff, Malatesta, and Walkling, 1996, who find that in the 1980s, shareholder proposals related to corporate governance led to no improvement in corporate governance or performance.

mandatory say on pay. In the Netherlands, Sweden and Norway, the say on pay votes are binding, unlike in the UK, Australia, and the proposed rule for the US where the votes are simply advisory. Thus far, very few compensation proposals have been rejected. The rejection in the UK of GlaxoSmithKline's package in 2003 has been widely noted since it led to the replacement of the entire compensation committee, but only four more packages have been rejected since then. In the Netherlands, Australia and Sweden, no packages have been rejected yet, though a few have received dissent nearing the 50 percent mark.

However, the simple fact that packages are not being rejected obviously doesn't mean that the new rules have had no effect. Surveys across the five countries find that investors seem generally happy with the results of the new rules. In particular, Deane (2007) cites a number of surveys finding that investors see pay as being more connected to performance. More importantly, there seems to be much better communication between boards and investors. A survey by Deloitte and Touche (2004) finds that 60 percent of investors think that the extent to which companies confer with investors has increased "to a large extent," and 100 percent of those surveyed believed that communication had improved at least somewhat. Moreover, the policy that UK investors find most important in affecting compensation plans is the shareholder vote, rather than disclosure, even though the votes are nearly uniformly positive. UK investors say that there in fact substantial costs to digesting all of the currently required disclosures.

The studies by Deane and Deloitte are only based on surveys, though. The only study that has so far applied state of the art empirical techniques to find the effect of say on pay on compensation is Ferri and Maber (2007) who look at executive pay in the UK from 2000 to 2007. Across a variety of specifications, they find that pay has become more sensitive to performance, especially negative performance. However, they find no evidence at all that say on pay has reduced the level of pay – if anything, pay may have risen somewhat (though if executives' pay becomes more risky, then its value to them falls).

The preliminary results of mandatory say on pay in other countries can thus be summarized as follows. Compensation packages are rejected extremely rarely, largely owing to improved communication between investors and board members. Furthermore, pay becomes more connected to performance, but its level does not fall at all. Thus some of the major concerns about say on pay in the US may be unfounded. Large shareholders do not tend to vote on compensation packages based on their size, but rather on their composition. It is unlikely that firms would no longer be able to attract talent and pay them at market rates. Moreover, the voting process has not been radicalized; votes on compensation packages have not thus far been used as levers by special interest groups.

7. Conclusion

This paper summarizes the development of the rules and regulations that have direct and indirect effects on executive compensation. With only a limited exception, namely backtracking in 1983, the path has been towards greater disclosure of both pay and possible conflicts of interest. Pay disclosure has become clearer and more thorough over time. It is difficult to find any major flaws in the current rules governing how executive pay is disclosed. The point that we have now arrived at in disclosure is a combination of rule-based and principle-based disclosure. There is a large set of tables that firms have to fill in, but the general rule is that they need to disclose any potential payments to executives. As long as this is carried out in good faith, there is no reason to think that investors would be uninformed.

As section 2 explains, the remaining question then revolves around the relationship between the board or directors and the shareholders. This paper summarizes the part of that relationship most closely related to executive pay. Some recent changes have increased shareholder power, while others have limited it. If there is a problem in corporate governance, it is that directors are still too insulated from shareholders. Even if a director is completely independent under Sarbanes-Oxley, he or she may be more interested in keeping a seat on the board than doing what is in the best interests of the shareholders. Directors rarely lose elections, and staggered board tenures make replacing a board nearly impossible.

Say on pay is one way to rectify possible problems with governance without completely changing the current corporate structure. It is narrowly targeted at CEO pay, rather than at the entire purview of the board. Since shareholders have expressed the desire to have more control over executive pay, it makes sense to modify this area in particular, rather than the entire shareholder-board relationship. Moreover, by making the vote nonbinding, say on pay achieves a balance between shareholder influence and independence of the board.

There are two policy goals of CEO compensation regulation: maximizing shareholder value and decreasing income inequality. Corporate governance reforms only directly affect shareholder value. However, by making CEO pay fairer, they help defuse a popular backlash against what sometimes looks like the unreasonable wealth of CEOs. A sensible national policy on inequality need not raise tax rates on the rich. Rather, its goal might be to ensure that all workers are paid a fair market wage, instead of some conspiring to earn extra. By accepting say on pay and other corporate governance reforms, Corporate America can raise shareholder value, slow the backlash against CEO pay, and dissuade the public from going back to confiscatory tax rates on the rich.

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