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

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ABSTRACT

The persistent outrage over CEO pay expressed by politicians, the press, media, labor unions, and the general public (but not shareholders) have prompted the imposition of a wide range of disclosure requirements, tax policies, accounting rules, governance reforms, direct legislation, and other rules constraining executive compensation stretching back nearly a century. We analyze the regulations that have substantially damaged the efficacy of CEO pay practices, ranging from the first disclosure rules in the 1930s to the 2018 Trump tax rules. We discuss the political forces behind the regulatory interventions, and assess the continuing unintended consequences of these interventions. 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, their shareholders, and social welfare.

"The most terrifying words in the English language are: I'm from the government and I'm here to help."

—Ronald Reagan

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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 prompted the imposition of a wide range of 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 policies, and their associated and inevitable unintended consequences, have increased (rather than decreased) pay levels and hindered the corporate 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 primary 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 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 June 2017, the U.S. House of Representatives 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 has virtually no chance to pass 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 complicated and counterproductive tax rules focused on CEO pay as part of the 2018 reform of the 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.[1] 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.

[1] See https://sayonpay.equilar.com/sayonpay/home.

Although poorly performing firms with highly paid executives are especially vulnerable to failing advisory votes on CEO pay, the primary predictor of a failed vote (or shareholder dissatisfaction with CEO pay more generally) is poor performance and *not* the level of pay. 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 to restrict CEO pay.

The consequences of attempts to regulate CEO pay have ranged from disastrous (e.g., the $1 million cap on the corporate deductibility of executive pay imposed during the Clinton administration in 1993 and expanded under the Trump administration in 2018) 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). 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 to economic efficiency, and thus would have the highest benefit to outright repeal.

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, and the pre-2006 accounting treatment for stock options. 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 the structure of CEO pay, partly because such restrictions could preempt state corporation laws.[2] 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 *only* if the payments represent reasonable compensation for services rendered. As typically interpreted, reasonableness is 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 dollar amounts of 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 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/Trump $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,"[3] CEO pay became a major political issue during the 1992 presidential campaign.[4] 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

[2]Congress has occasionally attempted to set limits on 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 total increases in pay for groups of executives. In addition, Congress has occasionally imposed restrictions on pay components, such as Sarbanes-Oxley's prohibition on company-provided loans; see Section 2.1 below for more discussion. More recently, Congress directly regulated both the level and structure of pay for executives in financial services firms that received capital funding under Treasury's Troubled Asset Relief Program ("TARP"); we discuss this further in Section 2.1 below.

[3]McCarroll, "The Shareholders Strike Back: Executive Pay," *Time*, (May 5, 1992).

[4]"Politics and Policy—Campaign '92: From Quayle to Clinton, Politicians are Pouncing on the Hot Issue of Top Executive's Hefty Salaries," *Wall Street Journal* (1992).

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.[5] 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.[6]

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.[7] In April, details of the considerably softened plan began to emerge.[8] 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 applied only to public firms and not to privately held firms, and applied only to compensation paid to the CEO and the four highest-paid executive officers as disclosed in annual proxy statements (the "Named Executive Officers" or NEOs); compensation for all others in the firm remained fully deductible, even if in excess of the million-dollar limit. More importantly, Section 162(m) did not apply to compensation considered performance-based for the NEOs.

Performance-based compensation, as defined under Internal Revenue Code (IRC) Section 162(m), included commissions and pay based on the attainment of one or more performance goals, but only if (1) the goals were determined by an independent compensation committee consisting of two or more outside directors, (2) the terms of the contract (including goals) were disclosed to shareholders and approved by shareholders before payment, and (3) payouts occurred only after an "improvement in productivity" (measured along some relevant dimension). Stock options generally qualified as performance based, but only if the exercise price was 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, did not qualify as performance-based compensation.

Under the IRC definition, a bonus based on formula-driven objective performance measures is considered performance based (so long as the bonus

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[5] Chronicle Staff and Wire Reports, "Big Earners cashing in now: fearful of Clinton's tax plans, they rush to exercise their options," *San Francisco Chronicle* (1992).

[6] Siconolfi, "Wall Street is upset by Clinton's support on ending tax break for 'excessive' pay," *Wall Street Journal* (1992).

[7] Freudenheim, "Experts see tax curbs on executives' pay as more political than fiscal," *New York Times* (1993).

[8] Greenhouse, "Deduction proposal is softened," *New York Times* (1993).

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). However, 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.

The "covered executives" subject to Section 162(m) (i.e., the CEO and four highest-paid executive officers) initially corresponded to the NEOs whose compensation was required to be disclosed in corporate proxy statements. However, 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). 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.

While Section 162(m) generally applies to all publicly traded U.S. corporations, two sector-specific subsections merit special mention. Section 162(m)(5) – passed as part of the American Recovery and Reinvestment Act of 2009 – imposes a $500,000 deductibility limitation, with no exemptions for performance-related pay for entities receiving capital under the U.S. Treasury's Troubled Asset Relief Program (TARP). Section 162(m)(5) applies to all companies, public and private, that received (and had not fully repaid) TARP assistance. Similarly, Section 162(m)(6) – passed in 2010 as part of the Affordable Care Act ("Obamacare") imposes a $500,000 deductibility limitation for health insurance providers, again with no exemptions for performance-related pay and regardless of whether the providers are publicly traded.

The deductibility limitations under Section 162(m) were considerably expanded in the Tax Cuts and Jobs Act, signed into law by President Trump in December 2017 and effective beginning in the 2018 tax year. In particular, the exemptions for performance-related pay were eliminated, implying that all compensation in excess of $1 million for "covered executives" is nondeductible as a compensation expense.[9] The new law also redefined "covered executives" to include the CFO (thus restoring consistency with the tax code and SEC disclosure requirements). In addition, while firms under the old rules could preserve deductibility by deferring payments until termination (or to a time when the executive was no longer an NEO), the new rules state that, once an executive is a covered executive in any year (starting in 2017), compensation will be subject to Section 162(m) in all future years, including after termina-

[9] The final bill includes a grandfather clause retaining deductibility for performance-based compensation derived from a written binding contract that was in effect prior to November 2, 2017, provided that the compensation is not materially modified thereafter.

tion. Thus, severance pay, deferred compensation payments, supplemental retirement payments, and similar types of post-termination payments to an employee who has ever been the CEO, CFO, or one of the three highest-paid officers in any fiscal year (beginning after December 31, 2016) are now subject to the annual $1 million deduction limit. Finally, while Section 162(m) had applied only to firms with publicly traded equity, the new rules expand coverage to firms with debt securities registered with the SEC.

1.1.2 The Negative Consequences of the Clinton $1 Million Deductibility Limitation

The explicit objective of the 1993 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.*[10]

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. Figure 1 shows how both the composition and level of grant-date pay for CEOs in S&P 500 companies evolved from 1992–2016. The pay-composition percentages in the figure are constructed by first calculating the composition percentages for each CEO, and then averaging across CEOs. As evident from the figure, underlying the growth in pay for CEOs since the 1990s is an escalation in stock-option compensation from 1993–2001 coupled with a dramatic shift away from options towards restricted stock (i.e., shares vesting with the passage of time) from 2002–2005 and towards performance shares (i.e., shares vesting upon attainment of pre-specified performance goals) since 2006. In 1992, base salaries accounted for 41% of the $3.1 million median CEO pay package, while stock options (valued at grant date) accounted for 23%. By 2001, base salaries accounted for only 18% of the median $10.1 million CEO pay, while options accounted for more than half of pay. By 2016, options fell to only 15% of pay, as many firms switched from granting options to granting restricted stock and performance shares (which together accounted for 49% of total pay).

While not the only factor driving the level and composition of CEO pay, Section 162(m) has been a leading cause of the evolution of pay since the early

[10] 1993 U.S. Code Congressional and Administrative News 877, as cited in Perry and Zenner (2001)

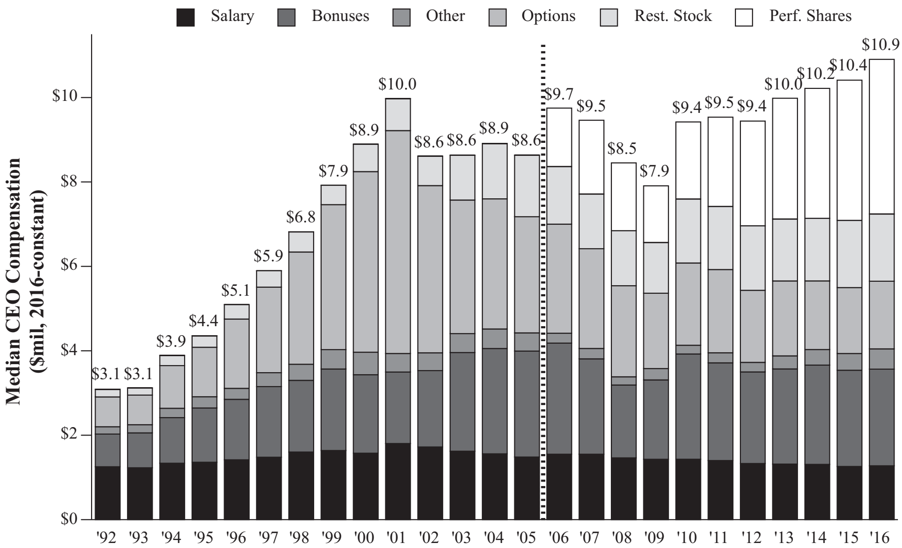

Figure 1: Median Compensation for CEOs in S&P 500 Firms, 1992–2016

Note: Bonuses include both discretionary bonuses and payouts from non-equity incentive plans. Total compensation includes salary, bonuses, stock options (valued at grant date), restricted stock and performance shares (valued at grant date), perquisites and miscellaneous (and uncommon) items such as tax reimbursements, severance payments, signing bonuses, debt forgiveness, imputed interest, payments for unused vacation dates, and life insurance premiums.

1990s. 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 discretionary plans with overly generous formulas (Murphy and Oyer, 2004).

In addition to raising (rather than lowering) the level of CEO pay, Section 162(m) disallows deductions for, and therefore discouraged, many value-increasing plan designs. For example, Section 162(m) disallows deductions for restricted stock or for options issued in the money, even when such grants are accompanied by an explicit reduction in base salaries. Section 162(m) also 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) distorts the information companies give to shareholders. In particular, in order to circumvent deductibility 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 contributed to the proliferation of so-called "performance share" awards evident in Figure 1, 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 there 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.

To be clear, many of the prescriptions implied by the Clinton Rules are directionally consistent with our own view of good governance practices. For example, while we believe that too many options were granted to too many people in the 1990s – in part fueled by Section 162(m) under the Clinton Rules – we remain steadfast to the view that CEO pay should be closely tied to value creation. In addition, we agree that compensation committees should be composed entirely of outside directors and not current employees, a prerequisite for exemptions under the Clinton Rules. But, given that all corporate governance decisions involve tradeoffs, there is a world of difference between advocating good practices and directly imposing them through abusive and ill-conceived tax policies.

1.1.3 The Negative Consequences of the Trump $1 Million Deductibility Limitation

It is difficult to argue with the principle that companies should only be able to deduct reasonable compensation expenses for services rendered. However,

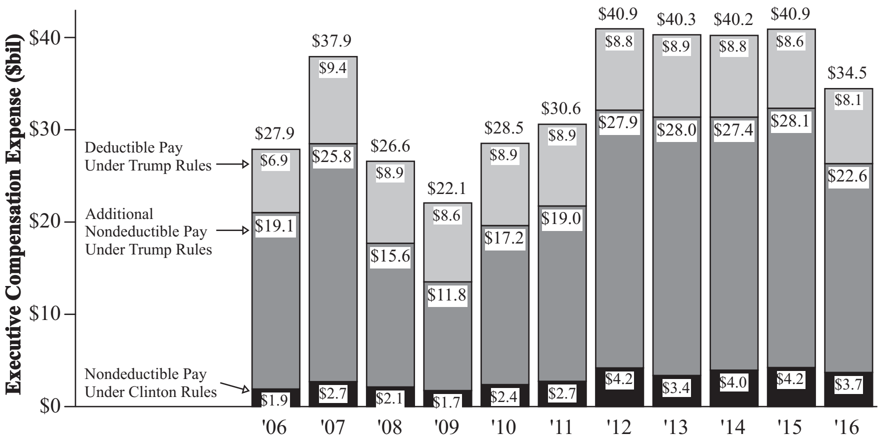

Figure 2: The Trump Tax Cut and Jobs Act of 2017 considerable expands the amount of compensation deemed "nondeductible" under IRC Section 162(m)

Note: The chart shows estimates for aggregate total executive compensation expense and the estimated amounts deemed nondeductible under Section 162(m) under the pre-2017 "Clinton Rules" (which allowed exemptions for qualified performance-based pay and did not apply to CFOs) and the post-2017 "Trump Rules" (which eliminates exemptions and applies to all Named Executive Officers (NEOs)). Nondeductible pay under the Clinton Rules includes the sum of base salaries, discretionary bonuses, and the vesting value of time-lapse restricted stock in excess of $1 million. Nondeductible pay under the Trump Rules includes salaries, bonuses, payouts from non-equity plans, gains from exercising stock options, and the vesting value of all stock grants in excess of $1 million. Estimates are based on all NEOs in the ExecuComp sample of S&P 500, S&P MidCap 400, and S&P SmallCap 600 companies.

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. Given the exemptions for performance-related pay, and the ability of firms to delay compensation until after executives were no longer subject to Section 162(m) (e.g., upon termination), the tax penalties imposed on firms deviating from the exemptions were relatively small. In contrast, the penalties imposed by the 2017 Tax Cuts and Jobs Act, are potentially huge.

Figure 2 provides our annual estimates of the 2006–2016 aggregate total compensation for U.S. executives and the amounts deemed excessive and therefore not deductible for corporate income tax purposes. Our estimates are based on all executives in Standard & Poors' ExecuComp database, which includes NEOs from firms in the S&P 500, S&P MidCap 400, S&P SmallCap 600, plus a number of other firms covered by S&P. The dark shaded region at the bottom depicts our estimates of excessive (i.e., nondeductible) compensation under the "Clinton Rules" (i.e., the Section 162(m) rules in effect before 2018), calculated as the excess over $1 million of the sum of base salary, discretionary bonus, and the vesting value of time-lapse restricted stock.[11] As shown in Figure 2, we estimate that deductions under the Clinton rules were disallowed on approximately \$1.9 billion in NEO compensation in 2006 (representing about 7% of total NEO compensation expense), growing to \$4.2 billion in 2015 (about 11% of total NEO compensation expense).

In addition to providing our estimates of pay where deductions were actually disallowed, Figure 2 provides our hypothetical estimates of disallowed deductions under the expanded Trump version of Section 162(m). Under the Trump Rules, all forms of realized compensation are subject to the deductibility limits, including salaries, discretionary and formula-based bonuses, gains from exercising stock options, and the vesting value of all (performance or time-vesting) stock grants. As shown in the figure, we estimate that deductions would have been disallowed under the Trump Rules on approximately \$21.0 billion in NEO compensation in 2006 (representing 75% of total compensation expense), growing to \$32.3 billion in 2015 (79% of total compensation expense). Moreover, the estimates in Figure 2 understate the disallowed deductions under Trump Rules since they ignore severance benefits, pensions, deferred compensation, and other pay realized upon or after termination, all now subject to the expanded Section 162(m).

While firms can take some solace in the reduction in top federal corporate tax rates from 35% to 21%, the implied tax penalty under the Trump Rules is much higher than under the loophole-laden Clinton Rules. We expect most firms to forego deductibility and make competitive payments to their top executives; what else can they do? Ultimately, however, the arbitrary and unrealistic "reasonableness" standard of \$1 million, imposed only on NEOs of firms with public equity or debt, increases the cost of being a publicly traded corporation in the United States.[12] In addition, the "once a covered employee, always a covered employee" aspect of the new rule make it unusually expensive for companies to make one-time payments that inadvertently bump a lower-paid executive into the top three highest-paid officers in any year.

The arbitrary deductibility cap on all forms of compensation under the 2018 Trump Rules imposes significant costs on publicly traded corporations. There is an unintended consequence to the new rules, however, that is sufficiently positive that we discuss it in more detail under "Good" regulations in Section 3.3 below. In particular, by imposing penalties on the *level* of compensation without distinguishing between different forms of compensation, the Trump

[11] While the SEC requires firms to report the value of restricted shares upon vesting, it does not require separate reporting of shares vesting based on time (subject to Section 162(m)) and those vesting upon attainment of performance hurdles (typically exempt from Section 162(m)). Figure 2 assumes that one-third of the vesting value reflects time-lapse restricted stock, while two-thirds reflect performance shares.

[12] Doidge *et al.* (2017) show dramatic declines in the number of U.S. firms since 1996, which they attribute to a decrease in the benefit, and increase in the cost, of being listed.

Rules reduce or eliminate many of the distortions and negative consequences caused by the Clinton Rules. Compensation committees are now able to make tradeoffs between fixed and variable compensation, or discretionary or nondiscretionary pay, without worrying about the differing tax implications. Similarly, there is no tax-related reason to obfuscate incentive arrangements through shareholder-approved omnibus plans, or to pre-commit to performance targets in an ever-changing economic environment.

1.1.4 Recommendations

In enacting and expanding Section 162(m), Congress used and abused the tax system to target a small group of executives and to punish shareholders of companies who pay high salaries. 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 (or staying private) more attractive.

1.2 The Pre-2006 Accounting Treatment for Options

In addition to controlling the tax code, Congress (at least indirectly) also influences how companies account for executive compensation it their financial statements. While the provisions in Section 162(m) exempting stock options from deductibility limits helped fuel the option explosion in the 1990s, another central factor was how options were accounted for in company financial statements before 2006.

1.2.1 Background

Executives stock options granted before 1970 were typically either restricted or qualified stock options (created respectively by the 1950 and 1964 Revenue Acts) and were taxed as capital gains to the recipient when the shares acquired were ultimately sold. Since these options were not formally considered compensation, companies did not record an expense for such options for either tax or accounting purposes. The emergence of non-qualified options in the 1970s – which were considered compensation for tax purposes – raised a new question: how should options be accounted for in company income statements? One possibility was to follow the tax code by recognizing an accounting expense at the time an option is exercised. But, in spite of its simplicity, this method is inconsistent with the basic tenet of accounting that expenses should be matched to the time period when the services associated with those expenses were rendered. Rather, the tenet suggested that options should be expensed over their term based on the grant-date value of the option. At the time, however (and for a long time to come) there was no accepted way of placing a value on an employee stock option.

In October 1972, the Accounting Principles Board (APB) – the predecessor to the current Financial Accounting Standards Board (FASB) – issued APB Opinion No. 25, Accounting for Stock Issued to Employees. Under APB Opinion No. 25, the compensation expense associated with stock options was defined as the (positive) difference between the stock price and the exercise price as of the first date when both the number of options granted and the exercise price become known or fixed. The expense for this difference between the price and exercise price – called the intrinsic value – was amortized over the period in which the employee is prohibited from exercising the option.[13] Under this rule, there was no charge for options granted with an exercise price equal to (or exceeding) the grant-date market price, because the intrinsic value is zero on the grant date.

After shelving a similar proposal in 1984, the FASB voted 7-0 in April 1992 to endorse an accounting charge for employee stock options and issued a formal proposal in 1993. The proposal created a storm of criticism among business executives, high-tech companies, accountants, compensation consultants, the Secretary of the Treasury, and shareholder groups.[14] Even President Clinton, usually a critic of high executive pay, waded into the debate, arguing that it would be unfortunate if FASB's proposal inadvertently undermined the competitiveness of some of Americas most promising high-tech companies.[15] In March 1994, FASB held public hearings on the issue. In the aftermath of the overwhelmingly negative response, FASB announced it was delaying the proposed accounting change by at least a year, and in December it dropped the proposal.

In 1995, FASB issued a compromise rule, FAS 123, which *recommended* but did *not require* that companies expense the fair market value of options granted (using Black-Scholes or a similar valuation methodology). However,

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[13] This period is often called the vesting period but this terminology is misleading since vesting implies that the executive is free to sell the option or keep it if he leaves the firm, as opposed to being only able to exercise the option.

[14] See, for example, Berton, "Business chiefs try to derail proposal on stock options," *Wall Street Journal* (1992); Harlan and Berton, "Accounting Firms, Investors Criticize Proposal on Executives' Stock Options," *Wall Street Journal* (1992); "Bentsen Opposes FASB On Reporting Stock Options," *Wall Street Journal* (1993); Berton, "Accounting Rule-Making Board's Proposal Draws Fire," *Wall Street Journal* (1994); Harlan, "High Anxiety: Accounting Proposal Stirs Unusual Uproar In Executive Suites," *Wall Street Journal* (1994).

[15] "Clinton Enters Debate Over How Companies Reckon Stock Options," *Wall Street Journal* (1993).

while FASB allowed firms to continue reporting under APB Opinion No. 25, it imposed the additional requirement that the value of the option grant would be disclosed in a footnote to the financial statements. Predictably, only a handful of companies adopted FASB's recommended approach.

The scandals that erupted across corporate America during the early 2000s focused attention on the quality of accounting disclosures, which in turn renewed pressures for companies to report the expense associated with stock options on their accounting statements. Before 2002, only a handful of companies had elected to expense options under FAS 123; the remainder elected to account for options under the old rules (where there was typically no expense). In the summer of 2002, several dozen firms announced their intention to expense options voluntarily; more than 150 firms had elected to expense options by early 2003 (Aboody *et al.*, 2004). Moreover, shareholder groups (most often representing union pension funds) began demanding shareholder votes on whether options should be expensed; more than 150 shareholder proposals on option expensing were submitted during the 2003 and 2004 proxy season (Ferri and Sandino, 2009). By late 2004, about 750 companies had voluntarily adopted or announced their intention to expense options. In December 2004, FASB announced FAS 123R which revised FAS 123 by *requiring* all U.S. firms to recognize an accounting expense when granting stock options, effective for fiscal years beginning after June 15, 2005.

1.2.2 The Negative Consequences of the pre-2006 Accounting Rules

The accounting treatment of options under APB Opinion No. 25 and FAS 123 cemented the dominance of the traditional stock option (an option granted with a fixed term and with an exercise price equal to the grant-date market price) and prevented companies from offering more novel option plans. For example, APB Opinion No. 25 imposes a higher accounting charge for options with an exercise price indexed to the stock-price performance of the market or industry, because the exercise price is not immediately fixed. Similarly, it imposes a higher accounting charge for options that only become exercisable if certain performance triggers are achieved, because the number of options is not immediately fixed. Finally, it imposes an accounting charge for options that are issued in the money but not for options issued at the money – a feature that became especially significant in the scandals three decades later involving backdating.

More importantly, the accounting treatment of options promulgated the mistaken belief that options could be granted without any cost to the company. This view was wrong, of course, because the opportunity or economic cost of granting an option is the amount the company could have received if it sold the option in an open-market transaction instead of giving it to employees. Nonetheless, the idea that options were free (or at least cheap) was erroneously

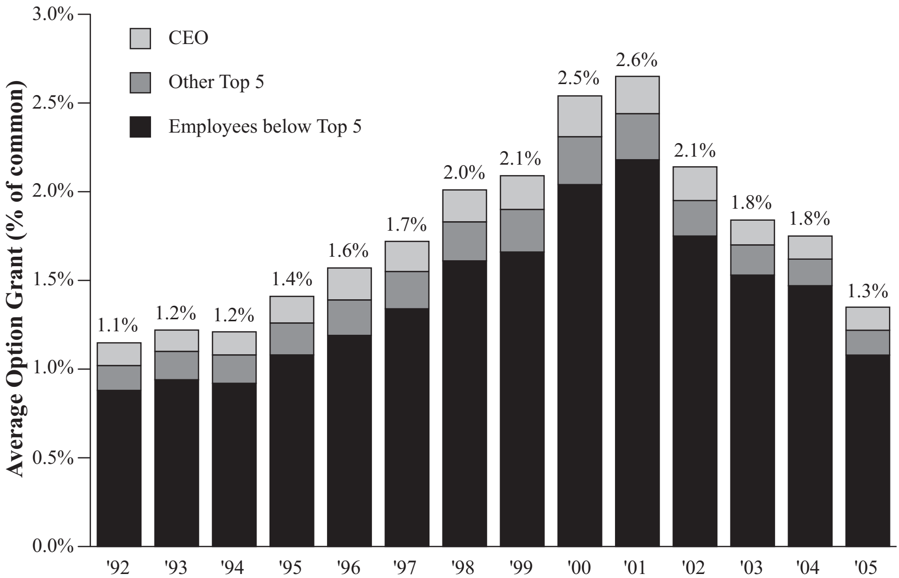

Figure 3: Grant-Date Number of Employee Stock Options (measured by % of company shares) in the S&P 500, 1992–2005

Note: The figure shows the average number of options granted to all employees of S&P 500 firms, expressed as a percent of total common shares outstanding (based on data from S&Ps ExecuComp database). Grants below the Top 5 executives are estimated based on data disclosed in proxy statements between 1992 and 2005. These data were no longer available after 2005, since the new disclosure rules in 2006 eliminated the requirement for firms to disclose the percent of the total options granted received by each of the Top 5 executives. Companies not granting options to any of their top five executives are excluded.

accepted in too many boardrooms. Options were particularly attractive in cash-poor start-ups (such as in the emerging new economy firms in the early 1990s) who could compensate employees through options without spending any cash. Indeed, providing compensation through options allowed the companies to generate cash, since when options were exercised the company received the exercise price and could also deduct the difference between the market price and exercise price from its corporate taxes. The difference between the accounting and tax treatment gave option-granting companies the best of both worlds: no accounting expense on the companies' books, but a large deduction for tax purposes.

The mistaken belief that options were free (or at least cheap) to grant fueled not only an explosion in option grants to top executives, but throughout their organizations. Figure 3 shows the average annual option grants as a fraction of total common shares outstanding. In 1992, the average S&P 500 company granted its employees options on about 1.1% of its outstanding shares. In 2001, in spite of the bull market that increased share prices (that, in turn, increased the value of each granted option), the average S&P 500 company granted options to its executives and employees on 2.6% of its shares. By 2005 (in anticipation of mandated accounting for stock options), annual grants as a fraction of outstanding shares fell below 1995 levels to 1.3%.

1.2.3 The Negative Consequences of the post-2006 Accounting Rules

The pre-2006 accounting rules for executive and employee stock options facilitated the belief that options were free (or at least cheap) to grant, which in turn resulted in too many options granted to too many employees. The mandate that firms recognize an accounting expense when granting stock options beginning (for most firms) in 2006 increased the perceived cost of granting options relative to granting restricted shares (where the accounting charge was basically unchanged before and after 2006). As a result, companies significantly reduced the number of options granted to top executives (and other employees), and greatly expanded the use of restricted shares.

Under FAS 123R (the accounting rule mandating expensing), the grant-date fair market value of employee stock options must be calculated using the Black and Scholes (1973) option-pricing formula or a related methodology. This valuation provides an estimate of what an outside investor would pay for a tradable stock option, and therefore approximates the firm's opportunity cost of awarding an option to an employee rather than selling it to an outside investor. In large part, this accounting charge has forced Compensation Committees to recognize that options are costly to grant, which in turn has led to more-informed and better decisions.

On the other hand, the mandated accounting charge has been accompanied with unintended and negative consequences. First, the new rules have imposed real costs on organizations through the complexity of computing the hypothetical cost of options and other equity instruments. In particular, since few corporations possess the internal resources to make (and defend) such calculations themselves, the accounting mandate has launched a cottage industry of accountants, consultants, and attorneys offering expensive valuation services and competing over different valuation methodologies and assumptions.

More importantly, the accounting mandate has facilitated the calculation of total compensation as the sum of base salaries, bonuses, and the grant-date fair market value of options and other equity awards. This calculation fails to distinguish between two often-confused but fundamentally different valuation concepts: the cost to the company of granting the compensation and the value to an executive from receiving the compensation. In particular, while the Black-Scholes formula provides a reasonable estimate of what a diversified outside investor might pay for a tradable option, it significantly overestimates the value of that option from the perspective of a risk-averse undiversified executive who is unable to sell the option or otherwise hedge against its risk.[16] Critics of executive compensation (including politicians) too-often treat a dollar in stock-option grants as being the equivalent of a dollar in base salary, without consideration of the fact that the former is a hypothetical valuation of an equity instrument that often expires worthless.

1.3 Section 280G & 4999: Golden Parachutes

1.3.1 Background

Section 162(m) enacted in 1993 was not the first time that Congress used (or abused) its authority to define "unreasonable" compensation and thus limit how much pay companies are allowed to deduct as a business expense on their corporate taxes, thereby increasing corporate income taxes. 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 Parachutes," award payments to incumbent executives following a change in corporate control. Most change-of-control agreements are "double trigger" – paid only when the executive is terminated (or resigns for good reason) following a change of control. However, some agreements are "single trigger" and are provided upon a change of control regardless of whether the executive is subsequently terminated.

Designing change-in-control agreements is neither an art nor a science, but more of a craft.[17] It is well established that incumbent managers face substantial job insecurity following changes in control (especially if they resist the acquisition). With no change-in-control agreement in place, incumbent managers will predictably resist acquisition attempts, potentially depriving shareholders of significant takeover premiums. In addition, incumbent managers without change-in-control protection have incentives to seek (and accept) alternative employment opportunities during the merger-negotiation period, when their skills and firm-specific knowledge are critical. Introducing severance payments tied to the change in control reduces management resistance to being acquired, and significantly improves management retention during merger negotiations.

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

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[16] See Hall and Murphy (2002) and Hall and Murphy (2003) for detailed analyses of the differences between the cost and value of executive stock options.

[17] 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).

executives will favor selling their firm at any price, regardless of the benefit to shareholders.

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 his \$4.1 million contractual 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 individual's 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 its executives. For example, suppose an executive with five-year average taxable compensation of \$1 million (i.e., the "base amount") receives a golden parachute payment of \$2.9 million, which is less than three times the \$1 million base amount.[18] 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 three times the \$1 million base amount. In this case, the IRS would define \$2.1 million as an "excess parachute payment." Therefore, under Section 280G, the company would lose the deductibility on \$2.1 million of the \$3.1 million parachute payment. In addition, 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.

1.3.2 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,

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[18] 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 a change in ownership of the company.

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.[19] 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 payment 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 the executive an additional amount for the tax (and the tax on the additional amount).[20] The percentage of agreements that included Golden Parachute 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, home security systems, 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) reducing parachute payments following a 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 the option until the date of the change in control. Since base compensation under Section 280G includes gains from exercising options, the first executive can receive a higher parachute payment without triggering the excise tax, thus increasing the benefits from early option 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

[19] Alpern and McGowan (2001), p. 6.

[20] Continuing with the example above, suppose the CEO owed $420,000 in excise taxes (i.e., 20% of the $2.1 million excess parachute payment). 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 $4.5 million, leaving him with after-tax income of $1.05 million (which is what he would have received without an excise tax).

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 selling the acquired shares) and therefore reducing the incentive effects of those plans.

Similarly, unvested restricted stock routinely becomes 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 upon termination without cause, regardless of whether that termination was related to a control change. Therefore, companies can circumvent the Section 280G three-times-base-compensation limitations (at a potentially huge cost to shareholders) by making payments available to executives terminated without a change in control, and not only those terminated following a change in control.[21]

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. The IRS, however, generally considers any new plan entered into within one year of the acquisition to be control related (and not exempt from Section 280G). Companies will also circumvent Section 280G by disguising control payments as payments for consulting services or 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 evidence 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, Section 280G 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. Overall, Section 280G reduces the beneficial effects of incentive compensation for CEOs and other executives and increases the costs of these plans to their firms.

[21] 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.

1.3.3 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 the CEO of Bendix. The tax rules are discriminatory (applying only to executive officers, large shareholders, or a defined set of highly compensated employees in public companies[22]) and are incredibly complex. The costs of complying with Section 280G are staggering: a third of a century later, every major accounting and law firm retains teams of professionals to help corporations comply with Section 280G calculations and regulations. In addition, there are dozens of boutique professional firms solely devoted to Section 280G compliance. However, the compliance costs are dwarfed by the costs of the restrictions Section 280G impose on Compensation Committees when designing and negotiating employment contracts with top executives, along with the costs of the unintended consequences discussed above in Section 1.3.2.

While the costs imposed by IRC Sections 280G and 4999 are enormous, we struggle to identify any real benefits. While the general purpose of the tax code is to generate revenues to fund government expenditures, Sections Sections 280G and 4999 were designed explicitly to affect behavior and not generate tax revenues. In particular, Sections 280G and 4999 were designed to make exceeding the government-imposed limit so costly for both the firm and the executive that no one would do it. These tax rules are an abuse of our tax system, and should be repealed in its entirety.

1.4 Section 409A: Excise Taxes on Non-Qualified Deferred Compensation

1.4.1 Background

Enron, like many large companies, allowed mid-level and senior executives to defer portions of their salaries and bonuses into unsecured non-qualified deferred compensation accounts, thus postponing paying income taxes until the deferred amounts were actually withdrawn.[23] When Enron filed for Chapter 11 bankruptcy protection in December 2002, about 400 senior and former executives became unsecured creditors of the corporation, and eventually lost most (if not all) of their money in these deferred accounts.[24] However, just before the bankruptcy filing, Enron allowed a small number of executives to

[22]Formally, while Subchapter S corporations are exempt from Section 280G, other private and closely held corporations can avoid 280G restrictions through a shareholder vote.

[23]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).

[24]Barboza, "Enron's Many Strands: Executive Compensation. Enron paid some, not all, deferred compensation," *New York Times* (2002).

withdraw millions of dollars from these deferred accounts. The disclosure of these payments generated significant outrage from Enron unsecured creditors (including Enron executives who were not allowed to withdraw their funds) and 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 compensation accounts to pre-determined dates (thus limiting the flexibility of individuals to determine when they receive taxable income). Congress limited this flexibility by imposing taxes on deferred compensation as soon as individuals *are able* to withdraw funds from their deferred compensation accounts (rather than when they actually withdraw funds). Individuals failing to pay taxes in the year in which they become able to withdraw funds owe a 20% excise tax on the total amount they could have withdrawn, plus interest penalties from the year when taxes were due but not paid.

In order for the individual to avoid deferred compensation being included in taxable income for any particular year under Section 409A, the underlying compensation plan must meet three general requirements. First, the amounts must be payable only on a pre-specified date or time, or upon a termination of employment, 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 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 at the appropriate time, then the individual is subject to the excise tax and interest penalties on the total amount payable from 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 including *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^{th} became the 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 calendar year is not paid until the following calendar year.

Although Section 409A applies across groups of employees in most organizations, it includes special provisions for separation-related payments for "specified employees" in publicly traded firms. Generally, "specified employees" include large employees with large shareholdings and the 50 most highly compensated officers.[25] For these specified 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 employment.

While restricted stock plans are subject to Section 409A, payments under restricted stock 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 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. 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 (i.e., options issued "in the money," often called "discount options") are subject to Section 409A, and become taxable as soon as they become exercisable.[26]

Since the price of shares that are readily tradable on an established securities market is generally accepted as the fair market value under Section 409A, publicly traded firms can typically avoid compliance problems for stock options by setting exercise prices no lower than the grant-date stock price. Compliance is more challenging (and expensive) for private, closely held, and start-up firms, since the IRS can challenge the exercise price as being lower than the

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[25]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.

[26]Discount options could comply with Section 409A by removing the early exercise opportunity and setting a single predetermined date when the option is exercisable.

fair market value. The final Section 409A rules provide that "fair market value may be determined through the reasonable application of a reasonable valuation method," which typically involves retaining independent (and expensive) valuation professionals or developing in-house valuation methodologies.

1.4.2 The Negative Consequences

Efforts to regulate executive compensation have traditionally focused on relatively narrow aspects of compensation, allowing plenty of scope for companies to circumvent the regulations (usually at a high cost). 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 created 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.

Traditional deferred compensation plans offer modest tax-deferral benefits to the recipient.[27] However, Section 409A applies to many types of plans driven by incentive considerations 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 payment from equity awards or pensions provides important retention incentives when 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). Similarly, unvested bonus banks allow firms to impose

[27] 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.

negative bonuses for poorly performing executives. While many retention and incentive plans can potentially be designed to be compliant with Section 409A, that compliance, however, imposes substantial costs and loss of flexibility.

1.4.3 Recommendations

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 withdraw from their deferred accounts (regardless of whether the money was actually 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 purpose 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 Compensation Committee's ability to create effective compensation and incentive packages.

2 The (Merely) 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.[28]

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.[29] 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.[30] 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.[31] 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).[32] 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

[28]See Schoeder and Hamburger, "Accounting Reform Is Left in SEC's Lap — Oxley Proposal Would Place Pitt in an Awkward Position Because of Past Ties to Industry," *The Wall Street Journal* (2002); Spinner, "Committee Passes Auditor Bill," *The Washington Post* (2002).

[29]Drawbaugh, "Post-Enron reform fight takes shape in Congress," *Reuters News* (2002).

[30]"WorldCom/Reform -2: Could Boost Sarbanes Reform Plan," *Dow Jones News Service* (2002); Adetunji and Humes-Schulz, "White House backs SEC reforms," *Financial Times* (2002).

[31]"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).

[32]Maremont, Cohen and Markon "Probe of Ex-Tyco Chief Focuses On Improper Use of Company Funds " *The Wall Street Journal* (2002).

statements. In addition, without advocating legislation, the President urged "compensation committees to put an end to all company loans to corporate officers."[33]

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.[34] 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 on outright ban on companies making any loans to officers or directors.[35] Senator Schumer famously exclaimed that, "This is wrong. It must be stopped. Why can't these corporate executives go to the bank like everybody else when they need loans?"[36] 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.[37]

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[33] "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.

[34] See The Public Company Accounting Reform and Investor Protection Act of 2002, as passed by the Senate Banking Committee, June 18, 2002.

[35] Hilzenrath and Dewar, "Senate Votes to Curb Insider Lending; Provision Targets Terms That Companies. Set for Directors, Executives," *The Washington Post* (2002). At the same time, the Senate rejected an amendment offered by Carl Levin (D-MI) to require firms to expense the fair-market value of stock options upon grant.

[36] Cornwell, "U.S. Senate votes to stop loans to CEOs," *Reuters News* (2002).

[37] 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.

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.[38] The SEC became more aggressive in 2009, launching two clawback cases (CSK Auto and Diebold, Inc.) where the targeted executives were not accused with personal wrongdoing.[39]

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 to any director or executive officer were potentially in violation.

2.1.2 The Negative Consequences

The prohibition of loans to executives and directors in Sarbanes Oxley takes precedents over state corporate laws that generally allowed such loans provided that they benefited the company (Sroka, 2013). Section 402 of Sarbanes Oxley 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. 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.[40] Sarbanes Oxley is also viewed

[38] Plitch, "Paydirt: Sarbanes-Oxley A Pussycat On 'Clawbacks'," *Dow Jones Newswires* (2006); Bowe and White, "Record Payback over Options," *Financial Times* (2007).

[39] Berman, "The Game: New Frontier For the SEC: The Clawback," *Wall Street Journal* (2010); Korn, "Diebold to Pay $25 Million Penalty," *Wall Street Journal* (2010).

[40] 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.

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 taxes due upon exercise.[41] Other arrangements potentially considered illegal loans include personal use of corporate credit cards (even if reimbursed by the executive); 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, as it often does with similar laws that are overly broad and difficult to interpret. However, the SEC explicitly refused to offer interpretive guidance for Section 402 of Sarbanes Oxley 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 in Oxley's private law practice.[42] While the SEC's response was noteworthy, it was expressly limited to the particular facts in the novel equity plan proposed by Oxley's client, 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 practices that might be construed as executive loans, regardless of their merit.

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 Compensation Committee's ability to create effective compensation and incentive packages.

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[41] Technically, cashless exercise programs are implemented by offering the executive a short-term bridge loan to finance the purchase of the shares (and taxes on the gain from exercise), followed by open-market transactions to sell a fraction of the purchased 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).

[42] The Oxley inquiry related 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).

In its hasty deliberations, Congress never considered less costly methods of stemming the perceived abuses in executive loan arrangements. 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 10K or proxy statements 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 pay 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.[43] By mid-1933 the Federal Reserve and the RFC required executive pay disclosures for banks under their respective jurisdictions. Similarly, the Federal Power Commission required pay disclosures for executives in 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 (which included approximately 2,000 corporations).[44] Business leaders questioned whether the FTC had the legal authority to compel such disclosures, but were reminded

[43]"Railroad Salary Report: I.C.C. Asks Class 1 Roads About Jobs Paying More Than $10,000 a Year," *Wall Street Journal* (1932). In order to obtain government assistance, the RFC required pay reductions ranging 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).

[44]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.

that, "Congress in its present temper would readily authorize" whatever the FTC wanted.[45] 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 requiring that companies disclose the name and all compensation (including salaries, bonuses, stock, and stock options) received by the three highest-paid executives in each company. 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."[46]

For nearly sixty years following the 1934 Securities Act, detailed disclosure of executive compensation was a uniquely American requirement. In 1993, Canada adopted U.S.-style disclosure rules, followed by the United Kingdom in 1997, Ireland and South Africa in 2000 and Australia in 2004. In May 2003, the European Union Commission issued an "Action Plan" recommending that all listed companies in the European Union (EU) report details on individual compensation packages by 2006; most EU countries 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 SEC's disclosure rules have long been a favorite method used by the SEC and Congress in attempts to regulate executive compensation practices. Indeed, most additions to disclosure requirements over time reflect policy responses to perceived excesses in executive compensation. The 1978 rules, for example, were largely driven by perceived abuses in executive perquisites and benefits, while the 1993 rules reflected growing concerns over stock options. The 2006 rule changes were motivated in large part by concerns over the influence of compensation

[45] "Federal Bureau Asks Salaries of Big Companies' Executives," *Chicago Daily Tribune* (1933).

[46] "U.S. Steel Guards Data on Salaries: Sends details confidentially to SEC head with request that they be kept secret," *New York Times* (1935).

consultants and perceived abuses in payments received by executives upon termination (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 led to reductions in objectionable practices: for example, perquisites increased after 1978 as executives learned what was common at other firms, option grants 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 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 to monitoring the performance of potentially acquiescent board members.

Although executive pay disclosure facilitates better monitoring of outside directors, the public nature of the disclosures impose large costs on organizations. The recurring populist revolts regarding 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 –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 commonsense disclosure of the level and structure of top-executive pay.

However, we question the implicit assumption that more disclosure is always preferred to less disclosure. The SEC now requires companies to provide details on:

- automobile allowances;
- personal trips on the company airplane;
- club memberships;
- target (and threshold and maximum) amounts payable under equity and non-equity compensation 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;
- which consultants are used (and, in some situations, how much those consultants are paid);
- details on the compensation peer groups;

and on and on.

The first proxy statements issued after the formation of the SEC in 1934 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 executive compensation.[47]

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 effectively processed) by shareholders to address legitimate 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 advisory (i.e., non-binding) votes on

[47] 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.

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.[48] Ultimately, in August 2002, the U.K. government introduced the Directors' Remuneration Report Regulations which required all publicly traded U.K. 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 requiring *binding* shareholder votes.[49]

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 of executive compensation, 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 proposed by Rep. Frank formed the basis of the SEC's sweeping new 2006 disclosure rules. The SEC stopped short of giving shareholders veto power over executive compensation arrangements, or mandating advisory shareholder votes on executive compensation.

Absent legislation mandating advisory votes on executive compensation for all U.S. publicly traded companies, shareholder activists (particularly labor union pension funds) began submitting shareholder resolutions to require Say on Pay votes at specific companies. During the 2006 proxy season, the American Federation of State, County, and Municipal Employees (AFSCME) submitted Say on Pay proposals at US Bancorp, Merrill Lynch, Bank of America, Home Depot, Countrywide Financial, Sara Lee, and Sun Microsystems.[50] While none of the proposals received a majority of the votes, the resolutions garnered more than 40% of the votes in five of the seven firms. During the 2007 proxy season, AFSCME led a coalition of union pension funds, public pension funds, asset management firms, and foundations to file approximately 60 Say on Pay resolutions. The resolutions garnered more than 50% of the shareholder votes in eight firms.[51] In February 2007, Aflac, Inc. became the first major U.S. company to

[48] Hodgson (2009); Ferri and Maber (2010); Thomas and Van der Elst (2015).

[49] In jurisdictions with *binding* shareholder votes, failing the vote typically means that compensation is determined by the most-recent shareholder-approved contract.

[50] Ossinger, "CEO Compensation Survey (A Special Report) — Poorer Relations: When it comes to CEO pay, why are the British so different?," *The Wall Street Journal* (2006); "Nappier says strong support of resolution at Sun Microsystems reflects shareholder disillusionment with executives' pay," *US Fed News* (2006). While the AFSCME originally announced 44 resolutions, Institutional Shareholder Services reported Say on Pay proposals at roughly 60 companies (White and Patrick, "Shareholders Push for Vote on Executive Pay," *The Wall Street Journal* (2007)).

[51] Whitehouse, "Holders Seek Vote on Exec Comp at 44 Companies and SEC Backing," *Dow Jones News Service* (2007).

promise shareholders an advisory vote on executive compensation packages.[52]

In March 2007, Rep. Frank (who became 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 executive compensation arrangements. Rep. Frank's "Shareholder Vote on Executive Compensation Act" passed in the House of Representatives by a 269–134 margin on April 20, 2007, in spite of being opposed by President Bush.[53] Later that same day, Senator (and presidential hopeful) Barack Obama introduced an identical bill in the Senate, which was stalled in the Senate Banking Committee by Chairman (and presidential hopeful) Christopher Dodd.[54]

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 votes for all firms receiving assistance under the 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 statement by February 26^{th}).

Therefore, in the Spring of 2009 – not long after the Dow Jones Industrial Average hit its financial crisis low 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. The Obama expectation was that shareholders would systematically disapprove of executive compensation for the year when these firms allegedly dragged the economy into a financial crisis. Interestingly, the plans were passed at *all* TARP recipients, 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. Goldman Sachs's and AIG's shareholders cast 98% of their votes in favor of management, followed by JPMorgan (97%), Morgan Stanley (94%), Citigroup (84%), and Bank of America (71%).[55]

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

[52] Tse, "Score One for Dissent; Aflac to Be 1st U.S. Firm to Allow Advisory Votes on Pay " *The Washington Post* (2007).

[53] Johnson, "House Votes Yea to "Say on Pay" "*CFO.com* (2007).

[54] Grant, "Obama joins push on executive pay awards," *Financial Times* (2007); Tse, "'Say-on-Pay' Movement Loses Steam," *The Washington Post* (2008).

[55] Tse, "Shareholders Say Yes To Executive Pay Plans; Review Tracks Advisory Votes at TARP Firms," *Washington Post* (2009).

publicly traded companies (i.e., not only financial services or TARP recipients) was mandatory Say on Pay votes. In December 2009, Barney Frank and Chris Dodd introduced the House and Senate versions of the proposed legislation, 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 are asked to approve the company's executive compensation practices in a non-binding vote occurring at least every three years. In addition, in the first year (and every six years thereafter) shareholders vote on whether their Say-on-Pay votes will occur every one, two, or three years. Companies are also required to disclose, and shareholders are asked to approve (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."[56] The proponents are likely disappointed with the results: as noted in the Introduction, more than 98% of the Russell 3000 firms reporting Say-on-Pay votes in the year ending April 30, 2017 received a "passing" vote (i.e., more than 50% approval), while over 70% of firms received more than a 90% approval rate. Analyses of 2011–2014 results by Murphy and Sandino (2018) (and others) show that companies failing Say on Pay votes have a combination of high CEO pay and low company performance. Conyon (2016) finds that the growth in subsequent pay is modestly lower in firms that previously garnered a large percentage of negative votes, while Denis *et al.* (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 significant effect on the level or structure of executive compensation in the United States.[57]

As emphasized in this paper, regulation inevitably produces unintended consequences. The most obvious (and most negative) unintended consequence

[56]"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).

[57]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).

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 Say-on-Pay and other proxy matters.[58] 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.[59] In a broad sample of Russell 3000 firms, Larcker *et al.* (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 negative and statistically significant.

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 incompetent, the fact 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 take into account company- and executive-specific situations and objectives.

Another unintended consequence of mandated Say on Pay is the opening it gave to Plaintiff attorneys. Since the imposition of Dodd-Frank's Say on Pay law, companies have faced scores of frivolous law suits claiming that the information contained in the proxy statement was insufficient for investors to make informed decisions to approve or reject 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.

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[58] In August 2018, the SEC changed its guidance and no longer accepts voting in accordance with the proxy advisory firm recommendations to be a "safe harbor" for institutions voting shares. While this change will certainly impose costs of institutional holders, it will benefit shareholders by reducing the influence of the advisory firms.

[59] For critiques of the ISS methodology, see Wachtell-Lipton's "Say on Pay 2012," available at: http://blogs.law.harvard.edu/corpgov/2012/07/14/say-on-pay-2012/ (accessed 8/6/2012).

2.3.3 Recommendations

As stressed by Bainbridge (2008), Say on Pay legislation 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 justifying 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 June 8, 2017, the U.S. House of Representatives approved the Financial CHOICE ("Creating Hope and Opportunity for Investors, Consumers, and Entrepreneurs") Act. The CHOICE Act, sponsored by Financial Services Committee 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. Unfortunately, the CHOICE Act has no chance to pass in the Senate, and the limited Dodd-Frank reforms passed in the Senate do not address corporate governance or executive compensation issues.

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 left 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.[60]

While ostensibly focused on regulating firms in the financial services industry, the authors of the Dodd-Frank Act seized the opportunity to pass a

[60] Lux and Green, "Dodd-Frank is Hurting Community Banks," *The New York Times* (2016).

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 of 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.[61] While the SEC had issued "final rules" on some of these issues, only the rules related to Say on Pay and the independence of the compensation committee and its advisors had been put into effect prior to the November 2016 elections. The SEC – charged with promulgating these rules – had espoused little enthusiasm for implementing any of the remaining provisions where final rules had not yet been issued.

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 employee pay the company needs an often non-existent single compensation database containing all worldwide employees. 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 to incorporate part-time employees, full-time temporary 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 after

[61] 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.

January 1, 2017, implying that, for firms with December closings, the ratios would first be disclosed in early 2018.[62]

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. By March 22, 2017, more than 100 unions, pension funds, activist investors, state treasurers, and consumer advocacy groups urged acting Chairman Piwowar to not delay implementation of the rule.[63] Ultimately, the SEC chose not to delay implementation.

Proponents of the disclosure are silent on what investors, compensation committees, or executives 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 fact, the key revelation in the disclosure is not how much the CEO makes (which was already publicly documented), but rather what the median employee makes, which in turn creates organizational havoc inside organizations as employees learn whether their pay is above or below the median. Ultimately, 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 Section 304 of Sarbanes-Oxley discussed in Section 2.1.1 above, 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 stock exchanges (e.g., NYSE and NASDAQ) to establish listing standards requiring each company

[62]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 acting Chairman Piwowar to not delay implementation of the rule (Lynch, "U.S. investors fight to preserve SEC rule on CEO pay ratio," *Reuters News* (2017)). Ultimately, the SEC chose not to delay implementation.

[63]Lynch, "U.S. investors fight to preserve SEC rule on CEO pay ratio," *Reuters News* (2017).

to develop, implement, and disclose clawback policies covering its current or former executive officers. A listed company would be required to file the policy as an exhibit to its annual report.

The June 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 of payments based on financial 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, exposing the firm to plaintiff lawsuits if they fail to go after even small amounts of mistaken 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 (see Section 1.4 above) or company-provided loans under Section 402 of Sarbanes Oxley (see Section 2.1 above) 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 are intended to 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.[64] Bizjak and Anderson (2003) compare CEOs who sit on their own compensation committees to CEOs who do not sit on their own compensation committees. They find that CEOs sitting on their own committees earn substantially less, have significantly higher shareholdings, and are more likely to be company founders than CEOs who do not sit on their own compensation committees. These CEOs sit on their compensation committees not to inflate their own salaries,

[64] 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.

but rather to influence the level and structure of pay for their subordinates. Using legislation prohibiting such CEOs from sitting on (or chairing) their compensation committees potentially 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 that (1) ensures compensation committees have the authority and budget to hire compensation consultants; and (2) imposes a list of independence criteria that compensation committees must consider before retaining a consultant.[65] The SEC has emphasized that its rules are not prescriptive and do require firms to hire outside consultants – or even independent outside consultants – only that the committee be able to hire consultants and to consider the factors that may bear on consultant 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 consultants provide other services.[66] The Dodd-Frank provisions are therefore part of a progressive attack by Congress and the SEC on consultant independence.

The initial and expanded SEC disclosure rules, and the Dodd-Frank listing requirements, have been imposed 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 con-

[65] 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) whether the consultant has policies and procedures to prevent conflicts of interest; (4) any business or personal relationship between the consultant and a member of the compensation committee; (5) whether 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.

[66] 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.

sultants and CEO pay,[67] 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 LLC, 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 (now Willis Towers Watson), 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 consulting services, and notwithstanding the fact that there was no direct evidence that these potential conflicts actually translated into misleading audits.

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 from doing their jobs.

A basic truism of government intervention into the determination of executive pay is that regulations inevitably produce important (and usually

[67] 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 (2018) show that the prevalence of consultants providing other services, and the statistical relation between conflicted consultants and CEO pay, had declined significantly by 2014.

undesirable) unintended consequences. For example, the million-dollar deductibility cap on top-executive pay facilitated the explosion in stock options in the 1990s that tripled the level of CEO pay. Similarly, the laws introduced to limit 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 three such fortunate 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 occurred. While the SOX provision was introduced 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 were required to take an accounting charge for stock options issued with an exercise price less than the grant-date market price (i.e., "discount options"). There was no accounting charge, however, for options issued with an exercise price equal to or higher than the grant-date market price. In the late 1990s, several firms (predominately Silicon Valley firms) deliberately falsified stock option agreements so that options granted on one date were reported as if they were granted on an earlier date when the stock price was unusually low with an exercise price equal to that unusually low price. This practice allowed the firms to grant discount options without incurring an accounting charge. The practice was not uncovered until 2005, following academic research by Erik Lie and subsequent investigations by the *Wall Street Journal*.[68]

The disclosure rules before Sarbanes-Oxley – which allowed a delay of up to 40 days before reporting option grants – provided substantial opportunity for companies to manipulate 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

[68] Key references include Lie (2005), Heron and Lie (2006a) and Heron and Lie (2006b), Maremont, "Authorities probe improper backdating of options: Practice allows executives to bolster their stock gains; a highly beneficial pattern," *Wall Street Journal* (2005), Forelle and Bandler, "Backdating probe widens as two quit Silicon Valley firm; Power Integrations Officials leave amid options scandal; 10 companies involved so far," *Wall Street Journal* (2006), Forelle, "How Journal Found Options Pattern," *Wall Street Journal* (2006), "Hot Topic: Probing Stock-Options Backdating," *Wall Street Journal* (2006).

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.[69]

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). TARP was established late in the Bush administration under the Emergency Economic Stabilization Act of 2008 (EESA), and amended early in the Obama administration 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 firms. For example, EESA 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 inaccuracies in financial statements. 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 (without any exemptions for qualified 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 annual taxable compensation over the prior five years. 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.

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 13^{th} – 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 2.3, the February 2009 Dodd Amendments extended the clawback provisions

[69] 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.

from the top five executives under EESA to the top 25 executives and applied them retroactively to the date of the TARP funding.[70] 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 prohibited *all* severance payments. 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 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 Congress's intentions was to punish the executives and firms alleged to be responsible for the crisis. More charitably, Congress may have decided that Wall Street compensation was sufficiently out of control that the only way to save Wall Street was to destroy its bonus 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 in preferred shares for common stock 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 effects, the Dodd Amendments were so draconian that they produced a positive one.

[70] 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 recipients 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.

3.3 The 2018 Expansion of Section 162(m)

As discussed in detail in Section 1.1 above, Section 162(m) of the Internal Revenue Code (IRC) places limits on the amounts of executive compensation publicly traded companies are allowed to deduct as an expense in corporate tax calculations. The limits apply to compensation for executives named in corporate proxy statements (i.e, "named executive officers" or NEOs). Under the original 1993 rule passed by the Clinton Administration, the $1 million deductibility cap did not apply to post-termination payments or to compensation from qualified performance-based incentive plans (as defined by the IRC). Under the expansion of Section 162(m) passed in 2017 by the Trump Administration, the $1 million deductibility cap applies to all forms of compensation (including performance-based pay) and applies to future compensation received by any executive previously designated as an NEO (including post-termination payments).

As depicted in Figure 2, the Trump expansion of Section 162(m) significantly increases the after-tax cost of compensating executives. While an average of 9% of aggregate NEO compensation was nondeductible under the Clinton Rules, approximately 74% of aggregate NEO compensation is nondeductible under the Trump expansion. However, while the Trump expansion has unambiguously increased the after-tax cost of compensating executives, it has created a beneficial (though unintended) side effect by reducing or eliminating many of the negative consequences caused by the Clinton Rules.

Between 1994 and 2017 (i.e., during the Clinton Rules), executive compensation practice has been driven in large part by Section 162(m) as Compensation Committees sought to design pay that was exempt from the deductibility limitations. Indeed, contemporaneous SEC disclosure rules passed along with Section 162(m) required firms to disclose to shareholders explicitly how their compensation plans complied with Section 162(m) exemptions. As discussed in Section 1.1.2, attempts to comply with Section 162(m) fueled the explosion in stock option grants in the 1990s and the more-recent (and ill-advised) escalation of performance-share plans, reduced the use of subjective assessments of CEO performance, and obfuscated pay disclosures through shareholder-approved "omnibus" plans.

The silver lining to the expansion of Section 162(m) under the Trump tax act is that, by imposing penalties on the *level* of compensation without distinguishing between different forms of compensation, Compensation committees no longer need to adopt value-destroying pay practices to comply with Section 162(m) exemptions. Compensation committees are therefore able to make tradeoffs between fixed and variable compensation, or discretionary or nondiscretionary pay, without worrying about the differing tax implications. Similarly, there is no tax-related reason to obfuscate incentive arrangements through shareholder-approved omnibus plans, or to pre-commit to performance targets in an ever-changing economic environment.

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 companies to circumvent regulations by changing other less-regulated components of pay. 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. 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 regulations are inherently political and driven by political agendas, and politicians seldom embrace value creation 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. In addition, such critics mistakenly believe that providing CEOs with better incentives destroys rather than creates wealth for society at large. Although these aspects are seldom part of the explicit discussion and debate surrounding pay, they are important and impact how and why governments intervene in executive compensation.

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