The Politics of Pay: 
The Unintended Consequences of 
Regulating Executive Compensation

KEVIN J. MURPHY
Kenneth L. Trefftzs Chair in Finance,
University of Southern California - Marshall School of Business
kjmurphy@usc.edu

MICHAEL C. JENSEN
Jesse Isidor Straus Professor of Business Administration Emeritus
Harvard Business School
mjensen@hbs.edu

May 30, 2017

Abstract

The persistent outrage over CEO pay among politicians, the media, labor unions, and the general public (but, curiously, not shareholders) have fueled continual calls to regulate executive compensation, which have been answered through disclosure requirements, tax policies, accounting rules, governance reforms, direct legislation, and other rules stretching back nearly a century. In this paper, we analyze the regulations that most impact the efficacy of CEO pay, and assess their continuing unintended consequences. Our emerging conclusion is that the best way the government can fix executive compensation is to stop trying to fix it, and by undoing the damage already caused through existing regulations that have, in aggregate, imposed enormous costs on organizations and their shareholders.

© Copyright 2017. Michael C. Jensen and Kevin J. Murphy. All Rights Reserved
The Politics of Pay: The Unintended Consequences of Regulating Executive Compensation

by Kevin J. Murphy and Michael C. Jensen

“The most terrifying words in the English language are: I’m from the government and I’m here to help.”

Ronald Reagan

There is widespread belief among politicians, the media, labor unions, and much of the general public (who get their information from politicians, labor unions, and the media) that CEO pay is inherently excessive and fundamentally broken. These perceptions have fueled continual calls to regulate executive compensation, which have been answered through disclosure requirements, tax policies, accounting rules, governance reforms, direct legislation, and other rules stretching back nearly a century and designed explicitly to influence the level and structure of CEO pay. In this paper, we discuss how these various regulatory attempts, and their associated and inevitable unintended consequences, have increased pay levels and hindered the Compensation Committee’s ability to create effective compensation and incentive packages. Indeed, we view government intervention into the contracts between managers and shareholders to be a first-order cause of many of the current problems in CEO pay. Ultimately, the best way the government can fix executive compensation is to stop trying to fix it, beginning by reversing or repealing the myriad rules and regulations that have, in aggregate, imposed enormous costs on organizations and their shareholders.

Fixing the problems caused by government intervention into the pay process is conceptually easy (simply remove the regulations) but politically challenging. But it is not impossible: in May 2017, the U.S. House of Representatives Financial Services Committee voted to repeal or rewrite many of the compensation-related rules and provisions contained in the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”). While the proposed legislation still has to pass the House and faces an even tougher uphill battle in the Senate, the willingness of legislators to consider undoing some of the damage caused by Dodd-Frank is promising. Even more promising would be repealing the

---

1 This paper draws from a variety of related papers, especially Murphy (2013), Murphy (2012), and Jensen, Murphy and Wruck (2004).
complicated and discriminatory tax rules focused on CEO pay as part of a simplification and reform of corporate and individual tax code.

For context, it is worth emphasizing that the most vocal critics of CEO pay are not shareholders, but rather uninvited guests to the bargaining table who have had no real stake in the companies being managed and no real interest in creating wealth for company shareholders. In contrast, results from nonbinding advisory shareholder votes on executive compensation (“Say on Pay”) suggest that shareholders are relatively satisfied with current executive compensation practices. For example, Equilar reports voting data for 2,444 Russell 3000 firms reporting Say-on-Pay votes from May 1, 2016 through April 30, 2017. During this period, only 38 firms (1.6%) received a “failing” vote (i.e., less than 50% approval), while 1,742 firms (71%) received over 90% approval. Simply put: the outcry over excessive executive compensation is not emanating from shareholders, but from other groups.

The apparent mismatch between the public criticism and shareholder acceptance of CEO pay is both instructive and important for our purposes. The primary predictor of a failing advisory vote on CEO pay (or shareholder dissatisfaction with CEO pay more generally) is poor performance and not the level of pay (although poorly performing firms with highly paid executives are especially vulnerable for failing votes). In other words, shareholders are much more concerned about the alignment between pay and performance than the level of pay, and are largely unconcerned when highly performing firms “share the wealth” with their top executives. In contrast, most attempts to regulate pay (through disclosure, taxes, legislation, etc.) have been singularly focused on reducing pay levels with little concern for underlying incentives. Thus, there is a mismatch between the objectives of the shareholders and those of the regulators, which in turn makes regulators try even harder.

The consequences of attempts to regulate CEO pay have ranged from disastrous (e.g., the $1 million cap on deductibility imposed in the Clinton administration) to merely mischievous (e.g., the mandated disclosure of the ratio of CEO pay to median worker pay, imposed under the 2010 Dodd-Frank Act but currently being reconsidered.) In our view, the limited positive benefits of the numerous regulatory actions are dwarfed by the (often, but not always, unintended) negative side effects. In this paper, we discuss the regulations that have most impacted the efficacy of CEO pay. We group the regulations in reverse order of the Good, the Bad, and the Ugly, and therefore begin with the regulations that (in our view) have caused the most damage and thus would have the highest benefit to outright appeal.

See https://sayonpay.equilar.com/sayonpay/home.
We discuss the “Ugly” regulations in Section 1, focusing on provisions in the U.S. tax code implemented explicitly to regulate and punish CEO pay. Section 2 discusses the merely “Bad” regulations, focusing on the negative consequences emanating from prohibitions on executive loans, disclosure rules, to Say-on-Pay and the other mischievous provisions of Dodd-Frank. Section 3 on the “Good” regulations is pretty short (spoiler alert), but will include a discussion of some regulations that have had positive unintended consequences. Section 4 concludes, emphasizing that the various regulations have a cumulative impact on the level and structure of executive compensation that significantly impedes the Compensation Committee’s ability to craft effective pay arrangements.

While this particular paper has a primary focus on regulations affecting CEO pay in the United States, their consequences are global since companies outside of the United States have increasingly adopted U.S.-style pay practices, with little regard for the U.S. regulations that drove those practices. Moreover, attempts to regulate executive compensation, and their associated negative consequences, are global phenomena. Providing an account of the international regulatory environment related to CEO pay (and its consequences) is beyond the scope of this paper, but provides similar fodder for future analyses.

1. The Ugly

In most circumstances, Congress has stopped short of directly capping the level of CEO pay or imposing restrictions on its structure, partly because such restrictions could pre-empt state corporation laws. Congress does, however, control the tax laws, which allows Congress to impose “excise taxes” on compensation deemed to be excessive. In addition, the Tax Code allows corporations to deduct compensation from income only if the payments represent reasonable compensation for services rendered. As initially (and reasonably) envisioned, reasonableness was defined in terms of the going-market price paid for services rendered by similarly situated executives in similarly situated firms. But, Congress proclaimed that it could legislatively define particular types or dollar amounts of

---

3 Congress has occasionally attempted to cap wage increases. For example, the World War II Stabilization Act of 1942 froze wages and salaries (for all workers, not just executives), and the 1971 Nixon wage-and-price controls imposed a 5.5% limit on increases in executive pay (the limit being binding for company-defined groups of executives, but not necessarily for individual executives). In addition, Congress has occasionally imposed restrictions on individual pay components, such as Sarbanes-Oxley’s prohibition on company-provided loans; see Section 2.1 below. More recently, Congress directly (and enthusiastically) regulated both the level and structure of pay for executives in financial services firms receiving assistance under Treasury’s Troubled Asset Relief Program (“TARP”); see Section 3.2 below.
compensation as unreasonable *per se* regardless of the going-market price for such services, and could therefore directly determine whether compensation is deductible for corporate tax purposes.

Congress has routinely used (or abused) its authority to impose punitive excise taxes and restrict the deductibility of compensation by using legislation (rather than markets) to define what compensation is excessive (and subject to excise tax) or “unreasonable” and therefore not deductible by the company.

### 1.1. Section 162(m): The Clinton $1 million Deductibility Cap

#### 1.1.1. Background

Consistent with *Time* magazine’s labeling of CEO pay as the “populist issue that no politician can resist,”⁴ CEO pay became a major political issue during the 1992 presidential campaign.⁵ After the election, then-president-elect Bill Clinton re-iterated his campaign promise to define compensation above $1 million as unreasonable, thereby disallowing deductions for all compensation above this level for all employees. Concerns about the loss of deductibility contributed to an unprecedented rush to exercise options before the end of the 1992 calendar year, as companies urged their employees to exercise their options while the company could still deduct the gain from the exercise as a compensation expense.⁶ In anticipation of the loss of deductibility, large investment banks accelerated their 1992 bonuses so that they would be paid in 1992 rather in 1993. In addition, several publicly traded Wall Street firms, including Merrill Lynch, Morgan Stanley, and Bear Stearns, announced that they were consider returning to a private partnership structure if Clinton’s plan were implemented.⁷

By February 1993, President Clinton backtracked on the idea of making *all* compensation above $1 million unreasonable and therefore non-deductible, deciding that

---

only pay unrelated to the productivity of the enterprise was unreasonable.\textsuperscript{8} In April, details of the considerably softened plan began to emerge.\textsuperscript{9} As proposed by the Treasury Department and eventually approved by Congress as part of the Omnibus Budget Reconciliation Act of 1993, Section 162(m) of the tax code applies only to public firms and not to privately held firms, and applies only to compensation paid to the CEO and the four highest-paid executive officers as disclosed in annual proxy statements (compensation for all others in the firm is fully deductible, even if in excess of the million-dollar limit).\textsuperscript{10} More importantly, Section 162(m) does not apply to compensation considered performance-based for the CEO and the four highest-paid people in the firm.

Performance-based compensation, as defined under Internal Revenue Code (IRC) Section 162(m), includes commissions and pay based on the attainment of one or more performance goals, but only if (1) the goals are determined by an independent compensation committee consisting of two or more outside directors, (2) the terms of the contract (including goals) are disclosed to shareholders and approved by shareholders before payment, and (3) payouts only occur after an “improvement in productivity” (measured along some relevant dimension). Stock options generally qualify as performance based, but only if the exercise price is no lower than the market price on the date of grant. Base salaries, time-lapse restricted stock (i.e., shares that vest with the passage of time), and options issued with an exercise price below the grant-date market price, do not qualify as performance based.

Under the IRC definition, a bonus based on formula-driven objective performance measures is considered performance based (so long as the bonus plan has been approved by shareholders), while a discretionary bonus based on ex post subjective assessments is not considered performance based (because there are not predetermined performance goals). In addition, the tax law has been interpreted as allowing negative but not positive discretionary payments: the board can use its discretion to pay less but not more than the amount indicated by a shareholder-approved objective plan.

\textsuperscript{8} Freudenheim, “Experts see tax curbs on executives’ pay as more political than fiscal,” New York Times (1993).


\textsuperscript{10} In 2006, the SEC disclosure rules were changed to require pay disclosure for the CEO, the Chief Financial Officer (CFO), and the three-highest paid executives (other than the CEO and CFO). This change in disclosure rules created an inconsistency with the Section 162(m) IRS rules (which used the prior SEC definitions of the CEO and the four-highest paid executives which Since disclosure of CFO compensation was not required prior to 2006 (unless the CFO happened to be among the four highest-paid), the IRS ruled in 2007 that CFO compensation was exempt from Section 162(m) deductibility limits.
In enacting Section 162(m), Congress used (or abused) the tax system to target a small group of individuals (the five highest-paid executives in publicly traded firms) and to punish shareholders of companies who pay high salaries. Indeed, the explicit objective of the proposal that evolved into Section 162(m) was not to increase tax revenues or improve incentives but rather to reduce the level of CEO pay. For example, the House Ways and Means Committee described the congressional intention behind the legislation:

> Recently, the amount of compensation received by corporate executives has been the subject of scrutiny and criticism. The committee believes that excessive compensation will be reduced if the deduction for compensation (other than performance-based compensation) paid to the top executives of publicly held corporations is limited to $1 million per year.\(^{11}\)

1.1.2. The Negative Consequences

Ironically, although the objective of the new IRC Section 162(m) was to reduce excessive CEO pay levels by limiting deductibility, the ultimate result was a significant increase in CEO pay. First, since compensation associated with stock options is generally considered performance-based and therefore deductible (as long as the exercise price is at or above the grant-date market price), Section 162(m) encouraged companies to grant more traditional stock options. Indeed, Murphy (2013) argues that Section 162(m) was in large part responsible for the stock option explosion in the 1990s. Second, while there is some evidence that companies paying base salaries in excess of $1 million lowered salaries to $1 million following the enactment of Section 162(m) (Perry and Zenner (2001)), many others raised salaries that were below $1 million to exactly $1 million (Rose and Wolfram (2002)). Finally, companies subject to Section 162(m) typically modified bonus plans by replacing sensible discretionary plans with overly generous formulas (Murphy and Oyer (2004)).

It is difficult to argue with the principle that companies should only be able to deduct reasonable compensation expenses for services rendered. However, the $1 million reasonableness standard is inherently arbitrary and has not been indexed for either inflation (70% from 1993-2017) or changes in the market for executive talent: compensation plans that seemed excessive in 1993 are considered modest by current standards. More importantly, Section 162(m) disallows deductions for many value-increasing plan designs. For example, Section 162(m) disallows deductions for restricted stock or for options issued in the money,

\(^{11}\) 1993 U.S. Code Congressional and Administrative News 877, as cited in Perry and Zenner (2001)
even when such grants are accompanied by an explicit reduction in base salaries. In addition, Section 162(m) disallows deductions for discretionary bonuses based on boards’ subjective assessment of value creation. Many compensation committees have welcomed the tax-related justification for not incorporating subjective assessments in executive reward systems. After all, no one likes receiving unfavorable performance evaluations, and few directors enjoy giving them. But, by failing to make the inherently subjective appraisals, directors are breaching one of their most important duties to the firm.

Moreover, Section 162(m) has distorted the information companies give to shareholders. In particular, in order to circumvent restrictions on discretionary bonuses, companies have created formal shareholder-approved “omnibus” plans that qualify under IRC Section 162(m) while actually awarding bonuses under a different shadow plan (often called the “plan-within-a-plan”) that pays less than the maximum allowed under the shareholder-approved plan. Quite often, these shadow plans have little or nothing to do with the performance criteria specified in the shareholder-approved plans, rendering meaningless the discussions of bonus plans in corporate proxy statements.

Finally, Section 162(m) has led to a proliferation of so-called “performance share” plans, in which executives are granted restricted stock units that vest (or are converted into unrestricted shares) upon meeting specified performance triggers. As background, after the Financial Accounting Standards Board (FASB) mandated accounting for stock options in 2006, firms rushed to replace their option plans with restricted stock plans. Since traditional time-lapse restricted stock is not considered “performance based” under Section 162(m), firms added performance triggers so that no shares would be awarded unless their was an increase in some measure of performance (e.g., net income, return on equity, revenues, earnings per share, etc.). Ultimately, most performance share plans are little more than poorly designed accounting-based bonus plans where the payout is in shares of stock rather than cash.

1.1.3. Recommendations

Repealing Section 162(m) in its entirety would greatly increase the Compensation Committee’s ability to create effective compensation and incentive packages. Section 162(m) is highly discriminatory, applying only to the compensation received by the top five (or four) executive officers, and applying only to publicly traded companies and not to private firms or partnerships. Ultimately, arbitrary and discriminatory tax rules such as Section 162(m) have
increased the cost imposed on publicly traded corporations and have made going-private conversions more attractive.

While the costs associated with Section 162(m) are palpable, the benefits (if any) are minuscule. To the extent that Section 162(m) was conceived as a way to reduce CEO pay, even its supporters admit it has failed miserably. The increased corporate tax revenues raised in the early years of Section 162(m) were immaterial, because few firms were affected by the $1 million cap and exemptions (mainly through stock options) were easily obtained. While the switch from options to restricted stock and the general growth in executive pay has presumably caused many more firms to pay higher corporate taxes, the benefit in terms of tax revenues will decrease with an anticipated cut in corporate tax rates.

1.2. Section 280G & 4999: Golden Parachutes

1.2.1. Background

Section 162(m) was not the first time that Congress used (or abused) their authority to define “unreasonable” compensation and thus limit pay deductibility. Rather, Congress first invented this authority a decade earlier to curtail change-in-control agreements, which became popular in the takeover market of the 1980s. These agreements, often called “Golden Parachute” agreements award payments to incumbent executives following a change in control, usually when CEOs lost their jobs (“double trigger”) but in many cases simply upon the control event (“single trigger”).

Designing change-in-control agreements is neither an art nor a science, but more of a craft. It is well established that incumbent managers face substantial job insecurity following changes in control (especially if they resisted the acquisition), because their roles are often redundant with existing roles at the acquirer, or the acquirer simply prefers to put its own people in charge. With no change-in-control agreement in place, incumbent managers will predictably resist acquisition attempts (if they are able), and will actively seek (and accept) alternative employment opportunities, outcomes that are clearly not in the interest of shareholders who generally benefit from market premiums paid to target firms in acquisitions. Introducing either single-trigger or double-trigger severance payments tied to

---

12 The vast academic literature on the economic consequences of change-in-control agreements evolved (not coincidentally) during the hostile takeover market in the 1980s. Among the first (and most influential) analyses of the potential benefits of “golden parachute” agreements is Jensen (1988). Among the first (and most influential) analyses showing increased post-acquisition turnover in underperforming takeover targets is Martin and McConnell (1991).
the change in control naturally reduces management uncertainty and hence resistance to being acquired, and significantly improves management retention during merger negotiations. Moreover, since risk-averse executives hired from the outside will “charge” for job insecurity by demanding higher levels of compensation, change-in-control protection reduces the ex ante cost of hiring outside talent.

On the other hand, change-in-control agreements can impede takeovers by increasing the cost for prospective acquirers, especially if the agreements cover dozens or hundreds of executives who have no plausible influence over the takeover decision. Or, change-in-control payments can be so rich that the executives will favor acquisitions at any price, regardless of the benefit to shareholders. In either case, the existence of the apparent bribes paid to top executives (but not to shareholders in general) attracted the ire of a Congress already skeptical of hostile takeovers and their benefits.

Change-in-control arrangements became controversial following a $4.1 million payment to William Agee, the CEO of Bendix. In 1982, Bendix launched a hostile takeover bid for Martin Marietta, which in turn made a hostile takeover bid for Bendix. Bendix ultimately found a “white knight” and was acquired by Allied Corp., but only after paying CEO Agee the Golden Parachute. The payment sparked outrage in Washington, and Congress attempted to discourage future golden parachutes by adding Sections 280G and 4999 to the tax code as part of the Deficit Reduction Act of 1984. Section 280G of the Code provides that, if change-in-control payments exceed three times the individuals base amount, then all payments in excess of the base amount are nondeductible to the employer. Also, Section 4999 imposes a 20% excise tax on the recipient of a parachute payment on the amount of payment above the base amount. The base amount is typically calculated as the individuals average total taxable compensation (i.e., W-2 compensation, which include gains from exercising stock options) paid by the company over the prior five years).

Because of the complexity of what appears to be a simple rule, modest increases in parachute payments can trigger substantial tax payments by both the company and executive. For example, suppose an executive with five-year average taxable compensation of $1 million receives a golden parachute payment of $2.9 million, which is less than three times the $1 million base amount. In this case, the entire $2.9 million parachute payment would be deductible by the company, and would be taxable as ordinary income to the executive. In contrast, suppose that the golden parachute payment was $3.1 million, which is more than

---

13 The golden parachute payment includes not only cash payments but also the value of accelerated vesting of stock and options, as long as the payment is contingent on a change of control or ownership of the company.
three times the $1 million base amount. Under Section 280G, the company would lose deductible on $2.1 million (of the $3.1 million parachute payment) as a compensation expense, and (under Section 4999) the executive would owe $420,000 in excise taxes (i.e., 20% of $2.1 million) in addition to ordinary income taxes on the full $3.1 million parachute payment.

1.2.2. The Negative Consequences

Section 280G impacted executive compensation in several ways. First, the law led to a proliferation in change-in-control agreements, which had previously been fairly rare. The Deficit Reduction Act was signed into law on July 18, 1984. By 1987, 41% of the largest 1,000 corporations had golden parachute agreements for its top executives, and the prevalence of golden parachutes increased to 57% in 1995 and to 70% by 1999.14 In addition, the standard Golden Parachute payment quickly became the government prescribed amount of three times base compensation. By 1991, 47.5% of CEO golden parachute arrangements specified a multiple of three times base pay; and by 1999 71% specified three times base pay. Thus, the rule designed to limit the generosity of parachute payments led to both a proliferation and a standardization of Golden Parachute payments in most large corporations. Apparently compensation committees and executives took the regulation as effectively endorsing such change-in-control agreements as well as the payments of three times average compensation (which quickly became the standard).

Second, Section 280G (and the corresponding Section 4999) gave rise to the “excise tax gross up,” in which the company would offset the tax burden of the 20% excise tax by paying an additional amount for the tax (and the tax on the additional amount).15 The percentage of agreements that included gross-up provisions increased from 38% in 1991 to over 82% by 1999. This gross-up concept was subsequently applied to a variety of executive benefits with imputed income taxable to the executive, such as company cars, club memberships, and personal use of corporate aircraft. More recently, largely due to pressure from proxy advisory groups, excise tax gross ups have declined in prevalence, with companies (in some cases)

---

15 For example, continuing with the example above, suppose the CEO owed $420,000 in excise taxes (i.e., 20% of the $2.1 million excess benefit). If the CEO had a gross-up clause (and assuming a marginal tax on ordinary income of 50% on top of the 20% excise tax), he would receive a gross-up payment of $1.4 million and a total change-in-control payment of $3.5 million, leaving him with after-tax income of $1.05 million (which is what he would have received without an excise tax).
reducing the compensation following the change-in-control to just below the amount that would trigger excise taxes.

Third, Section 280G also provided incentives for companies to shorten vesting periods in stock option plans, and incentives for executives to exercise stock options even earlier than they would normally be exercised. Consider two otherwise identical executives with golden parachutes paying three times base compensation and holding identical options. Suppose that one of the executives exercises a year prior to the change in control, while the other holds up until the change in control. Since base compensation under Section 280G includes gains from exercising options, the first executive can receive a higher parachute payment before triggering the excise tax, thus increasing the benefits from early exercise. Moreover, unexercisable stock options routinely become vested (or exercisable) upon a change in control, and the value of these options is defined by the IRC as part of the parachute payment subject to the excise taxes. Therefore, companies and executives can reduce change-in-control related tax liabilities by shortening the time until options become exercisable, and by exercising early and therefore reducing the incentive effects of those plans.

Similarly, unvested restricted stock routinely become vested upon a change in control, and the value of these shares upon vesting is defined by the IRC as part of the parachute payment subject to the excise taxes. Thus, companies can also reduce change-in-control related tax liabilities by shortening the vesting period for restricted stock.

Perhaps most importantly, the 1984 tax laws regarding Golden Parachutes appear to have triggered the proliferation of Employment Agreements for CEOs and other top-level executives in most large firms since the mid-1980s. Section 280G applies only to severance payments contractually tied to changes of control. Individual CEO employment agreements typically provide for severance payments for all forms of terminations without cause, including (but not limited to) terminations following control changes. Therefore, companies can circumvent the Section 280G three-times-base-compensation limitations (at a potentially huge cost to shareholders) by making payments available to all terminated executives, and not only those terminated following a change in control.16

Other ways that companies attempt to circumvent the Section 280G limitations is by raising salaries or paying large bonuses prior to the change of control, but the IRS generally considers any new plan entered into within one year of the acquisition to be control related

---

16 Over time, the IRS has become more aggressive in challenging severance payments under employment agreements when the termination that triggered the payments is considered closely associated with the change in control.
(and not exempted from Section 280G). Companies will also disguise control payments, such payments for consulting services, covenants not to compete, or as reasonable compensation for services rendered prior to the change in control. In all these cases, the taxpayer has the burden of proving with clear and convincing evidences that the payments made under these arrangements would have been made even if no change-in-control had occurred.

In summary, although Section 280G was meant to reduce the generosity of parachute payments, the government action appears to have increased the prevalence of: (i) change-in-control plans; (ii) tax gross-ups; (iii) early exercise of stock options; (iv) short vesting periods for restricted stock and stock options; and (v) employment agreements. Each of these outcomes both reduces the incentive effects of incentive compensation for CEOs and other executives and increases the costs of these plans to their firms.

1.2.3. Recommendations

Sections 280G and 4999 of the U.S. Tax Code came into existence in 1984 as the result of a Congressional knee-jerk reaction to a $4.1 million severance payment paid to a single executive. The tax rules are discriminatory (applying only to executive officers, large shareholders, or a defined set of highly compensated employees in public companies) and incredibly complex. The compliance costs are staggering: a third of a century later, every major accounting and law firm retains teams of professionals to help corporations comply with 280G/4999 calculations and issues, and there are dozens of boutique professional firms solely devoted to 280G/4999 compliance. However, the compliance costs are dwarfed by the restrictions 280G/4999 imposes on Compensation Committees designing and negotiating employment contracts with its top executives, along with the unintended consequences discussed above.

While the costs imposed by IRC Sections 280G and 4999 are enormous, we struggle to identify any real benefits. The rule was not designed to generate tax revenues, but rather to make exceeding the government-imposed limit so costly for both the firm and the executive that no one would do it. Sections 280G/4999 are an abuse of our tax system, and should be repealed in its entirety.

---

17 Formally, while Subchapter S corporations are exempt from Section 280G, other private and closely held corporations can avoid 280G restrictions through a shareholder vote.
1.3. Section 409A: Excise Taxes on Non-Qualified Deferred Compensation

1.3.1. Background

Enron, like many other large companies, allowed mid-level and senior executives to defer portions of their salaries and bonuses through the company’s unsecured non-qualified deferred compensation program, thus postponing the income taxes due until withdrawal.\(^{18}\) When Enron filed for Chapter 11 bankruptcy protection in December 2002, about 400 senior and former executives became unsecured creditors of the corporation, eventually losing most (if not all) of the money in their accounts.\(^{19}\) However, just before the bankruptcy filing, Enron allowed a small number of executives to withdraw millions of dollars from their deferred accounts. The disclosure of these payments generated significant outrage (and lawsuits) from Enron creditors and plan-participants that lost their money, and attracted the ire of Congress.

As a direct response (some would say knee-jerk reaction) to what happened at Enron, Section 409A was added to the Internal Revenue Code as part of the American Jobs Creation Act of 2004. The objective of Section 409A was to thwart another Enron situation by restricting withdrawals from deferred accounts to pre-determined dates (thus limiting the flexibility of individuals in determining when they receive taxable income). Since Congress’ available tool to limit this flexibility was the Tax Code, the 2004 Act imposed taxes on deferred compensation not on withdrawal but rather when the individual obtains a “legally binding right” during a taxable year to compensation that is or may be payable in a later taxable year. The underlying assumption was that, if an individual could withdraw money from his deferred compensation, that individual must have a legally binding right to that compensation even if the individual decides not to exercise that right (and might never exercise that right). Individuals failing to pay taxes in the year in which the amounts are deemed to no longer be subject to the substantial forfeiture risk (i.e., the legally binding right) owe a 20% excise tax and interest penalties on the amount payable.

Violating Section 409A triggers immediate income tax on vested amounts, a 20% addition to tax, and a premium-interest tax. In order for the individual to avoid deferred

---

\(^{18}\) Since the amounts in these deferred accounts are secured only by the firm’s ability to pay and are available to creditors in a bankruptcy proceeding, the amounts are deemed subject to a “substantial risk of forfeiture” and only become taxable upon withdrawal (or, more generally, when there is no longer a substantial risk of forfeiture).

compensation being included in taxable income for any particular year, the underlying compensation arrangement must meet three general requirements. First, the amounts must be payable only upon a specific date or time, separation from service, death, disability, a change-in-control, or an unforeseeable emergency. Second, the plan must prohibit acceleration of scheduled payments. Third, to the extent the individual has discretion over the amount deferred or the timing or form of the payout, the election must be made prior to (or early in) the tax year. If any of these three plan requirements fail (or if there is no written plan), and if the individual fails to pay taxes on the associated income, then the individual is subject to the excise tax and interest penalties on the total amount payable in the plan, even if the individual has not received or may never receive any of the income.

One of the striking features of Section 409A is that it significantly expands the definition of deferred compensation by applying to any compensation that employees earn in one year, but that is paid in a future year. While qualified retirement plans (such as 401(k) plans) are exempt, types of plans covered include supplemental executive retirement plans (“SERPs”), excess benefit plans, long-term incentive plans, split-dollar life insurance, guaranteed bonuses, taxable health benefit promises, severance agreements, change-in-control agreements, salary and bonus deferral arrangements, deferred commissions, restricted stock, and performance shares. Annual bonuses earned in one year but paid in the following year are also potentially subject to Section 409A, but the final rule included a “Short-Term Deferral” exemption for bonuses that “vest” at the end of a year but are paid within the first 2-1/2 months of the following year. As a result of this exemption, March 15 de facto bonus payment day for thousands of companies offering annual bonus plans.

The other striking feature of Section 409A is its wide coverage: while Section 162(m), for example, applies only to proxy-named executives at publicly traded companies, and Section 280G applies only to officers, large shareholders, and highly paid employees, Section 409A applies to essentially all employees, executives, directors, and independent contractors, and is imposed on publicly traded and private corporations, as well as a wide range of not-for-profit and public institutions. For example, compensation for public school teachers (or university professors) that is earned over nine months but paid over twelve months is subject to Section 409A, since some of the compensation earned in one year is not paid until the following year.

Although Section 409A applies across groups of employees any organizations, it includes special provisions for separation-related payments for “specified employees” in publicly traded firms. Generally, “specified employees” include large shareholding-
employees and the 50 most highly compensated officers.\textsuperscript{20} For these employees, Section 409A requires that the payment of deferred compensation (including SERPs, severance benefits, change-in-control payments, etc.) be delayed for six months following the separation from service.

While time-lapse and performance-based restricted stock are subject to Section 409A, payments under these plans are generally in compliance since the amounts are only payable and taxable upon a specific date or time (i.e., when the restrictions lapse). In contrast, stock options with early exercise provisions presented a challenge for the drafters of Section 409A, because option-holding employees could be deemed to have a legally binding right to the spread between the stock price and the exercise price immediately when the option becomes exercisable, regardless of whether the employee had any intention of exercising the option or, in fact, did so.\textsuperscript{21} The final rule includes a special exemption for stock options that are issued with an exercise price equal to (or greater than) the fair market value of the underlying stock on the grant date. Options that are issued with an exercise price less than the grant-date fair market value (“discount options”) are subject to Section 409A, and become taxable as soon as they become exercisable.\textsuperscript{22}

Since the price of shares that are readily tradable on an established securities market is generally accepted as the fair market value under Section 409, publicly traded firms can typically avoid compliance problems by setting exercise prices no lower than the grant-date market price. Compliance is more challenging (and expensive) for private, closely held, and start-ups, since the IRS can challenge the exercise price as being lower than the fair market value. The final rules provide that “fair market value may be determined through the reasonable application of a reasonable valuation method,” which typically involve retaining independent (and expensive) valuation professionals or developing in-house valuation methodologies beyond the firms’ capabilities and budgets.

\textsuperscript{20} If the firm has fewer than 50 officers, then only the employees who are officers are considered “key.” In addition, if the firm has fewer than 500 employees, the maximum number of officers that must be identified is limited to 10\% of employees.

\textsuperscript{21} It is worth noting that executive and employee stock options never “vest” (in the sense that the holders can freely sell their options in an open market) but rather become “exercisable.” That is, the option holders can realize the spread between the market and exercise price (the “intrinsic value”) by exercising but lose the “option value” of holding the stock option until (or just before) expiration.

\textsuperscript{22} Discount options could comply with Section 409A by removing the early exercise opportunity, and setting a single predetermined date when the option is exercisable.
1.3.2. The Negative Consequences

Efforts to regulate executive compensation have traditionally focused on relatively narrow aspects of compensation, allowing plenty of scope for costly circumvention. An apt analogy is the Dutch boy using his fingers to plug holes in a dike, only to see new leaks emerge out of reach. Section 409A represents another extreme: a law so broad with coverage so extensive that it anticipates holes where none exist, and imposes solutions where none are needed. While it is impossible to condone the looting activities of a handful of Enron executives prior to that company’s bankruptcy, Section 409A is a blunt and all-encompassing instrument that has imposed enormous compliance costs across a vast range of employees in publicly traded, private, and non-profit organizations.

Section 409A has made executive compensation less effective, and more costly, by significantly restricting the pay arrangements that can be written between companies and managers. For example, the regulations effectively prohibit the granting of in-the-money options (at least those with early exercise provisions), regardless of whether those options are granted in lieu of cash compensation or are deemed by the Compensation Committee to be in the best interest of shareholders. The regulations also constrain the Committee’s discretion in accelerating awards (or vesting of awards), and in delaying awards. Simply giving the Committee discretion to delay annual bonuses past the 2-1/2 month short-term deferral exemption negates that exemption, even if bonuses are actually paid within 2-1/2 months.

While traditional deferred compensation plans offer modest tax-deferral benefits to the recipient, Section 409A applies to many types plans driven by incentive and not tax considerations. Indeed, the ability to delay payment of compensation earned in the current year is a critical tool in designing effective executive incentive plans. Requiring executives to wait for full payment (in the form of deferred cash bonuses, restricted stock or performance shares upon vesting, options upon exercise, or pensions upon retirement) provide important retention incentives (to the extent that the right to the payment is dependent on continued employment). In addition, deferring bonus payments through unvested “bonus banks” provides an account to fund clawbacks (if the underlying performance measures are subsequently revised) or negative bonuses (i.e., penalties for poor current performance). While these plans can potentially be designed to be compliant with Section 409A, that compliance imposes substantial cost and loss of flexibility.

23 One of the primary benefits of tax deferral is that recipients often are in a lower tax bracket post retirement, but this benefit rarely applies to top executives who are reasonably expected to remain in top income brackets even after retirement.
Moreover, it is difficult to comply simultaneously with the myriad (and often conflicting) provisions of Sections 162(m), 280G, and 409A. As an example, annual bonus plans designed to comply with 162(m) are routinely based on performance metrics in audited financial statements in company 10-K statements, typically issued only after the 2-1/2 month short-term deferral” exemption allowed by Section 409A. While Section 409A offers one-off extensions to the short-term deferral for purposes of 162(m) compliance, these extensions apply only to the proxy-named executives (covered by 162(m) and not the broader top-management team.

1.3.3. Recommendations

The alleged “fraudulent conveyance” that occurred in Enron seems best handled in the bankruptcy courts, and not through the introduction of a complex and onerous section of the tax code.

Prior to Section 409A, the taxation of deferred compensation was determined by the “doctrine of constructive receipt,” which essentially imposes individual tax liabilities at the time that the funds are made available to the individual without substantial limitations (including risk of forfeiture). This doctrine would suggest that the Enron executives were liable for taxes when Enron first allowed the executives to access their deferred accounts (as opposed to when the money was withdrawn). But, it is important to recognize that Section 409A was not passed to ensure the IRS received its tax revenues at the appropriate time (which seems an appropriate use of the tax code), but rather to affect employee behavior and restrict employer flexibility in designing plans and making distributions.

Ultimately, it is not clear that Section 409A would have changed the Enron outcome, but the alleged “fraudulent conveyance” that occurred in Enron seems best handled in the bankruptcy courts, and not through the introduction of a complex and onerous section of the tax code. It is clear that Section 409A has imposed enormous compliance costs across a vast range of organizations and employees. Section 409A is an unnecessary and unwarranted expansion of the doctrine of constructive receipt, and repealing it in its entirety would greatly increase the Board’s ability to create effective compensation and incentive packages.
2. The Bad

2.1. Sarbanes Oxley and the ban on loans to executives

2.1.1. Background

Accounting scandals erupted across corporate America during the early 2000s, destroying the reputations of once-proud firms such as Enron, WorldCom, Qwest, Global Crossing, HealthSouth, Cendant, Rite-Aid, Lucent, Xerox, Tyco International, Adelphia Communications, Fannie Mae, Freddie Mac and Arthur Anderson. Following Enron’s bankruptcy in December 2001, and as many of these other scandals were unfolding, Congress rushed to pass legislation to strengthen auditing requirements, improve financial disclosures, and to protect investors from fraudulent accounting activities.

On April 22, 2002, Representative Michael Oxley (R-OH) sponsored and the House of Representatives passed the “Corporate and Auditing Accountability, Responsibility, and Transparency Act” by a bipartisan 334-90 vote, referring the bill to the Senate Banking Committee with the support of the SEC and President George W. Bush. The relatively mild Oxley bill proposed a new auditor oversight board, delegating most of the major decisions to the SEC.24

A counterpart Senate bill, sponsored by Senate Banking Committee Chairman Paul Sarbanes (D-MD), imposed much stricter limits on auditor-client relationships and setting new rules for stock analysts.25 The bill passed the Banking Committee on June 18, 2002 on a 17-4 vote, but faced an upward battle in the full Senate, with the Republicans (and the President) favoring either the much weaker House version or new policies being drafted by the SEC. With popular anger over the Enron scandal waning over time, it seemed unlikely that any reform would be passed and signed into law until after the November 2002 elections, if ever.

The prospects for reform changed dramatically on June 25, 2002, after WorldCom revealed it had overstated its earnings by more than $3.8 billion during the previous five

---


quarters. The disclosure followed an SEC investigation into over $400 million in loans that WorldCom made to CEO Bernard Ebbers (used, in part, to fund Ebbers’ side businesses). One day later, on June 26, Adelphia Communications filed for bankruptcy protection, triggered by March 2002 disclosures that Adelphia had guaranteed $2.3 billion in loans to entities controlled by its founders, the Rigas family. Contemporaneously, the SEC disclosed that it was investigating whether Tyco International Ltd.’s former CEO (Dennis Kozlowski) had improperly used a company-provided loan to purchase an $18 million New York apartment and $13.1 million in artwork (the latter without paying sales taxes). The WorldCom, Adelphia, and Tyco disclosures sparked outrage in Congress and provided renewed bipartisan support for corporate reform that only strengthened when top WorldCom executives invoked their fifth-amendment right not to testify to Congress.

On July 9, 2002, President George W. Bush announced new enforcement initiatives for corporate governance reforms in the wake of the accounting scandals, advocating for greater punishments for executives involved in accounting fraud and calling for CEOs to personally vouch for their firm’s annual financial statements. In addition, without advocating legislation, the President urged “compensation committees to put an end to all company loans to corporate officers.”

The Sarbanes bill, as passed by the Senate Banking Committee on June 18, 2002, required companies to disclose within seven days all loans made by the company to any executive officer or director, specifying the amounts paid and balances owed. On July 12, 2002, as the full Senate considered the Sarbanes bill, Senator Charles Schumer (D-NY) proposed amending the provision from mere disclosure to an outright ban on companies making any loans to officers or directors. Senator Schumer famously exclaimed that, “This

---

27 “Adelphia tumbles further on loan concerns,” Reuters News (2002); the size of loans ultimately grew to $3.1 billion, Treaster, “Adelphia Files for Bankruptcy,” (2002).
29 “Transcript of President's Address Calling for New Era of Corporate Integrity,” New York Times (2002). Critics were quick to recall that President Bush was the beneficiary of low-interest loans totaling more than $180,000 a decade earlier as a director at Harken Energy Corp.
30 See The Public Company Accounting Reform and Investor Protection Act of 2002, as passed by the Senate Banking Committee, June 18, 2002.
31 Hilzenrath and Dewar, “Senate Votes to Curb Insider Lending; Provision Targets Terms That Companies
is wrong. It must be stopped. Why can’t these corporate executives go to the bank like everybody else when they need loans?”

Ultimately, the Schumer amendment was passed on a voice vote, and the Sarbanes bill, amended not only with the Schumer amendment but requiring CEO/CFO certification of financial statements and creating a new felony category for securities fraud, passed the Senate in a 97-0 vote on July 15, 2002. When the House and Senate met in conference to work on a “compromise” bill that could pass both chambers, the tougher Senate version was adopted as the framework, and most of the changes were to strengthen the prescriptions. The final bill was approved by the Conference Committee on July 24, 2002 and passed by both the House (on a 423-3 vote) and Senate (on a 99-0 vote) the next day. On July 30, 2002, President Bush signed the Sarbanes-Oxley Act of 2002 into law.

The Sarbanes-Oxley Act represented the most sweeping overhaul of securities laws since the 1930s, and was primarily focused on setting or expanding standards for accounting firms, auditors, and boards of directors of publicly traded companies, and not on CEO pay. However, Congress – outraged by CEOs who received large bonuses or corporate loans prior to restatements or bankruptcy – added two provisions that directly affected executive compensation.

First, Section 304 of Sarbanes Oxley requires CEOs and CFOs to reimburse the company for any bonus or equity-based compensation received, and any profits realized from selling shares, in the twelve months commencing with the filing of financial statements that are subsequently restated as a result of corporate misconduct. This “clawback” provision of Sarbanes Oxley – which was subsequently extended in the Dodd-Frank Act discussed below – was notable mostly for its ineffectiveness. Indeed, in spite of the wave of accounting restatements that led to the initial passage of Sarbanes Oxley, the first individual clawback settlement under Section 304 did not occur until more than five years later, when UnitedHealth Groups former CEO William McGuire was forced to return $600 million in compensation. The SEC became more aggressive in 2009, launching two clawback cases

---

32 Cornwell, “U.S. Senate votes to stop loans to CEOs,” Reuters News (2002).
33 A third provision – discussed below in Section 3.1 under Good practices – required that executives disclose new grants of stock options within two business days of the grant. This provision had the unintended but ultimately beneficial effect of curbing option backdating for top executives.
(CSK Auto and Diebold, Inc.) where the targeted executives were not accused with personal wrongdoing.  

Second, and more consequentially, Section 402 of Sarbanes Oxley amended the Securities Exchange Act of 1934 by making it unlawful for any company “directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer.” Loans made prior to the law’s adoption were grandfathered, but could not be renewed or materially modified. Violations of Section 402 are subject to civil and criminal penalties applicable to violations of the Exchange Act, including in fines of up to $25 million and 25 years in prison (Sroka (2013), p. 544). Moreover, Section 402 did not contain a materiality threshold, so that even low-valued loans were potentially in violation.

2.1.2. The Negative Consequences

The prohibition of loans in Sarbanes Oxley supplants state corporate laws that generally allowed such loans provided that they benefited the company (Sroka (2013)). Section 402 makes no such distinction, and imposes an absolute ban regardless of whether such loans serve a useful and legitimate business purpose. For example, prior to Sarbanes Oxley, companies would routinely offer loans to executives to buy company stock, often on a non-recourse basis so that the executive could fulfill the loan obligations by returning the purchased shares. Similarly, companies attracting executives would routinely offer housing or relocation subsidies in the form of forgivable loans, a practice made unlawful under the new regulations. Sarbanes Oxley is also viewed by many as prohibiting company-maintained cashless exercise programs for stock options, where an executive exercising options can use some of the shares acquired to finance both the exercise price and income.

---


36 Indeed, it is easy to show that a traditional at-the-money stock option is equivalent to a non-recourse loan to purchase company stock at a zero interest rate. Loans to purchase stock that carry a positive interest rate or require an executive down payment are less costly to grant than traditional options, and deliver better incentives by both forcing executives to invest some of their own money in the venture and by only providing payouts when the stock price appreciates by at least the interest charged on the loan. It is unfortunate that Congress prohibited these types of plans.

37 Offering housing subsidies in the form of loans that are forgiven with the passage of time is preferable to a lump-sum subsidy, since the company can avoid paying the full subsidy if the executive leaves the firm before the loan is repaid or fully forgiven.
taxes due upon exercise.\textsuperscript{38} Other arrangements vulnerable to challenge include premium payments on split-dollar life insurance; personal use of corporate credit cards (even if reimbursed); cash advances, and loans under qualified retirement programs (e.g., 401(k) plans).

Corporate attorneys and compensation practitioners expected the SEC to clarify the scope of the ban through rulemaking, and it often does with similar laws that are overly broad laws and difficult to interpret. However, the SEC explicitly refused to offer interpretive guidance for Section 402 until February 2013, when it responded to a limited inquiry by former Representative Oxley (the co-author of the Act) on behalf of one of Oxley’s clients (RingsEnd Partners LLC) in private practice.\textsuperscript{39} While the SEC’s response was noteworthy, it was expressly limited to the particular facts in the novel equity plan proposed by RingsEnd, and provided little guidance or precedence for other arrangements that might be interpreted as loans subject to Section 402. In the absence of such guidance, most companies have completely terminated all executive loan practices, regardless of their merit.

\textbf{2.1.3. Recommendations}

The prohibition of executive loans in Sarbanes Oxley was hastily imposed by an angry Congress without hearings or debate, as a knee-jerk reaction to the abuses at WorldCom, Adelphia, Tyco, and other firms involved in the accounting scandals in the early 2000s. In a classic case of “throwing the baby out with the bathwater,” Section 402 banned a variety of pay practices that benefit shareholders but involve (or can be interpreted as involving) loans to executives. Repealing Section 402 in its entirety would greatly increase the Board’s ability to create effective compensation and incentive packages.

In its hasty deliberations, Congress never considered less costly methods of stemming the perceived abuses in executive loan arrangements, or compared the costs of these abuses at a handful of scandalized companies to the benefit of these arrangements in hundreds of

\textsuperscript{38} Technically, cashless exercise programs are implemented by offering the executive a short-term bridge loan to finance the purchase of the shares (including taxes), followed by open-market transactions to sell some of the shares to repay the loan. Subsequent to Sarbanes Oxley, executives exercising options have turned to conventional banks for bridge-loan financing, significantly increasing the transaction costs and further diluting the shares outstanding (since under company-maintained programs, the company need only issue the net number of shares and not the full number of shares under option).

\textsuperscript{39} The Oxley inquiry was in regards to an equity-based incentive plan offered by RingsEnd Partners LLC, in which participating employees would put shares of stock awarded under a compensation plan into a trust, which would use the shares as collateral for a loan from an independent lender to purchase additional shares. See Oxley (2013).
others. Sroka (2013) argues, and we agree, that the abuses could largely be avoided through more-extensive disclosure of loans to executives (including a discussion of their legitimate business purposes), collateral requirements, and formal limitations on the amounts that can be loaned.

2.2. Disclosure Rules

2.2.1. Background

Under the Securities Act, details on executive pay are publicly disclosed in company 10-K or proxy statement issued in connection with the company’s annual shareholders’ meeting. Ultimately, these disclosures have provided the fodder for all subsequent pay controversies. We have become accustomed to the idea that shareholders – and the public in general – have a right to know the details of the compensation paid to top executives in publicly traded corporations. However, it is worth noting that the push for pay disclosure was not driven by shareholders but rather by “New Deal” politicians outraged by perceived excesses in executive compensation.

In 1933 Franklin D. Roosevelt became president, ushering in the New Deal in a country recovering from the Great Depression. The demand for disclosure initially focused on the compensation for railroad executives in firms receiving government assistance from the Reconstruction Finance Corporation (RFC), and resulted in an informal (but uniformly complied with) cap of $60,000 per year for all railroad presidents.40 By mid-1933 the Federal Reserve began investigating executive pay in its member banks, the RFC conducted a similar investigation for non-member banks, and the Power Commission investigated pay practices at public utilities. In October 1933, the Federal Trade Commission (FTC) requested disclosure of salaries and bonuses paid by all corporations with capital and assets over $1 million (approximately 2,000 corporations).41 Business leaders questioned whether the FTC had the legal authority to compel such disclosures, but were reminded that, “Congress in its

40 “Railroad Salary Report: I.C.C. Asks Class 1 Roads About Jobs Paying More Than $10,000 a Year,” Wall Street Journal (1932). The required reductions ranged from 15% (for executives earning less than $15,000) to 60% (for executives earning more than $100,000. See “RFC Fixed Pay Limits: Cuts Required to Obtain Loans,” Los Angeles Times (1933); “Cut High Salaries or Get No Loans, is RFC Warning,” New York Times (1933).

41 See Robbins, “Inquiry into High Salaries Pressed by the Government,” New York Times (1933) and “President Studies High Salary Curb: Tax Power is Urged as Means of Controlling Stipends in Big Industries,” New York Times (1933). In addition to investigating corporate executive pay, President Roosevelt personally called attention to lavish rewards in Hollywood, resulting in a provision added to the moving-picture code that imposed heavy fines on companies paying unreasonable salaries.
present temper would readily authorize” whatever the FTC wanted. Executives were particularly incensed that the FTC would demand such closely guarded information without any explanation of how the information would be used and without any confidentiality guarantees.

Following the Securities Act of 1934, the responsibility for enforcing pay disclosures for top executives in publicly traded corporations was consolidated into the newly created Securities and Exchange Commission (SEC). In December 1934, the SEC issued permanent rules demanding that companies disclose the name and all compensation (including salaries, bonuses, stock, and stock options) received by the three highest-paid executives. The securities of companies not complying with the new regulations by June 1935 would be removed from exchanges. Several companies, including United States Steel Corporation, pleaded unsuccessfully for the SEC to keep the data confidential, arguing that publication “would be conducive to disturbing the morale of the organization and detrimental to the best interests of the registrant and its stockholders.”

For nearly sixty years following the 1934 Securities Act, detailed disclosure of executive compensation was a uniquely American experience. Canada adopted U.S.-style disclosure rules in 1993, followed by the United Kingdom in 1997, Ireland and South Africa in 2000 and in Australia in 2004. In May 2003, the European Union (EU) Commission issued an “Action Plan” recommending that all listed companies in the EU report details on individual compensation packages by 2006; most EU countries has passed rules requiring such disclosure by 2011.

2.2.2. The Negative Consequences

While the SEC has no direct power to regulate the level and structure of CEO pay, the agency does determine what elements of pay are disclosed and how they are disclosed. The SEC has routinely expanded disclosure requirements from year to year, with major overhauls in 1978, 1993, 2006, and 2011. Under the theory that sunlight is the best disinfectant, the SECs disclosure rules have long been a favorite method used by the SEC and Congress in attempts to curb perceived excesses in executive compensation. Indeed, most additions to disclosure requirements over time reflect policy responses to perceived abuses. The 1978 rules, for example, were largely driven by perceived abuses in perquisites and benefits, while

43 “U.S. Steel Guards Data on Salaries: Sends details confidentially to SEC head with request that they be kept secret,” New York Times (1935).
the 1993 rules reflected growing concerns over stock options. The 2006 rules were motivated in large part by concerns over the influence of compensation consultants and perceived abuses in post-termination payments (including severance, supplemental executive retirement programs, and change-in-control payments).

While disclosure policy has evolved over time in response to perceived abuses, there is little evidence that enhanced disclosure has lead to reductions in objectionable practices: for example, perquisites increased after 1978 as executives learned what was common at other firms, options exploded following the 1993 rules, and executive compensation in Canada increased significantly after disclosure was introduced. Similarly, the use of compensation consultants increased following the 2006 disclosure rules, as boards hired their own “independent” consultants to supplement those hired by management.

The recent debates on Say on Pay notwithstanding (see Section 2.3 below), determining the level and structure of executive pay is the proper role of the Compensation Committee and Board of Directors, and not outside shareholders or the government. Thus, the logic of disclosure – from the standpoint of legitimate shareholder concerns – is not so shareholders can decide whether particular executives are overpaid or underpaid, but rather to give shareholders information relevant in monitoring the performance of the potentially acquiescent board of directors.

Although disclosure facilitates better monitoring of outside directors, the public curiosity aspect of disclosure imposes large costs on organizations. The recurring populist revolts against CEO pay, for example, could not have been waged without public pay disclosure. Public disclosure effectively ensures that executive contracts in publicly held corporations are not a private matter between employers and employees but are rather influenced by the media, labor unions, and by political forces operating inside and outside companies. Compensation committees – elected by but not perfect agents for shareholders – will naturally respond to these political pressures through less efficient but politically more acceptable pay packages. These important but often ignored costs of disclosure must be weighed against the benefits (better monitoring of directors) in determining the optimal amount of pay disclosure for top managers.

2.2.3. Recommendations

It is generally accepted that shareholders – and the public, for that matter – have a right to know how much the CEO and other top officers are paid. Although shareholders do not
presume similar rights to know what the company pays other factors of production, the
determination of top-management pay seems different because of the perception that CEOs
set their own pay levels by pushing generous pay packages past acquiescent corporate
boards. We agree with this legitimate shareholder concern, and support limited and common-
sense disclosure of the level and structure of top-executive pay.

However, we question the embedded assumption that more disclosure is always
preferred to less. The SEC now requires companies to provide details on automobile
allowances, personal trips on the company airplane, target (and threshold and maximum)
amounts under equity and non-equity plans, the actuarial values of pension benefits, details
on every unvested option or security held at the end of the year, details on potential
severance and change-in-control payments, what consultants are used (and, in some
situations, how much they are paid), details on the compensation peer group, and on and on.
The first proxy statements issued after the formation of the SEC were typically about three-
to-five pages long, with less than one page devoted to executive compensation. By 2007, the
average proxy statement exceeded 70 pages, nearly all focused on compensation.44

While recommending a precise template for disclosure reform is beyond the scope of
this paper, it seems obvious to us that the information required to be provided far exceeds the
information that is necessary (or can even be processed) to address legitimate shareholder
concerns over executive compensation. We thus call for a careful cost-benefit analysis of the
various items disclosed, with an objective of significantly reducing the quantity (though not
necessarily the quality) of the information disclosed.

2.3. Say on Pay

2.3.1. Background

While formally introduced in the United States as part of the July 2010 Dodd-Frank
Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), the international
history of non-binding advisory votes on executive compensation (“Say on Pay”) began a
decade earlier with a July 1997 proposal from the United Kingdom’s Secretary of State for
Trade and Industry.45 Ultimately, in August 2002, the U.K. government introduced the
Directors’ Remuneration Report Regulations which required all publicly traded U.K.

44 The average length of 2007 proxy statements for the 100 largest firms (ranked by revenues) was 62.8 pages
(ignoring appendices). In 2006 – before the 2006 disclosure rules – the average length was 45 pages.
45 Hodgson (2009); Ferri and Maber (2010); Thomas and Van der Elst (2015).
companies to include an executive pay report in their annual filings, and submit that report to a non-binding advisory shareholder vote. The U.K. Say on Pay legislation was followed by similar rulings in Australia, Denmark, Portugal, Spain, and Sweden; the Netherlands and Norway went a step further by allowing binding shareholder votes.

In November 2005, Rep. Barney Frank (the ranking Democrat on the House Financial Services Committee) sponsored the Protection Against Executive Compensation Abuse Act (H.R. 4291) that required enhanced disclosure and giving shareholders veto power on both the company’s “Compensation Plan” and on change-in-control compensation agreements. While the proposed bill did not win House approval, the enhanced disclosure requirements (without the veto power) formed the basis of the SEC’s sweeping new 2006 disclosure rules.

Absent legislation mandating advisory votes on executive compensation for all U.S. publicly traded companies, shareholder activists (particularly labor union pension funds) began submitting Say on Pay shareholder resolutions. During the 2006 proxy season, the American Federation of State, County, and Municipal Employees (AFSCME) submitted proposals at US Bancorp, Merrill Lynch, Bank of America, Home Depot, Countrywide Financial, Sara Lee, and Sun Microsystems. While none of the proposals received a majority of the votes, the resolutions at garnered more than 40% of the votes in five of the targets. During the 2007 proxy season, an AFSCME-led coalition of labor funds, public pension funds, asset management firms, and foundations filed approximately 60 Say on Pay resolutions; the resolution garnered more than 50% of the shareholder vote in eight firms.

In February 2007, Aflac, Inc. became the first major U.S. company to promise shareholders an advisory vote on executive compensation packages.

In March 2007, Rep. Frank (now Chairman of the House Financial Services Committee following the 2006 mid-term elections) introduced a milder version of his 2005 bill, requiring non-binding advisory votes rather than giving shareholders veto power over compensation payments. The “Shareholder Vote on Executive Compensation Act”– in spite of being

---


-27-
opposed by President Bush – passed by a 269-134 margin in the House on April 20, 2007.49 Later that same day, Senator (and presidential hopeful) Barack Obama introduced an identical bill in the Senate. Obama’s bill was permanently stalled in the Senate Banking Committee by Chairman (and presidential hopeful) Christopher Dodd.50

On February 17, 2009, following the November 2008 elections giving Democrats control of the presidency as well as both chambers of Congress, President Obama signed into law the American Recovery and Reinvestment Act of 2009 (ARRA) which, among other new restrictions (discussed below in Section 3.2), imposed mandatory Say on Pay resolutions for all firms receiving assistance under Treasury’s Troubled Asset Relief Program (“TARP”). On February 26, the SEC confirmed that the Say on Pay votes would apply to the 2009 proxy season (for TARP recipients that had not already filed their proxy by February 26th).

Therefore, in the Spring of 2009 – not long after the Dow Jones Industrial Average hit its crisis minimum at about 6500 – shareholders had an opportunity to provide a non-binding vote of approval on the 2008 compensation received by the top executives at approximately 400 TARP recipients (i.e., compensation for the year when these firms allegedly dragged the economy into a financial crisis). As an interesting historical footnote, the plans were passed at all firms, with an average of 88.6% of the votes cast in favor of management. Among the TARP recipients garnering the strongest support were the Wall Street firms whose compensation systems allegedly fostered the financial crisis, including Goldman Sachs (98%), AIG (98%), JPMorgan (97%), Morgan Stanley (94%), Citigroup (84%), and Bank of America (71%).51

On June 17, 2009, the Obama administration released and sent to Congress its 89-page financial reform plan, described as a “sweeping overhaul of the financial regulatory system.” Among the many proposed rules applying to all publicly traded companies (i.e., not only financial services or TARP recipients) was mandatory Say on Pay. In December 2009, Barney Frank and Chris Dodd introduced the House and Senate versions of the deal, respectively, which went into conference. On July 21, 2010, President Obama signed the Dodd-Frank Act into law.

Under Section 951 of the Dodd-Frank Act, shareholders will be asked to approve the company’s executive compensation practices in a non-binding vote occurring at least every three years (with an additional vote the first year and every six years thereafter to determine whether the Say-on-Pay votes will occur every one, two, or three years). In addition, companies are required to disclose, and shareholders are asked to approve (again, in a non-binding vote), any golden parachute payments in connection with mergers, tender offers, or going-private transactions.

2.3.2. The Negative Consequences

The “Say-on-Pay Movement” was driven primarily by politicians and labor unions (particularly the AFSCME) to “reign in excessive executive pay.” The proponents are likely disappointed with the results: as noted in the Introduction, less than 2% of the Russell 3000 firms reporting Say-on-Pay votes from May 1, 2016 through April 30, 2017 received a “failing” vote (i.e., less than 50% approval), while over 70% received over 90% approval. Analyses of 2011-2014 results by Murphy and Sandino (2017) (and others) show that negative Say on Pay votes weakly reflect a combination of high pay and low company performance. Conyon (2016) finds that the growth in subsequent pay is lower in firms that previously garnered a large percentage of negative votes, while Denis, Jochem and Rajamani (2017) find modest reductions in CEO pay for companies with compensation peers that receive a large percentage of negative votes. Overall, however, there is little evidence that Say on Pay has had a direct effect on the level or structure of executive compensation in the United States.

As emphasized in this paper, regulation inevitably produces unintended consequences. The most obvious (and most negative) unintended consequence associated with Say on Pay reflects the increasing influence of proxy-advisory firms (primarily Institutional Shareholder Service (ISS)). To fulfill their required fiduciary duties to vote proxies, institutional investors routinely rely on ISS and other proxy-advisory firms for recommendations on how to vote on

52 “AFSCME Plan 2006 Shareholder Proposals: Board Accountability Needed to Reign in Excessive Executive Pay,” PR Newswire (2005). Specifically, in launching the first shareholder resolutions for Say on Pay, the chairman of AFSCME’s Employees Pension Plan stressed that, “This coming proxy season our priority is to restrain excessive and undeserved executive compensation.” It is worth noting that stock prices reacted negatively to AFSCME-sponsored say-on-pay proposal announcements and positively when such proposals were defeated; see Cai and Walkling (2011).

53 The experience in the United Kingdom is similar. While there is some evidence that negative Say-on-Pay votes have led to some reductions in salary continuation periods in severance agreements and some changes in performance-based vesting conditions in equity plans, there is no evidence that the votes have affected compensation levels; see Ferri and Maber (2010).
Say-on-Pay and other proxy matters. Malenko and Shen (2016) show that ISS recommendations are influential: a negative ISS recommendation leads to a 25 percentage point decrease in Say-on-Pay voting support. In turn, the proxy-advisory firms rely on a limited (and controversial) set of quantitative criteria to determine whether to offer positive or negative voting recommendations.54 In a broad sample of Russell 3000 firms, Larcker, L. and Ormazabal (2015) show: (1) the recommendations of the proxy-advisory firms do, indeed, affect voting outcomes; (2) anticipating this result, firms change their compensation policies to avoid negative recommendations; and (3) the market reaction to these changes is statistically negative.

Dealing and complying with ISS (and, to a lesser extent, Glass Lewis) has become a significant distraction to Compensation Committees, and an impediment to implementing innovative and effective pay practices. While we are not suggesting that the proxy advisory firms are bad intentioned or even incompetent, the truth is that they need to make recommendations on thousands of compensation plans within a condensed three- or four-week time period, and as a result rely on “checklists” or redlines that are not in the interest of shareholders. Firms inherently face different competitive and incentive challenges, and there is neither a “one-size-fits-all” solution to these challenges, nor a limited set of quantitative criteria that can substitute for a careful and holistic assessment of compensation plans that takes into account company- and executive-specific situations and objectives.

Another unintended consequence of mandated Say on Pay is the opening it gave to the Plaintiff bar. Since the imposition of Say on Pay, companies have faced scores of frivolous law suits claiming that the information contained in the proxy statement was insufficient for investors to make informed advisory decisions approving or rejecting the companies’ pay practices (Katz (2013)). The complaints generally claim that the directors have breached their fiduciary duty because of the insufficient proxy disclosure. The prevailing understanding is that these lawsuits could be settled for an extortion payment of about $600,000, far less than the cost of going to court.

2.3.3. Recommendations

As stressed by Bainbridge (2008), Say on Pay represents an “unjustified incursion on director authority” that could not satisfy any principled cost-benefit analysis. In particular, Bainbridge argues that proponents of Say on Pay cannot establish any of the three distinct

claims necessary for such legislation: (1) there is an executive compensation “problem” justifying legislative intervention; (2) such intervention should be imposed at the federal level; and (3) Say on Pay would help. In our view, the limited (if any) benefits of Say on Pay are dwarfed by the cost associated with reduced innovation and flexibility in the provision of compensation and incentives.

On May 4, 2017, the House Financial Services Committee approved the Financial CHOICE (“Creating Hope and Opportunity for Investors, Consumers, and Entrepreneurs”) Act, referring the bill to the House for a vote at a future date (Ellerman (2017)). The CHOICE Act, sponsored by Chairman Jeb Hensarling, repeals and rewrites much of the Dodd-Frank Act, including the sections on corporate governance and executive compensation. While not eliminating Say on Pay altogether, the CHOICE Act amends Section 951 of the Dodd-Frank Act by requiring advisory votes only in years “in which there has been a material change to the compensation of executives of an issuer from the previous year.” While the proposed amendment invites debate over what constitutes “material” changes in compensation, it seems to us to be a useful compromise, freeing companies from the regulatory burden of annual (or even tri-annual) votes, while also reducing the workload of ISS and Glass Lewis during the condensed proxy season.

2.4. Other Dodd-Frank Mischief

The Dodd-Frank Act was the culmination of President Obama’s and Congress’s controversial and wide-ranging efforts to regulate the financial services industry following the 2007-2009 financial crisis. In spite of its enormous length – the bill itself spans 848 pages – the Act leaves most of the details to be promulgated by a variety of government entities. Indeed, attorneys at DavisPolk (2010) calculate that the Act requires regulators from at least nine agencies to create 243 new rules, conduct 67 studies, and issue 22 periodic reports. In 2016, the New York Times estimated that the full implementation of Dodd-Frank would exceed 22,000 pages of new regulations.55

While ostensibly focused on regulating firms in the financial services industry, the authors of the Dodd-Frank Act seized the opportunity to pass a sweeping reform of executive compensation and corporate governance imposed on all large publicly traded firms across all industries. The new rules – reaching far beyond Say on Pay – include listing requirements that firms adopt clawback and anti-hedging policies, new criteria for independence for

compensation committees and their advisors, and new disclosure rules including the split of CEO/Chairman positions and the ratio of CEO to median worker pay. While the SEC had issued “final rules” on some of these rules, only the rules related to Say on Pay and the independence of the committee and its advisors were into effect prior to the November 2016 elections. The SEC – charged with promulgating these rules – had espoused little enthusiasm to push for implementing any of these provisions (including those where final rules had been issued) even before the May 2017 Financial CHOICE Act that, if passed, would repeal most of the provisions. Nonetheless, even given the uncertainty surrounding implementation, it is worth discussing the potential consequences of the various Dodd-Frank provisions.

2.4.1. The CEO-Worker Pay Ratio

The most mischievous and controversial compensation provision in Dodd-Frank – slipped in at the last minute by Senator Bob Menendez (D-NJ) – is the required disclosure of the ratio of CEO pay to the median pay of all employees. The calculation costs alone can be immense for large multinational or multi-segment corporations where payroll is decentralized: to compute the median the company needs an often non-existent single compensation database with all employees worldwide. In addition, Dodd-Frank instructs companies to compute employee pay using the same methodology mandated to compute top-executive pay, which includes detailed analyses of perquisites, benefits, and changes in the actuarial value of pensions. The rule also provides no guidance on how incorporate part-time employees, full-time but seasonable employees, unpaid interns, and a host of other complications.

In August 2015 – after an extensive and unusually active comment period – the SEC adopted its final rules requiring public companies to disclose the ratio of the compensation of its CEO to the median compensation of its employees. In acknowledgement of the calculation difficulties, the SEC allowed limited flexibility, including allowing statistical sampling and excluding non-US employees from countries where data privacy rules make compliance illegal. The pay-ratio disclosure was mandated for fiscal years beginning on or

---

56 While not directly related to executive compensation, the potentially most significant corporate-governance rule in Dodd-Frank is the Proxy Access rule allowing shareholders to include their director nominees on the proxy alongside with the board’s nominees. The SEC’s Proxy Access rule – implemented in August 2010 – was rejected by the U.S. Circuit Court of Appeals (Washington, DC) in July 2011, noting that the SEC failed in analyzing the cost the rule imposes on companies and in supporting its claim that the rule would improve shareholder value and board performance. SEC had expressed no intention to revisit its rule after the 2011 rebuke, even before the 2016 elections made such a revisit even less likely.
after January 1, 2017, implying that, for December fiscal-closing firms, the ratios would first be disclosed in early 2018.

On February 6, 2017, acting SEC Chairman Michael Piwowar directed his staff to reopen the comment period, and to reconsider the implementation of the rule based on any comments submitted. On March 22, 2017, more than 100 unions, pension funds, activist investors, state treasurers, and consumer advocacy groups urged Chairman Piwowar to not delay implementation of the rule.57 While the Financial CHOICE Act would repeal the rule in entirety, the Act has yet to be addressed by the full House (likely) or the Senate (challenging). As of late May 2017, the implementation of the pay-ratio rule is, at best, uncertain.

Proponents of the disclosure are silent on what shareholders are supposed to do with this new information, or how they should determine whether a ratio is too high or too low. Ultimately, this provision reflects a belief in Congress, labor unions, and shareholder activists that CEO pay is excessive and its sole purpose is the hope that disclosing the ratio will shame boards into lowering CEO pay. In our view, the CEO-worker pay-ratio is not an answer to a legitimate question relevant to shareholders’ interests, and the mandated disclosure should be repealed.

2.4.2. Clawback Requirements

Section 954 of Dodd-Frank requires firms, as a listing requirement, to report and implement policies for recouping payments to executives based on financial statements that are subsequently restated. The rule applies to any current or former executive officer (an expansion of Sarbanes-Oxley, where only the CEO and CFO were subject to clawbacks), and applies to any payments made in the three-year period preceding the restatement (Sarbanes-Oxley only applied for the twelve months following the filing of the inaccurate statement).

In June 2015, the SEC released its proposed rules regarding the recovery of executive compensation under Dodd-Frank Section 954, but has not yet issued a final rule. The proposed rule would direct the national securities exchanges and national securities associations to establish listing standards that would require each company to develop and implement a policy providing for the recovery of incentive-based compensation based on financial information required to be reported under the securities laws that is received by

current or former executive officers, and require the disclosure of the policy. A listed company would be required to file the policy as an exhibit to its annual report.

The May 2017 Financial CHOICE Act amends the SEC’s proposed rule to impact only current or former executive officers with control or authority for company financial reporting. Our own view is a bit more nuanced. We believe, as a matter of company policy, that every incentive plan for every employee should provide for recovery for payments based on results that prove to be incorrect (for much the same reason that banks should be able to recover incorrect deposits, even if the depositor isn’t to blame). We do not distinguish between employees with or without control or authority or those accused of wrong-doing (although these factors should certainly be factored into terminations for cause).

The important nuance in our view that the recovery for errant payments should be at the discretion of the Compensation Committee and not the federal government. While we agree that Compensation Committees should be more aggressive in seeking recovery, we also recognize the difficulty (and potential litigation cost) associated with recouping payments from an employee (or often former employee) who had a contract and who has already spent or paid taxes on those payments. The Dodd-Frank rule – and even the milder rule in the Financial CHOICE Act – requires firms to both develop and implement clawback policies, opening the firm to plaintiff lawsuits if they fail to go after even small amounts of errant payments regardless of the litigation cost.

Given the cost of recovering amounts already paid, a better solution is to defer a portion of each year’s bonus into an account that is subject to forfeiture upon restatements or other revisions of the original performance data. Forgiveness of company-provided loans can also be rescinded to fund recoveries, or the ill-gained reward can be deducted from nonqualified retirement benefits, deferred compensation accounts, or other funds under the control of the company. Unfortunately, the restrictions on deferred compensation under Section 409A or company-provided loans under Sarbanes Oxley makes it more difficult to fund recoveries through innovative plan design.

2.4.3. Compensation Committee Independence Requirements

In June 2012, the SEC adopted final rules to implement the compensation committee independence requirements under Section 952 of the Dodd-Frank Act. Specifically, the SEC directed the national securities exchanges to develop definitions of independence that take into consideration “relevant factors” including, (1) the source of compensation of a director,
including any consulting, advisory or other compensatory fee paid by the listed company to the director; and (2) whether the director is affiliated with the listed company (or any of its subsidiaries or any affiliate of any subsidiary). The SEC emphasized that (unlike the Sarbanes-Oxley mandate relating to audit committee independence), its rules are not prescriptive and that exchanges have flexibility in defining compensation committee independence so long as they consider the factors listed above.

While the independence criteria imposed by the SEC are not particularly objectionable, we question whether the criteria are needed or to what problem they will solve. Since 1994, companies have been required to have compensation committees consisting solely of independent directors in order for any pay to be exempt from the $1 million deductibility cap. In 1999, full independence of the auditing committee was required for all NYSE-listed firms; this requirement was extended to all firms in the 2002 Sarbanes-Oxley Act. In 2003, NYSE and NASDAQ listing requirements tightened the definition of independence and mandated that boards of listed firms have a majority of outside directors; the NYSE further required full independence for the compensation and nominating committees. Thus, the new Dodd-Frank criteria is part of a progression from requiring “independent” compensation committees to “really independent” committees to “really, really independent” committees.

Critics hoping that independence requirements would reduce levels of executive pay have been disappointed. Both the level of pay and the use of equity-based compensation increase with the fraction of outsiders on the board; Fernandes, et al. (2012) show that pay levels increase with board independence even after controlling for the risk associated with higher incentives. The evidence is therefore consistent with the hypothesis that directors – paying with shareholder money and not their own – prefer better-aligned incentives but are not particularly interested in restraining pay levels. Making committees “really, really independent” rather than just “independent” will not yield results placating the critics.

Moreover, evidence that board independence “improves” pay is elusive. Bizjak and Anderson (2003) analyze the level and structure of compensation for CEOs who sit on their companies’ compensation committees (a relatively common occurrence before the early 1990s). Most critics of CEO pay (including Bebchuk-Fried and many shareholder activists) are horrified by the idea that the CEO could be a member of his own compensation committee, and would predict that such CEOs would inflate their own pay with few constraints. And yet, Bizjak and Anderson (2003) find that the CEOs sitting on their own

58 While it was relatively common for CEOs to sit on their own compensation committees, I am unaware of any instances where the CEO was actually allowed to vote on his or her individual compensation package.
compensation committees earn substantially less (and not more) than other CEOs, have significant shareholdings and are typically company founders or their family members. These CEOs sit on their compensation committees not to inflate their own salaries, but rather to influence the level and structure of pay for their subordinates. Prohibiting such CEOs from sitting on (or chairing) their compensation committees harms shareholders, and illustrates a cost of the “one-size-fits-all” nature of corporate governance regulation.

2.4.4. Compensation Advisor Independence Requirements

In addition to imposing new criteria for committee independence, the SEC’s final rules implementing Section 952 of the Dodd-Frank Act require exchanges to adopt listing standards (1) establishing the authority of and funding for the compensation committees to retain or obtain the advice of compensation advisors; and (2) imposing a list of independence criteria that boards must consider in retaining a consultant. Again, the SEC emphasized its rules are not prescriptive and do require firms to hire outside consultants – or even independent outside consultants – only that the committee consider the factors that may bear on independence.

Critics seeking explanations for high executive pay have increasingly accused outside consultants as being (partly) to blame for the perceived excesses in pay. Concerns over the role of consultants led the SEC – as part of their 2006 overhaul of proxy disclosure rules – to require companies to identify any consultants who provided advice on executive or director compensation; to indicate whether or not the consultants are appointed by the companies’ compensation committees; and to describe the nature of the assignments for which the consultants are engaged. The SEC’s disclosure requirements were followed by Congressional hearings on consultants’ conflicts of interest in December 2007, and expanded SEC disclosure rules in 2009 requiring disclosures of fees paid to consultants when those

---

59 In particular, compensation committees must consider: (1) whether the firm retaining the compensation consultant engages the consultant for other services beyond executive or director pay advice; (2) the amount of fees that the client firm pays to the compensation consultant as a percentage of the consultant’s total revenues; (3) the policies and procedures of the consultant designed to prevent conflicts of interest; (4) any business or personal relationship between the compensation adviser representing the consultant and a member of the compensation committee; (5) whether the compensation adviser representing the consultant owns any stock in the client firm; and (6) any business or personal relationship between the compensation consultant and the client firm’s executive officers.
consultants provide other services.\textsuperscript{60} The Dodd-Frank provisions are therefore part of a progressive attack on consultant independence.

The initial and expanded SEC disclosure rules, and the Dodd-Frank listing requirements, have been introduced without any evidence that “conflicted consultants” are, indeed, complicit in perceived pay excesses. While the evolving empirical evidence suggests, at most, a modest link between conflicted consultants and CEO pay,\textsuperscript{61} the SEC disclosure requirements have resulted in dramatic changes in the compensation consulting industry. The largest full-service consulting firms in 2006 (Towers Perrin, Mercer, Hewitt, and Watson Wyatt) have experienced significant declines in market share among their S&P 500 clients, while the largest non-integrated firms focused only on executive compensation (Frederick Cook and Co. and Pearl Meyer) have increased market share. In addition, many of the top consultants from the full-service firms left to create their own “boutique” firms focused on advising boards. For example, consultants from Towers Perrin and Watson Wyatt formed Pay Governance, consultants from Hewitt formed Meridian Compensation Partners, and consultants from Mercer formed Compensation Advisory Partners. The full-service firms have also consolidated: Towers Perrin and Watson Wyatt merged to create TowersWatson, while Hewitt was acquired by Aon.

As discussed by Murphy and Sandino (2010), the experience of the full-service consulting firms closely parallels the experience of accounting firms offering both auditing and consulting services. Concerns regarding conflicts when accounting firms offered services beyond auditing led not only to the Sarbanes-Oxley Act and to detailed disclosures of fees charged for auditing and non-auditing businesses, but also to the practice of companies avoiding using their auditors for other services. This practice has defined the industry, in spite of the fact that the auditors (with their vast firm-specific knowledge) might be the efficient provider of such services, and notwithstanding the fact that there was no direct evidence that these potential conflicts actually translated into misleading audits.

\textsuperscript{60} The 2009 rules included a “safe harbor” where firms did not have to disclose fees for any consultant when the firm had at least one consultant working exclusively for the Compensation Committee that did not provide other services to management.

\textsuperscript{61} Based on the initial year of consultant disclosures, Sroka (2013) find no evidence that CEO pay is related to consultant conflicts of interest. Based on similar data (supplemented with IRS and Department of Labor data identifying actuarial service providers), Murphy and Sandino (2010) find some evidence that CEO pay is modestly higher in firms where consultants provide other services. In subsequent time-series analyses, Murphy and Sandino (2017) show that the prevalence of consultants providing other services, and the statistical relation between conflicted consultants and CEO pay, had declined significantly by 2014.
3. The Good

The prior two sections focused on regulations that have significantly restricted the Compensation Committee in designing effective pay practices for top-level executives. While a broader discussion of U.S. Securities Laws is beyond the scope of this paper, we have struggled to identify regulations focused directly on executive compensation that have helped, rather than hindered, Compensation Committees in doing their jobs.

A basic truism of government intervention into the executive pay process is that regulations always produce important (and usually undesirable) unintended consequences. The million-dollar deductibility cap on top-executive pay, for example, facilitated the explosion in stock options in the 1990s that tripled the level of CEO pay. Similarly, the laws introduced to reduce golden parachute payments led to a proliferation of change-in-control arrangements, employment contracts, and tax gross-ups.

Sometimes, not often, the unintended consequences from pay regulation are positive rather than negative. In the remainder of this section we discuss two such happy accidents.

3.1. Sarbanes Oxley and the 48-Hour Reporting Rule

Under Section 403(a) of the August 2002 Sarbanes-Oxley Act, corporate officers and directors must report any change in ownership of company stock and stock options within two business days after the transaction occurs. Before Sarbanes-Oxley, the requirement had only been to disclose trades in Form 4 filings within ten days after the close of the calendar month in which the transaction had occurred. While this provision was introduced primarily to provide more timely information on insider trading, it had the unintended but ultimately beneficial effect of curbing the unsavory practice of option backdating more than two years before the practice was uncovered.

As background, under the accounting rules in effect prior to 2006, companies would record an accounting charge for “discount” stock options (that is, issued with an exercise price less than the grant-date market price), but not for options issued with an exercise price equal to or higher than the grant-date market price. In the late 1990s, several firms (predominately in the Silicon Valley) deliberately falsified stock option agreements so that options granted on one date were reported as if granted on an earlier date when the stock price was unusually low, thus allowing the firms to grant discount options without the...
accounting charge. The practice was not uncovered until 2005, following academic research by Erik Lie and subsequent investigations by the *Wall Street Journal*.62

The disclosure rules before Sarbanes-Oxley – which allowed a delay of up to 40 days before reporting option grants – providing substantial opportunity for manipulating grant dates. Heron and Lie (2006a) and Narayanan and Seyhun (2005) show that the abnormal run-up in stock prices following reported grant dates (which they interpret as evidence of backdating) declined substantially after the new two-day reporting rules, thus suggesting that the Sarbanes-Oxley Act had the unintended (but desirable) effect of stemming backdating practices.63

### 3.2. Pay Restrictions for TARP Recipients

Between October 2008 and December 2009, the U.S. Government invested nearly $400 billion into financial services and automotive firms through the Troubled Asset Relief Program (TARP), established under the Emergency Economic Stabilization Act of 2008 (EESA), as amended by the American Recovery and Reinvestment Act of 2009 (ARRA). As part of the original 2008 EESA law, Congress imposed pay restrictions on top executives in the bailed-out banks. For example, ESSA extended the clawback provisions in Sarbanes-Oxley to the top-five executives (and not just the CEO and CFO), and covered a much broader set of material inaccuracies in performance metrics. In addition, EESA lowered the IRS cap on deductibility for the top-five executives from $1 million to $500,000, and applied this limit to all forms of compensation (and not just non-performance-based pay). EESA also prohibited new golden parachutes agreements for the Top 5 executives, and capped payments under existing plans to 300% of the executives’ average taxable compensation over the prior five years. In addition, EESA extended the definition of golden parachutes to amounts paid in “the event of an involuntary termination, bankruptcy filing, insolvency, or receivership” and not only payments made in association with a change in control.

---


63 The reporting requirements under Sarbanes-Oxley apply only to executive officers and directors, and there is evidence from SEC investigations that some companies continued backdating for lower-level employees subsequent to the August 2002. However, since grants to such employees are not publicly disclosed, it has not been possible to perform a comprehensive analysis of the practice.
While serious, the October 2008 pay restrictions for TARP recipients were just the beginning. In mid-February 2009, separate bills proposing amendments to EESA had been passed by both the House and Senate, and it was up to a small conference committee to propose a compromise set of amendments that could be passed in both chambers. On February 13th – as a last-minute addition to the amendments – the conference chairman (Senator Chris Dodd) inserted a new section imposing new restrictions on executive compensation. The compromise bill was quickly passed in both chambers with little debate and signed into law by President Obama on February 17, 2009. The final rules implementing the Dodd amendments were issued by the U.S. Treasury on June 9, 2009.

In addition to the Say on Pay requirements discussed above in Section 0, the Dodd Amendments extended the clawback provisions from the top five executives under EESA to the 25 executives and applied them retroactively. In addition, while the original EESA disallowed severance payments in excess of 300% of base pay for the top five executives, the Dodd Amendments covered the top 10 executives and disallowed all payments (not just those exceeding 300% of base). Most importantly, the Dodd Amendments allowed only two types of compensation: base salaries (which were not restricted in magnitude), and restricted stock (limited to grant-date values no more than half of base salaries). The forms of compensation explicitly prohibited under the Dodd amendments for TARP recipients include performance-based bonuses, retention bonuses, signing bonuses, severance pay, and all forms of stock options.

When the Dodd Amendments were enacted in February 2009, Congress (and the general public) was outraged at Wall Street and its bonus culture, and suspicious that this culture was a root cause of the financial crisis. By limiting compensation to uncapped base salaries coupled with modest amounts of restricted stock, the Dodd amendments completely upended the traditional Wall Street model of low base salaries coupled with high bonuses paid in a combination of cash, restricted stock, and stock options. One interpretation of the Congress’s intentions was to punish the executives and firms alleged to be responsible for the crisis. More charitably, Congress may have decided that banking compensation was sufficiently out of control that the only way to save Wall Street was to destroy its bonus

64 The number of executives covered by the Dodd Amendments varied by the size of the TARP bailout, with the maximum number effective for TARP investments exceeding $500 million. As a point of reference, the average TARP firm among the original eight recipient received an average of $20 billion in funding, and virtually all the outrage over banking bonuses have involved banks taking well over $500 million in government funds. Therefore, we report results assuming that firms are in the top group of recipients.
culture. Whatever the intent, it is our opinion that the restrictions were misguided and not in the interest of taxpayers or shareholders.

However, there was a silver lining: the TARP recipients found the draconian pay restrictions sufficiently onerous that they hurried to pay back the government in time for year-end bonuses. On June 17, 2009, five of the eight original TARP recipients (Goldman Sachs, Morgan Stanley, JPMorgan Chase, Bank of New York Mellon, and State Street) fully repaid $50 billion in TARP funding and escaped the draconian measures; Bank of America and Wells Fargo repaid their loans (totaling $50 billion) by the end of 2009 and had limited exposure to the compensation restrictions. Citigroup exchanged its $25 billion government investment for equity in early 2010, and became no longer subject to the pay restrictions at that point. Therefore, while almost all attempts to regulate executive compensation have produced negative unintended side affects, the Dodd Amendments were so draconian that they produced a positive one.

4. Conclusion

Conceptually, Compensation Committees are charged with defining the company’s compensation philosophy, setting the level of pay (often with reference to pay for similarly situated executives in similarly situated firms), and designing the company’s equity and non-equity incentive plans (including choosing the performance metrics and targets, and determining how the compensation payouts vary with these metrics). It is a demanding responsibility, critical to a well-functioning corporation.

In practice, however, committees spend an inordinate amount of their time not on their fundamental responsibilities but rather worrying about whether compensation will be deductible under IRC Section 162(m), whether the change-in-control agreements will trigger Section 280G limitations, whether their incentive plans will be deemed non-qualified deferred compensation plans subject to Section 409A, and whether their plans will receive favorable Say on Pay votes (which, in turn, is influenced by a positive recommendation from ISS. These various regulations and pressures are cumulative and interactive: ISS’s guidelines on excise tax gross-ups, for example, would be largely moot if Section 280G were repealed, and ISS’s analysis of pay levels would be largely moot if Say on Pay were repealed.

Perceived abuses and excesses in executive compensation have led to continual calls for pay regulation. In his biting criticism of Say on Pay laws, Bainbridge (2008) argues that
proponents must establish three claims: (1) there is an executive compensation “problem” justifying legislative intervention; (2) such intervention should be imposed at the federal level (as opposed to at the state or corporate level); and (3) federal legislation would make things better rather than worse. Bainbridge’s criticism applies broadly to all attempts to regulate pay beyond shareholder advisory votes. While there are certainly ways that the design of CEO pay can be improved (likely without reducing the level of pay), we have yet to encounter a problem in executive compensation that is efficiently addressed through existing or potential regulation.

The reality is that CEO pay is already heavily regulated, and that the regulations have been universally unblemished by success. Part of the problem is that regulation – even when well intended – inherently focuses on relatively narrow aspects of compensation allowing plenty of scope for costly circumvention. In our discussion of Section 409A above, we recalled the apt analogy of the Dutch boy using his fingers to plug holes in a dike, only to see new leaks emerge. Each new hole requires a new regulation or set of regulations, introduced without repealing any existing regulations (regardless of whether the original purpose of the prior regulation is well in the past). The only certainty with pay regulation is that new leaks will emerge in unsuspected places, and that the consequences will be both unintended and costly.

A larger part of the problem is that the regulation is often mis-intended. The regulations are inherently political and driven by political agendas, and politicians seldom embrace “creating shareholder value” as their governing objective. While the pay controversies fueling calls for regulation have touched on legitimate issues concerning executive compensation, the most vocal critics of CEO pay (such as members of labor unions, disgruntled workers and politicians) have been uninvited guests to the table who have had no real stake in the companies being managed and no real interest in creating wealth for company shareholders. Indeed, a substantial force motivating such uninvited critics is one of the least attractive aspects of human beings: jealousy and envy. Although these aspects are seldom part of the explicit discussion and debate surrounding pay, they are important and impact how and why governments intervene into pay decisions.
References


Bowe, Christopher, and Ben White, 2007, “Record Payback over Options,” Financial Times (December 7).


Chronicle Staff and Wire Reports, 1992, “Big Earners cashing in now: fearful of Clinton’s tax plans, they rush to exercise their options,” San Francisco Chronicle (December 29).

Conyon, Martin J., 2016, Shareholder Dissent on Say-on-Pay and CEO Compensation.

Cornwell, Susan, 2002, “U.S. Senate votes to stop loans to CEOs,” Reuters News (July 12).

“Cut High Salaries or Get No Loans, is RFC Warning,” 1933, New York Times (May 29).


“Federal Bureau Asks Salaries of Big Companies' Executives,” 1933, Chicago Daily Tribune (October 18).


Ferri, Fabrizio, and David Maber, 2010, Say on Pay Votes and CEO Compensation: Evidence from the UK.


Heron, Randall A., and Erik Lie, 2006b, What Fraction of Stock Option Grants To Top Executives Have Been Backdated or Manipulated, Unpublished Working Paper.


Murphy, Kevin J., 2013, Executive Compensation: Where we are, and how we got there, in George Constantinides, Milton Harris, and René Stulz, eds.: Handbook of the Economics of Finance (forthcoming).


Murphy, Kevin J., and Tatiana Sandino, 2017, Compensation Consultants and the Level, Composition and Complexity of CEO Pay.

“Nappier says strong support of resolution at Sun Microsystems reflects shareholder disillusionment with executives' pay,” 2006, US Fed News (November 2).


“President Studies High Salary Curb: Tax Power is Urged as Means of Controlling Stipends in Big Industries,” 1933, New York Times (October 23).


“RFC Fixed Pay Limits: Cuts Required to Obtain Loans,” 1933, Los Angeles Times (May 29).


