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Show Me the Money: The CEO Pay Ratio Disclosure Rule and the Quest for Effective Executive Compensation Reform

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SHOW ME THE MONEY: THE CEO PAY RATIO DISCLOSURE RULE AND THE QUEST FOR EFFECTIVE EXECUTIVE COMPENSATION REFORM

*Biagio Marino**

The CEO Pay Ratio Disclosure Rule ("the Rule") represents the latest regulation designed to combat one of corporate governance's most polarizing issues: the meteoric rise of executive compensation and its damaging effect on the income inequality gap in the United States. Adopted by the Securities and Exchange Commission (SEC) in August 2015, and effective in 2018, the Rule comports with over eighty years of regulations that have required public companies to disclose information about their pay practices. The Rule now mandates further public disclosure by requiring companies to reveal the ratio of their CEO's compensation to the median annual compensation of all other company workers.

Although a company's board of directors determines compensation levels, the CEO Pay Ratio Disclosure Rule embodies a renewed effort to empower shareholders in the process. By requiring companies to disclose more information about their pay practices, regulators believe that shareholders will be in a better position to hold boards accountable for awarding excessive compensation. However, given the limited results of similar regulations, concerns have emerged regarding the disclosure methods employed and whether the current corporate structure of board empowerment will continue to inhibit shareholders from achieving this regulation's intended purpose.

This Note discusses past attempts to combat growing levels of executive compensation, analyzes the role of both shareholders and directors in the compensation-setting process, and discusses conflicting views concerning shareholder-director power, the disclosure mechanism, and the pay-ratio metric. Finally, this Note balances these views by proposing alterations to the CEO Pay Ratio Disclosure Rule that preserve the long-standing corporate structure, while also offering shareholders an accountability mechanism to enhance the Rule's intended results.

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INTRODUCTION

Louis Brandeis coined the phrase, "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."[1] For decades, regulators adhered to this principle in combating a growing national issue: the tremendous rise of executive compensation, and its contribution to the overwhelming income inequality gap in the United States.[2] From the 1940s into the early 1970s, most Americans experienced a broad increase in their quality of living, as executives were compensated at levels proportionate to other workers.[3] However, the income gap began to widen in the 1970s, as growth for middle- and lower-income families did not grow at similar levels to high-income families.[4] The growing compensation disparity between executives and the rest of the working nation over the last fifty years has only exacerbated the call for reform.[5] While in 1965 the CEO-to-worker compensation ratio was only 20 to 1, an Economic Policy Institute study showed that in 2014, the ratio had grown to 303 to 1.[6] Today, a Walmart employee earning $9 per hour must work 1,036 hours to earn the same salary that Walmart's CEO earns in just one hour.[7] Along with these statistics, executive compensation has developed into a "hot-button issue" largely due to the process in which it is determined, as well as public instances of executive pay being uncorrelated with company or personal performance.[8] The most famous example includes the ousting of former Disney president Michael Ovitz, who received a total of $140 million in pay despite being employed for only fourteen months.[9]

Although a company's board of directors determines compensation, regulators have progressively focused on empowering shareholders in the process by providing them with more information about a company's pay

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1. LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (1932).

2. *See* WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 331–42 (4th ed. 2012); *see also* Omari Scott Simmons, *Taking the Blue Pill: The Imponderable Impact of Executive Compensation Reform*, 62 SMU L. REV. 299, 302 (2009) ("No corporate governance issue captures the imagination and frustration of the American public and politicians more than executive compensation.").

3. *See* CHAD STONE ET AL., CTR. ON BUDGET & POLICY PRIORITIES, A GUIDE TO STATISTICS ON HISTORICAL TRENDS IN INCOME INEQUALITY (2016), http://www.cbpp.org/sites/default/files/atoms/files/11-28-11pov_1.pdf ("Incomes grew rapidly and at roughly the same rate up and down the income ladder, roughly doubling in inflation-adjusted terms between the late 1940s and early 1970s.") [https://perma.cc/853K-N3X9].

4. *See id.*

5. *See* discussion *infra* Part I.C.

6. Press Release, Econ. Policy Inst., CEOs Made 303 Times More Than Typical Workers in 2014 (June 22, 2015), http://www.epi.org/press/ceos-made-303-times-more-than-typical-workers-in-2014/ [https://perma.cc/4L2N-EB49].

7. *See* EXECUTIVE PAY WATCH, http://www.aflcio.org/Corporate-Watch/Paywatch-2015# (last visited Nov. 19, 2016) [https://perma.cc/4SW7-P8HP].

8. *See* Lisa M. Fairfax, *Shareholder Democracy on Trial: International Perspective on the Effectiveness of Increased Shareholder Power*, 3 VA. L. & BUS. REV. 1, 10 (2008); *see also* Randall S. Thomas, *Explaining the International CEO Pay Gap: Board Capture or Market Driven?*, 57 VAND. L. REV. 1171, 1182–83 (2004).

9. *See In re* Walt Disney Co. Derivative Litig., 825 A.2d 275, 279 (Del. Ch. 2003).

practices and levels.[10] The latest example is the Securities and Exchange Commission's (SEC) CEO Pay Ratio Disclosure Rule ("the Rule").[11] Adopted in August 2015, and effective in 2018, the final Rule requires public companies to disclose the ratio of the compensation of their CEO to the median compensation of the rest of their employees.[12] The SEC believes that this will provide shareholders with additional information when exercising their say-on-pay votes.[13] Implemented under the 2010 Dodd-Frank Wall Street Consumer Protection Act[14] (Dodd-Frank), say-on-pay votes are *nonbinding advisory* shareholder votes to approve or disapprove of the compensation paid to named executive officers.[15]

Despite increased regulations, executive pay has skyrocketed over the last fifty years.[16] Inadequate results have fostered concerns regarding the federal government's and the SEC's methods in combating this evolving issue. First, a question arises as to whether disclosure is a proper method to aid shareholders and, if so, whether regulations such as the CEO Pay Ratio Disclosure Rule are focusing on the "right" information to disclose. Second, opposing groups debate whether the allocation of power between shareholders and directors in corporate affairs is adequately structured to facilitate shareholder activism in a way that allows them to adequately rectify the pay-setting process.

Part I provides a background of the history of executive compensation, including how it is determined, the role of directors and shareholders in the process, a summary of past regulations, and the basic components of the CEO Pay Ratio Disclosure Rule. Part II then analyzes the shareholder-director power struggle, whether disclosure is an efficient technique to combat this issue, and, specifically, whether the use of a "ratio" is a proper disclosure metric. Lastly, Part III proposes alterations to the pay ratio and compensation-setting process that affirm the necessary powers of the board of directors and also provide shareholders with the mechanisms needed to effectuate meaningful change.

I. EXECUTIVE COMPENSATION: THE WHO, WHAT, WHEN, AND HOW

While many debate its cause and potential consequences for our nation, there has been an undisputed and dramatic rise in executive compensation,

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10. *See infra* Part I.C.

11. Pay Ratio Disclosure, Securities Act Release No. 9877, Exchange Act Release No. 75610, 80 Fed. Reg. 50,104 (Aug. 18, 2015).

12. *See id.*

13. *See* Press Release, SEC, SEC Adopts Rule for Pay Ratio Disclosure (Aug. 5, 2015), http://www.sec.gov/news/pressrelease/2015-160.html [hereinafter Pay Ratio Press Release] [https://perma.cc/SEG7-78JD].

14. Pub. L. No. 111-203, 124 Stat. 1376 (2010).

15. Press Release, SEC, SEC Adopts Rule for Say-on-Pay and Golden Parachute Compensation as Required Under Dodd-Frank Act (Jan. 25, 2011) [hereinafter Say-on-Pay Press Release], https://www.sec.gov/news/press/2011/2011-25.htm [https://perma.cc/KX3A-XLYD].

16. *See infra* Part I.B.

and it has contributed to the income inequality gap in our nation.[17] Part I.A discusses the basics of executive compensation, including its structure, how it is determined, and the power of shareholders in the process. Part I.B then examines the history of executive compensation trends, including the shift toward incentive-based compensation and the emergence of institutional investors as potential "problem solvers." Next, Part I.C discusses various corrective executive compensation reforms adopted by the federal government and the SEC. Finally, Part I.D outlines the basic components of the CEO Pay Ratio Disclosure Rule.

A. Determining Executive Compensation

Although the exact structure differs from company to company, executive compensation generally refers to a manager's total pay package, including base salary, bonuses, stock grants,[18] stock options,[19] and other financial benefits.[20] In public corporations, the board of directors is responsible for setting executive compensation packages on behalf of shareholders.[21] Generally, the board will form a compensation committee composed of independent directors.[22] In crafting compensation packages, the committee relies on hired consultants and experts who provide them with information on common pay practices.[23] One ordinary practice involves utilizing information from "peer groups," which represent companies that are similar in size, market reach, and other relevant factors.[24] Committees ordinarily use the pay practices and levels of these peer groups as a benchmark when structuring their own compensation packages.[25] After the committee evaluates the company's executives and

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17. *See Income Inequality Is America's 21st Century Monster*, VOICE REPORTER (May 6, 2011), http://voiceforthemembersslate.blogspot.com/2011/05/income-inequality-is-americas-21st.html (citing reports suggesting that income inequality in the United States is worse than in countries like Pakistan, Ethiopia, and the Ivory Coast) [https://perma.cc/A3M7-3GTB].

18. Stock grants are a specific number of shares in the company that executives frequently receive at the beginning of the year. *See* ALLEN ET AL., *supra* note 2, at 332.

19. Stock options are commonly known as "call" options. They refer to the right, but not an obligation, to purchase a certain number of shares at a set price. Employees are allowed to exercise this option within a certain period or on a specific date. Holders of stock options typically want to exercise these options when the call price is below the market price. *See Employee Stock Option—ESO*, INVESTOPEDIA, http://www.investopedia.com/terms/e/eso.asp (last visited Nov. 19, 2016) [https://perma.cc/P6LT-KTAU].

20. *See Executive Compensation Resource Center: Overview*, SIFMA, http://www.sifma.org/issues/regulatory-reform/executive-compensation/overview/ (last visited Nov. 19, 2016) [https://perma.cc/Z2RJ-X5S2].

21. *See* Matthew Farrell, *A Role for the Judiciary in Reforming Executive Compensation: The Implications of* Securities and Exchange Commission v. Bank of America Corp., 96 CORNELL L. REV. 169, 173 (2010).

22. *See id.* Generally, directors are "independent" if they are not current or former employees of the company and have no other company affiliations. *See id.* at 173 n.17.

23. *See id.* at 173.

24. Penny Hersher, *Ratcheting up CEO Pay—or Competing for Talent?*, HUFFINGTON POST (May 25, 2011), http://www.huffingtonpost.com/penny-herscher/ratcheting-up-ceo-pay---o_b_272218.html [https://perma.cc/6WEN-VFZU].

25. *See* Peter Whoriskey, *Cozy Relationships and "Peer Benchmarking" Send CEOs' Pay Soaring*, WASH. POST (Oct. 3, 2011), http://www.washingtonpost.com/business/

determines appropriate pay levels, the board reviews it and officially has the final say.[26] However, the board usually approves this package "as a routine matter without much inquiry."[27]

Directors acquire the authority to make corporate governance decisions, such as setting executive compensation levels, from the Delaware Code. Title 8, section 141 states that "[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors."[28] This provides the board with tremendous discretion to control corporations and make decisions independent from shareholders. Corporate law provides shareholders with voting rights only in limited instances: (1) electing the board of directors;[29] (2) removing the directors;[30] (3) voting on charter amendments;[31] and (4) voting on fundamental corporate changes, such as a merger agreement[32] or the sale of a certain amount of company assets.[33] Therefore, the only way for shareholders to currently exert any influence on this issue is by removing directors who award excessive pay packages.

First, shareholders may replace board members at the annual shareholder meeting if another candidate obtains the plurality votes needed,[34] unless a bylaw or charter provision specifies otherwise.[35] Nevertheless, only candidates nominated by the board itself are included in the company's proxy materials.[36] Shareholders nominating an alternate candidate

economy/cozy-relationships-and-peer-benchmarking-send-ceos-pay-soaring/2011/09/22/gIQAgq8NJL_print.html (noting that "researchers have found that about 90 percent of major U.S. companies expressly set their executive pay targets at or above the median of their peer group") [https://perma.cc/EC88-JZ46].

26. *See* Farrell, *supra* note 21, at 173.

27. Randall S. Thomas & Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CIN. L. REV. 1021, 1027 (1999).

28. DEL. CODE ANN. tit. 8, § 141(a) (2016).

29. *Id.* § 211(b). This is done at an annual stockholder meeting on a date and time specified in the corporation's bylaws. *See id.*

30. *Id.* § 141(k). Unless specified differently in a corporation's charter, shareholders may remove any director, with or without cause, through a majority vote at an annual shareholder meeting. *See id.*

31. *Id.* § 242(a). Shareholders may vote to amend provisions in the charter only after the board of directors passes a resolution setting forth the proposed amendment. *See id.* § 242(b)(1).

32. *Id.* § 251(c). Shareholders may vote on merger agreements only after the board of directors approves the merger, and the shareholders are not subject to the exceptions listed in section 251(f). *See id.*

33. *Id.* § 271(a).

34. *Id.* § 216(3).

35. Altering the shareholder votes needed contrary to the plurality rule requires a charter or bylaw provision pursuant to section 216 of the Delaware Code. *See id.*

36. *See* Michael S. Kang, *Shareholder Voting as Veto*, 88 IND. L.J. 1299, 1305 (2013). Proxy materials are "documents [that] are used to inform shareholders and solicit votes for corporate decisions, such as the election of directors . . . . SEC regulations require a public company to disclose specific information in its proxy materials, so that investors can be clear on the procedures to follow in certain circumstances." *Proxy Materials*, INVESTOPEDIA, http://www.investopedia.com/terms/p/proxymaterials.asp (last visited Nov. 19, 2016) [https://perma.cc/EG35-4UZG].

therefore bear the costs of independent proxy solicitations.[37] If the board is staggered,[38] shareholders may not replace a director who is not up for election at the annual shareholder meeting.[39] Second, any director may be removed with or without cause by a majority shareholder vote.[40] However, directors on a staggered board may be removed only for cause.[41]

Subject to various limitations, shareholders may submit rule proposals on issues such as executive compensation, which are then required to be voted on under SEC Rule 14a-8.[42] When voting on these proposals, or those submitted by managers or other shareholders, votes are required in the form of either approval or rejection without allowing for commentary or suggestions.[43]

B. More Money, More Problems: The Rise of Executive Compensation and Performance-Based Pay

The last fifty years have witnessed the explosion of executive pay levels, the evolution of incentive-based compensation[44]—including its failure to link pay to performance—and its contribution to income inequality. Overall, inflation-adjusted CEO compensation increased 997 percent from 1978 to 2014.[45] Given that a typical worker's annual compensation grew by only 10.9 percent during the same period, it is apparent why public scrutiny of this issue has increased.[46] Despite the stock market's decline by roughly half between 1965 and 1978, CEO annual compensation still increased by 78.7 percent.[47] This general trend continued as CEO compensation grew progressively in the 1980s, exploded in the 1990s, and peaked in 2000.[48]

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37. *See* Kang, *supra* note 36, at 1306–07. They must pay for proxy materials to be mailed to shareholders. *See id.*

38. "If a staggered board is chosen, the directors shall be divided into two or three classes as nearly equal in number as possible and one class shall be elected by ballot annually." 12 C.F.R. § 239.27(b) (2014).

39. *See* DEL. CODE ANN. tit. 8, § 141(a).

40. *Id.* § 141(k).

41. *Id.* § 141(k)(1).

42. *See* 17 C.F.R. § 240.14a-8.

43. *See* Kang, *supra* note 36, at 1307.

44. Incentive-based compensation is synonymous with performance-based compensation.

45. Alyssa Davis & Lawrence Mishel, *CEO Pay Continues to Rise as Typical Workers Are Paid Less*, ECON. POL'Y INST. 1, 3–4 (June 21, 2015), http://www.epi.org/files/2015/top-ceos-make-300-times-more-than-typical-workers.pdf [https://perma.cc/C6VD-9GB2].

46. *See id.*; *see also* David Owen, *The Pay Problem: What's to Be Done About C.E.O. Compensation?*, NEW YORKER (Oct. 12, 2009), http://www.newyorker.com/magazine/2009/10/12/the-pay-problem [https://perma.cc/MLC6-KNCK].

47. *See* Davis & Mishel, *supra* note 45, at 3–4.

48. *See id.*; Carola Frydman & Raven E. Saks, *Executive Compensation: A New View from a Long-Term Perspective, 1936–2005*, at 1 (Nat'l Bureau of Econ. Research, Working Paper No. 14145, 2008), http://www.nber.org/papers/w14145.pdf [https://perma.cc/9HHF-YVUU].

Up until the late 1980s, CEOs and other top executives were typically compensated like all other employees in their companies.[49] Their compensation was comprised of an annual salary and a discretionary bonus.[50] Yet, despite decreases in company profits, most executive salaries and bonuses continued to grow.[51] Because CEOs and top executives received large salaries regardless of corporate performance, compensation structures at the time provided little incentive for them to expend maximum effort to enhance shareholder profits, the primary goal of any business or corporation.[52] In response to increased public pressure to correlate executive pay with performance, boards began compensating executives in the form of stock grants and, to a greater extent, stock options.[53] Boards viewed these performance-based pay structures as a way to align the goals of executives and shareholders, thereby mitigating agency problems.[54] The harder executives worked to maximize the profits of shareholders, the more the stock grants and options awarded to them would be worth.[55] While only 30 percent of CEOs received stock option awards during the 1980s, this number rose to roughly 70 percent by 1994.[56] Nonetheless, incentive-based pay did little to alleviate, and may have even exacerbated, problems of uncorrelated pay and performance. Surveys indicate that from 1991–1993, CEOs at the largest U.S. corporations earned $2.4 million, $3.5 million, and $4.1 million in those respective years.[57] By 2000, the average CEO earned approximately $20 million,[58] with large companies such as Enron paying their top five executives a staggering total of $282.7 million.[59]

After peaking in 2000, pay fluctuations occurred due to the rise and fall of the stock market.[60] After an initial decline in CEO pay in the early

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49. *See* ALLEN ET AL., *supra* note 2, at 331.

50. *See id.*

51. Graef S. Crystal, *How Much CEOs Really Make*, FORTUNE (June 17, 1991), http://archive.fortune.com/magazines/fortune/fortune_archive/1991/06/17/75159/index.htm [https://perma.cc/C6L4-82MQ].

52. *See* Lori B. Marino, Comment, *Executive Compensation and the Misplaced Emphasis on Increasing Shareholder Access to the Proxy*, 147 U. PA. L. REV. 1205, 1212–13 (1999).

53. *See* ALLEN ET AL., *supra* note 2, at 332; *see also* Graef Crystal, *CEOs and Incentives: The Myth of "Pay-for-Performance*,*"* L.A. TIMES (Jan. 8, 1995), http://articles.latimes.com/1995-01-08/business/fi-17839_1_pay-package [https://perma.cc/CP5F-VTR9].

54. For a discussion on agency problems, see *infra* Part II.A.

55. *See, e.g.*, Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q.J. ECON. 653, 653–54 (1998) ("If there is no meaningful link between CEO pay and company performance, it is doubtful that the trillions of dollars of assets in public corporations are being managed efficiently.").

56. *See id.* at 663. Over this same period, the average value of a stock option grant rose 683 percent, from $155,000 to $1,200,000. *See id.* at 662.

57. *See* Marino, *supra* note 52, at 1210.

58. *See* Davis & Mishel, *supra* note 45, at 3.

59. *See* Dan Ackman, *Pay Madness at Enron*, FORBES (Mar. 22, 2002), http://www.forbes.com/2002/03/22/0322enronpay.html [https://perma.cc/5WRC-2TUL].

60. *See generally* Rick Newman, *The CEO "Pay Gap" Is Actually Narrowing*, U.S. NEWS & WORLD REP. (Apr. 17, 2013), http://www.usnews.com/news/blogs/rick-

2000s, pay levels bounced back in 2007.[61] A similar recovery occurred in 2014 following the 2008 financial crisis.[62] Although executive pay currently remains below the peak levels of the early 2000s, it still remains substantially higher than levels reported before the turn of the century.[63] Furthermore, stock options still make up the largest component of the average large company's CEO pay package today.[64]

C. Disclosure-Related Executive Compensation Reforms

Part I.C.1 discusses the history and development of SEC regulations designed to curb growing executive compensation levels. Part I.C.2 then examines similar actions taken by the federal government.

1. SEC Regulations: Securities Act, Exchange Act, and Subsequent Revisions

Since 1933, regulators have implemented the philosophy of disclosure in most, if not all, executive compensation regulations. The SEC maintains that it is not its duty to regulate and determine the "right" level of compensation for executives but rather that this responsibility lies with the compensation committee of the board of directors.[65] Despite these assertions, the SEC has enacted various regulations with the purpose of "advanc[ing] the interests of shareholders through better disclosure."[66] Although they do not directly influence pay levels, shareholders may, in theory, replace directors who they believe award excessive compensation packages.[67] Requiring companies to disclose information about executive

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newman/2013/04/17/the-ceo-pay-gap-is-actually-narrowing (discussing how the pay gap narrowed in the early 2000s but has since recovered) [https://perma.cc/8D2J-KXXA].

61. *See* Davis & Mishel, *supra* note 45, at 4.

62. *See id.* at 6 (noting that by 2014, the CEO-to-worker compensation ratio also recovered to 303.4 to 1, a rise of 107.6 from 2009).

63. *See id.* Accompanying the tremendous rise of executive compensation has been the development of institutional investors (insurance companies, pension funds, hedge funds, mutual funds, investment advisors, etc.) as shareholders. *See generally* John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991) (discussing the rise of institutional investors in the 1980s). While these investors owned only 7 to 8 percent of U.S. corporations in 1950, by 2010 this level reached 67 percent, with many owning 2 to 3 percent of a single corporation. *See* Luis A. Aguilar, Comm'r, SEC, Institutional Investors: Power and Responsibility, Speech at Georgia State University (Apr. 19, 2013), http://www.sec.gov/News/Speech/Detail/Speech/1365171515808 [https://perma.cc/GFR7-W7RU]. Today, institutional investors are responsible for roughly 70 percent of the trading on the New York Stock Exchange within a given day. *Institutional Investors*, BUSINESSDICTIONARY, http://www.businessdictionary.com/definition/institutional-investors.html (last visited Nov. 19, 2016) [https://perma.cc/W9VP-CCUS].

64. *See* David I. Walker, *The Manager's Share*, 47 WM. & MARY L. REV. 587, 661 (2005).

65. Christopher Cox, Chairman, SEC, Speech by SEC Chairman: Introductory Remarks at the SEC Open Meeting (July 26, 2006), https://www.sec.gov/news/speech/2006/spch072606cc.htm [https://perma.cc/6F34-QWBT].

66. *Id.*

67. *See supra* Part I.A.

compensation levels therefore provides shareholders greater insight into the decisions of these directors.

As one of the architects of the Securities Act of 1933 ("the Securities Act"), Felix Frankfurter stated that "[t]he existence of bonuses, of excessive commissions and salaries . . . may all be open secrets among the knowing, but the knowing are few."[68] Following the 1929 Great Depression, in which thousands of employees were laid off, corporate executives increased their salaries to compensate for a reduction in profit-based bonuses.[69] In response to the economic turmoil, Congress passed the Securities Act and the Securities Exchange Act of 1934 ("the Exchange Act"). Although both addressed a multitude of issues, Congress hoped that its executive compensation sections would shame executives into accepting lower pay.[70] For example, section 14 of schedule A of the Securities Act requires public companies to disclose the compensation of officers and directors for the prior year and the year following an offering if such compensation exceeds $25,000.[71]

The SEC expanded their regulations in 1938 by enacting the first executive compensation disclosure rules for proxy statements.[72] In 1942, 1952, 1978, and 1983, the SEC continuously revised several disclosure requirements, including shifting disclosure from a tabular to a narrative approach.[73] Unlike the tabular approach, which requires companies to disclose hard numbers, the narrative approach requires an explanation of a company's pay policies.[74] However, the difficulty in comparing compensation levels from year to year and company to company became an obstacle under the narrative form.[75] The SEC responded by significantly revising its requirements in 1992 to combine both approaches.[76] First, in an effort to obtain more detailed information, the SEC established new rules requiring companies to disclose the compensation of their CEO and top four highest paid executives in tabular form.[77] Second, the compensation committee was required to describe and explain their compensation decisions in narrative form.[78] The purpose of these amendments was to provide shareholders with knowledge of compensation forms, the method

68. Jerry W. Markham, *Regulating Executive Compensation—Why Bother?*, 2 J. BUS. & TECH. L. 277, 284 (2007) (quoting Felix Frankfurter, *Securities Act—Social Consequences*, FORTUNE, Aug. 1933, at 55).

69. *See id.* at 284–85.

70. *See id.* at 278 (commenting that the opposite effect occurred).

71. 15 U.S.C. § 77aa(14) (2012).

72. *See* Executive Compensation and Related Person Disclosure, Securities Act Release No. 8732A, Exchange Act Release No. 54302A, Investment Company Act Release No. 27444A, 71 Fed. Reg. 53,158, 53,160 n.44 (Sept. 8, 2006).

73. *See* Markham, *supra* note 68, at 285.

74. *See* Executive Compensation and Related Person Disclosure, 71 Fed. Reg. at 53,160.

75. *See id.* at 53,161.

76. *See* Markham, *supra* note 68, at 285.

77. *See* Executive Compensation Disclosure, Securities Act Release No. 6962, Exchange Act Release No. 31327, Investment Company Act Release No. 19032, 57 Fed. Reg. 48,126, 48,127 (Oct. 21, 1992); ALLEN ET AL., *supra* note 2, at 335–36.

78. *See* Executive Compensation Disclosure, 57 Fed. Reg. at 48,127; ALLEN ET AL., *supra* note 2, at 336.

the board used in reaching their decisions, and the relationship between corporate pay and performance.[79]

As more complex pay structures emerged, the SEC observed that the 1992 requirements failed to account for all of the elements of compensation that companies began using.[80] To rectify these failures, the SEC amended the rules in 2006 by calling for companies to provide a single number demonstrating the compensation for each of their top executives.[81] They additionally created the Executive Compensation Disclosure Rule, requiring companies to disclose a Compensation Discussion and Analysis (CD&A) in narrative form.[82] The CD&A requires companies to give context to the mandatory tabular disclosure of compensation numbers by also compelling them to provide (1) the objectives of the compensation program, (2) an explanation of what the compensation program is designed to reward, (3) each element of compensation, (4) the rationale for using each element, (5) how the company determines the amount of each element, and (6) how these choices fit the compensation objectives as a whole.[83] The SEC believed that these modifications would be effective in adapting to a continuously evolving marketplace.[84]

2. Federal Statutes to Curb Compensation

In recent years the federal government has joined the SEC's mission by enacting various statutes containing executive compensation provisions. Although not focused solely on this issue, they include important components that regulators believed would aid in curtailing high pay levels. Part I.C.2.a discusses the Sarbanes-Oxley Act (SOX), and Part I.C.2.b outlines various provisions of Dodd-Frank.

a. Knock Your SOX Off

Congress passed SOX in July 2002[85] in response to various corporate and accounting scandals that cost investors billions of dollars.[86] Although it

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79. *See* Executive Compensation Disclosure, 57 Fed. Reg. at 48,126.

80. *See* Executive Compensation and Related Person Disclosure, 71 Fed. Reg. at 53,160. The rigid requirements of 1992 were incompatible with the emerging complexity of compensation packages. *See* Christopher Cox, Chairman, SEC, Speech By SEC Chairman: Chairman's Opening Statement; Proposed Revisions to the Executive Compensation and Related Party Disclosure Rules (Jan. 17, 2006), https://www.sec.gov/news/speech/spch011706cc.htm [https://perma.cc/586R-KXEE].

81. *See* ALLEN ET AL., *supra* note 2, at 336.

82. *See* Executive Compensation and Related Party Disclosure, Securities Act Release No. 8655, Exchange Act Release No. 53185, Investment Company Act Release No. 27218, 71 Fed. Reg. 6,542, 6,545 (Feb. 8, 2006).

83. 17 C.F.R. § 229.402 (b)(1)(i)–(vi) (2014).

84. *See* Cox, *supra* note 80 (noting that the rules were "out of date").

85. Pub. L. No. 107-204, 116 Stat. 745 (2002).

86. *See* Linda Chatman Thomsen & Donna Norman, *Sarbanes-Oxley Turns Six: An Enforcement Perspective*, 3 J. BUS. & TECH. L. 393, 394 (2008) ("The story behind [SOX] begins with the fraud at Enron Corporation, which led to its December 2001 filing of what was then the largest bankruptcy in U.S. history.").

focused mostly on auditing practices, it federalized provisions for forfeiting executive pay.[87] Section 304, commonly known as the "clawback" provision, provides that if an issuer restates its financials due to excessive misconduct, the CEO and CFO are required to pay back any bonuses (incentive or equity-based), and trading profits earned in the twelve months following the incorrect financial information.[88]

However section 304 does not specify what degree of misconduct is necessary to trigger the regulation, it only governs the recoupment of compensation paid to CEOs and CFOs, and it does not specify that the CEO or CFO be involved in or have knowledge of the misconduct.[89] This ambiguity has generated criticisms that were highlighted most notably in *SEC v. Jenkins*.[90] Although the SEC admitted that the former chairman and CEO of CSK Auto Corporation did not engage in personal misconduct, it sought reimbursement of $4 million from him because he signed off on fraudulent financial statements.[91] Based on a plain language reading of the statute, the District Court of Arizona held that a CEO could be liable for a company's fraudulent financial statements without committing any misconduct or violating any securities law.[92] In other words, section 304 imposes "vicarious strict liability" on CEOs and CFOs.[93]

b. Dodd-Frank Wall Street Reform and Consumer Protection Act

Congress augmented its response to executive compensation and income disparity problems by passing Dodd-Frank in 2010.[94] Dodd-Frank targets four specific reforms aimed at providing greater transparency and accountability on executive compensation: clawbacks, say-on-pay, compensation committee independence, and pay versus performance disclosure.[95]

87. *See* Simmons, *supra* note 2, at 328.

88. 15 U.S.C. § 7243(a) (2012). The term "issuer" refers to the corporation issuing the bonus.

89. *See id.*

90. 718 F. Supp. 2d 1070 (D. Ariz. 2010).

91. *See id.* at 1072–73.

92. *See id.* at 1075 ("Applying these steps of statutory interpretation, the Court holds that the text and structure of Section 304 require only the misconduct of the issuer, but do not necessarily require the specific misconduct of the issuer's CEO or CFO.").

93. *See* Isaac U. Kimes, *Unfettered Clawbacks—Why Section 304 of the Sarbanes-Oxley Act Requires a Personal Misconduct Standard*, 42 U. MEM. L. REV. 797, 813 (2012).

94. *See* Kathleen L. Casey, Comm'r, SEC, Speech by SEC Commissioner: Remarks Before the Forum for Corporate Directors (Mar. 22, 2011), https://www.sec.gov/news/speech/2011/spch032211klc.htm ("Dodd-Frank is more than ten times longer, and mandates more than ten times the rulemakings and studies that [SOX] required.") [https://perma.cc/WSY2-AV9X].

95. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010); *see also* Jill E. Fisch, *Leave It to Delaware: Why Congress Should Stay out of Corporate Governance*, 37 DEL. J. CORP. L. 731, 734 (2013) ("Congress made a deliberate determination that the financial crisis had exposed shareholders' inability to ensure management accountability.").

Section 954 clarified and added a more stringent clawback requirement than SOX in three important ways. First, it extended the look-back period from twelve months to three years.[96] Second, it broadened the scope of clawbacks beyond just the CEO and CFO to include any current or former executive.[97] Third, it clarified SOX's ambiguity by mandating that evidence of misconduct is no longer required.[98] Therefore, incentive-based compensation such as stock options can be recovered regardless of whether executive misconduct was involved in a company's material noncompliance with financial reporting requirements.

Additionally, section 951 mandated the creation of say-on-pay, an advisory shareholder vote on executive compensation.[99] It currently mandates that public companies must give their shareholders an *advisory* vote—at least once every three years based on shareholder preference—to approve or disapprove of the compensation paid to their CEOs and four highest earning executives during the prior fiscal year.[100] The mandate's primary purpose is to empower shareholders to hold executives accountable for compensation schemes that they reject.[101] However, Dodd-Frank ensures that no shareholder vote is able to overrule decisions made by the company or its board.[102] In other words, none of the shareholder votes carry mandatory force.[103] Companies must instead only reveal the board's consideration of shareholder votes when making any decisions the following year.[104]

Adopted to strengthen the objectivity of compensation committees, section 952 now requires all publicly traded U.S. companies to comprise their committees of directors who are independent.[105] Boards must now consider whether any directors (1) received any additional fees beyond just director fees and (2) have any affiliations with the company or a related subsidiary.[106]

Lastly, section 953 enhanced the 2006 SEC executive compensation regulations by requiring companies to disclose the relationship between executive compensation actually paid and the financial performance of the company, taking into account changes in the value of shares of stock and

96. 15 U.S.C. § 78j-4 (2012).
97. *Id.*
98. *See id.*
99. *Id*. § 78n-1. The SEC adopted Rule 14a-21(a) and other rules on January 25, 2011. Say-on-Pay Press Release, *supra* note 15.
100. 15 U.S.C. § 78n-1(a)(1).
101. *See* Fisch, *supra* note 95, at 734, 737.
102. 15 U.S.C. § 78n-1(c)(1)–(3).
103. However, this does not prohibit shareholders from making their own proposals through proxy materials. *See id.* § 78n-1(c)(4).
104. *See* Shareholder Approval of Executive Compensation and Golden Parachute Compensation, Securities Act Release No. 9178, Exchange Act Release No. 63768, 76 Fed. Reg. 6010, 6016 (Feb. 2, 2011).
105. *See* 15 U.S.C. § 78j-3.
106. *See id.* § 78j-3(a)(3).

dividends.[107] Section 953 additionally mandated the SEC to adopt the CEO Pay Ratio Disclosure Rule.[108]

D. CEO Pay Ratio Disclosure Rule

In accordance with their congressional mandate, the SEC adopted the CEO Pay Ratio Disclosure Rule on August 18, 2015.[109] Effective in 2018, the final Rule requires public companies to (1) disclose the annual total compensation of their CEO, (2) report the median of the annual total compensation of all other employees, and (3) provide the ratio of the annual total compensation of all employees to the annual total compensation of the CEO.[110] The SEC believes that this new regulation will strike an appropriate balance that aids both companies and shareholders.[111] First, it asserts that the Rule will assist shareholders during their say-on-pay votes because it provides them with additional information when evaluating a CEO's compensation.[112] The SEC additionally maintains that the Rule provides companies with sufficient flexibility in determining their pay ratios that will reduce compliance costs.[113]

Companies subject to the Rule are permitted to select any date within the final three months of their last fiscal year to determine its employee population.[114] Those defined as "employees" within the meaning of the final Rule include U.S. and foreign employees, as well as part-time, seasonal, and temporary employees.[115] Companies are allowed to exclude foreign employees from their median employee determination only under a data privacy exception or a de minimis exception.[116]

The Rule does not require companies to use a specific methodology when identifying the median of their employee population.[117] Rather, companies retain flexibility to calculate the median based on their particular structure

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107. *See id.* § 78n(i).

108. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1903–04 (2010).

109. Pay Ratio Disclosure, Securities Act Release No. 9877, Exchange Act Release No. 75610, 80 Fed. Reg. 50,104, 50,104 (Aug. 18, 2015).

110. *See id.* at 50,104–05. This requirement does not apply to emerging growth companies, smaller reporting companies, or foreign issuers. *See id.* at 50,108.

111. *See* Pay Ratio Press Release, *supra* note 13.

112. *See* Pay Ratio Disclosure, 80 Fed. Reg. at 50,106 (asserting that the pay-ratio rule will generate shareholder engagement in executive compensation issues because it provides shareholders with a company-specific metric to evaluate the CEO's compensation within the context of the company).

113. *See* Pay Ratio Press Release, *supra* note 13.

114. *See* Pay Ratio Disclosure, 80 Fed. Reg. at 50,119.

115. *See id.* at 50,116.

116. Under a data privacy exception, companies can exclude foreign employees when the rule would violate the laws of the foreign country in which the non-U.S. employee works. Under a de minimis exception, companies may do so if non-U.S. employees make up 5 percent or less of the company's total employee population. *See id.* at 50,123–35.

117. *See id.* at 50,135. Companies may identify the median using their total employee population or a statistical sampling of that population. *See id.* They may then calculate the median through options such as annual total compensation or information derived from tax and payroll records. *See id.* Companies also may apply a cost-of-living adjustment to the compensation measure. *See id.*

and business methods.[118] They are required, however, to describe the methodology that they use.[119] Although the SEC recognized potential complexities without a uniform procedure, it believed that providing companies with flexibility would reduce costs while simultaneously aligning the Rule with the goals of section 953(b) of Dodd-Frank.[120]

The final Rule defines "annual total compensation" to mean total compensation for the last completed fiscal year in accordance with Item 402(c)(2)(x) of Regulation S-K.[121] This includes compensation in the form of salary, bonuses, stock awards and options, contributions to retirement plans, and other contributions to personal benefits.[122] Although Item 402(c)(2)(x) is ordinarily used for calculating the compensation of only CEOs and other named executives, applying it to all other employees ensures consistent results. In accordance with granting companies adequate flexibility, the Rule allows for reasonable estimates in calculating any element of total compensation.[123]

II. CONFLICTS WITHIN CONFLICT: SEARCHING FOR THE RIGHT FORMULA WITHIN THE EXECUTIVE COMPENSATION DILEMMA

Recent executive compensation reforms have concentrated on empowering shareholders through increased disclosure. While some view enhanced shareholder power as a necessary solution for corporate governance reform, others are wary of its dangerous deviation from long-established corporate law principals. Part II.A begins with a discussion of the principal-agent problem that is central to this schism among executive compensation reformers. Part II.B then discusses conflicting positions regarding the proper allocation of power between shareholders and the board of directors. Part II.C addresses whether the SEC's method of enhancing disclosure is a proper means of empowering shareholders. Lastly, assuming the benefits disclosure provides, Part II.D analyzes whether the innovation of a "pay ratio" is a beneficial disclosure metric for shareholders.

A. The Principal-Agent Problem

Various scholars commenting on rising executive pay agree with the premise that "[a]ny discussion of executive compensation must proceed

118. *Id.* at 50,107 ("[The rule] permit[s] registrants to select a methodology for identifying the median employee that was appropriate to the size and structure of their business and the way they compensate employees.").

119. *See id.*

120. *See id.*

121. *See id.* at 50,108. Item 402(c)(2)(x) requires companies to disclose extensive information regarding their CEO's and other named executive officers' compensation. *See id.* at 50,107.

122. *See* Stephen Miller, *Determining CEO Pay Ratio Isn't So Simple*, SOC'Y HUM. RESOURCE MGMT. (Aug. 7, 2015), http://www.shrm.org/hrdisciplines/compensation/articles/pages/ceo-pay-ratio.aspx [https://perma.cc/4B9Q-HFGV].

123. *See* Pay Ratio Disclosure, 80 Fed. Reg. at 50,107–08.

against the background of the fundamental agency problem afflicting management decision-making."[124] An agency relationship is one "that arises when one person ('a principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control."[125] Therefore, agents have power to make decisions that affect the principal so long as they are within the scope of their delegated authority.[126] In an ideal world, agents would always act and make decisions that align with the goals of their principal. However, we know that this is not always the case. Principals therefore incur agency costs to assure that suboptimal decisions are not being made.[127] The principal may expend resources to monitor the agent or provide him or her with certain incentives to assure conformity to his or her goals.[128]

In the context of corporations, shareholders are principals who delegate authority to both directors and managers as their agents.[129] Shareholders' goals of maximizing profits and gaining positive investment returns have dominated corporate America for decades.[130] Nonetheless, because the board is vested with the power to manage the corporation's business and affairs, shareholders are unable to ensure that day-to-day decisions are made with this goal in mind.[131] They therefore elect and hire directors and managers who they believe will do so.[132] Directors and managers would do just that under an efficient model. However, as rational actors, we also expect them to strive to maximize their own utility, sometimes to the detriment of shareholder interests.[133] Because managers do not have a major ownership stake in the corporation, if any at all, they therefore bear only a small fraction of the results from their self-interested decisions, leaving shareholders to bear the majority of the consequences.[134] This creates a greater incentive for managers to pursue their own economic

124. Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP. 71, 72 (2003).

125. RESTATEMENT (THIRD) OF AGENCY § 1.01 (AM. LAW INST. 2006).

126. *See* ALLEN ET AL., *supra* note 2, at 8.

127. *See* Lucian A. Bebchuk & Jesse M. Fried, Pay Without Performance*: Overview of the Issues*, 30 J. CORP. L. 647, 654–55 (2005).

128. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

129. *See id.* at 309 (defining the relationship between stockholders and managers of a corporation as a "pure agency relationship").

130. *See* Jia Lynn Yang, *Maximizing Shareholder Value: The Goal That Changed Corporate America*, WASH. POST (Aug. 26, 2013), http://www.washingtonpost.com/business/economy/maximizing-shareholder-value-the-goal-that-changed-corporate-america/2013/08/26/26e9ca8e-ed74-11e2-9008-61e94a7ea20d_story.html [https://perma.cc/S9XB-MV3J].

131. *See* Mark Anson et al., *Aligning the Interests of Agents and Owners: An Empirical Examination of Executive Compensation*, IVEY BUS. J. (May–June 2004), http://iveybusinessjournal.com/publication/aligning-the-interests-of-agents-and-owners-an-empirical-examination-of-executive-compensation/ [https://perma.cc/UT39-GZGJ].

132. *See* Jenson & Meckling, *supra* note 128, at 308–09.

133. *See id.* at 308.

134. *See* Anson et al., *supra* note 131.

motives without considering the detrimental effects it may have on shareholders.[135]

It is argued that this principal-agent dilemma is the cornerstone of executive compensation problems.[136] Two approaches, as well as their shortcomings, have emerged to analyze this dilemma: the optimal contracting approach and the managerial power approach. Under the optimal contracting approach, boards strive to craft compensation packages that minimize agency costs and create a tighter link between the goals of shareholders and managers.[137] Boards focus on developing compensation structures that encourage managers to maximize the value of the company and overall shareholder wealth.[138] The emergence and modernization of stock-option compensation was seen as a way to achieve this goal.[139] Yet not only did these compensation schemes fail to assuage agency concerns, but perhaps unexpectedly they contributed to the rising levels of executive compensation.[140] Critics assert that their failures, and the limitations of the optimal contracting approach, stem from the idea that something is obstructing directors from negotiating at arm's length with management during the compensation-setting process.[141] Although incentive-based compensation may alleviate agency problems between shareholders and managers, such problems may still exist among shareholders and directors.[142] Most directors serving on compensation committees have previously held positions as executives at other companies.[143] Because these directors may therefore have goals more aligned with managers than shareholders, they may be more inclined to award higher compensation packages.[144]

The managerial power approach also highlights the failures of the compensation-setting process by emphasizing the ability of managers to influence their own compensation by "capturing" the board and extracting rent.[145] Corporate managers and executives generally have substantial

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135. *See id.*

136. *See, e.g.*, Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002).

137. *See id.* at 753 n.4 (describing the optimal contracting approach "taken by an important line of legal scholarship").

138. *See* Troy A. Paredes, *Too Much Pay, Too Much Deference: Behavioral Corporate Finance, CEOs, and Corporate Governance*, 32 FLA. ST. U. L. REV. 673, 704 (2005).

139. *See* Bebchuk & Fried, *supra* note 124, at 82; *see also* Paredes, *supra* note 138, at 704 ("The redesign of options . . . is the very kind of executive compensation innovation that the optimal contracting approach anticipates.").

140. *See supra* Part I.B.

141. *See* Jennifer S. Martin, *The House of Mouse and Beyond: Assessing the SEC's Efforts to Regulate Executive Compensation*, 32 DEL. J. CORP. L. 481, 486 (2007).

142. *See generally* Mary-Hunter Morris, *The Price of Advice*, 86 U. DET. MERCY L. REV. 153 (2009) (discussing the diverging interests of shareholders and directors).

143. *See id.* at 164.

144. *See* Bebchuk & Fried, *supra* note 127, at 656.

145. *See* Bebchuk et al., *supra* note 136, at 786. Rents are the excess of pay obtained by an executive through his power over what he or she would have obtained under optimal contracting. *See id.* at 784–86.

power.[146] They are therefore in a superior position to garner the board's support and influence their own pay.[147] Although directors may remove an underperforming manager or CEO, directors have a tendency to defer to their judgments when they are performing adequately.[148] This approach posits that the only limitations on compensation are "outrage costs and constraints" based on how much scrutiny a compensation package is expected to drawn from shareholders and the public.[149] Directors will avoid embarrassment or reputational harm by disapproving compensation packages that may result in public backlash.[150] Without this check, managers would be able to exert unconstrained influence on directors to provide them with the greatest compensation packages possible.

B. The Power Struggle Between Shareholders and Directors

The power struggle between shareholders and directors in corporate governance affairs has emerged as a potential cause of ineffective executive compensation reform. Shareholder primacists assert that the current corporate structure inhibits shareholders from effectuating any positive change on important issues and that the allocation of power should be altered to reflect the rise of institutional investors as beneficial contributors in corporate governance affairs. In contrast, director primacists affirm the settled U.S. corporate law principle that decision-making authority is properly vested in the board of directors.[151] They justify this assertion based on the director primacy theory and team production theory. This section discusses these opposing positions.

1. Shareholder Democracy and Institutional Investor Promise

The most fundamental argument advocating for enhanced shareholder power is the contention that the current corporate structure hinders shareholders' ability to become influential contributors in corporate affairs.[152] Given the board's broad managerial power, shareholders have only two options when they disagree with director decisions: replace these directors or veto those decisions that require a shareholder vote.[153] Shareholders face obstacles when asserting both of these powers.[154]

146. *See id.* at 784.
147. *See id.* at 784–86.
148. *See id.*
149. *See id.* at 786.
150. *See id.*
151. *See, e.g.*, Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1736 (2006) (arguing that the present regime of limited shareholder voting is proper).
152. *See* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 851–65 (2005).
153. *See supra* Part I.A.
154. *See generally* Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43 (2003) (arguing that although shareholder power to replace directors is vital to corporate governance, it is largely a myth).

The emergence of staggered boards has inhibited shareholders' ability to replace directors who they believe are not adequately making decisions that maximize shareholder value.[155] Under a "unitary board," shareholders have an opportunity to replace an entire board of directors during one election.[156] When boards are staggered, shareholders must win two elections just to obtain majority control.[157] Additionally, shareholders wishing to repeal these staggered boards have had little success due to the lack of response from management.[158] Shareholders wishing to nominate alternative director candidates face substantial costs and difficulties because those who run a proxy contest bear the costs of a director campaign themselves.[159]

Shareholder primacists also assert that the right to veto only major corporate decisions initiated by the board does not comport with the goal of maximizing company and shareholder value.[160] The veto power ensures that major changes will never be made to the detriment of the company and its shareholders.[161] Yet, because only the board can make corporate governance proposals, this power becomes essentially useless when the board prefers the status quo in spite of shareholders' desire for change.[162] Shareholders are therefore stuck until the board proposes something. Even where both shareholders and directors agree that major changes are necessary, the changes actually implemented will likely reflect board, rather than shareholder, preference.[163] Consequently, unless shareholders are given power to initiate "rules-of-the-game decisions," inefficient governance arrangements will likely result.[164] In sum, shareholder primacists maintain that unless significant reforms to the corporate elections process are undertaken, shareholders will be unable to replace a board of directors whom they feel are constructing excessive compensation packages or will be prevented from altering the company's rules in a beneficial way.

Many corporate governance problems, including executive compensation, exist due to dispersed ownership.[165] As a company's ownership structure becomes composed of additional investors, it becomes increasingly difficult for any particular shareholder to influence the

155. *See* Bebchuk, *supra* note 152, at 853.

156. *See* Bebchuk, *supra* note 154, at 44.

157. *See* Bebchuk, *supra* note 152, at 853.

158. *See, e.g.*, *id.* at 853–56 (providing statistics showing that management generally does not follow resolutions to repeal staggered boards).

159. *See id.* at 856.

160. *See id.* at 862–65; *see also supra* notes 36–37 and accompanying text.

161. *See* Bebchuk, *supra* note 152, at 862 (describing veto power as only a "negative" power).

162. *See id.*

163. *See id.* at 862–64.

164. *See generally id.* (proposing reforms allowing shareholders to intervene in corporate decisions and adopt "value-increasing governance arrangements that management disfavors").

165. *See, e.g.*, Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposals for Securities Intermediaries*, 113 YALE L.J. 269, 271 (2003) (explaining how dispersed shareholders are in a poor position to remedy various corporate issues).

corporation in a profound way.[166] This is due to both collective action and rational apathy problems.[167] The tremendous rise of institutional investors within the last two decades has generated optimism for shareholder primacists because they believe these investors will be able to overcome these issues.[168]

Collective action problems emerge as soon as multiple shareholders exist.[169] Any single shareholder who expends money and resources to monitor or coordinate changes in management typically incurs all of the costs.[170] Yet, all shareholders equally share any benefit that results from his or her actions.[171] The costs accompanying shareholder activism therefore may not justify the potential benefits.[172]

Shareholders also face rational apathy problems.[173] Shareholders lack incentives to expend resources participating in corporate governance issues, such as voting, to the extent that they believe that their vote will not be pivotal in the outcome.[174] When this sentiment exists, shareholders' economic incentives are to remain passive.[175] However, rational apathy decreases as shareholder ownership increases because it raises the likelihood that his or her vote will be decisive.[176]

Many scholars assert that the rise of institutional investors as shareholders has the potential to overcome these issues because they have greater capacity and incentive to participate in corporate governance issues, such as executive compensation.[177] Traditional institutional investors like pension funds and mutual funds typically own larger amounts of stock than individual investors.[178] Depending on the circumstances, these stock blocks may be large enough to give the institutional investors an incentive

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166. *See* Kelli A. Alces, *Revisiting Berle and Rethinking the Corporate Structure*, 33 SEATTLE U. L. REV. 787, 792–93 (2010).

167. *See id.* at 792 ("The wide dispersal of shareholders led to collective action problems and apathy that made shareholder discipline of managers ineffective at best and almost impossible at worst.").

168. *See* Eric L. Johnson, *Waste Not, Want Not: An Analysis of Stock Option Plans, Executive Compensation, and the Proper Standard of Waste*, 26 J. CORP. L. 145, 170 (2000) (stating that institutional investors can and have shown the ability to be effective monitors).

169. *See* Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 454 (1991).

170. *See* Choi & Fisch, *supra* note 165, at 278.

171. *See id.*

172. *See* ALLEN ET AL., *supra* note 2, at 154.

173. *See* Choi & Fisch, *supra* note 165, at 278.

174. *See id.*

175. *See* ALLEN ET AL., *supra* note 2, at 155.

176. *See id.* at 154.

177. *See, e.g.*, Robert C. Illig, *The Promise of Hedge Fund Governance: How Incentive Compensation Can Enhance Institutional Investor Monitoring*, 60 ALA. L. REV. 41, 48–53 (2008) (providing statistics demonstrating that, despite their historic passivity, institutional investors continue to show promise as potential monitors).

178. *See* Michael B. Dorff, *Softening Pharaoh's Heart: Harnessing Altruistic Theory and Behavioral Law and Economics to Rein in Executive Salaries*, 51 BUFF. L. REV. 811, 834–35 (2003).

to be active.[179] Unlike individuals, they also have a greater ability to coordinate with one another and overcome collective action problems.[180]

Other nontraditional institutions, such as hedge funds,[181] have generated shareholder activist optimism due to their unique ability to generate significant benefits for shareholders.[182] Most notably, hedge fund managers have a greater incentive to obtain positive returns for shareholders because managers' pay is based on the performance of the company they invest in.[183] Furthermore, the organizational structure of hedge funds allows them to positively impact overall shareholder wealth in a distinct way.[184] Hedge funds are devoid of the regulatory and practical barriers that face mutual funds and the political pressures that confront pension funds.[185] For example, tax law does not inhibit a hedge fund from obtaining overly concentrated positions in a single company in the same manner as mutual funds.[186] Overall, hedge funds have generated renewed hope among shareholder activists because they are more prepared to actively lobby for calculated changes that increase shareholder returns.[187]

2. Director Primacy and Shareholder Empowerment Skeptics

In contrast to shareholder primacists, director primacists promote the need for untethered board of director power in corporate governance affairs. Part II.B.2.a discusses the director primacy model and Part II.B.2.b analyzes team production theory. Then, Part II.B.2.c examines arguments made by those skeptical of the potential benefits of institutional investor prominence.

179. *See id.* at 835.

180. *See* Choi & Fisch, *supra* note 165, at 280.

181. Hedge funds are characterized as having four characteristics: "(1) they are pooled, privately organized investment vehicles; (2) they are administered by professional investment managers with performance-based compensation and significant investments in the fund; (3) they are not widely available to the public; and (4) they operate outside of securities regulation and registration requirements." Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 53 J. FIN. 1729, 1735 (2008).

182. *See id.* at 1730 (finding that "hedge funds increasingly engage in a new form of shareholder activism and monitoring that differs fundamentally from previous activist efforts by other institutional investors"); *see also* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1069 (2007) (stating that "hedge fund activism is strategic and ex ante").

183. *See* Brav et al., *supra* note 181, at 1735.

184. *See id.* at 1730 (noting that hedge funds "can hold highly concentrated positions in small numbers of companies, and use leverage and derivatives to extend their reach").

185. Kuang-Wei Chueh, *Is Hedge Fund Activism New Hope for the Market?*, 2008 COLUM. BUS. L. REV. 724, 733–42.

186. *See* Brav et al., *supra* note 181, at 1734.

187. *See* Brian R. Cheffins & John Armour, *The Past, Present, and Future of Shareholder Activism by Hedge Funds*, 37 J. CORP. L. 51, 58 (2011); *see also* Matteo Tonello, *The Activism of Carl Icahn and Bill Ackman*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (May 29, 2014), http://corpgov.law.harvard.edu/2014/05/29/the-activism-of-carl-icahn-and-bill-ackman/ ("A study by eVestment documents a seven-fold increase in the assets managed by [hedge funds] from $23 billion in 2002 to an estimated $166 billion in early 2014.") [https://perma.cc/FSQ7-L7WW].

a. Why Change History for Mystery?

Lying at the core of shareholder disempowerment theories is the director primacy model, which advocates for a status quo concerning the allocation of power between shareholders and directors.[188] The crux of this model rests on the belief that increased shareholder power "seems likely to disrupt the very mechanism that makes the widely held public corporation practicable: namely, the centralization of . . . decisionmaking authority in the board of directors."[189] Given the various complexities and problems accompanying large corporations, this model advocates for maintaining a hierarchal structure with a centralized decision-making body.[190] Moreover, it posits that conferring centralized decision-making authority upon the board is cheaper and more efficient.[191] Increasing shareholder power would therefore only hinder the corporation because the board of directors requires considerable discretion.[192] Unlike shareholder primacists who urge for expanded voting rights, advocates of this theory hold that shareholder voting should not be used as an assertion of power, but as a last resort accountability device.[193] While critics of the status quo assert that allocating more voting power to shareholders serves as a better accountability check, this model emphasizes the preservation of the current structure by highlighting regulators' lack of interference with it throughout history.[194]

b. Team Production Theory

Similarly, team production theory stresses the value of a board member as a "mediating hierarch."[195] Distinct from various other models, this theory recognizes that other actors beyond just shareholders make firm-specific investments[196] in the corporation.[197] Because determining the exact contribution of each individual actor is arduous, allocating profits accordingly is a challenging endeavor. Prior agreements encourage shirking, and ex post rewards create incentives for rent seeking.[198] The

188. *See* Bainbridge, *supra* note 151, at 1735–36.

189. *Id.* at 1749.

190. *See id.*

191. *See id.* at 1746.

192. *See id.* at 1749–50 (noting that increased shareholder power would inevitably shift some portion of the board's authority to the shareholders).

193. *See id.* at 1750.

194. *See id.* at 1750–51.

195. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 276–78 (1999).

196. Firm-specific investments are those that are difficult to recover once they are committed to the project. *See id.* at 249.

197. *See id.* at 250; *see also* Jonathan R. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173, 188–97 (discussing various groups who make firm-specific investments).

198. *See* Blair & Stout, *supra* note 195, at 249. Shirking occurs because the costs of doing so are born by all individuals, not just the shirker. *See id.* at 249 n.3. Rent seeking is an inefficient situation where individuals are competing with each other to gain the greatest amount of wealth from a fixed sum. *See id.* at 249 nn.3–4.

need for an independent "mediating hierarch" becomes lucid when viewing the public corporation through this lens. As a mediating hierarch, the board is in the best position to decisively balance the interests of competing stakeholders—executives, employees, creditors, and shareholders—to improve the joint welfare of the entire firm beyond that of just shareholders.[199] In this capacity, the board functions in ways similar to trustees.[200] Given the potential for competing interests, the current corporate structure allows boards to be isolated from various influences and control.[201] The current shareholder voting power is therefore proper because it maintains the board's power to balance competing interests without one group (shareholders) exerting excessive influence.[202]

c. The Fallacy of Institutional Investor Promise

Despite the optimism expressed by shareholder primacists, many critics remain wary of the potential consequences that may accompany the emergence of institutional investors as shareholders.[203] Two specific concerns support this skepticism: the lack of incentive for institutional investors to become active participants in corporate affairs and the potential for inefficiencies due to their private interests.

As noted above, shareholders remain passive in corporate governance issues due to collective action and rational apathy problems.[204] While the evolution of institutional shareholders provides a theoretical solution to these problems, various findings support the belief that even the most active institutional investors spend minimal time on corporate governance issues.[205] Although concentrated ownership alleviates some collective action concerns, institutional investors still face free-riding and economic-cost problems that limit activist incentives.[206] Furthermore, playing an

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199. *See id.* at 271. *But see* Usha Rodrigues, *A Conflict Primacy Model of the Public Board*, 2013 U. ILL. L. REV. 1051 (arguing that modern boards lack knowledge of all the interests of a corporation's constituents to balance them accordingly).

200. *See* Blair & Stout, *supra* note 195, at 253, 290–92 (noting that "boards exist not to protect shareholders *per se*, but to protect the enterprise-specific investments of *all* the members of the corporate 'team'").

201. *See id.* at 291–92.

202. *See id.* at 309–15.

203. *See generally* Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561 (2006) (arguing that the divergent interests of institutional shareholders is a concern); P. Alexander Quimby, *Addressing Corporate Short-Termism Through Loyalty Shares*, 40 FLA. ST. U. L. REV. 389 (2013) (suggesting that the rise of institutional investors has accompanied the same practices that lead to financial crises).

204. *See supra* notes 169–76 and accompany text. For further discussion of collective action and rational apathy problems, see ALLEN ET AL., *supra* note 2, at 154.

205. *See, e.g.*, Bainbridge, *supra* note 151, at 1751 (citing evidence showing that institutions rarely elected board of directors, coordinated activities, or submitted shareholder proposals). *But see supra* notes 181–87 and accompanying text (describing and highlighting studies demonstrating the unique motivation of hedge funds to actively participate in corporate governance affairs).

206. *See* John C. Bogle, *The $7 Trillion Question: Mutual Funds & Investment Welfare*, 1 J. BUS. & TECH. L. 45, 49–50 (2006); Paul Rose, *Common Agency and the Public*

active role may generate undesirable tension with the company.[207] Even though they may disagree with director or managerial decisions, large investors will either support them or remain passive in order to maintain valuable relationships.[208] Doing so also allows them to uphold their reputation within the business community.[209] Remaining passive may therefore represent a "win-win" situation from both an economic and reputational standpoint.[210]

A second issue concerns institutional investor private interests and their ability to exercise opportunistic behavior to the detriment of other shareholders.[211] When shareholders have similar agendas, it is more likely that they will be able to coordinate together in furtherance of a common goal.[212] Nonetheless, modern shareholders come in many different varieties and with different self-interests.[213] While shareholders are interested in enhancing overall shareholder value, they are also in a position to promote their private agendas whenever they expect to reap returns that outweigh the costs of doing so.[214] For example, public and union pension funds may favor proposals that further their special labor interests at the expense of other shareholders.[215]

Furthermore, "short-termism"[216] practices of institutional investors may create further conflict between themselves and other shareholders and stockholders.[217] Because many institutional investors such as hedge and mutual funds are concerned with short-term profitability, they are less likely to promote long-term policies that concern other shareholders.[218] These short-term practices also collide with the objectives of corporate lawmakers who provided shareholders with voting rights to aid in promoting the

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Corporation, 63 VAND. L. REV. 1355, 1356 (2010) (acknowledging the reduction in collective action problems).

207. *See, e.g.*, Usha Rodrigues, *Let the Money Do the Governing: The Case for Reuniting Ownership and Control*, 9 STAN. J.L. BUS. & FIN. 254, 277–78 (2004).

208. *See id.* at 278.

209. *See id.*

210. *See* Bogle, *supra* note 206, at 49–50 ("[P]assivity in governance may pay. Let others undertake the hard work and costs of activism. If their efforts are successful, the 'passive-ists' . . . will not only reap the rewards . . . [but] will also increase their chances of getting the . . . business of the activists.").

211. *See* Anabtawi, *supra* note 203, at 565–66.

212. *See id.* at 575.

213. *See generally id.* at 579–93 (discussing five different divergences among shareholders: short-term and long-term shareholders, diversified and undiversified shareholders, inside and outside shareholders, public and union pension funds and economic shareholders, and hedge and unhedged shareholders).

214. *See id.* at 593.

215. *See id.* at 588–90.

216. Quimby, *supra* note 203, at 391. Short-termism is "the practice of short-term investing by shareholders and short-term business decisions by directors and managers at the expense of long-term corporate sustainability." *Id.*

217. *See id.* at 391–96.

218. *See* Anabtawi, *supra* note 203, at 564 ("[T]he hedge fund is [therefore] likely to favor policies . . . that produce short-term gains, even if a more patient investment orientation would generate higher returns over the long term.").

company's long-term future.[219] Regardless, shareholder primacists argue that even if institutional shareholders pursue their short-term interests, they will be unable to garner the majority support that is needed.[220] Yet, their large size may still allow them to form coalitions or negotiate with management from an influential power position.[221]

C. Is Disclosure the Cure?

Disclosure requirements have been an integral component of executive compensation reforms dating back to the 1930s.[222] The recently adopted CEO Pay Ratio Disclosure Rule conforms to the SEC's long-held belief that "[a]n educated investing public ultimately provides the best defense against fraud and costly mistakes."[223] Although most knowledge of executive compensation derives from mandatory disclosure requirements, some argue that disclosure embodies a "double-edged sword" because the transparency it provides may actually contribute to rising executive pay.[224] This section analyzes both edges of this sword against the backdrop of eighty years of rising executive compensation levels.

1. Benefits of Disclosure on Executive Compensation

Disclosure reforms began as an attempt to address the scarcity of executive compensation information available to the public and investors in the marketplace.[225] Generally, regulators believe that markets operate more efficiently when all parties are privy to the same information.[226] In addition to greater transparency and efficiency, other benefits of disclosure have been acknowledged.[227] First, it assists shareholders in reducing the costs to become informed, thereby making it easier for them to actively participate in corporate governance affairs.[228] This counteracts rational apathy problems that would exist if shareholders needed to expend resources to

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219. *See* Quimby, *supra* note 203, at 397.

220. *See* Anabtawi, *supra* note 203, at 594.

221. *See id.* at 596–97.

222. *See generally* Harwell Wells, *"No Man Can Be Worth $1,000,000 a Year": The Fight over Executive Compensation in 1930s America*, 44 U. RICH. L. REV. 689, 707 (2010) (stating that information regarding executive compensation pay practices was rarely available to the public or shareholders prior to the 1930s).

223. *See* SEC, 2005 PERFORMANCE AND ACCOUNTABILITY REPORT 5 (2005), https://www.sec.gov/about/secpar/secpar2005.pdf [https://perma.cc/EX5D-DNYV].

224. Walker, *supra* note 64, at 658.

225. *See* Nathan Knutt, *Executive Compensation Regulation: Corporate America, Heal Thyself*, 47 ARIZ. L. REV. 493, 496 (2005) (noting that before the 1930s, compensation of executives was not public material).

226. *See id.*

227. *See generally* Edward M. Iacobucci, *The Effects of Disclosure on Executive Compensation*, 48 U. TORONTO L.J. 489 (1998) (discussing the role of disclosure in affecting how executives are paid and how much they are paid in light of the rise of institutional investors).

228. *See id.* at 497–98. *But see* Robert Dean Ellis, *Equity Derivatives, Executive Compensation, and Agency Costs*, 35 HOUS. L. REV. 399, 447 (1998) (arguing that more disclosure increases monitoring costs because it overwhelms institutions with additional materials beyond those needed to analyze compensation schemes).

obtain material information.[229] Second, mandatory disclosure encourages compensation committees to devise compensation schemes that better align with shareholder goals.[230] When first adopting disclosure regulations, the SEC believed that disclosure requirements would shame boards of directors into doing the right thing for shareholders and employees.[231] Today, by requiring companies to not only disclose compensation levels but also to explain why these levels are chosen, companies may revisit their compensation practices not just to comply with regulations but to avoid public pressure or embarrassment.[232] Given their large size, disclosure additionally allows institutional investors to deter management and generate a reputation for scrutinizing excessive pay packages.[233] Other benefits to disclosure include allowing investors to make better investment decisions, improving stock market accuracy, deterring fraud, and enhancing accountability for boards and compensation committees.[234] Regulators recognized these benefits and thus, by the 1990s, aimed at making disclosure clearer and easier for shareholders to understand and use.[235]

2. Disclosure Detriments and Ratcheting-up Problems

On the other edge of the sword is the belief that disclosure may in fact result in higher levels of pay for executives.[236] Various studies suggest that the growth of executive compensation has increased beyond that which can be explained by changes in firm size, performance, and industry classification.[237] From these studies emerged the proposition that enhanced disclosure leads to compensation "ratcheting upwards," as corporate boards use disclosed compensation practices of other firms as a benchmark in setting their own pay practices.[238] Compensation committees use "peer groups" when formulating compensation packages.[239] Typically, these committees believe that their CEO is at least above average, and want to

229. *See* Iacobucci, *supra* note 227, at 498.

230. *See id.* at 497–98.

231. *See* Markham, *supra* note 68, at 278. This goal remained the same when the SEC amended its reforms in the 1990s. *See* ALLEN ET AL., *supra* note 2, at 336.

232. *See* Simmons, *supra* note 2, at 344.

233. *See* Iacobucci, *supra* note 227, at 498–99 (discussing the potential for institutional investors to be the solution to various corporate governance issues).

234. *See* Geoffrey A. Manne, *The Hydraulic Theory of Disclosure Regulation and Other Costs of Disclosure*, 58 ALA. L. REV. 473, 479–80 (2007).

235. *See supra* notes 76–84 and accompanying text.

236. *See* Thomas, *supra* note 8, at 1264 (suggesting that disclosure may increase executive pay).

237. *See, e.g.*, Markham, *supra* note 68, at 287 (citing a study stating that mean compensation in 2003 would have been roughly half of its actual size if compensation was actually based on the firm size, performance, and industry classification).

238. *See* Walker, *supra* note 64, at 658; *see also* Simmons, *supra* note 2, at 343 (highlighting Walker's argument that enhanced disclosure may lead to more opaque, inefficient compensation practices).

239. *See supra* note 24 and accompanying text.

pay their CEO at levels reflecting this conviction.[240] When all boards strive to compensate their CEOs at levels higher than their competitors, it leads to an increase in pay across all markets.[241] This creates inefficiencies for regulators because it undermines the link between pay and performance by allowing top executives to be paid at similarly high levels regardless of corporate performance.[242]

D. Are We Using the Right Metric?

Assuming that disclosure can be beneficial, it is still apparent that benefits will not be realized without disclosure of the "right" information. The usefulness of a "pay ratio" to shareholders is therefore pivotal to the CEO Pay Ratio Disclosure Rule's success. Current SEC Chair Mary Jo White stated, "To say that the views on the pay-ratio disclosure requirement are divided is an obvious understatement."[243] Despite recognizing its high compliance costs, the SEC has maintained that the pay ratio is a fitting metric that will provide useful information to shareholders.[244] Others remain skeptical of both its reliability and impending practicality for shareholders and potential investors.[245] This section discusses arguments proffered by both pay-ratio advocates and critics.

1. Pay-Ratio Advocates

Proponents of the pay ratio emphasize its ability to help investors evaluate CEO pay levels when exercising voting rights on executive compensation matters such as say-on-pay.[246] Moreover, many suggest that

240. *See* ALLEN ET AL., *supra* note 2, at 336 ("Typically, compensation committees would want to pay their CEO at roughly the 75th percentile among comparable companies, reflecting the fact that their CEO is (of course) above average.").

241. *See* Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895, 916–17 (1992).

242. *See* Marino, *supra* note 52, at 1213; *see also* Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 COLUM. L. REV. 1867, 1877 (1992) (noting that regardless of performance, the "ratcheting effect" generates continuously higher levels of pay).

243. Mary Jo White, Chair, SEC, Statement at Open Meeting on Security-Based Swap Rules Under Title VII and on Pay Ratio Disclosure Rule (Aug. 5, 2015), http://www.sec.gov/news/statement/statement-at-open-meeting-on-sbs-and-pay-ratio-disclosure.html [https://perma.cc/CM29-VX54].

244. *See* Pay Ratio Press Release, *supra* note 13. The SEC estimates first year implementation costs to be $1.3 billion. *See* Timothy J. Bartl, *Deep-Six the CEO Pay Ratio Rule*, CFO (Oct. 1, 2015), http://ww2.cfo.com/compensation/2015/10/deep-six-ceo-pay-ratio-rule/ [https://perma.cc/3JKG-ZDPS].

245. *See generally* Bartl, *supra* note 244 (opining that the pay-ratio produces a misleading, immaterial disclosure that generates a tremendous financial burden on companies).

246. *See, e.g.*, Brandon J. Rees, AFL-CIO, Comment Letter on Proposed Rule to Require Pay Ratio Disclosure (Dec. 2, 2013), https://www.sec.gov/comments/s7-07-13/s70713-562.pdf ("Pay ratio disclosure will also help investors evaluate CEO pay levels when voting on executive compensation matters such as 'say-on-pay' resolutions.") [https://perma.cc/7KVP-KJCR]; Theresa Whitmarsh, State of Washington Investment Board, Comment Letter on Proposed Rule to Require Pay Ratio Disclosure (Nov. 26, 2013), https://www.sec.gov/comments/s7-07-13/s70713-437.pdf ("Investors will be able to use

the company-specific metric will allow greater insight into the health of corporations, including the integrity of corporate leaders and the disclosure's effect on employee morale.[247] As some have noted, high levels of CEO pay relative to other workers can have a detrimental effect on employee morale and productivity.[248] Observing low morale may therefore lead companies to alter their compensation structures in a positive way.[249] Because the pay ratio is intended to be company specific, its advocates also suggest that it will alleviate the "ratcheting up" of executive compensation that resulted from other disclosure regulations.[250] Rather than focusing on horizontal comparisons among CEOs, the new metric allows shareholders and investors to consider the vertical distribution of pay within their particular firm.[251]

2. Pay-Ratio Critics

Critics assert that the pay ratio will not change investor practices significantly, because most shareholders already have established methods for determining what pay level they consider appropriate for CEOs.[252] Since 2010, the fifteen shareholder resolutions advocating for a pay-ratio method of disclosure received the support of less than 7 percent of shareholders.[253] Importantly, the SEC also may be inadvertently skewing the calculation by using the ratio.[254] For example, if Company A has five employees earning $50,000 per year, they generate the same median salary ($50,000) as Company B, which includes two employees earning $10,000 and three employees earning $50,000. Assuming the compensation of the CEO is the same in both companies, Company A and Company B will have

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CEO-to-worker pay ratios as an additional metric in evaluating say-on-pay votes and other executive compensation issues.") [https://perma.cc/34ZK-W6GD].

247. *See, e.g.*, Paul Schwarzbach, Allied Value, LLC, Comment Letter on Proposed Rule to Require Pay Ratio Disclosure (Oct. 24, 2013), https://www.sec.gov/comments/s7-07-13/s70713-298.pdf ("Pay ratios will be a useful tool for assessing the integrity of corporate leadership, the viability of corporate incentive structures, and the likelihood of situations deleterious to employee morale.") [https://perma.cc/KNC8-2DN8].

248. *See, e.g.*, Heather Slavkin Corzo, *Pay Ratio Rule Gives Shareholders Better Exec Comp Info*, CFO (Oct. 1, 2015), http://ww2.cfo.com/compensation/2015/10/pay-ratio-rule-gives-shareholders-better-exec-comp-info/ [https://perma.cc/4LML-PRFX].

249. *See id.*

250. *See, e.g.*, Americans for Financial Reform, Comment Letter on Proposed Rule to Require Pay Ratio Disclosure (Dec. 2, 2013), https://www.sec.gov/comments/s7-07-13/s70713-505.pdf ("In enacting 953(b) and mandating the disclosure of the pay ratio as well, Congress sought to address investor concerns that the old disclosure requirements encouraged companies to focus on peer to peer comparisons when setting CEO pay, the practice of which helped lead to increasingly higher levels of CEO pay.") [https://perma.cc/37HW-AB5Z].

251. *See id.*

252. *See* Steve Seelig, *CEO Pay Ratio Opens Fair-Pay Debate to Everyone*, CFO (Oct. 1, 2015), http://ww2.cfo.com/compensation/2015/10/ceo-pay-ratio-opens-fair-pay-debate-everyone/ [https://perma.cc/2RE7-VRXK].

253. *See* Bartl, *supra* note 244.

254. *See* S. Kumar, *The Big Flaw in the SEC's CEO Pay-Ratio Rule*, FORTUNE (Aug. 6, 2015, 2:06 PM), http://fortune.com/2015/08/06/sec-ceo-pay-ratio-inequality/ [https://perma.cc/4E5Y-RWFK].

the same pay ratio, even though Company B has a less equal pay structure.[255] Accordingly, the use of a weighted average[256] in computing the pay of average employees may prove beneficial because it accounts for how many workers get paid at different levels within the company and limits the impact of outliers.[257]

Critics further maintain that the ratio is a "silly" or "misleading" calculation because it does not provide investors with useful comparable data.[258] For example, a domestic corporation may have a better ratio than a multinational company due to legal, currency, or cost-of-living differences.[259] The inclusion of part-time and seasonal workers also raises concerns about ratio accuracy because some industries require more part-time, hourly paid workers than other industries.[260] A company in the retail outlet industry may have a higher ratio than a bank, which requires less part-time, hourly paid workers.[261] The ratio thus might not reflect these differences and could potentially mislead shareholders and investors about a company's health.[262]

Lastly, critics discredit the notion that the ratcheting-up problem will be alleviated through the pay ratio.[263] Although more weight is given to the vertical distribution of pay, nothing inhibits boards and compensation committees from using the pay ratios of competitors as a benchmark when crafting compensation packages.[264] Companies may potentially increase CEO pay to elevate their pay ratios to levels similar to their competitors. This would create a broad increase in compensation across all industries in a manner similar to that observed following previous disclosure regulations.[265]

255. For a similar hypothetical, see *id.*

256. A weighted average is that "in which each quantity to be averaged is assigned a weight, and these weightings determine the relative importance of each quantity on the average." *Weighted Average*, INVESTOPEDIA, http://www.investopedia.com/terms/w/weightedaverage.asp?optm=sa_v2 (last visited Nov. 19, 2016) [https://perma.cc/8ABL-9FEP].

257. *See* Seelig, *supra* note 252.

258. *See* David McCann, *CEO Pay Ratio Rule Rankles Both Sides of Heated Debate*, CFO (Aug. 5, 2015), http://ww2.cfo.com/compensation/2015/08/ceo-pay-ratio-rule-rankles-sides-heated-debate/ [https://perma.cc/2YP6-KZUY].

259. *See* Allen Smith, *SEC Pay-Ratio Rule Spotlights CEO Compensation*, SOC'Y HUM. RESOURCE MGMT. (Aug. 8, 2015), http://www.shrm.org/legalissues/federalresources/pages/sec-pay-ratio-rule.aspx [https://perma.cc/T8V8-ESYT].

260. *See* McCann, *supra* note 258.

261. *See* IKE BRANNON, CTR. CAP. MKTS., THE EGREGIOUS COSTS OF THE SEC'S PAY-RATIO DISCLOSURE REGULATION (2014), http://www.centerforcapitalmarkets.com/wp-content/uploads/2013/08/Egregious-Cost-of-Pay-Ratio-5.14.pdf [https://perma.cc/YQE2-YT45].

262. *See id.*

263. *See* Michael S. Piwowar, Comm'r, SEC, Additional Dissenting Comments on Pay Ratio Disclosure (Aug. 7, 2015), https://www.sec.gov/news/statement/additional-dissenting-statement-on-pay-ratio-disclosure.html#_ftn65 [https://perma.cc/A6GY-AGUW].

264. *See* Miller, *supra* note 122 (citing reports predicting that CEOs and boards will use low pay ratios as an argument for raising CEO pay).

265. *See id.*

III. CEO PAY RATIO DISCLOSURE RULE MODIFICATIONS AND SHAREHOLDER-DIRECTOR COMPROMISE

Regardless of the various schisms and uncertainties that exist within the executive compensation debate, one thing is universally recognized: executive compensation has contributed to the income inequality gap in this country and attempts to curb it have been futile to date. The efficacy of any mandatory disclosure regulation depends on two vital factors: (1) whether companies are disclosing the right information to shareholders and, if they are, (2) whether proper mechanisms exist to allow them to effectuate meaningful change. The future implications for the CEO Pay Ratio Disclosure Rule are no exception. Part III.A proposes altering the median employee calculation to a weighted average approach and calls for two additional calculations to be disclosed in conjunction with the modified pay ratio: the percent change of the modified pay ratio from the previous year and the percent change in company profits from the previous year. Part III.B proposes the adoption of quasi-mandatory say-on-pay votes that are triggered when company pay practices are detrimentally uncorrelated with performance.

A. New and Improved Pay Ratio

Given the limited success of past disclosure reforms, the use of a pay ratio represents an innovative attempt by the SEC to depict a company's pay practices and health through a single metric. Nevertheless, various alterations to the ratio may enhance its efficiency and usefulness for shareholders and investors. First, the use of a weighted average should be used when calculating the average compensation of other workers besides the CEO.[266] Furthermore, two numerical calculations should be disclosed in conjunction with this modified pay ratio: (1) the percent change of the pay ratio from the previous year and (2) the percent change of company profits from the previous year.

1. Pay-Ratio Shortcoming and Weighted Average Implementation

Employing a weighted average approach, rather than a median calculation, better describes a company's pay structure and inhibits ratio manipulation. The weighted average provides enhanced accuracy because it gives greater weight to common compensation levels.[267] For example, if Company A employs 101 workers, fifty of whom earn $100,000, and fifty one of whom earn $50,000, the median calculation would equal $50,000. This value does not demonstrate that Company A pays roughly half of its employees at a level greater than the median. Under a weighted average approach, this calculation would equal approximately $74,750, which better exemplifies Company A's pay structure.

266. *See supra* notes 256–57 and accompanying text.
267. *See supra* notes 256–57 and accompanying text.

Moreover, a weighted average approach better safeguards against ratio manipulation that would be inconsistent with the goals of the regulation. Under the median calculation, a company has a greater capability of improving its pay ratio without altering CEO pay at all. In the example above, if Company A hired only two additional workers at a salary of $100,000, the median calculation would double to $100,000. Although this would lower its pay ratio, it would not provide the intended results of the current regulation and would mislead shareholders. Applying this manipulative tactic under a weighted average approach would not alter the ratio in a profound way, as the new weighted average would rise slightly, to approximately $75,240. Because companies will be unable to hire new workers or modify the compensation of a few current workers to profoundly alter their pay ratios, reducing CEO compensation becomes the most practical tactic.

Lastly, the use of a weighted average assuages concerns accompanying the Rule's inclusion of part-time and seasonal workers in the employee population.[268] These workers typically earn lower wages than full-time employees. Under the current Rule, their inclusion may lower the median compensation for all other employees besides the CEO in a way that does not accurately reflect a company's pay structure. Conversely, their inclusion under a weighted average calculation is marginalized because there are usually substantially fewer part-time workers as compared to full-time employees. This provides a greater incentive for companies to hire more of these workers without fear that doing so might negatively affect their pay ratios.

2. Percent-Change Disclosure Benefits

Requiring companies to disclose the percent changes proposed may present shareholders with a better picture of a company's health and facilitate shareholder activism in the process. Shareholders and investors are given greater insight into how a company's compensation structure is changing in relation to performance. This allows them to better determine whether pay levels crafted by the board are justified. For example, shareholders observing a growing pay ratio in conjunction with decreasing company profits may be more skeptical of board decisions. Greater emphasis is therefore placed on the board's CD&A to justify why pay levels should be at certain levels. Without understanding compensation levels in relation to performance, shareholders may be inclined to simply defer to the explanations provided by the board.

Including percent changes may additionally generate increased shareholder activism because it gives shareholders and investors insight into the future stability and growth of a company. Most shareholders are concerned with long-term policies and company value.[269] Long-term shareholders who observe a period of declining profits in conjunction with

268. *See supra* notes 260–62 and accompanying text.
269. *See supra* notes 218–19 and accompanying text.

higher pay ratios may be more inclined to actively lobby for executive pay alterations that provide long-term benefits to the company.

B. Quasi-Mandatory Voting and Shareholder-Director Balance

Part III.B.1 proposes the adoption of quasi-mandatory say-on-pay votes. Then, Part III.B.2 discusses the proposal's ability to aid shareholders in influencing executive compensation without disrupting the necessary powers of the board of directors.

1. Annual Quasi-Mandatory Say-on-Pay

Regulators have continuously and unsuccessfully attempted to link pay to performance by using incentives, specifically in the form of stock grants and options.[270] To date, these incentives had been targeted solely at management and executives in an effort to get them to make decisions that maximize shareholder wealth.[271] Nevertheless, it is now time to return the favor to shareholders by incentivizing them to become influential actors in fighting high executive compensation levels. To promote greater activism, say-on-pay votes should occur annually, rather than the current scheme that allows shareholders to decide whether they should occur annually, every two years, or every three years. This eliminates the possibility that companies will compensate their CEOs and top executives higher in years with no shareholder vote.

The ideal scenario for shareholders and the public involves two different trends: (1) the change in profits is increasing at a higher rate than the change in the proposed pay ratio or (2) the change in profits is decreasing at a lower rate than the change in the proposed pay ratio. Shareholder votes should continue to remain advisory when these situations occur. However, shareholder votes should carry more weight when two alternative, unfavorable conditions exist: (1) the change in profits is increasing at a lower rate than the change in the proposed pay ratio or (2) the change in profits is decreasing faster than the change in the proposed pay ratio. When either of these criteria are met, if 50 percent of shareholders vote with disapproval for the compensation of their CEO, the CEO is subject to a clawback provision that requires him or her to return the amount of pay necessary to equate the change in the ratio with the change in profits. For example, if Company A's pay ratio increases by 10 percent but company profits only increase by 5 percent, if the majority of shareholders vote with disapproval as to the CEO's salary, he or she would be required to return pay until the percent change in the ratio reached 5 percent as well.

270. For a discussion on the emergence and results of incentive-based compensation, see *supra* notes 49–64 and accompanying text.
271. *See supra* Part II.A.

2. Shareholder-Director Balance

This proposal creates a compensation-setting process that properly balances the dual interests of both shareholder and director primacists. Part III.B.2.a discusses the proposal's adherence to director primacy views while Part III.B.2.b analyzes its ability to effectively aid shareholders and assuage various concerns past regulations failed to rectify.

a. Director Power Preservation

Corporations involve many contributing constituents including shareholders, creditors, directors, and executives, each of whom strives to maximize their individual utility.[272] The modern corporation necessitates an isolated decision-making body capable of balancing these interests.[273] The board is in the best position to do so because it is composed of independent directors who can objectively make decisions for the betterment of the corporation as a whole. Conforming to these views, this proposal affirms the necessary powers of the board to manage the business and affairs of the corporation in accordance with section 141 of the Delaware Code. Directors and committees retain the ability to craft compensation packages as they see fit. Shareholders remain uninvolved in the compensation-setting process and lack any power to usurp board decisions in favor of their own. Their ability to influence CEO compensation is only triggered under unique circumstances and when enough shareholders disapprove of the CEO's compensation. Even when these requirements are satisfied, shareholders will still be unable to exert any decision-making power because the amount of compensation a CEO would forfeit in a clawback is automatically determined. CEOs would be required to return the amount needed to equate the two percent changes regardless of what shareholders believe should be the appropriate compensation level. These alterations therefore do not compromise the board's ability to carry out its decision-making functions nor do they provide shareholders with any power to substitute the board's decisions for their own.

Additionally, board of director independence from managerial influence may be strengthened. The existence of the shareholder vote creates an additional disincentive for boards to succumb to the desires of powerful managers.[274] Awarding a CEO with the compensation he or she desires may alter the ratio in a way that triggers the mandatory shareholder vote. This may generate both public and shareholder criticism and increase potential outrage costs. If shareholders obtain the majority votes needed for the clawback to apply, these directors will be scrutinized even further.

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272. *See supra* Part II.B.2.b.
273. *See supra* Part II.B.2.b.
274. For a discussion of managers' ability to influence the board's pay decisions, see *supra* notes 145–50 and accompanying text.

Therefore, the directors may not be willing to confront the heightened potential risks associated with yielding to management's desires.

b. Shareholders' Enhanced Rights and Solutions

Without altering the board's decision-making functions, this proposal affords shareholders a mechanism to effectuate meaningful change on executive compensation issues in a way hindered by the current structure. Excessive executive pay has deleterious effects on individuals, companies, and the national economy.[275] These harmful consequences necessitate a way for shareholders to hold boards accountable for suboptimal compensation decisions. Yet unlike other major corporate decisions that are halted by a majority shareholder veto, no such mechanism currently exists in the compensation-setting process.[276] Although say-on-pay votes offer shareholders greater rights than previously held, their advisory status still marginalizes their impact and creates little incentive for shareholders to be active. Providing shareholders with quasi-mandatory say-on-pay votes allows them greater influence in situations where CEO pay may be unjustifiably high to the detriment of various corporate constituents. Although they still lack decision-making power, expanded voting power provides them with an accountability device similar to a shareholder veto of other major corporate decisions. Their ability to influence CEO pay furthermore incentivizes them to take an active role in the manner intended by the SEC.

Providing shareholders with more "skin in the game" additionally enhances shareholder activism by alleviating both collective action and rational apathy problems. Because shareholder votes may be pivotal in influencing CEO pay, shareholders will have more of an incentive to coordinate and oppose compensation packages that they disapprove. Moreover, it assuages the ratcheting up of compensation that accompanied previous disclosure regulations. Boards will be inhibited from using compensation packages of peer groups as a benchmark because similar companies have different structures and profits from year to year. If boards decide to raise the compensation of their CEOs to that of their competitors, not only will they confront higher public and shareholder scrutiny than ever before, but doing so may increase the pay ratio to a level that triggers the shareholder accountability mechanism.

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275. *See supra* Part I.B.
276. *See supra* Part I.A.