Fordham Urban Law Journal

Volume 34 | Number 3 Article 7

2007

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Timothy De Lizza
Fordham University School of Law

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Cover Page Footnote

Juris Doctor Candidate, Fordham Law School, 2008; Baccalaureate, Earlham College, 2002. The author would like to thank Professor Paul Washington for his assistance in preparing this Comment.

THE INCOHERENCY OF AMERICAN CORPORATE GOVERNANCE AND THE NEED FOR FEDERAL STANDARDS

*Timothy De Lizza**

INTRODUCTION

On January 17, 2006, Chairman Christopher Cox of the Securities Exchange Commission ("SEC") announced that the SEC would propose extensive revisions to its current rules relating to executive compensation.[1] These rules are now enacted.[2]

"Over the last decade and half," Cox said in his speech, "the compensation packages awarded to directors and top executives have changed substantially. Our disclosure rules haven't kept pace with changes in the marketplace, and in some cases disclosure obfuscates rather than illuminates the true picture of compensation."[3] He added that the rules were "about wage clarity, not wage controls . . . [because] the SEC lacks statutory authority to impose salary caps on corporate executives and we'd be out of bounds to attempt that through indirection."[4]

The problem of executive compensation, however, far exceeds disclosure. It involves substantive unfairness of the wages that executives receive, the process used to set their wages, and the inconsistent regulation of corporate governance.[5] Cox's suggestion that the SEC's mandate will not allow it to set wage controls explains his silence on these matters.[6] The SEC, however, already sets wage controls, both directly and indirectly.[7]

* Juris Doctor Candidate, Fordham Law School, 2008; Baccalaureate, Earlham College, 2002. The author would like to thank Professor Paul Washington for his assistance in preparing this Comment.

1. Christopher Cox, Chairman, SEC, Chairman's Opening Statement, Proposed Revisions to the Executive Compensation and Related Party Disclosure Rules (Jan. 17, 2006), *available at* http://www.sec.gov/news/speech/spch011706cc.htm; *see also* Press Release, SEC, SEC Votes to Propose Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters (Jan. 17, 2006), *available at* http://www.sec.gov/news/press/2006-10.htm.
2. *See* Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53,158 (Sept. 8, 2006) (to be codified at 17 C.F.R. pts. 228-29, 232, 239, 240, 245, 274).
3. Cox, *supra* note 1.
4. *Id.*
5. *See infra* Parts I-III.
6. Cox, *supra* note 1.
7. *See* Sarbanes-Oxley Act of 2002 § 304(a), 15 U.S.C.A, § 7243 (West 2007).

Less clear is whether these controls go beyond the SEC's mandate and to what extent new rules could regulate executive compensation. This may mean that the SEC's new rules are an overcautious attempt to stay within its mandate, and will lead to ineffective rulemaking.

This Comment suggests that the U.S. Congress should expand the SEC's mandate so that it has clear authority to implement corporate governance standards. Part I provides an overview of problems regarding how much executive pay is given, how pay is set, and how it is disclosed.[8] It then highlights regulatory responses to those problems, including how they provide contradictory incentives and result in unpredictability and over-regulation.[9] Part II considers the current scope of the SEC's mandate, including courts' and commentators' difficulty in defining its boundaries.[10] Part II concludes that this difficulty sometimes makes the SEC's regulatory actions either ineffective or beyond its mandate.[11] Part III looks at the SEC's recently enacted executive compensation rules and concludes that as a result of the SEC's mandate, the rules will not fix the problems set out in Part I.[12] Last, Part IV argues that the U.S. Congress must expand the SEC's mandate to enable the SEC to set federal corporate governance standards, and to allow it to effectively regulate executive compensation.[13]

I. An Overview of the Executive Compensation Debate

Critics of current executive compensation standards have made three broad complaints relating to executive compensation: the pay is too high, the process currently in place for setting compensation is flawed, and executive compensation is poorly disclosed.[14] Regulatory responses to these problems have created mixed results, and in some cases, arguably worsened the problem.[15] Additionally, the many official and unofficial regulatory bodies sometimes provide contradictory incentives that result in unpredictability and over-regulation.[16]

8. *See generally infra* notes 14-81 and accompanying text.
9. *See generally infra* notes 82-153 and accompanying text.
10. *See generally infra* notes 154-209 and accompanying text.
11. *See generally infra* notes 154-209 and accompanying text.
12. *See generally infra* notes 210-23 and accompanying text.
13. *See generally infra* notes 224-31 and accompanying text.
14. *See generally infra* notes 17-81 and accompanying text.
15. *See generally infra* notes 82-153 and accompanying text.
16. *See generally infra* notes 82-153 and accompanying text.

Pay is Too High

Adjusted for inflation, the pay of the average worker remained almost flat at $27,000 from 1990 to 2004, while average Chief Executive Officer ("CEO") pay rose from $2.82 million to $11.8 million.[17] Thus, CEOs now receive about four hundred times the salary of low-ranking employees.[18] This problem affects small to mid-sized companies, as well as larger ones.[19]

Compensation of CEOs at two thousand of the biggest U.S. companies increased thirty percent in 2004, compared with fifteen percent in 2003 and nine and a half percent in 2002.[20] This increase occurred even as company and portfolio values dropped.[21] Corporate assets used to compensate the top five executives at companies grew from less than five percent to more than ten percent of aggregate corporate earnings from 1993 to 2003.[22] Again, many companies have seen CEO pay rise as shareholder returns have gone down.[23]

These figures suggest that, as a percentage of aggregate corporate earnings, pay for U.S. executives is too high compared to the compensation of the average worker, and it is "delinked" to company performance.[24]

Similar studies suggest that pay is too high when compared to executive compensation of foreign counterparts,[25] and when com-

17. Stephen Labaton, *S.E.C. to Require More Disclosure of Executive Pay*, N.Y. TIMES, Jan. 18, 2006, at A1 [hereinafter Labaton, *Disclosure*]; *see also* THE CONFERENCE BOARD, COMMISSION ON PUBLIC TRUST AND PRIVATE ENTERPRISE 4 n.3 (finding that between 1992 and 2002, CEO compensation rose three hundred and forty percent in comparison to thirty-six percent for the average worker).

18. Labaton, *Disclosure*, *supra* note 17, at A1. **R**

19. Amy Cortese, *Executive Pay: A Special Report; Smaller Fish Are Also Doing Swimmingly*, N.Y. TIMES, Apr. 9, 2006, at 7.

20. Stephen Labaton, *S.E.C. to Propose New Rules on How Executive Pay Is Reported*, N.Y. TIMES, Jan. 11, 2006, at C3 [hereinafter Labaton, *Executive Pay*].

21. *Id.*

22. *Id.*

23. Tommy McCall, Chart, *Executive Pay: A Special Report; Pay for Performance? Sometimes, But Not Always*, N.Y. TIMES, Apr. 9, 2006, at C6.

24. Labaton, *Executive Pay*, *supra* note 20. When commentators suggest pay is "delinked" from performance they mean pay is high at underperforming companies as compared to more successful peer competitors. *See, e.g.*, McCall, *supra* note 23, at C6. **R** **R**

25. A 1999 study found that the United States had the highest total current compensation (salary and annual bonus) at 573,000 euros followed by the United Kingdom (470,000 euros), Canada (355,000 euros), and France (227,000 euros). Mark J. Loewenstein, *The Conundrum of Executive Compensation*, 35 WAKE FOREST L. REV. 1, 1 n.6 (2000). If the study had included long-term incentive compensation, the difference between the United States and the other countries would have been greater. *See id.*

pared to other highly sought after employees, such as sports figures, entertainers, and professionals including attorneys and investment bankers.[26]

There are two counterarguments to the claim that pay is too high. One argument is that even if executives are overpaid, it is not a problem.[27] Many people are not shareholders.[28] Even for those who are shareholders, the amount of value dilution that results from over-compensation is negligible on a per share basis.[29] This suggests that the problem gets disproportionate attention.[30] As a response to this first common counterargument, critics of executive compensation generally argue that excessive compensation indicates broader governance problems, affects company morale, and is used by rating agencies as a factor in debt and credit ratings.[31]

The other argument countering the claim that executive compensation is too high is that market forces serve to limit executive compensation and that executives are worth what they earn.[32] Commentators who hold this view suggest that the executive compensation problem is overstated and that major tinkering with corporate governance should be avoided, especially insofar as it suggests giving more power to shareholders.[33] These commentators point to the large pool of potential executives and the companies that bid for their services, and they conclude that the free market fixes compensation.[34] They note the wealth of information available about compensation and the qualifications of the execu-

26. Mark A. Salky, *The Regulatory Regimes for Controlling Excessive Executive Compensation: Are Both, Either, or Neither Necessary?*, 49 U. MIAMI L. REV. 795, 798-99 (1995).

27. Michael B. Dorff, *Does One Hand Wash the Other? Testing the Managerial Power and Optimal Contracting Theories of Executive Compensation*, 30 J. CORP. L. 255, 257 (2005).

28. *Id.*

29. *Id.*

30. *Id.*

31. *Id.*; Claudia H. Deutsch, *Behind Big Dollars, Worrisome Boards*, N.Y. TIMES, Apr. 9, 2006, at C6.

32. *See, e.g.*, Loewenstein, *supra* note 25, at 4 (arguing that research does not support the proposition that CEOs are overpaid); Kevin J. Murphy, *Top Executives Are Worth Every Nickel They Get*, 64 HARV. BUS. REV. 125 (1986) (stating that executive compensation is not excessive); Nicholas Wolfson, *A Critique of Corporate Law*, 34 U. MIAMI L. REV. 959, 975-78 (1980) (contending that market forces control excessive compensation). R

33. *See* Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615 (2005) (critiquing LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (Harvard Univ. Press ed., 2004)).

34. Loewenstein, *supra* note 25, at 2. R

tives who receive that compensation.[35] Furthermore, they argue that studies suggesting that pay is delinked to stock performance ignore the fact that CEOs may have little ability to influence stock prices because many factors, including general economic conditions and politics, affect prices.[36] These commentators conclude that competition for CEOs is fierce and considerable, which leads to efficient and appropriate levels of executive pay.[37]

The Process of Setting Pay Is Flawed

There are three central figures in the internal corporate structure: shareholders, the board of directors, and management.[38] Shareholders are the owners of the company. Through an agency relationship, they directly "elect" a board of directors at an annual meeting. The board of directors then selects management, who in turn runs the company.

While shareholders are theoretically the most powerful stakeholder, problems of rational apathy significantly diminish their power.[39] Most shareholders are rationally apathetic; since their investments are small, they will not research companies or make sophisticated voting decisions.[40] Large institutional investors are the exception since they are more sophisticated and have more influence, but even they face the hurdle of the expenses involved in bringing shareholder actions.[41]

The board of directors has the ultimate authority to set executive compensation.[42] Although Delaware law is silent on methods of

35. *Id.*

36. *Id.* at 7. This inference works both ways. If CEOs have little ability to influence stock prices, why are they worth so much to shareholders?

37. *Id.* at 2.

38. For a more thorough description of these relationships, see JEFFREY D. BAUMAN ET AL., CORPORATIONS LAW AND POLICY MATERIALS AND PROBLEMS 456-68, 476-80 (5th ed. 2003).

39. *Id.* at 476-78.

40. *Id.*

41. *Id.*

42. Delaware's statute states "[t]he business and affairs of the corporation shall be managed by or under the direction of a board of directors." DEL. CODE ANN. tit. 8, § 141(a) (2007). Delaware's law will be discussed primarily throughout this comment because of its status as the preferred state of incorporation, including more than half of all U.S. publicly-traded companies. *See* Delaware Division of Corporation, http://www.state.de.us/corp/ (last visited Apr. 16, 2007). Delaware claims this is due to the state's "business friendly" statutes, simplified procedures, and well respected courts. *See id.* Others, however, suggest Delaware is often the preferred state of incorporation because it won a "race to the bottom" to have the most relaxed corporate laws. *See* William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 670-71 (1974) (stating "in its zeal to maintain its primacy as the fa-

setting compensation, including whether a compensation committee is necessary, compensation cannot breach the directors' fiduciary duties.[43] Permissible indemnity rights, however, take the potency of these duties away.[44] Where shareholder actions successfully challenge executive compensation, there is often a taint of self-dealing.[45]

In many public corporations the task of setting pay is delegated to a compensation committee[46] since such a committee is required to qualify for certain tax deductions[47] and for a New York Stock Exchange ("NYSE") listing.[48] The committees are typically composed of "disinterested" and independent outside directors who determine executive compensation,[49] but the actual extent of these directors' independence is debatable.

The CEO and management typically nominate directors, which might create a sense of loyalty or concern for continuing nomination in future elections.[50] There is also an "old boys club" element to the nominations in that personal friends of the CEO or CEOs from other companies are often selected, which might create motive for tacit or even subconscious inflation of salaries.[51] For exam-

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vored state of incorporation Delaware adopts legal rules that favor directors and management at the expense of shareholders").

43. Delaware's common law fiduciary duty of due care requires that directors "use that amount of care which ordinarily careful and prudent men would use in similar circumstances." *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 748 (Del. Ch. 2005). Breaches are not easy to prove, as the plaintiff must show gross negligence evidenced by reckless indifference or systematic failure to exercise reasonable oversight. *See id.*

44. These clauses limit shareholders to injunctive relief for most common breaches. *See* DEL. CODE ANN. tit. 8, § 145 (providing permissible indemnification rights); *see also* DEL. CODE ANN. tit. 8, § 102(b)(7) (allowing certificates of incorporation to include a provision eliminating personal liability of a director for breach of the duty of care).

45. *See In re* Abbott Laboratories Derivative Shareholders Litigation, 325 F.3d 795, 800 (7th Cir. 2003) (finding breach of good faith duty where chairman sold significant stock shortly before disclosing problems to public).

46. Delaware creates authority to assemble committees for such tasks. DEL. CODE ANN. tit. 8, § 141(c)(2).

47. 26 C.F.R. § 1.162-27(3).

48. NYSE, NYSE Listed Co. Manual § 303A.05 (2004), http://www.nyse.com/listed/1022221393251.html (follow "Click here to Open NYSE Listed Company Manual" hyperlink; then follow "Section 3 Corporate Responsibility" hyperlink) [hereinafter Listed Manual].

49. Charles C. Pak, *Toward Reasonable Executive Compensation: Outcry for Reform*, 1994 ANN. SURV. AM. L. 633, 645 (1995).

50. *Id.* The NYSE's recent reforms, however, require boards to have director-nominating committees that are composed entirely of independent directors. *See* Listed Manual, *supra* note 48, § 303A.04. R

51. Pak, *supra* note 49, at 645. R

ple, in 1996, almost ninety percent of companies had at least one CEO or Chief Operating Officer ("COO") on its board.[52]

Compensation consultants who owe no fiduciary duties to shareholders may also advise the committees.[53] Management typically hires these consultants.[54] Thus, the consultants will often have an incentive to push compensation upward to guarantee future consulting contracts.[55] For example, the *New York Times* recently reported that Verizon's compensation consultant received $500 million in consulting fees from Verizon between 1997 and 2005.[56] Directors often rely heavily on consultant's figures because the directors themselves are typically not experts in compensation, typically have separate full time jobs, and might meet as infrequently as four times a year.[57]

An illustrative example is the Disney Board in the period prior to the hiring of the CEO's friend as the company president.[58] A Delaware court described the Compensation Committee as "stacked" with the CEO's personal friends and acquaintances, who although "not necessarily beholden to him in a legal sense, were certainly more willing to accede to his wishes and support him unconditionally than truly independent directors."[59] The director that mainly negotiated the contract also served as the CEO's personal attorney.[60] Critics suggest that a market failure inevitably oc-

52. BAUMAN ET AL., *supra* note 38, at 585. **R**

53. Pak, *supra* note 49, at 645. **R**

54. *Id.*

55. Eric Dash, *Executive Pay: A Special Report; Off to the Races Again, Leaving Many Behind*, N.Y. TIMES, Apr. 9, 2006, at C1.

56. Gretchen Morgenson, *Gilded Paychecks: Troubling Conflicts; Outside Advice on Boss's Pay May Not Be So Independent*, N.Y. TIMES, Apr. 10, 2006, at A1, A16 [hereinafter Morgenson, *Paychecks*]; *see also* Letter from Mark M. Reilly, Partner, Compensation Consulting Consortium, to Nancy Morris, Secretary, SEC (Apr. 6, 2006) http://www.sec.gov/rules/proposed/s70306/mmreilly8793.pdf (citing other prominent examples of compensation consultants that lacked independence). Public comments on proposed rules are just that—comments made by the interested public, typically solicited during the proposed phase of rulemaking and posted without change on the SEC website. SEC, *See How to Submit Comments*, http://www.sec.gov/rules/submitcomments.htm (last visited Apr. 16, 2007).

57. *See* Pak, *supra* note 49, at 645. **R**

58. *See generally In re* Walt Disney Co. Derivative Litig., 907 A.2d 693 (Del. Ch. 2005).

59. *Id.* at 760-61. This board relationship is completely legal. *See id.*

60. *Id.* at 144. In another dramatic example, a Compensation Committee approved special payments to WorldCom's CEO after the CEO allowed the head of the Committee to use a company airplane. Don Stancavish, *WorldCom to Get Report on Rescinding Ebbers's Pay*, BLOOMBERG NEWS, Sept. 10, 2002.

curs when this favoritism combines with a relative inability of shareholders to influence director elections.[61]

Another problem is the so-called Lake Woebegone Syndrome, under which all CEOs are above average.[62] Many firms choose to benchmark salaries at sixty-five percent of their competitors, and often use unnamed aspirational peers rather than those firms with whom they realistically compete for talent.[63] No board wants to tell a CEO that she deserves only the average salary when compared to others, especially when they tout the CEO's above-average abilities.[64] Instead, the board pays the CEO above the average, and bases that compensation against high-profile, high-paying companies rather than those for whom they might legitimately compete for business and talent.[65] Inflated figures are then given to consultants, which ultimately boosts salaries across America.[66]

Problems in How Compensation Is Disclosed

In addition to substantive and procedural problems, critics point to the obfuscation of annual reports.[67] As SEC Chairman Cox said in an interview with the *New York Times*, disclosure has become less accurate and less useful in recent years.[68]

The most commonly cited example of faulty disclosure is Jack Welch. In 2002, "the world learned about Jack Welch's retirement perks—including Red Sox tickets, a Manhattan apartment for life, country club memberships, and free use of a corporate jet—not

61. Dorff, *supra* note 27, at 290-91 (concluding that CEO power over directors results in excessive compensation using an experimental model); *see also* Douglas C. Michael, *The Corporate Officer's Independent Duty as a Tonic for the Anemic Law of Executive Compensation*, 17 J. CORP. L. 785, 798 (1992).

62. This reference, sometimes made by commentators, is to Garrison Keillor's "A Prairie Home Companion" radio show. The show typically has a storytelling segment about Lake Wobegon, which is always described as "the little town that time forgot and the decades cannot improve . . . where the women are strong, the men are good-looking, and all the children are above average." *See* A Prairie Home Companion From American Public Media Home Page, http://prairiehome.publicradio.org/about (last visited Apr. 16, 2007).

63. Rachel Beck, *Benchmarking Inflates CEO's Salaries*, BOSTON GLOBE, Mar. 29, 2005, *available at* http://www.equilar.com/NewsArticles/032905_BostonGlobe.pdf.

64. *Id.*

65. *Id.*

66. *Id.*

67. *See* Cox, *supra* note 1.

68. Joseph Nocera, *Disclosure Won't Tame C.E.O. Pay*, N.Y. TIMES, Jan. 14, 2006, at C1.

from the General Electric proxy statement, but from his angry wife's divorce papers."[69]

Comments submitted to the SEC suggest that the problem is larger than headline cases. One commentator, an expert witness, wrote:

> I personally observed obscurantism involved in executive compensation when I had the chief legal officer of a top Fortune 100 corporation explain the correct way to calculate executive compensation. The legal officer based the explanation on data published in the annual report. The legal officers [sic] company had just announced an [eighty-three million dollar] bonus award to executives of the company. The company had been in bankruptcy for two years. I have been reading annual reports for more than [forty] years, yet it took the legal officer a full hour to lead me through all the separate line items needed to calculate an approximation of the . . . bonuses involved. That is obscurantism.[70]

The proliferation of stock options and perquisites are two major forms of stealth compensation. Stock options are particularly misleading since their reported value is the book value at the time they are granted.[71] As a result, shareholders cannot tell how much their CEOs are actually being paid.[72] Instead, shareholders only learn how much their board thought they would pay at the time the stock options were granted.[73] This figure might bear no relation to the actual value of the stocks when exercised.[74] Stock option backdating is perhaps the most dramatic illustration of the potential for misleading investors, since the stock is dated at an earlier point (when the stock price was lower)[75]—making the exchange the equivalent of granting cash.[76] In other words, investors think that options create incentives for future performance when in fact, they just pay cash without incentives.[77] Cablevision's actions provide a

69. *Id.*

70. Michael Phillips, Comment from Expert Witness on Executive Compensation (Feb. 13, 2006), *available at* http://www.sec.gov/rules/proposed/s70306/mphillips9996.htm.

71. Patrick McGeehan, *Executive Pay: A Special Report; Options in the Mirror, Bigger Than They Seem*, N. Y. TIMES, Apr. 9, 2006, § 3, at 6.

72. *Id.*

73. *Id.*

74. *Id.*

75. Paul Krugman, *Incentives for the Dead*, N. Y. TIMES, Oct. 20, 2006, at A23.

76. *See generally id.*

77. *Id.*

well-illustrated example.[78] Cablevision gave stock options to a deceased executive and backdated the options to make it appear as if the executives had received the option while he was still alive.[79]

Stealth compensation can also take other forms. For example, CEOs may defer compensation without disclosing its existence, and in some cases, may earn an above-market interest rate on the money, thereby adding millions to those earnings.[80] Compounding these problems, there is little disclosure regarding how compensation is set. Compensation consultants' names and relationships to corporations are often unknown to shareholders or the public.[81]

Regulatory Responses

Within the past twenty years some states, the Internal Revenue Service ("IRS"), the SEC, stock exchanges, compensation committees, and interest groups have implemented a wealth of reforms with regard to executive compensation. These reforms have resulted in mixed success. The most prominent attempts are described below, along with an assessment of each reform's effectiveness.

IRS Tax Code Reforms (1984 and 1993)

Congress has tried to regulate executive compensation through the IRS. In 1984, Congress enacted section 280(g), which disallowed tax deductions for certain "golden parachutes" through the IRS tax code,[82] and in 1993 Congress enacted section 162(m), which eliminated tax deductions for executive compensation above one million dollars unless certain conditions are met.[83] Compensation contingent on performance goals is exempt from the rule.[84]

78. *Id.*

79. *Id.*

80. Gretchen Morgenson, *A 'Holy Cow' Moment in Payland*, N.Y. TIMES, Feb. 19, 2006, at 1.

81. Morgenson, *Paychecks*, *supra* note 56, at A1, A16. **R**

82. 26 U.S.C.A. § 280(g) (West 2007). A golden parachute is an "anti-takeover" protection mechanism that gives officers a lucrative amount of money, stock options, and other perks if they are fired during a takeover. *See id*.

83. *See* 26 C.F.R. § 1.162-27 (2007). This reform also created strict federal independence standards since, if a director has ever been an officer of the publicly held corporation, she will be defined as an inside director for tax purposes. *See id.* § 1.162-27(e)(3)(C). If she sits on the compensation committee, the consequences of the IRS determining that she is an inside director is that the compensation committee cannot set acceptable performance goals for the purpose of obtaining performance-based tax deductions. *Id.*

84. 26 C.F.R. § 1.162-27(e)(3)(c). Stock options are considered performance-based remuneration for the purpose of the IRS tax deductions. *Id.*

These reforms came under criticism quickly.[85] Commentators have suggested that section 162(m) "made [one million dollars] the new salary floor."[86] Further, commentators claim that both reforms led to more, often hidden, salary inflation as corporations started offering "gross-ups"—money to offset the increased tax burden.[87]

Additionally, after the performance-based tax laws were enacted, many firms started paying executives with stock options, which meant that executives were being paid regardless of how they performed. Some commentators call such incentives "paying for pulse" because to receive the incentive, executives only need to stay alive. Stock options fit this category because "if you give someone two million options at today's price and it's not indexed to the market and it's not indexed to the peer group, he's going to get paid on the basis of what the market does, not on what he does."[88]

The tax laws remain unchanged despite these criticisms. One explanation of congressional inaction in altering the reform is that Congress does not have the expertise of the SEC in handling corporate governance matters.[89]

SEC Disclosure Reforms (1992)

The SEC last reformed its executive compensation policy in 1992.[90] The change in policy required corporations to include shareholder proposals that relate to executive compensation in their proxy materials.[91] These proposals were previously excludable as "ordinary business operations" of the company.[92] The 1992 reforms also required companies to "unbundle" proxy propositions

85. *See, e.g.*, Ryan Miske, Note, *Can't Cap Corporate Greed: Unintended Consequences of Trying to Control Executive Compensation Through the Tax Code*, 88 MINN. L. REV. 1673, 1679 (2004).

86. *See, e.g.*, NOCERA, *supra* note 68, at C1.

87. Phyllis Plitch, *For Some CEO's, 'Gross-Up' Perk Cushions Fall*, WALL ST. J., Nov. 17, 2005, AT C3. THE *Journal* cited a study claiming seventy-two percent of the chief executives of the NYSE's top fifty companies enjoy golden parachute "gross-ups," that is, gross-ups triggered when executives receive severance packages. *Id.*

88. William J. Holstein, *Office Space: Armchair M.B.A.; The Case for Cutting the Chief's Paycheck*, N.Y. TIMES, Jan. 29, 2006, at 10.

89. *Cf.* Joan M. Heminway, *Rock, Paper, Scissors: Choosing the Right Vehicle for Federal Corporate Governance Initiatives*, 10 FORDHAM J. CORP. & FIN. L. 225, 275, 284-87 (2005) (arguing that Congress may be presumed not to have expertise in corporate governance while the SEC has expertise in corporate governance matters).

90. *See* Salky, *supra* note 26, at 809-10. **R**

91. *Id.* at 809.

92. *Id.*

involved in a shareholder vote.[93] Prior rules allowed companies to force shareholders to vote for a bundle of propositions even if they opposed individual propositions.[94] The 1992 changes in disclosure rules included five components: (1) a "Summary Compensation Table" summarizing CEO compensation, as well as the compensation of the next four highest paid officers; (2) a compensation committee report by the board explaining performance factors used to make compensation decisions; (3) tables explaining long-term incentives such as stock options and stock appreciation rights; (4) a "Performance Graph" comparing the corporation's total shareholder return to various indices; and (5) disclosure of potential conflicts of interest of compensation committee members.[95]

NYSE Listing Standard Reforms (2003)

In order to have their stocks traded on national exchanges, such as the New York Stock Exchange, companies must follow the listing standards of those exchanges.[96] In 2003, for example, new NYSE listing manual amendments required compensation committees to consider the listed company's performance, relative shareholder return, awards given to the CEO candidate in the past years, as well as the value of similar incentives to CEOs at comparable companies.[97] Committees must also produce a report which outlines their process.[98] The reforms also added a requirement for shareholder approval for stock option plans,[99] and director independence standards.[100]

The Duty of Good Faith (2002-2005)

Recently, shareholders have attempted to create a limit on salary through Delaware's fiduciary duty of good faith.[101] For a time,

93. *Id.*
94. *Id.* at 810.
95. *Id.*; *see also* Executive Compensation Disclosure, 57 Fed. Reg. 48,126-48,128 (Oct. 21, 1992) (to be codified at 17 C.F.R. pts. 228-29, 240, 249). For an example of a current compensation disclosure, see IBM, Investor Relations, http://www.ibm.com/investor/corpgovernance/cgec.phtml (last visited Apr. 16, 2007).
96. *See generally* Listed Manual, *supra* note 48. **R**
97. *See id.* § 303(A)(5).
98. *Id.* § 303(A)(5)(b)(i)(C).
99. *Id.* § 303(A)(8). Loopholes exist, however, that can be used to avoid seeking shareholder approval for these plans. *See* Roshan Sonthalia, Comment, *Shareholder Voting on All Stock Option Plans: An Unnecessary and Unwise Proposition*, 51 UCLA L. REV. 1203, 1215-16 (2004).
100. *See* Listed Manual, *supra* note 48, § 303A.02(a). **R**
101. *See, e.g.*, *In re* Walt Disney Co. Derivative Litigation, 907 A.2d 693 (Del. Ch. 2005).

courts struggled to define what the "duty of good faith" meant, including whether it placed a substantive limit on executive salaries or if the duty was limited to process factors.[102] The Delaware Chancery Court recently held that a breach of good faith cannot involve a substantive limit, and rather requires intentional failure to engage in a reasonable decision making process.[103] In addition to limiting the breach to procedural deficiencies, this adds a mens rea element to the cause of action. Delaware's courts appear to have rejected the effort to impose a substantive limit on executive compensation using the duty of good faith, given their dismissal of a high profile case with extreme facts.[104]

Sarbanes-Oxley (2002)

Although cutting deeper into the areas of auditing, the Sarbanes-Oxley Act of 2002 affected executive compensation when it prohibited public corporations from extending credit to executive officers or directors, renewing such credit, or arranging an extension of credit.[105] Apart from traditional notions of personal loans, the expansive language of Sarbanes-Oxley applies to many other executive compensation benefits, such as the cashless exercise of stock options and split-dollar life insurance polices.[106] It also mandates that certain executive officers must reimburse certain bonuses and compensation to the issuer if the company is required to restate its earnings due to misconduct.[107]

102. *Compare id.* at 753-56 (holding a breach of good faith cannot involve a substantive limit, and rather requires intentional failure to engage in a reasonable decision making process), *with* In re PSE & G Shareholder Litigation, 801 A.2d 295, 311-13 (N.J. 2002) (holding board decisions must be reasonable); *see also In re* Abbott Laboratories Derivative Shareholders Litigation, 325 F.3d 795, 800 (7th Cir. 2003) (applying Delaware law and holding board breached duty of good faith without mentioning process factors). Former New York State Attorney General Eliot Spitzer went further to substantively limit executive compensation in the not-for-profit realm. *See* N.Y. Not-for-Profit Corp. Law § 515(b) (McKinney 2007). This statute was used against the NYSE's head, Richard Grasso, and Adelphi University's President, Peter Diamandopoulos, to refund portions of their salaries. *See* Beverly Goodman, *From Wall Street to Your Nonprofit's Office*, Non-Profit Times, Oct. 14, 2004, http://www.nptimes.com/fme/oct04/fme_1.html. Grasso's case is currently being appealed. *Grasso to Challenge a Judge's Ruling on Compensation*, N.Y. Times, Oct. 27, 2006, at C10.

103. *See In re* Walt Disney Co., 825 A.2d 275, 289 (Del. Ch. 2003); *see also In re Walt Disney Co. Derivative Litigation*, 907 A.2d. at 752.

104. *See generally In re Walt Disney Co. Derivative Litigation*, 907 A.2d. 693.

105. Sarbanes-Oxley Act of 2002 § 402(k)(1), 116 Stat. 787 (2002).

106. *See* Kathryn Stewart Lehman, *Executive Compensation Following the Sarbanes-Oxley Act of 2002*, 81 N.C. L. Rev. 2115, 2135 (2003).

107. Sarbanes-Oxley Act of 2002 § 304(a), 15 U.S.C.A. § 7243 (West 2007).

Emergence of Interest Groups

Institutional investors and shareholder service groups have also sought to regulate executive compensation by developing "best practices" guidelines and pressuring corporate boards to confirm to these guidelines. Implicated in these private attempts to regulate executive compensation is the suggestion that government under-regulation is responsible for some of the problems described in Part I of this Comment, and that these private organizations can fill the gap created by public under-regulation. While they serve as a check on management and directorial power, after the initial high expectation of rising influence, it appears that only a minority of institutional investors—predominately public and union pension funds—choose to play an active role in corporate governance.[108]

Institutional investors may follow social or political agendas, rather than protect the economic interest of shareholders.[109] For example, the California Public Employees' Retirement System ("CalPERS"), one of the largest institutional shareholders in America, will often support social policy issues.[110] Additionally, unions have used their pension funds as a bargaining chip in labor negotiations.[111]

For many, a greater concern is the influence of Institutional Shareholder Services, Inc. ("ISS") in filling the gaps left by state and federal regulators.[112] ISS is the world's leading adviser to big shareholders on corporate elections.[113] It has a client roster of 1,600 institutions that together own twenty-three trillion dollars worth of stocks, which is about half the world's stock market value.[114] Nearly all these institutions pay for ISS's views on corporate elections.[115] Thus, the power for decision making, which af-

108. Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 630 (2006).

109. *Id.*; *see also* Stephen M. Bainbridge, *Shareholder Activism and Institutional Investors* (2005) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=796227.

110. Michael E. Murphy, *Dispelling TINA'S Ghost from the Post-Enron Corporate Governance Debate*, 43 SANTA CLARA L. REV. 63, 74-75 (2002) (suggesting that CalPERS's support is a positive development).

111. Aaron Bernstein & Amy Borrus, *Labor Sharpens Its Pension Sword*, BUS. WEEK ONLINE, Nov. 24, 2003, http://www.businessweek.com/magazine/content/03_47/b3859089_mz021.htm.

112. Dean Starkman, *A Proxy Adviser's Two Sides: Some Question Work of ISS for Companies It Scrutinizes*, WASH. POST, Jan. 23, 2006, at D1.

113. *Id.*

114. *Id.*

115. *Id.*

fects a significant amount of corporate governance rules, is placed in ISS.[116]

ISS's most recent policy guidance suggests it will focus increasingly on executive compensation.[117] It sets out a case-by-case approach that looks at factors including payouts delinked to performance, internal pay disparities, and performance metrics that are changed during the performance period.[118]

While the use of these metrics is likely good, commentators have expressed concern surrounding extensive reliance on ISS's views because of the company's apparent conflict of interest. Often, ISS acts as an adviser to the corporations it rates.[119] As one securities lawyer put it, "[i]f your governance is not getting a good grade, you go see them and they tell you how to get a good grade . . . . If that's not a conflict, I don't know what is."[120] Thus, a self-interested third party holds the power to fill the gaps in corporate governance, rather than an objective governance agency.

One industry response to this problem was to fund the creation of a new proxy advisor firm, Proxy Governance Inc., which has been criticized for its own conflict of interest for direct ties to management.[121]

116. "'You have centralized decision-making about what governance should look like,' said Gary Lutin, principal of New York investment bank Lutin & Co, and a long-time ISS critic. 'Who anointed these guys?'" *Id.*

117. *See* ISS, ISS U.S. CORPORATE GOVERNANCE POLICY 2006 UPDATES 17 (2005), *available at* http://media.gibsondunn.com/fstore/documents/pubs/2006_us_policy_update_1117051.pdf [hereinafter ISS CORPORATE GOVERNANCE POLICY].

118. *Id.*

119. Starkman, *supra* note 112, at D1.

120. *Id.* ISS is not the only rating agency that has had suspicions cast on it for advising the companies that it rates. The SEC questioned Moody's and Standard & Poor's similar practices regarding stock ratings. *See* Concept Release: Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws, Exchange Act Release Nos. 33-8236, 34-47972, http://www.sec.gov/rules/concept/33-8236.htm; *cf. In re* Fitch, Inc., 330 F.3d 104, 111 (2d Cir. 2003) (denying Fitch Rating service press "Shield" privileges because of its self interest with companies it serves, and suggesting rating services are no longer impartial reporters when they are paid by companies they are rating). Institutional shareholders also face pressure to subscribe to ISS, since it gives them cover in fulfilling their fiduciary duty of care to their members in voting—and is less costly than weighing the costs and benefits of each company for which they cast votes. *See* Letter from Henry A. McKinnell, Chairman of the Board and CEO, Business Roundtable, to Jonathan G. Katz, Secretary, SEC (Dec. 22, 2003), http://www.sec.gov/rules/proposed/s71903/s71903-381.pdf.

121. *See* Gretchen Morgenson, *Pfizer and the Proxy Advisor: Drug Maker Has Ties to Firm that Endorsed Its Slate of Directors*, N.Y. TIMES, Apr. 21, 2005, at C1.

Current Points of Tension Within Rules

Since there are so many official and unofficial regulatory bodies, they sometimes provide contradictory incentives that result in unpredictability and over-regulation of executive compensation. This seems almost inevitable given the differing biases, mandates, self-interests, and expertise levels of the stakeholders. Some of the more prominent tension points are described below.

What makes a director independent?

Qualification for membership of the compensation committee is a focal point of controversy since definitive standards for director independence are almost completely lacking.[122]

Because no single organization has explicit authority to create definitive corporate governance standards, many organizations have developed their own standards to judge independence, including the IRS, the SEC, the NYSE, the National Association of Securities Dealers Automated Quotations ("NASDAQ"), and several interest groups.[123]

At one end of the spectrum, state law relies only on a vague duty of loyalty to address independence issues, but breaches are very difficult to prove.[124] On the other end, the IRS requires that the compensation committee consist solely of "outside directors" defined as directors who have never been an officer of the company and who receive no other compensation from the company except for as a director.[125]

122. *See* CalPERS, *Core Principles of Accountable Corporate Governance*, http://www.calpers-governance.org/principles/domestic/us/page09.asp (last visited Apr. 16, 2007) (suggesting that a uniform definition of independence is needed).

123. For a more extensive discussion, see *And Now the Independent Director! Have Congress, the NYSE, and NASDAQ Finally Figured Out How to Make the Independent Director Actually Work?*, 117 HARV. L. REV. 2181 (2004) [hereinafter *And Now the Independent Director*].

124. *See, e.g.*, Beam v. Steward, 845 A.2d 1040, 1049-52 (Del. 2004) (holding directors are entitled to a presumption that they were faithful to their fiduciary duties and that friendship or an outside business relationship with a CEO is not enough to rebut that presumption).

125. The performance goal under which compensation is paid must be established by a compensation committee comprised solely of two or more outside directors. A director is an outside director if the director [i]s not a current employee of the publicly held corporation; [i]s not a former employee of the publicly held corporation who receives compensation for prior services (other than benefits under a tax-qualified retirement plan) during the taxable year; [h]as not been an officer of the publicly held corporation; and [d]oes not receive remuneration from the publicly held corporation, either directly or indirectly, in any capacity other than as a director. For this

Under Sarbanes-Oxley, the SEC has created standards for director independence that only apply to audit committee members.[126] These are, in certain ways, stricter than the national exchange rules, but in other ways, more vague.[127] The SEC also regulates independence standards indirectly through its influence of stock exchanges rules. Directors are not "independent" unless the board of directors affirmatively determines that the director has no material relationship with the listed company.[128] This can be seen as a flexible catch-all standard, rather than a hard and fast rule like the tax code. The NYSE also creates more solid rules that—unlike the tax code—limit the material relationship effect to three years.[129] Under the NYSE standard, there is a lack of independence where there are "interlocking directorates" on two companies' compensation committees.[130]

Interest groups have created their own independence rules that incorporate the governmental and exchange guidelines. For example, ISS creates three categories of directors: Inside Director, Affiliated Outside Director, and Independent Outside Director.[131] These standards diverge from the IRS and NYSE standards. One example of this divergence is "cooling-off" periods that must pass between the ending of an interest and board membership before a director is considered independent. For ISS, the cooling-off period is five years, but infinite if the director was once a CEO of the company.[132] For the NYSE, there is a consistent three-year cooling-off period.[133] For the IRS, there is a lifetime ban for certain

purpose, remuneration includes any payment in exchange for goods or services.

26 C.F.R. § 1.162-27(3) (2005).

126. Sarbanes-Oxley Act of 2002 §§ 201-04, 15 U.S.C.A. §§ 7231-34 (West 2007).

127. For example, unlike the national exchange rules, directors are allowed no compensation outside their role as directors. *Id.*; *see also And Now the Independent Director*, *supra* note 123, at 2188 n.32. **R**

128. Listed Manual, *supra* note 48, § 303A.02(a). **R**

129. *Id.* § 303A.02(b).

130. *Id.* § 303A.02(b)(iv). Interlocking directorates exist where an executive officer of company *A* has a director on company *B*'s board, and an executive officer of company *B* also has a director on company *A*. *Id.*; *see also* ISS CORPORATE GOVERNANCE POLICY, *supra* note 117, at 7 n.6. **R**

131. ISS CORPORATE GOVERNANCE POLICY, *supra* note 117, at 5. **R**

132. *Id.*

133. Listed Manual, *supra* note 48, at § 303A.02(b). **R**

executives, and the ban is extended to executives of acquired companies.[134]

The net effect of these independence standards is cumulative and companies must follow the most stringent standards set by all stakeholders to avoid repercussions. This creates a situation where under federal law a director may be "independent" for audit committee purposes but not compensation committee purposes. Smaller companies or companies located in "company towns" are likely to find the increased standards especially burdensome, since they will have more difficulty finding parties without material links who are also qualified to serve as members. Even larger companies may find it difficult to find qualified members given that outside directors must be qualified and may not violate antitrust provisions.[135]

Debate also exists as to whether director independence even matters.[136] Although past studies on the subject should be viewed skeptically given the fogginess of what "independence" means, if it were true that independence did not improve shareholder value, then the negative effects of over-regulation would be even more pronounced.

Options: Friend or Foe?

When Congress enacted section 162(m) stating that executive compensation above one million dollars was no longer tax deductible,[137] but exempted stock options from the rule,[138] corporations were given a strong incentive to use stock options.

After stock option plans came under heavy criticism, other regulators created disincentives, even as the IRS incentive remained. For example, in 2004, the Financial Accounting Standards Board ("FASB"), which sets "generally accepted accounting standards," announced that stock options must be expensed to meet generally

134. 26 C.F.R. § 1.162-27(3)(i)(vi) (2007) ("[A]n outside director would no longer be an outside director if a corporation in which the director was previously an officer became an affiliated corporation of the publicly held corporation.").

135. BAUMAN ET AL., *supra* note 38, at 579. **R**

136. *Id.* at 587-90.

137. *See* 26 C.F.R. § 1.162-27. This reform also created strict federal independence standards because if director has ever been an officer of the publicly held corporation, she will be considered an inside director for tax purposes. *See* id. § 1.162-27(e)(3)(C). Thus, if she sits on the compensation committee, the committee cannot set acceptable performance goals for the purpose of obtaining performance-based tax deductions. *Id.*

138. 26 C.F.R. § 1.162-27(e)(3)(c).

accepted accounting standards.[139] The recent NYSE reforms also added a requirement of shareholder approval for stock option plans.[140] Finally, the SEC reversed its previous position on this issue, and announced that companies would no longer be allowed to exclude option-expensing proposals from their proxy statements based on the "ordinary business" exception.[141] As a result of this triad of pressures, companies have reduced their use of stock options because it looks worse on their financial statements.[142]

What Is the Effect of State and Private Sector Encroachment on Traditional SEC Roles?

In the past few years, state and private sectors have begun to encroach on some of the SEC's traditional roles in governing corporate law. Most notably, ISS has treaded on the SEC's disclosure authority while some state attorney generals have taken a far more aggressive role in regulating corporate fraud.

ISS has started to increasingly challenge the primacy of the SEC's traditional disclosure authority. Since the SEC released its proposed disclosure rules to update executive compensation requirements, ISS has released its own competing disclosure chart, including the notation that the update was necessary because "the current SEC requirements on pay disclosure are inadequate," and the suggestion that the chart would be updated further if the SEC adopts new disclosure rules.[143] This chart consists of numerous categories that are not currently disclosed under SEC rules, including the amount of "gross-ups" given and the structure of differed compensation.[144]

Recently, state attorney generals, most notably Eliot Spitzer in New York, have begun to compete with the SEC's traditional role

139. *See* FASB, Statement of Financial Accounting Standards No. 123R (rev. 2004), http://www.fasb.org/pdf/fas123r.pdf. Prior to this, the use of options was reported, but not as an expense.

140. N.Y.S.E. Listing Standard § 303(A)(8) (2002). There are, however, loopholes that can be used to avoid seeking shareholder approval for these plans. *See* Sonthalia, *supra* note 99, at 1203, 1215-16. **R**

141. United Brotherhood of Carpenters and Joiners of America, SEC No-Action Letter, 2002 WL 31749942 (Dec. 6, 2002).

142. It is also noteworthy that each of these stakeholders are subject to SEC influence. *See infra* note 157 and accompanying text.

143. *See* ISS CORPORATE GOVERNANCE POLICY, *supra* note 117, at 18-19. **R**

144. *Id.*

as an agenda setter and enforcer in the area of securities fraud.[145] For example, the SEC and the N.Y. Attorney General negotiated separate settlements in the Alliance Capital mutual fund fraud case.[146] The SEC ordered Alliance Capital to pay $250 million for the fraud.[147] Spitzer reached a separate settlement that required Alliance Capital to offer fee discounts to customers.[148] The SEC's reaction indicated it felt this was rulemaking by enforcement.[149]

How Should Pay Be Set to Reflect Performance?

Stock options are only one controversial aspect of a larger question of how pay can fairly reflect performance. Interest groups have actively promoted guidelines that outline how to precisely determine compensation, including pressuring committees to take account of payouts under all scenarios.[150] The debate escalates when the search for a fair number starts. As noted above, no board wants to tell a CEO that she deserves only the average salary when compared to others, but rules are unclear on how to stop this trend.

The NYSE standards allow the consideration of the value of incentives to CEOs at comparable companies as one of several factors.[151] Other organizations reject this approach. For example, the Conference Board, an organization composed of high-ranking CEOs, chairpersons, and government figures, has suggested refusing to base compensation on median compensation statistics, which tends to lead to artificial inflation as everyone attempts to reach

145. *See* Jonathan R. Macey, *State-Federal Relations Post-Eliot Spitzer*, 70 BROOK. L. REV. 117, 128 (2004) (arguing that Spitzer has used the New York Attorney General's office to usurp traditional SEC governance functions).

146. *Id.*

147. *Id.*

148. *Id.*

149. *Id.* at 130. When asked whether his recent activities should have been taken by the SEC rather than a state attorney general, Spitzer was quoted as responding "Yes but they haven't. And if they haven't . . . we will do it." *Id.* at 127.

150. The Business Roundtable, an organization composed of CEOs of major companies, is representative in its guidelines for determining executive compensation. The guidelines state that at minimum:

> [T]he compensation committee should understand all aspects of the compensation package and should review the maximum payout under that package, including all benefits. The compensation committee should understand the maximum payout under multiple scenarios, including retirement, termination with or without cause, and severance in connection with business combinations or the sale of the business.

BUSINESS ROUNDTABLE, EXECUTIVE COMPENSATION: PRINCIPLES AND COMMENTARY 1 (2003), http://www.businessroundtable.org/pdf/ExecutiveCompensationPrinciples.pdf.

151. *See* N.Y.S.E. Listing Standard § 303(A)(5) (2002).

the top quartile.[152] The Conference Board found that since recent levels of compensation were excessive, they were not an appropriate baseline for setting future compensation.[153]

II. THE SEC'S MANDATE

Although the SEC has various tools with which to regulate compensation, the SEC's mandate to do so becomes blurry once its rulemaking authority is used to create regulations that go beyond disclosure. The blurriness has made several recent rulemaking actions appear either ineffective or beyond its mandate. The effect of this uncertainty on executive compensation will become clearer in Part III, which argues that this uncertainty has prevented the SEC from adequately dealing with the excessiveness, process, predictability, and over-regulation problems outlined above.[154]

Background of the SEC's Rulemaking Authority

The SEC is an independent federal commission created through and empowered by the 1934 Securities Exchange Act.[155] The SEC possesses rulemaking powers that have been used to compel disclosure.[156] The primary vehicles for this disclosure are annual reports that public companies must send to shareholders, and Form 10-K reports that companies must send to the SEC.[157] Companies with more than ten million dollars in assets whose securities are held by more than five hundred owners must produce these and other periodic reports and disclosure materials to solicit shareholders' votes

152. *See* THE CONFERENCE BOARD, COMMISSION ON PUBLIC TRUST AND PRIVATE ENTERPRISE 4-8 (2003), http://www.conference-board.org/pdf_free/SR-03-04.pdf.

153. BAUMAN ET AL., *supra* note 38, at 584. R

154. *See infra* Part III .

155. *See* 15 U.S.C. § 78d (2006) (codifying the 1934 Act). The five commissioner positions are appointed by the President and split between the parties, so that neither party ever has more than three seats. *Id.* Once appointed, the executive branch cannot remove or interfere with commissioners' activities. *See* Heminway, *supra* note 89, at 279-81. This makes the commission fairly bipartisan and independent. *Id.* at 280-82. This is often, although not always, true in practice. For example, the current SEC administration (composed of three Republicans and two Democrats) unanimously endorsed the recently proposed executive compensation rules. *See* John W. Schoen, *New Rules May Not Slow Growth of CEO Pay*, MSNBC.COM, Jan. 7, 2006, http://msnbc.msn.com/id/10895953/.

156. *See, e.g.*, Bus. Roundtable v. SEC, 905 F.2d 406, 407 (D.C. Cir. 1990).

157. The 10-K report is submitted to the SEC and typically contains more detailed information about the company's financial condition than the annual report. For a fuller description, see SEC, Form 10-K, http://www.sec.gov/answers/form10k.htm (last visited Apr. 16, 2007) (describing Form 10-K); SEC, Annual Report, http://www.sec.gov/answers/annrep.htm (last visited Apr. 16, 2007) (describing the Annual Report).

in annual or special meetings held for the election of directors and the approval of other corporate actions.[158]

As noted above, in certain circumstances, the SEC has the power to directly regulate compensation through the Sarbanes-Oxley Act. Sarbanes-Oxley mandates that certain executive officers must reimburse certain bonuses and compensation to the issuer if the company is required to restate its earnings due to misconduct.[159] Sarbanes-Oxley also gives the SEC power to prevent compensation in the form of loans.[160]

The SEC also has indirect power over executive compensation through its regulation of stock exchanges.[161] The stock exchanges' authority to control corporations arises from contract rights, and the primary consequence of failing to comply with the exchanges is de-listing the company. Congress has given the SEC the ability to oversee self-regulatory organizations, and to amend those organizations' rules where the SEC "deems necessary or appropriate [1] to insure the fair administration of the self-regulatory organization, [2] to conform its rules to requirements of [the Exchange Act] and the rules and regulations thereunder applicable to such organization, or [3] otherwise in furtherance of the purposes of [the Exchange Act]."[162] Self-regulatory organizations include stock exchanges such as the NYSE and NASDAQ.[163]

The SEC has a significant hand in the NYSE guidelines because it has approval power of the listing guidelines under section 19 of the Securities Exchange Act.[164] Additionally, whenever the stock exchanges wish to modify their own rules they must obtain the SEC's approval.[165] It has been suggested that these listing standards may have been influenced by a "regulation by raised eye-

158. SEC, The Laws that Govern the Securities Industry, http://www.sec.gov/about/laws.shtml (last visited Apr. 17, 2007).

159. Sarbanes-Oxley Act of 2002 § 304(a), 15 U.S.C.A. 7243 (West 2006).

160. Sarbanes-Oxley Act of 2002 § 402(k)(1), 116 Stat. 787.

161. 15 U.S.C.A. § 78s(c) (West 2006).

162. *Id.*

163. *See id.* § 78c(a)(26) ("The term 'self-regulatory organization' means any national securities exchange [or] registered securities association . . . .").

164. Even this authority is uncertain, as the D.C. Circuit questioned in dicta the legitimacy of the SEC's section 19(b) ability to approve rules affecting substantive matters. *See* Bus. Roundtable v. SEC, 905 F.2d 406, 409 (D.C. Cir. 1990).

165. 15 U.S.C.A. § 78s(b)(1). This link is so strong that some commentators have suggested NYSE actions may constitute "state action" for constitutional purposes. Steven J. Cleveland, *The NYSE as State Actor?: Rational Actors, Behavioral Insights & Joint Investigations*, 55 Am. U. L. Rev. 1, 84 (2005).

brow" and that the SEC has a larger role in the guidelines.[166] For example, after the SEC suggested that the exchanges update their guidelines in February 2002, on June 6, 2002, the NYSE issued a report proposing broad new initiatives and the SEC released a simultaneous press release applauding the proposal.[167] This process resulted in the 2003 NYSE revisions.

The SEC also has indirect power available through regulating section 14(a)(8) shareholder proposals.[168] Rule 14(a)(8) requires a public company to provide an opportunity for a shareholder who owns a relatively small amount of the company's securities to have her proposal placed alongside management's proposals in that company's proxy materials for presentation to a vote at an annual or special meeting of shareholders.[169] The rule generally requires the company to include the proposal unless the shareholder has not complied with the rule's procedural requirements or the proposal falls within one of the thirteen substantive bases for exclusion.[170]

166. Self-Regulatory Organizations; NYSE and NASDAQ; Order Approving NYSE and NASDAQ Proposed Rule Changes and NASDAQ Amendment No. 1 and Notice of Filing and Order Granting Accelerated Approval to NYSE Amendments No. 1 and 2 and Nasdaq Amendments No. 2 and 3 Thereto Relating to Equity Compensation Plans, 68 Fed. Reg. 39,995 (July 3, 2003). For another example, the National Association of Securities Dealers ("NASD"), AMEX, NYSE, and SEC promulgated a Memorandum of Understanding in which they agreed that a blue sky exemption would be granted to NASDAQ and exchange securities only if the self-regulated organizations adopted voting rights listing standards tracking rule 19c-4. *See* Memorandum of Understanding: The Uniform Marketplace Exemption from State Securities Exemption Requirements (Apr. 28, 1990), NASAA Rep. (CCH) ¶ 2351 (1990) (quoted in Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19c-4*, 69 WASH. U. L.Q. 565, 627 (1991)); *see also* Donald E. Schwartz, *Federalism and Corporate Governance*, 45 OHIO ST. L.J. 545, 571 (1984) (suggesting "regulation by raised eyebrow" occurred when stock exchanges started requiring audit committees after the SEC suggested it do so in a press conference); *cf. Bus. Roundtable*, 905 F.2d at 410 n.5.

167. Press Release, NYSE, NYSE Board Releases Report of Corporate Accountability and Listing Standards Committee (June 6, 2002), *available at* http://www.abanet.org/buslaw/corporateresponsibility/pressrelease20020606.pdf; Statement by Commissioner Harvey L. Pitt on the Draft Report of the NYSE's Corporate Accountability and Listing Standards Committee (June 6, 2002), http://www.sec.gov/news/press/2002-85.htm. In other cases, the NYSE, NASDAQ, and the SEC have explicitly worked together developing rules. *See* News Release, NASD, NYSE, NASD Move to Strengthen Rules Concerning Analysts, IPOs Both Efforts in Support of Joint Effort with SEC, NY Attorney General (Oct. 3, 2002), *available at* http://www.nasd.com/PressRoom/NewsReleases/2002NewsReleases/NASDW_002895 (noting "[t]he proposed amendments were developed in a collaborative effort among the NYSE, the SEC and NASD, and will be proposed to the SEC by the NYSE and NASD.").

168. *See* 17 C.F.R. § 240.14a-8 (1999).

169. SEC, Division of Corporate Finance: Staff Legal Bulletin No. 14, http://www.sec.gov/interps/legal/cfslb14.htm (last visited Apr. 16, 2007).

170. *Id.*

What the SEC counts as a "basis for exclusion" has been used in a way that affects substantive corporate governance.[171] The inclusion of executive compensation to the list of allowable proposals has been important, as over the last few years the majority of section 14(a)(8) shareholder proposals related to executive compensation.[172]

Finally, the SEC has indirect power through its influence on accounting standards. The FASB sets generally accepted accounting standards, including how compensation is expensed.[173] The SEC requires its registrants to adhere to FASB standards.[174] Although the FASB is an ostensibly independent quasi-governmental organization, since Sarbanes-Oxley was passed it has received government funding that the SEC has power to oversee.[175] Additionally, the SEC has sway over who is selected to be on the board, or as the SEC has framed it, while the FASB's parent, the Financial Accounting Foundation ("FAF"), "makes the final determinations regarding the selection of FASB and FAF members . . . we should provide the FAF with our views and that the FAF should consider those views in making its final selection."[176]

The SEC may have more influence than this indicates. For example, a former SEC commissioner suggested that the FASB would have required stock options to be expensed earlier if it had been allowed to do so by the SEC.[177]

171. *See generally* SEC No-Action Letter, 2002 WL 31749942 (Dec. 6, 2002).

172. G. Jeffrey MacDonald, *Scandal Fallout: Tougher Evaluation of CEO Pay*, CHRISTIAN SCI. MONITOR, Mar. 21, 2005, *available at* http://www.csmonitor.com/2005/0321/p13s02-wmgn.html ("CEO pay was the single most frequent target of shareholder resolutions in 2003 and 2004, and the 2005 proxy-voting season is shaping up to follow suit.").

173. Since 1973, the FASB has established U.S. financial accounting standards. SEC Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Release Nos. 33-8227, 34-47743 (Apr. 25, 2003), *available at* http://www.sec.gov/rules/policy/33-8221.htm [hereinafter SEC Policy Statement].

174. *Id.*

175. *J. Richard Williams,* FUNDING FASB: PUBLIC MONEY, PUBLIC DOMAIN, CPA J., May 2004, *available at* http://www.nysscpa.org/cpajournal/2004/504/perspectives/nv2.htm; *see also* Sarbanes-Oxley Act of 2002 § 109, 15 U.S.C. 7219 (2006).

176. *See* SEC Policy Statement, *supra* note 173. R

177. Arthur Levitt, *You Are the Guardians*, CFO MAG. May 2003, *available at* http://www.cfo.com/article.cfm/3009202/1/c_3046591 (stating that the SEC commissioner told the paper, "I could have allowed FASB to go ahead with it. I didn't, . . . I think it would have gone through had I allowed it to.").

The Boundaries of the SEC's Mandate

Historically, administrative agencies such as the SEC have enjoyed broad deference from courts.[178] The Supreme Court has held that when a court reviews an agency's construction of the statute that it administers, first, the court must first decide whether Congress has spoken directly on the matter and follow Congress's interpretation if clear.[179] If Congress has not spoken on the specific issue, then the court must ask whether the agency's interpretation is based on a permissible construction of the statute.[180] Even if the court would have interpreted the statute differently, the agency's interpretation must control unless it is "arbitrary, capricious, or manifestly contrary to the statute."[181] In addition, administrative agencies are not stopped from rulemaking merely because to do so would preempt state law.[182]

As with all agencies, there are limits to the SEC's rulemaking power under its mandate. The SEC rules "cannot exceed the power granted the Commission by Congress."[183] Throughout its history and increasingly since the early 1990s, the SEC, courts, and commentators have struggled to define the scope of the SEC's rulemaking mandate. Despite the deference granted to agencies, many interpretations have been struck down in split opinions or almost struck down by courts.[184]

There is a general sense that the SEC's rules govern "procedural" law, while state law governs "substantive" law. As indicated above, this view is an increasingly outmoded view. Even assuming this sense is still accurate, "except at the extremes, the terms 'substance' and 'procedure' precisely describe very little except a dichotomy, and what they mean in a particular context is largely determined by the purposes for which the dichotomy is drawn."[185]

A major limit on SEC power came in 1990 in reaction to the SEC's rule 19(c)(4), which barred self-regulatory stock exchanges from diluting the per-share voting power of existing sharehold-

178. *See* Chevron, USA, Inc. v. Nat'l Res. Def. Council, Inc., 467 U.S. 837 (1984).
179. *Id.* at 842-43.
180. *Id.* at 843.
181. *Id.* at 844.
182. *See* Fidelity Sav. & Loan Ass'n v. De La Cuesta, 458 U.S. 141, 153-54 (1982).
183. Santa Fe Indus. Inc. v. Green, 430 U.S. 462, 473 (1977) (internal quotations omitted).
184. *See* U.S. v. Chestman, 947 F.2d 551, 586-88 (2d Cir. 1991) (Mahoney, J., concurring in part and dissenting in part) (noting eight cases where the SEC interpretations of its statutory powers were overturned by courts).
185. Sun Oil Co. v. Wortman, 486 U.S. 717, 726 (1988).

ers.[186] The D.C. Circuit struck down the rule in *Business Roundtable v. SEC*.[187]

The *Business Roundtable* decision held that the SEC had no authority to pass the rule because it directly affected the substantive allocation of shareholder powers, and thus exceeded the SEC's statutory authority under section 19 of the Securities and Exchange Act.[188] The court suggested that SEC rulemaking done under its implied authority is limited to Congress's mandate when enacting the statutes that empower the agency and that Congress was primarily concerned with disclosure.[189] Thus, matters that concern only disclosure are presumably in a "safe harbor."[190]

The court acknowledged that there was a gray area between substance and procedure. Specifically, the court noted that Rule 14(a)(4)(b)(2) requires companies to provide shareholders with a means to vote for directors as individuals, thus barring corporations from "tying" board nominee votes by forcing them to vote for all or none of their candidates.[191]

The value of *Business Roundtable* as precedent is unclear, as the case may have been decided differently if argued on different grounds.[192] The court itself acknowledged that the SEC may have authority to enact the controversial rule under section 14(e) of the Williams Act, but did not reach the issue because the SEC did not argue it as a basis of authority.[193] Since the decision, the Second Circuit has held that the SEC's 14(e) rulemaking provision grants

186. *See* Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19c-4*, 69 WASH. U. L.Q. 565, 565-66 (1991) [hereinafter Bainbridge, *Resurrection of SEC Rule 19c-4*].

187. 905 F.2d 406 (D.C. Cir. 1990).

188. 15 U.S.C. § 78s (1988); *see Bus. Roundtable*, 905 F.2d at 407.

189. *See Bus. Roundtable*, 905 F.2d at 410. The court's holding seems in tension with other rules that appear well settled and go well beyond disclosing information. *See, e.g.*, Securities Exchange Act Rule 14(a)(8), 17 C.F.R. § 240.14a-8 (2007) (allowing shareholders the ability to include proposals in companies' proxy materials in certain circumstances).

190. *Bus. Roundtable*, 905 F.2d at 410-11.

191. *Id.* at 411.

192. *Id.* at 417. Section 14(e) of the Williams Act gives the SEC rulemaking authority to prevent the use of fraudulent devices to prevent competing bids. *See* Williams Act § 14(e), 15 U.S.C. § 78n(e) (2007); U.S. v. Chestman, 947 F.2d 551, 556-64 (2d Cir. 1991) (holding a SEC rule under 14(e) did not violate the SEC mandate even though it altered fiduciary relationships). *But see* Bainbridge, *Resurrection of SEC Rule 19c-4*, *supra* note 186, at 593 (suggesting that Supreme Court precedent makes an interpretation of the SEC's mandate impermissible). R

193. See *Bus. Roundtable*, 905 F.2d at 417. The Williams Act included amendments to the SEC's authority enacted in 1968 primarily to regulate tender offers. *See generally* Williams Act § 14, 15 U.S.C. § 78n.

the SEC the power to regulate beyond the disclosure regime and into the substantive regulation of fiduciary duties.[194]

Additionally, the *Business Roundtable* decision did not create a limit on the SEC mandate in the sense that it did not prevent the SEC from achieving its desired result. Under SEC pressure, the rule in controversy was enacted by all major stock exchanges within a few years of the decision.[195]

Finally, a court may be more reluctant to draw the SEC's mandate so narrowly now that Sarbanes-Oxley has preempted state law relating to certain aspects of executive compensation and has broadened the SEC's overall powers.

The Effect of Lack of Clarity on the SEC's Mandate on Recent Rulemaking

Recently proposed SEC rules have begun to follow a pattern: the SEC's authority to pass a rule is questioned, while proposed rules are simultaneously criticized as unlikely to reach their stated purpose.

For example, in December 2004, the SEC released a final rule that required a much larger number of hedge fund advisors to register with the SEC.[196] Although the SEC has authority to require registration of hedge funds under the Investment Advisors Act of 1940, the Act had an exemption that allowed fund advisors who managed fourteen or fewer clients to avoid registration.[197] The exemption widely limited the Act's reach, as a group of investors could be counted as a single "client" if they were collectively part of a single investment fund.[198] The new rule counted each individual investor as a "client," expanding enormously the number of hedge funds that required registration.[199]

The hedge fund rule was vacated as exceeding the SEC's mandate after a large hedge fund advisor's legal challenge.[200] The D.C. Circuit reasoned that it was beyond the scope of the SEC's statutory authority to redefine the meaning of the word "client" to include all investors because "at best it is counterintuitive to

194. *See* Chestman, 947 F.2d at 556-64. *But see* Bainbridge, *Resurrection of SEC Rule 19c-4*, *supra* note 186, at 593. R

195. Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 620 (2003).

196. Registration Under the Advisors Act of Certain Hedge Fund Advisors, 69 Fed. Reg. 72,054 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275, 279).

197. *Id.*

198. *Id.*

199. *Id.*

200. *See generally* Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).

characterize the investors in a hedge fund as the 'clients' of the adviser" since the "adviser owes fiduciary duties only to the fund, not to the fund's investors."[201] Additionally, the court found the rule was arbitrary because it would not meet the goal of covering hedge funds that were national in scope, since the court saw no necessary link between the number of investors and the amount of assets of a hedge fund.[202]

Others suggested the rule would not have achieved its intended purposes since the SEC may not have had the funding to implement the rule. One commentator said of the hedge fund rule:

> [T]he commission is not adequately staffed or technologically equipped to effectively regulate the markets today. Adding 5,000 hedge funds to its to-do list is a dangerous undertaking. While it is desirable to have a watchdog, there is no way the staff of the S.E.C. can do it well–which sets them up for attacks from state regulators, who tend to uncover fraud and then wonder, loudly and publicly, what picnic the S.E.C. was enjoying while investors were swindled.[203]

Thus, the hedge fund rule was criticized as ineffective and beyond the scope of the SEC's mandate.

Another recent example is the proposed SEC stockholder nomination rule. This would have required companies to place stockholder nominees for directors in company proxy materials in certain circumstances.[204] Two proposed triggering events were: (1) at least one of a company's director nominee had over thirty-five percent "withhold votes" at an annual meeting; or (2) if a shareholder or group of shareholders holding at least one percent of a company's stocks submitted a proposal under Rule 14(a)(8) asking the company to be subject to the direct access process and the proposal received at least fifty percent of the votes cast at the annual meeting.[205] The SEC claimed that nothing in the proposed rules established a right of security holders to nominate candidates for election; rather, the rules would change how the company disclosed

201. *Id.* at 881.

202. *Id.* at 883.

203. *See* Jenny Anderson, *A Modest Proposal to Prevent Hedge Fund Fraud*, N.Y. TIMES, Oct. 7, 2005, at C6.

204. *See* Security Holder Director Nominations, 68 Fed. Reg. 60,787 (Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 274). The rules can be limited or eliminated by state law. *Id.*

205. *Id.* at 60,789-91.

the nomination by requiring its disclosure through the company's proxy statement.[206]

Commentators have questioned whether the proposed rule will affect shareholder power as intended because the process would take two years to implement, and the triggers do not necessarily relate to problems indicating poor corporate governance.[207] They have also questioned whether the proposed rule is beyond the SEC's mandate since it impacts who is eventually elected to boards.[208] In fact, at least one organization has already threatened to challenge the proposed rule's legality if it is ever implemented.[209] As with the hedge fund rule, the shareholder nomination proposal was challenged as ineffective and beyond the SEC's mandate.

III. The SEC's Recently Enacted Executive Compensation Rules

The SEC's recently enacted executive compensation rules expanding disclosure requirements may not significantly affect compensation since they continue the pattern set out above: the rules are arguably beyond the SEC's mandate and ineffective because they are overly cautious in an effort to stay within a disclosure regime.[210] As a result, the rules do not even address the executive compensation problems of excessiveness, process, predictability, and over-regulation that were discussed earlier.[211]

Overview of the New Rules

The new rules require public companies to provide a single figure for total compensation including significant perquisites, stock

206. *Id.* at 60,787.

207. *See* Tara L. C. Van Ho, Comment, *Reconstructing the Marriage of Ownership and Control: Is the SEC Missing an Important Step in Its Hesitancy to Adopt Proposed Rule 14A-11?*, 73 U. Cin. L. Rev. 1211, 1237 (2005) (questioning whether proposed rule 14(a)(11) will impact shareholder power).

208. *Compare* Patty M. DeGaetano, *The Shareholder Direct Access Teeter-totter*, 41 Cal. W. L. Rev. 361, 411 (2005) (suggesting that the proposed rule is outside the SEC's current scope of authority and would not withstand judicial challenge), *with* Van Ho, *supra* note 207, at 1239 (suggesting that the proposed rule is within the SEC's mandate since it is subject to state law and deals only with the mailing of proxy materials and not internal board mechanics). R

209. Phil McCarty, *SEC's Proxy Plan Threatened with Suit by Business Chamber*, Wall St. J., Mar. 11, 2004, at A2.

210. *See infra* notes 197-210 and accompanying text; *see also* Cox, *supra* note 1 (noting the SEC's desire to stay within its mandate with its new rules).

211. *See supra* Parts I-II.

options, and retirement benefits for the chief executive officer, the chief financial officer, all directors, and three other highest-paid officers.[212] These changes affect company required proxy statements, as well as annual reports and registration statements.[213] The rule also modifies the current reporting requirements of Form 8-K regarding compensation arrangements.[214]

Prior rules required that companies disclose the compensation of the chief executive officer and the next four highest-paid executives in management. Specifically, the new rule will require companies to disclose the pay, severance, bonus, stock and option grants, and retirement packages of the chief executive officer, the chief financial officer, and the next three highest-paid executives.[215]

The Probable Effectiveness of the Rules

Part I of this Comment described multiple problems relating to executive compensation including excessiveness of pay, a flawed pay-setting process, inadequate disclosure, and over-regulation leading to lack of predictability and inconsistent incentives. The enacted rules address the issue of disclosure, but ignore the rest of these problems.

The SEC's disclosure theory is that once companies are required to disclose the extent of pay, investors can make informed decisions, assess the information themselves, and reach their own conclusions: "[it] is [the investors'] job, not the government's, to determine how best to align executive compensation with corporation performance, to determine the appropriate levels of executive pay, and to decide on the metrics for determining it."[216]

While the new rules should be applauded for attempting to fix the problem of obfuscation of executive pay, shareholder advo-

212. *See* Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53,158 (Sept. 8, 2006) (to be codified at 17 C.F.R. pts. 228-29, 232, 239, 240, 245, 274).

213. *Id.* A proxy statement and annual report are documents public companies are required to mail to shareholders annually. The proxies are solicitations of the right to vote on the shareholder's behalf at a shareholder meeting. For a thorough description of proxies, see BAUMAN ET AL., *supra* note 38, at 471-76. R

214. *See* Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53,158 (Sept. 8, 2006) (to be codified at 17 C.F.R. pts. 228-29, 232, 239, 240, 245, 274).

215. *Id.*; *see also* Press Release No. 2006-123, SEC (July 26, 2006), *available at* http://www.sec.gov/news/press/2006/2006-123.htm. One part of the new rules as originally proposed that was not adopted would have required disclosure of up to three other employees who receive more compensation than any of the top five executives. *See* Stephen Labaton & Claudia Deutsch, *Look Who Is Making The Most*, N.Y. TIMES, Jan. 19, 2006, at C1.

216. Cox, *supra* note 1.

cates have generally agreed with SEC Chairman Cox that the rules will not create wage controls and have criticized the rules for placing the burden on shareholders to control compensation without giving the shareholders effective tools with which to do so.[217]

Others have suggested that there may be a shaming effect through disclosure, but the problem with this idea is that "[a]nyone who isn't embarrassed to ask for $100 million isn't embarrassed if it is disclosed."[218] Accordingly, the rules are not likely to control the inflation of compensation, and in fact may even raise salaries.[219] As one reporter noted:

> [I]t won't be just you and me who are getting a fuller picture of executive compensation—so will the nation's chief executives. And history suggests that whenever they discover a fellow C.E.O. is getting something they don't have, they make a grab for it. In other words, as laudable as more disclosure is, there is a real possibility that it will make a bad situation worse.[220]

Another commentator described the logic behind this effect:

> [T]here may sometimes be perverse effects to mandatory disclosure. My intuition is that disclosure is most effective when it forces the identification of the laggard—the one whose behavior is in some recognizable way inferior to his peers in terms of a consensus about social respectability. In other words, it helps induce what sociologists call a "mimetic" process, or in more pedestrian terms, organizational conformity. In the compensation area, however, it may, if anything, have caused companies to raise compensation faster than it might have otherwise, as peer payments become more visible and companies want to be at least competitive and—if they believe their executives are "special"—supracompetitive.[221]

Thus, there is significant danger that pay will rise as a result of the new disclosures.

217. Letter from Les Greenberg, Chairman, Committee of Concerned Shareholders, to Jonathan G. Katz, Secretary, SEC (Jan. 27, 2006), http://www.sec.gov/rules/proposed/s70306/ccs012706.pdf (noting that proxy contests are very expensive).

218. Deutsch, *supra* note 31, at C6.

219. *See, e.g.*, Schoen, *supra* note 155.

220. Nocera, *supra* note 68, at C1. This idea was echoed in public comments on the rule. "CEOs may just have more information to get compliant board compensation committees to help top executives keep up or surpass their peers in a continuing ratcheting up of compensation at the expense of typical stockholders." Letter from Frank C. Inman, Former Professor of Economics and Finance, to SEC Staff (Feb. 7, 2006), http://www.sec.gov/rules/proposed/s70306/fcinman3662.htm. R

221. Donald C. Langevoort, *Commentary: Stakeholder Values, Disclosure, and Materiality*, 48 CATH. U. L. REV. 93, 96-97 (1998).

In sum, the adopted rules may not help compensation problems, and there is a danger that they will worsen the situation by creating new bargaining chips for CEOs without creating new controls for shareholders. This at least suggests that the executive compensation problems of inadequate disclosure, substantive unfairness, process unfairness, and regulatory ineffectiveness are all linked, and that complementary and consistent regulation governing all of these elements may be necessary to improve the United States' system of compensating executives.

Authority to Pass the Rules

The adopted rules are likely to pass judicial challenge, as they function purely through disclosure, which is considered a safe harbor under a *Business Roundtable* analysis.

Nonetheless, there is at least an argument that the rules do go beyond disclosure. Consider what the compensation committee's engagement in a "Compensation Discussion and Analysis" must disclose: the objectives of the compensation program, what the compensation program is designed to reward, each element of the plan and the choice for the elements, how each element applies, the role of executive officers in the compensation process, how benchmarking was used, the dollar amount of post-employment benefits, such as golden parachutes triggered by a change in control, and the dollar value of options.[222]

This list presupposes that corporations and compensation committees already use these processes and consider these factors in setting executive compensation, but never disclose their findings to the public. Whether this presumption is warranted is far from clear. Even if many companies do undergo this process, it is not due to any current legal requirement.[223] To the extent that companies do not currently consider these factors, the requirement of disclosure has the effect of substantive rulemaking. In order to disclose, a corporation must either change the way it sets compensation or at least go through the motions to determine data and

222. Press Release, No. 2006-123, *supra* note 215; *see also* Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53,158 (Sept. 8, 2006) (to be codified at 17 C.F.R. pts. 228-29, 232, 239, 240, 245, 274). R

223. For example, in the *Disney* case, several members of the compensation committee had minimal information in front of them, including no information on the potential dollar value of a no-fault termination clause. *See In re* Walt Disney, 907 A.2d 693, 753-56 (Del. Ch. 2005) (finding this ignorance did not amount to gross negligence nor a breach of the duty of care). Presumably, the new rules effectively mandate compensation committees to make this information available.

then actively ignore it. This may be a good policy, but it may also extend beyond disclosure by effectively requiring companies to have certain information before determining compensation. This is arguably beyond the SEC's mandate. In fact, if the rules do lower compensation it may be because compensation committees are less likely to be blindsided by the real cost of a no-fault termination clause or a stock option plan.

Thus, the focus on disclosure is likely to sufficiently shield the recent rules from judicial challenge. Also, the rules are likely within the SEC's mandate. Nevertheless, even if the rules do lower compensation packages, it may be the result of the rules more subtle encroachment on board operations rather than of investors reacting to new information.

IV. Federal Corporate Governance Standards

The U.S. Congress has at least two options in clarifying the SEC's mandate: Congress can interpret the mandate narrowly so that the SEC has no control over "substantive" corporate governance standards, or Congress can interpret the mandate broadly to give the SEC clear control over corporate governance standards.

To improve the U.S. system of regulating executive compensation, Congress may have to codify a broad interpretation of the SEC's mandate. Although clarifying the SEC's power as narrow would add predictability, it is ultimately an inadequate option because it would largely preserve the status quo.

A Narrow Mandate

To clarify the SEC's mandate so that it is construed narrowly, at minimum, Congress would likely need to codify some form of the *Business Roundtable* standard of separating disclosure from substantive law. Beyond this, it would also need to answer questions left open by the *Business Roundtable* decision, including whether the SEC can "approve" substantive law made by stock exchanges.

The advantage of this clarification is that it provides the least intrusion on state law, and benefits the SEC and businesses with the predictable pursuit of the current agenda.

One disadvantage, however, is that this change would not help solve substantive or procedural problems. Further, though this change would be a step forward in clarity and predictability, it may be that there is no possible bright line rule separating disclosure and the SEC's current other functions from substantive governance law. Thus, the best that Congress could tell us is to read the statute narrowly.

Moreover, the change may do little to cure the current patchwork of SEC control over corporate governance. Why should the SEC regulate remuneration of loans, but not other areas of compensation? Why should companies that choose to be listed on stock exchanges be governed by the SEC with a raised eyebrow, while sizable, unlisted companies can avoid similar scrutiny?

A narrow mandate would also fail to solve the substantive and process problems currently troubling executive compensation in the United States. While it may relieve some of the tension regarding competition for standard setting, the impact is likely to be limited because the current contradictory regulatory incentives, such as those surrounding the granting of stock options, would still be in place.

Moreover, a narrow mandate may actually make the current system worse. The current system allows multiple parties to create standards that promote regulatory competition and thereby lead to more efficient results than would result if the SEC's presence were removed completely. For example, the very vagueness of the SEC's mandate may create a looming omnipresence over Delaware law, forcing Delaware to be more efficient to avoid federal preemption.[224] Likewise, perhaps state attorney generals create checks on the SEC by uncovering fraud when the SEC is lax.[225]

A Broad Mandate

To clarify the SEC's mandate so that it is construed broadly, Congress would likely need to codify the SEC's ability to set minimum corporate governance standards, thus overturning the *Business Roundtable* decision. This would also give the SEC the ability to preempt independent actors and state actors.[226]

224. *See* Roe, *supra* note 195, at 603-04 (discussing federal competition's influence on Delaware). **R**

225. *See* Macey, *supra* note 145, at 117 (arguing that Spitzer reacted to perceived SEC laxness). On the other hand, the lack of clarity is not only omnipresent over Delaware, it is also omnipresent over corporations that are subject to many masters with minimal predictability. Still, this uncertainty may be better than removing the SEC from the field completely.

226. Congress could also choose to give government funding to a quasi-governmental standard setter like the FASB, which the SEC would have the power to oversee. *Cf. Williams*, *supra* note 175; *see also* Sarbanes-Oxley Act of 2002 § 109, 15 U.S.C. § 7219 (2006). Other examples include the United Kingdom's Financial Service Code and Combined Code. *See generally* The Combined Code on Corporate Governance

Although Congress never embraced it, the idea of federal corporate governance standards is not new. Twice in the early twentieth century there were movements in Congress and the executive branch to completely federalize corporate law.[227] In the late 1970s, there was a push by an SEC commissioner and prominent members of the American Bar Association ("ABA") to create national minimum standards, including the requirement of independent boards and shareholder rights to vote on more issues.[228]

While this affects the balance of federalism, this is an area upon which federal law has already encroached.[229] As described above, there are already numerous ways for the SEC to directly and indirectly regulate substantive corporate governance, although the current uncertainty surrounding the SEC's mandate often leads to ineffective governance of executive compensation. Thus, congressional endorsement would allow the SEC to continue what it has already been attempting to do, while encouraging it to do so more effectively and without the danger of legal challenge.

Definitive governance standards would help every party in the corporate structure. Boards would know what rules they must follow and shareholders would have clearer standards for measuring their boards. For example, as noted above, in selecting an "independent" director at present, a board is likely, at minimum, to look at standards set by the SEC, the IRS, the NYSE, ISS, and possibly one or two key institutional shareholders. If the SEC created one single standard, even if it were not perfect, only one authoritative source would exist. Even those who believe that the free market effectively checks compensation may find this appealing because it would relieve pressure to follow interest group standards that may have no empirical basis. Also, there may be an overall lower regulatory burden since boards are currently pressured to follow the most extreme parts of all the regulators' definitions.

Clarification of the SEC's mandate to include standard-setting would also give Congress an opportunity to effectively fund the

(July 2003), http://www.fsa.gov.uk/pubs/ukla/lr_comcode2003.pdf (presenting non-binding guidelines where a company must explain a choice not to follow advice).

227. Roe, *supra* note 195, at 603-04; Cary, *supra* note 42, at 670-71. **R**

228. Cary, *supra* note 42, at 670-71.

229. *See* Roe, *supra* note 195, at 603-04. The SEC could arguably create non-binding standards for corporate governance under its current disclosure regime without violating its mandate. For example, the SEC could enact rules that required companies to disclose whether they use a specific definition of "independent director" and if not, to explain why. Such a requirement, however, would run the danger of adding another standard-setter to the corporate governance equation without eliminating other standard-setters. **R**

SEC's pursuit. This clarification would help uncover market failures, and remove the danger of over-regulation and over-emphasis on areas of unproven corporate governance.[230] The change would be particularly desirable because in many recent cases, the burden of showing the economic wisdom and effectiveness of proposed reforms has been placed on the private sector.[231]

Finally, and most important, this broad clarification of the SEC's mandate is the only solution with a high probability of fixing the many executive compensation problems set out in Part I of this Comment. As noted above, current executive compensation problems are linked, which makes predictable, consistent regulation governing all of these elements necessary to improve the U.S. system of compensating executives.

An increase in the SEC power to regulate substantive corporate governance would eliminate much of the regulatory confusion described above. It would also allow the SEC to tailor regulations to simultaneously reach substantive, disclosure, and process matters. This would eliminate current contradictory incentives and allow for the meaningful changes that are unlikely to result from the SEC's recently proposed disclosure-based rules.

CONCLUSION

The SEC's recently proposed rules do not extend far enough to regulate executive compensation and may only lead to a further escalation of salaries. If Congress is serious about fixing the system, it must also address the process by which compensation is set. To accomplish this, the best option is to expand the Commission's mandate so it can act as a corporate governance standard setter, as well as perform research and economic analysis, which will ultimately benefit the market and shareholders.

230. The research resulting from the SEC's standard-setting position could be performed similarly to the Federal Trade Commission ("FTC") Bureau of Economics, which assists the FTC's antitrust and consumer protection activities through providing economic support and analysis of potential agency actions. *See* Fed. Trade Comm'n Home Page, http://www.ftc.gov/be/index.htm (last visited Apr. 16, 2007).

231. The new rules are an example. *See* Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53,158 (Sept. 8, 2006) (to be codified at 17 C.F.R. pts. 228-29, 232, 239, 240, 245, 274). Another example is the recent shareholder director proposal. *See* Security Holder Director Nominations, 68 Fed. Reg. 60,787 (Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249, 274). There is a danger in this reliance. Currently, ISS has the incentive to overstate the need for governance, while pro-management organizations have the opposite incentive. This situation has meant that currently held information regarding executive compensation is potentially biased.