The Pay Ratio Disclosure Rule does not Provide Useful Information to Tackle the Executive Overcompensation Problem

Huan Lou

Nothing seems to get U.S. corporations' dander up like a threat to perks of their chief executives. On September 18, 2013 the Securities and Exchange Commission ("SEC") published a proposal to add a chief-executive-officer-("CEO")-median-employee pay ratio to Item 402 of Regulation S-K to implement § 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[1]. Currently almost all publicly held companies have to publish their CEOs' compensation packages and the underlying rationale under 17 C.F.R. § 229.402 (2011). Now, on top of that, the proposed pay ratio rule will require a registered company[2] disclose the median of annual total compensation of all employees (excluding the CEO) of an issuer, the annual total compensation of that issuer's CEO and the ratio of the two amounts, which is referred as the "pay ratio[3]". So far like a rock dropped in a lake, the proposed amendment to Item 402 has invoked waves of reactions from institutional investors, lawyers, and

[1] Pay Ratio Disclosure, 78 Fed. Reg. 60560 (proposed Sept. 18, 2013) (to be codified at 17 C.F.R. pt. 229, 249).

[2] Three types of listed companies are exempted from the pay ratio disclosure rule. They are emerging growth companies defined in Jumpstart Our Business Startups Act § 102(a)(3), smaller reporting companies that comply with a small scale set of disclosure rules set forth in Items 402 (m)- (r), and foreign private issuers and MJDS filers. *See id.* at 16- 18.

[3] *Id.*

CEOs and directors of public companies[4]. Investors, such as union pension funds, welcome the new rule, which they plan to use to slow CEO pay increase while a voice from the SEC speaks out the failure to discern any additional value brought by the pay ratio[5].

This article is designed to discover the value that the pay ratio proposal brings to investors, public companies and the society and the costs that it may incur. Part I of the article starts with the existing CEO pay disclosure rule and the pay ratio proposal. Then it deciphers how and by whom a CEO's pay is decided. Part II summarizes how the pay ratio will impact investors' investment decisions and problems it may cause. Then assuming the pay ratio does decrease a CEO's compensation, the article talks about that the disclosure will bring about some value and at the same time negative influence to a registrar and the labor market. At last the article recommends the use of a company-profit-CEO's-compensation ratio instead of the pay ratio to measure the fairness of a CEO's pay. Finally it concludes that the pay ratio leads to more trouble than benefits to public company investors and the macro-economy and an alternative ratio may be a better indicator on the fairness of a CEO's pay with lower calculation cost to the registrar.

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[4] Andrew Ackerman & Joann S. Lublin, *SEC Wants Boss-Employee Pay Gap on Display*, WALL ST. J., Sept. 19, 2013, at C1. *See generally* Comments on Pay Ratio Disclosure, http://www.sec.gov/comments/s7-07-13/s70713.shtml (showing that the SEC has collected 32,460 pieces of responses as of November 9, 2013 and the comment period of the proposal ends on December 2, 2013).

[5] "There are no- count them, zero-benefits that our staff have been able to discern," said Daniel Gallagher, a Republican member of the SEC. *Id.*

I. The CEO Compensation Regulatory Mechanism and Its Decision Making Process

A. The Current CEO Pay Disclosure Regulations

The statutory monitor over a CEO's pay can be traced back to 1938 when the SEC promulgated its first executive and director compensation disclosure rules for proxy statements[6]. The regulation has gone through several revolutionary revisions and matured to the current version set forth in 17 C.F.R. § 229.402 (Aug. 12, 2011), which employs tabular and narrative method to describe the compensation packages as accurately and concisely as possible[7]. The SEC requires a public company identify its CEO's total pay, salary, bonus, stock awards, option awards, non-equity incentive plan compensation, change in pension value and nonqualified deferred compensation earnings, and others in the Summary Compensation Table[8]. Specifically, a registrar has to disclose the components for option awards and stock awards, such as number

[6] 3 Fed. Reg. 1991 (Securities and Exchange Comm'n Aug. 11, 1938).

[7] At different times, the SEC has adopted rules mandating narrative, tabular, or combinations of narrative and tabular disclosure as the best method for presenting compensation disclosure in a manner that is clear and useful to investors. *See, e.g.*, Release No. 34-3347 (Dec. 18, 1942), Release No. 34-4775 (Dec. 11, 1952), Release No. 33-6003 (Dec. 4, 1978), Release No. 33-6486 (Sept. 23, 1983), Release No. 33-6962 (Oct. 16, 1992), Release No. 33-7032 (Nov. 22, 1993). Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 78338, at 10 fn. 46 (Securities and Exchange Comm'n Dec. 22, 2006).

[8] Regulation S-K, 17 C.F.R. §229.402 (a)(5)(2011).

and market value of securities unexercised, number and market value of shares not vested[9]. Bearing the spirit of lightening the compliance burden, the Item 402 of 2011 forfeits the disclosure of a CEO's any personal benefits or property worth less than $ 10,000[10]. In response to the public outcry toward an unsuccessful CEO's unduly fat paycheck, the 2011 regulation demands a narrative description of the change-in-control arrangement (or the "golden parachute" provision)[11], including the triggering circumstances, payments in each covered circumstance, and the rationales behind[12]. Even more, the shareholders have been empowered by Congress to vote on the executive payments for a frequency not less than three years since July, 2012[13]. This "say-

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[9] *Id.* (f)(1). *See also* Charles M. Yablon, *Bonus Questions- Executive Compensation in the Era of Pay for Performance*, 75 NOTRE DAME L. REV. 271, 293 (1999) (endorsing that current SEC disclosure rules succeeded fairly well in providing detailed information concerning the compensation practices of publicly traded firms though the severance pay problem was left out at that time).

[10] Id. (i)(2)& (3).

[11] Disclosure of Executive Compensation, 48 Fed. Reg. 44467-02, at 6 (Securities and Exchange Comm'n Sept. 29, 1983).

[12] Regulation S-K, 17 C.F.R. §229.402 (j) (2011).

[13] 15 U.S.C. § 78 n-1 (2012) (stating that "[n]ot less frequently than once every 3 years, a proxy or consent or authorization for an annual or other meeting of the shareholders for which the proxy solicitation rules of the Commission require compensation disclosure shall include a separate resolution subject to shareholder vote to approve the compensation of executives, as disclosed pursuant to section 229.402 of title 17, Code of Federal Regulations, or any successor thereto.").

on-pay" provision gives shareholders direct power to deny a compensation package or a golden parachute agreement[14]. Though it appears to impose high pressure on the compensation decision makers, the results of voting showed that more than 98% of companies in Russell 3000 received a favorable vote on their SOP proposal in 2011[15].

B. The Pay Ratio Proposal

The Congress conceives that the current CEO compensation disclosure rule insufficient to solve the oversized remuneration problem. Therefore it promulgates § 953 (b) in Dodd-Frank Act, of which the unclear legislative intent offers little help in interpreting the statutory disclosure requirement[16]. In the proposal, the SEC wants the "median of the total compensation of all employees" available to the public[17]. First, the SEC explains that "all employees" mean all

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[14] SEC Release, SEC Adopts Rules for Say-on-Pay and Golden Parachute Compensation as Required Under Dodd-Frank Act, (Jan. 25, 2011) http://www.sec.gov/news/press/2011/2011-25.htm. See also Blake H. Crawford, Eliminating the Executive Overcompensation Problem: How the SEC and Congress Have Failed and Why the Shareholders Can Prevail, 2 J. Bus. Entrepreneurship & L. 273, 305 (2008).

[15] Mark A. Metz, *Say What!? Results of the First Year of Mandatory Say on Pay in the United States and Related Litigation*, 12 J. BUS. & SEC. L. 281, 282-83 (2011).

[16] The SEC, supra note 1, at 20.

[17] The proposed amendment is written in the following language: the proposal would require the disclosure of "(A) the median of the annual total compensation of all employees of the registrant, except the principal executive officer of the registrant; (B) the annual total compensation of the principal executive officer of the registrant; and (C) the ratio of the amount in (A) to the amount

full-time, part-time, seasonal and temporary workers of the registrant or any of its subsidiaries, including foreign subsidiaries as well[18]. The inclusion of the registrant's global work force implicates the data privacy regulations of the European Union workers and the transfer of payrolls and the pension and benefit processing[19]. Second, with respect to "total compensation", the SEC would not permit certain compensation adjustments that ostensibly reflect a more accurate picture of the human capital investment. The SEC explicitly disallows full-time equivalent adjustments for part-time workers, annualizing adjustments for temporary and seasonal employees, or cost-of-living adjustments for overseas employees. The SEC blindly believes the costs of those adjustments are not justified though it admits the adjustments may

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in (B), presented as a ratio in which the amount in (A) equals one or, alternatively, expressed narratively in terms of the multiple that the amount in (B) bears to the amount in (A)." Id.

[18] See Letters from American Bar Association; American Benefits Council; Brian Foely & Co. and Senator Menendez, the sponsor of Section 953(b) (stating that "[s]pecifically, I want to clarify that when I wrote 'all' employees of the issuer, I really did mean all employees of the issuer. I intended that to mean both full-time and part-time employees, not just full-time employees. I also intended that to mean all foreign employees of the company, not just U.S. employees."). See the Securities Act of 1933 Rule 405 and the Exchange Act of 1934 Rule 12b-2 for the definition of "significant subsidiary", which is applied in this proposal as well.

[19] European Union Directive on the Protection of Individuals with Regard to the Processing of Personal Data and on the Free Movement of Such Data 95/46/EC, 1995 O.J.L. 281 (setting forth the regulatory framework governing the transfer of personal data from an EU Member State to a non-EU country).

cure the distortion of the pay gap[20]. And the nonexecutive employees' compensation is calculated according to Item 402, which is designed specifically to evaluate a CEO's pay. Thirdly, the method of calculating the median of total compensation of all employees is not prescribed in the proposal[21]. The SEC permits the registrant to employ any reasonable manner, such as sampling, that is cost-efficient based on the particular conditions of the registrant[22].

Regarding the median pay number, a registrar can calculate the ratio of its CEO's compensation and employees' pay. Unfortunately neither the statute nor the legislative history tells the intended benefits of the ratio[23]. Supporting commenters speculate that the pay ratio-type information will help investors understand how issuers distribute compensation dollars throughout the firm in ways that may boost employees' morale and productivity[24] because they

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[20] The SEC, supra note 1, at 35.

[21] Median is "a value in an ordered set of values below and above which there is an equal number of values or which is the arithmetic mean of the two middle values if there is no one middle number." Here the median payment of all employees is a number that half of employees are paid above and half below. Merriam-Webster Dictionary, http://www.merriam-webster.com/dictionary/median (last visited Nov. 22, 2013).

[22] Id. at 39.

[23] Section 953 (b) originated in the Senate. It was first introduced in S. 3049, the "Corporate Executive Accountability Act of 2010" and then appeared in S. 3217, the "Restoring American Financial Stability Act of 2010." The brief references to the pay ratio disclosure in the legislative records all opposed to the provision. See the SEC, supra note 1, at 11.

[24] The SEC, supra note 1, at 92. See also letter from Calvert Investment Management.

feel the CEO is on the same team with them with a relatively small pay disparity[25]. Another alleged benefit is that the pay ratio disclosure will promote social equality by making employees and shareholders feel fair with a narrow pay gap. But conceiving the SEC a disclosure regulator and investors' protector, the minority of the Congress affirmatively insist that the SEC concentrate on improving disclosure about the underlying assets to enable investors to conduct due diligence[26]. Those Congress members point out that though the pay ratio information appeals to "popular notions that CEO salaries are too high", it does not provide "material information to investors who are trying to make a reasoned assessment of how executive compensation levels are set[27]."

C. How a CEO's Compensation Is Decided

Despite the disclosing requirement, the proposal does not suggest a healthy or desirable ratio or a ratio range[28]. To appreciate the pay ratio's impacts on the CEO's compensation, this section offers a brief overview of factors that a company's hiring authority takes into consideration. A recruitment committee normally counts the company's financial and operational

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[25] Linda J. Barris, The Overcompensation Problem: A Collective Approach to Controlling Executive Pay, 68 Ind. L.J> 59, 71 (1992) (stating that an official of the Colgate-Palmolive Company admitted that the biggest barrier to teamwork is executive pay).

[26] S. REP. NO. 111-176, at 245 (2010).

[27] Id.

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objectives when it sets the CEO compensation[29]. Heavy weight is given to these factors, like earnings before interest, taxes, depreciation and amortization (EBITDA), earnings per share (EPS), product development, customer service, and etc[30]. The company expects the CEO will lead the company hit the set goals in the above areas. Moreover, firms hope to recruit top executive talents and this competition inevitably raises pay levels[31].

Scholars have reduced the finance-based, performance-based and market competition factors to formulas that directly reflect how these factors interact with each other and influence the total pay number. The article uses *v* as a CEO's outside options, *y* the value of the CEO's production to the firm, β the fraction rate of the CEO's share in the total CEO work production surplus and 1-β the fractional rate of the company's surplus share[32]. Then the CEO's wage is $w_{\beta=}$ $(1-\beta)v + \beta y$ and the company's surplus is $S_{\pi=}$ $(1-\beta)(y-v)$[33]. Based on the formulas, a CEO's work productivity *y*, the opportunity cost or outside option *v*, and the split ratio β theoretically set the foundation of the compensation metric. Also $S_{\pi=}$ $(1-\beta)(y-v)$ indicates that the market price for a CEO *v* should not exceed the CEO's production value.

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[29] See RiskMetrics Group, Explorations in Executive Compensation 13 (2008), available at http://www.riskmetrics.com/sites/default/files/RMGExplorationsinExecutiveCompensation2008
0520Final.
pdf.

[30] Omari Scott Simmons, Taking the Blue Pill: The Imponderable Impact of Executive Compensation Reform, 62 S.M.U. L. Rev. 299, 311 (2009).

[31] Id. at 312.

[32] Pietro Garibaldi, Personnel Economics in Imperfect Labour Markets 2 (2006).

[33] Id. at 5.

y is measured by the additional revenue that CEO brings to the company, the CEO's marginal revenue product[34]. One empirical survey reveals that thirty-five to sixty percent of the firm performance can be attributed to the management[35] while economic climate and the state of industry count for ten to twenty percent and thirty to forty-five percent respectively[36]. Therefore CEOs that have bigger impact on the company value should be paid more[37]. The second decisive factor *v* represents the compensation that he could obtain from another employment opportunity but forfeit it because of the current position. *v* is directly linked to the CEO market, which is not robust and lacks transparency[38]. The insufficient CEO market fails to cap CEO compensation and therefore increases the possibility that *v* exceeds *y.* An insufficient market also enhances a CEO's bargaining power and influences β. A recruiter has to distribute a large portion of the firm surpluses to a potential CEO to retain him[39].

D. Compensation Committees Decide CEOs' Pay and Board Capture

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[34] Derek Bok, The Cost of Talent: How Executives and Professionals Are Paid and How It Affects America 14-15 (1993).

[35] The Curse of Charisma, Economist, Sept 7, 2002, at 58.

[36] Rakesh Khurana, The Curse of the Superstar CEOP. Harv. Bus. Rev., Sept. 2002, at 60, 63.

[37] Thomas, supra note, at 1201.

[38] Simmons, supra note , at 314 (showing that "the number of candidates that a Fortune 500 firm would consider in a CEO search would be few" and the selection process involves internal politics and social pressure that often require "secrecy and confidentiality").

[39] Randall S. Thomas, Explaining the International CEO Pay Gap: Board Capture or Market Driven?, 57 Vanderbilt L. Rev. 1171, 1224 (2004).

Compensation decisions at most public companies are made by independent compensation committees due to § 952 of the Dodd-Frank Act and § 10C of the Securities Exchange Act of 1934 (the "Exchange Act"). Under § 10C no company, subject to limited exceptions, can be listed unless specific conditions are satisfied with respect to the authority of the compensation committee, the independence of the members of the compensation committee, and the consideration by the compensation committee of specific factors relating to the independence of compensation advisers[40]. Accordingly New York Stock Exchange (NYSE) and Nasdaq Exchange set up their own standards of the independence of compensation committees[41]. For example, the NYSE directs its listed companies to consider the sources of the committee members'[42] compensation and the relationships of the members to the listed company[43]. Unlike

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[40] *See* Lawrence R. Bard & Daniel R. Kahan, *Stock Exchanges Submit Proposed Compensation Committee and Adviser Independence Rule Changes to SEC*, MORRISON FOESTER LLP (Oct. 3, 2012), http://www.mofo.com/files/Uploads/Images/121003-Stock-Exchanges-Submit-Proposed-Changes-to-SEC.pdf.

[41] Id.

Thereafter the NYSE promulgated its rule on the independence standard of compensation committee members in the NYSE Listed Company Manual § 303A.02(a)(ii) and Nasdaq adopted the new rule in NASDAQ Rule 5605(d)(2)(A). *See* Joseph E. Bachelder III, *Exchange Rules on Independence of Compensation Committee Members*, MCCARTER & ENGLISH, LLP (May 9, 2013 9:30 AM), http://blogs.law.harvard.edu/corpgov/2013/05/09/exchange-rules-on-independence-of-compensation-committee-members/.

[42] The compensation committee consists of independent outside directors most times. See Metz, supra note **Error! Bookmark not defined.**, at 282.

the NYSE, the Nasdaq leaves no discretion to the board to determine whether the compensation is sufficiently material to preclude a director from being independent as preclusion is automatic[44].

Despite of the stringent rules, there is still a structural weakness that renders compensation committees passive in negotiating CEOs' pay[45]. Board Capture theorists may explain that boards of directors and compensation committee members heat up the CEO's market by irrationally aligning with the CEO's interest because they are or were executives at other companies and they expect this CEO to do the same when he votes at board meetings for other companies[46]. A compensation committee is normally comprised of non-employee directors handpicked by the CEO[47]. They have little incentive and time[48] to negotiate the pay package

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[43] Bachelder, supra note 41.

[44] Id.

[45] "Overcompensation is basically the fault of passive boards that agree to salary packages on demand, without spirited negotiations." See Adam Bryant, Some Second Thoughts on Options, N.Y. Times, Sept. 21, 1997, § 3, at 1 (quoting Professor Charles Elson).

[46] James D. Cox, The ALI, Institutionalization, and Disclosure: The Quest for the Outside Director's Spine, 61 Geo. Wash. L. Rev. 1233, 1243 (1993) (stating that "[T]he prevalent ethos of nominating committees [is] to submit names believed acceptable to the CEO ..."); and Charles M. Elson, The Duty of Care, Compensation and Stock Ownership, 63 U. Cin. L. Rev. 649, 651 (1995).

[47] Thomas, supra note , at 1191.

[48] "The committee meets several times a year and sometimes every time there is a board meeting." See GRAEF S. CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES 43 & 215 (1991).

against the CEO and expect that this CEO will not say "no" to their pay when sitting on their own companies' compensation committees[49]. An empirical study reveals a correlation between the compensation committee members' payments and the CEO's remuneration[50]. "For every increment of $100,000 in the average annual salary of the outside directors on the compensation committee, the salary of the company's CEO can be expected to rise $51,000[51]." Therefore the CEO market is distorted due to the structural weakness of the CEO-controlled corporate governance.

E. CEOs are Generally Considered Overpaid

[49] Susan J. Stabile, One for A, Two for B, and Four Hundred for C: The Widening Gap in Pay Between Executives and Rank and File Employees, 36 U. Mich. J.L. Reform 115, 129 (2002) (stating that CEOs have stronger economic incentives to dominate the compensation negotiation than boards or compensation committees do to resist domination).

[50] James A. Cotton, *Toward Fairness in Compensation of Management and Labor: Compensation Ratios, a Proposal for Disclosure*, 18 N. Ill. U. L. Rev. 157, 172 (1997).

[51] The SEC and the Issue of Runaway Executive Pay: Hearings on S. 1198 Before the Subcomm. on Oversight of Government Management, Comm. on Governmental Affairs, 102d Cong., 1st Sess. 8 (1991) (statement of Graef S. Crystal, Adjunct Professor of Organizational Behavior and Industrial Relations, University of California at Berkeley).

With 475 to 500 multiples of the average CEO compensation and the pay of average employees[52], the current majority view is that CEOs are generally overpaid. Public is furious about the average CEO of a S&P 500-Index company receiving $ 9.25 million in 2009 while millions of workers losing their jobs and retirement savings[53]. For instance, Aubrey McClendon, CEO of Chesapeake Energy, took home $ 112.5 million in 2008. Meanwhile Chesapeake Energy's net income only reached $ 623 million, an almost fifty percent decline from the prior year[54]. Among S&P 500 firms[55], the average CEO compensation levels have climbed 146% from

[52] SeeJennifer Reingold & Fred Jespersen, Executive Pay, Bus. WK., Apr. 17, 2000, at 110 (stating that in 1999, the average CEO earned 475 times the average wage of a blue collar worker); AFLCIO, CEO Pay: Still Outrageous, at http://www.aflcio.org/corporateamerica/paywatch/pay/ (last visited Dec. 19, 2002) (citing Business Week to the effect that the average CEO made 531 times the average blue-collar's pay in 2000, compared to a multiple of 85 in 1990).

[53] James Parks, Don't Let the Chamber and Big Biz Gut Worker's Say on CEO Pay, AFL-CIO Now Blog (Oct. 18, 2010), http://blog.aflcio.org2010/1O/18/dont-let-the-chamber-and-big-biz-gut-workers-say-on-ceo-pay/.

[54] Stuart Lazar, The Unreasonable Case for a Reasonable Compensation Standard in the Public Company Context: Why It Is Unreasonable to Insist on Reasonableness, 59 Buff. L. Rev. 937, 938 (2011).

[55] The S&P 500 companies capture approximately 80% coverage of available market capitalization. S&P Dow Jones Indices, http://us.spindices.com/indices/equity/sp-500 (last visited Nov. 13).

1993 to 2003[56]. But the firm size and performance can explain only 40% of the actual increase, with 60% of the total increase remaining unexplained[57]. It implies that v and β must have increased to explain the 60% pay growth.

F. Investors Use Financial Ratios to Evaluate Corporation's Performance

It has a long history that investors and boards of directors rely on financial ratios to make business decisions, such as evaluating stock prices[58]. A study made in 1912 identifies eight ratios most useful in the analysis of company performance[59], which develop to the modern accepted ratios, such as pre-tax profit margin, liquidity ratio, capitalization ratio, and net income to net worth[60]. Most, if not all, of the ratios focus on how well certain assets of the corporation can produce revenue. For example the net income to net worth ratio shows how much the company is earning on the shareholders' investment, about which shareholders are obviously curious [61]. The amount of a CEO's compensation influences this ratio indirectly in a manner that the net income

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[56] Lucian Bebchuk & Yaniv Grinstein, The Growth of Executive Pay, 2 (2005).

[57] Bebchuk & Grinstein, at 8.

[58] See generally J. Edward Ketz, et al., A Cross-Industry Analysis of Financial Ratios: Comparabilities and Corporate Performance 1 (1990).

[59] Sister Isadore Brown,O.S.U., M.A., The Historical Development of the Use of Ratios in Financial Statement Analysis 14-15 (1995).

[60] James A. Cotton, Toward Fairness in Compensation of Management and Labor: Compensation Ratios, A Proposal for Disclosure, 18 N. Ill. U.L. Rev. 157, 176 (1997).

[61] Understanding Financial Statements, New York Stock Exchange, 1986-87, at 18.

decreases when CEO pay goes up. [This ratio may raise a red flag for shareholders when revenue is climbing up but the ratio does not look proportionately good.]

II. The Pay Ratio does not Substantially Help Investors Restrain CEO' Compensation and Promote Company Performance

A high pay ratio may warn a board of directors that they need think about the fairness of the CEO pay but it does not evaluate CEO's compensation based on core decisive factors. This ratio does not provide material information with respect to compensation decisions and investment decisions. In spite of the fact that the pay ratio does not necessarily lead to CEO pay cuts, some companies may decrease executive pay if the number is too embarrassing. But this productivity-unrelated deduction can artificially depress the U.S. CEO market and IPOs. The ostensible usefulness of the ratio does not deny the need of compensation disclosure because of the ugly reality of the overcompensation problem. This article proposes an alternative ratio: net income/ CEO pay, which reflects whether a CEO produces the value that entitles him the handsome payment.

A. The Pay Ratio does not Solve Some Controversial Problems, Such as the Lucrative Golden Parachute Provision and Option Plans

The pay ratio disclosure is designed to respond to the public outcry of the lucrative pay to CEOs when they are forced to resign due to their unsatisfying performance. Shareholders feel it unfair to pay a CEO who fails to achieve the financial and operational goals, based on which the compensation was set[62]. But the pay ratio disclosure does not do a better job than current Item 402, which has already covered the golden parachute in a separate table from the summary

[62] See RiskMetrics Group, supra note 29.

compensation table[63]. The pay ratio does nothing to scrutiny the reasonableness and fairness of a strongly favoring CEO golden parachute provision. It does not make any effort to prevent the replay of the Walt Disney's golden parachute litigation, in which Disney Company's shareholders filed derivative lawsuits against the company's board for giving the president Ovitz $140 million for his slightly over one year work[64].

The pay ratio simply compares the a CEO's pay and the median employee pay that are computed based on the same standard set forth in Item 402(c)(2)(x)[65]. Since Item 402(c)(2)(x) leaves unsolved the option valuation, the pay ratio disclosure provides no further help on this issue either and cannot forestall option-award-centered litigation. For example, Professional Management Associates, Inc. entered a five-year compensation agreement with its CEO, who would receive a bonus of 2.5% of the company's pre-tax income, half of which was paid in cash and the other in common stock of the company[66]. The company made a lot of profits with the

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[63] 17 C.F.R. § 229.402 (t).

[64] In 1995, Walt Disney Company hired as the president and second man, Michael Ovitz, who secured a five-year employment contract with an acceleration provision in the event of termination. Because Ovitz did not get along with the CEO Michael Eisner, Ovitz was dismissed and based on the acceleration clause received benefits valued up to $ 140 million. Outraged toward the payment, shareholders filed derivative lawsuits in California and Delaware courts for breach of fiduciary duties. See Walt Disney, Co., Notice of Annual Meeting Stockholders 4 (1997).

[65] The SEC, supra note 1, at 50.

[66] Professional Management Associates, Inc. v. Coss, 574 N.W.2d 107, 109 (ct. of App. MN 1998).

CEO and therefore the CEO's bonus reached astonishingly high numbers during the five years, like $ 65.5 million in 1995 and $102.5 million in 1996[67]. Four institutional shareholders went mad about the compensation and brought a derivative suit against the board for the alleged corporate waste[68]. Even if at that time the board of directors had referred to the CEO and median employee pay ratio, they would not have known the CEO's bonus would soar so much that shareholders would feel it egregiously unfair.

The pay ratio cannot insulate the board or the compensation committee from compensation law suits because it does not solve the lucrative golden parachute and option valuation. Shareholders will sue the board for too much pay to an underperforming CEO based on the golden parachute when the business plummets or they will sue based on undervaluing option awards when the business soars.

B. The Pay Ratio does not Provide Material Information to the Investors

Not only cannot the pay ratio solve some controversies left from the current disclosure regulation, but does not give useful information for investors to make business decisions or for a board of directors to make compensation decisions. "The objectives of the firm are to benefit shareholders by attracting capital, performing efficiently and profitably, and complying with the law[69]." But the pay ratio does not tell shareholders how much profit their company has made or

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[67] Id. at 110

[68] Id at 109.

[69] E. Norman Veasey & Christine T. DiGugliemlo, What Happened in Delaware Corporate Law and Governance From 1992-2004? A Retrospective on Some Key Developments, 153 U. PA. L. REV. 1399, 1411 (2005) (citing a former Chief Justice of the Delaware Supreme Court).

how well the company is performing[70]. As to a compensation evaluation, the pay ratio does not tell the board the CEO's productivity *y*, which can be checked whether the CEO hits the financial and operational goals. The ratio does not compare the CEO's pay to the market opportunity cost *v* to see how much premium the company has paid and whether the CEO's *y* entitles him to the premium[71]. Therefore the pay ratio does not offer substantial guidance to shareholders and the board regarding investments and CEO's compensation.

C. The Pay Ratio does not Necessarily Increase Employees' Morale

Proponents of the compensation ratio rule claim that the rule will reduce CEO's unduly high compensation and bring some reasonable balance to a CEO and regular employees[72] based on the logic that sunlight eliminates unfairness[73]. With embarrassment a compensation committee is pressured to cut CEO's pay. However embarrassment and media attention do not necessarily lead to a board action though the ratio may have some positive effect on the

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[70] Financial ratios indicate the performance of a company. See p. 13.

[71] See p. 8.

[72] Cotton, supra note , at 178.

[73] See generally Louis D. Brandeis, Other People's Money and How Bankers Use it 92, 101-102 (1914)(claiming "sunlight is said to be the best of disinfectants . . . and publicity has already played an important part in the struggle against the Money Trust" and believing the investors will strike the unreasonably high commissions if bankers disclose them).

company's consciousness of the pay gap[74]. Thus "[d]isclosure itself doesn't necessarily restrain executive pay"[75].

Moreover, there are other ways to decrease the pay ratio without actually hurting a CEO's compensation. First, a CEO can increase the median person's pay and at the same time squeeze out juice from the below median employees as long as their compensations are above the legal minimum. Dodging media critics, this action does not make workers at the bottom feel any better and worsens the morale[76]. Second, a CEO can increase workers' compensation but trim down their training expenses. This method is not of the company's best interest because it risks lowering employees' productivity. In a long run, the redistribution of labor expense to salaries does not boost the company's morale because its employees cannot compete with well-trained workers from comparable companies.

D. The Pay Ratio Unduly Influences CEO's Operational Decisions and May Cause Novel Opaque Pay Methods

[74] See Stabile, supra note 49, at 163 (stating that "it is unlikely that merely disclosing compensation ratios will lead to some action that will create a more reasonable relationship between the pay of executives and rank and file workers.").

[75] Accounting Professor: Transparency Won't Necessarily Control CEO Pay, Temple. U. News Center, (Oct. 17, 2007) http://news.temple.edu/news/accounting-professor-transparency-won%E2%80%99t-necessarily-control-ceo-pay (citing Professor Steven Balsam).

[76] Cf. Cotton, supra note , at 181.

The pay ratio exaggerates unfairness of the CEO's compensation without allowing necessary adjustments for employee coverage[77]. The rigid rule may invoke two responses from CEOs, which are changes of the labor structure and creation of novel compensation methods. First, some companies will be incentivized to outsource poorly paid jobs to increase the median payment number. The flip side is the increase of administrative cost and losses of profits generated by the to-be-outsourced department. Or companies will reduce workforce in their foreign subsidiaries where the labor cost is relatively low. But obviously this reduction sacrifices the low labor cost advantage. Therefore the proposal does not motivate CEOs to maximize companies' interests.

Second, executives may create some opaque and novel compensation method that is not under the "total compensation" radar[78]. The SEC proposed a flexible approach to compute a CEO's and the median person's compensation, such as using tax records or payrolls[79]. In this situation, executives can recommend boards of directors to pay them benefits in a novel way that the benefits are included in their payrolls or tax records. The disclosure will be "a continuing race between the regulators, on the one hand, and corporate executives and their compensation consultants, on the other[80]."

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[77] The SEC, supra note 1, at 36 (stating that the SEC disallows such adjustments due to high costs though it admits some adjustments avoid distortion of the pay gap).

[78] David I. Walker, The Manager's Share, 47 Wm. & Mary L. Rev. 587, 656-57 (2005)

[79] The SEC, supra note 1, at 117.

[80] Walker, supra note, at 656.

E. Assuming the Pay Ratio Disclosure Does Make the Board Cut a CEO's Compensation, the Pay Cut is not Always Good for the Company and Shareholders

i) Promoting Social Equality is not a Shareholder's Primary Purpose

CEO compensation reduction may make the society appear more equal by narrowing the pay gap of different talents in various professions. CEO's pay is directly involved in the growing disparity of incomes within the top twenty percent[81]. The generous executive compensation attracts people who have talents for other occupation to the already competitive CEO market, and therefore make people less happy and less successful than they would have become had they not choose the CEO path[82]. Even if the lowered compensation rate releases people to utilize their talents better, shareholders care more about a company's profits than social equality[83]. Investors would not incorporate social governance issue into their investment decision[84] because no clear authoritative research reflects that the market incorporates workers' satisfaction fully into stock valuations[85]. The SEC acts out of the delegated authority of protecting investors by advocating for other stakeholders, such as employees and other professionals.

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[81] Charles M. Yablon, Bonus Questions- Executive Compensation in the Era of Pay for Performance, 75 Notre Dame L. Rev. 271, 302 (1999).

[82] Id.

[83] See Veasay & DiGuglimlo, supra note 69, at 1411 (stating the shareholders focus on the firm's performance and profits).

[84] The SEC, supra note 1, 97.

[85] See A. Edmans, Does the stock market fully value intangibles? Employee satisfaction and equity prices, J. FINANCIAL ECONOMICS 101, 621-640 (2011).

ii) The Pay Ratio May Reduce the Number of Certain Compensation Litigations

Compensation litigation arises from primarily shareholders' claim for breach of fiduciary duties for corporation waste. A low pay ratio lends some credence to show the compensation is not unreasonably high. For example, if UnitedHealth Group compensation committee had looked at the pay ratio number during Dr. McGuire's administration, it might have concluded CEO Dr. McGuire's backdate stock options were too much and reduced the pay to avoid shareholders' lawsuit[86]. A board of directors or its compensation committee obtains a direct view of the fairness of the CEO's compensation and may deny the oversized pay package to forestall money-burning litigations. But the ratio cannot effectively prevent golden-parachute or option-valuation related lawsuits[87].[the ratio may provide shareholders information to lobby for changes in a company's compensation structure (One for A P163)]

F. Calculation of the Pay Ratio Incurs High Cost and Discourages IPOs

A large number of registrants and law firms object to the proposal due to the foreseeable huge costs that would be incurred by the proposal. The SEC estimates the direct costs to calculate the ratio may include approximately 201 to 500 hours per year and $3 to $100 million dollars[88]. The number varies depending on the complexity of privacy data compliance and

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[86] After years of litigation, the federal court approved special litigation committee's settlement. The protracted lawsuit brought the plaintiffs' counsel attorney's fees in the amount of more than $29 million which was paid by the company. <u>In re UnitedHealth Grp. Inc. S'holder Derivative Litig.</u>, 631 F. Supp. 2d 1151, 1154 (D. Minn. 2009).

[87] See p.14.

[88] The SEC, supra note 1, at 102.

different payroll system processes[89]. In addition, the disclosure of the median payment amount may provide sophisticated competitors with a clue to infer a registrant's cost structure and therefore places the registrant in a disadvantaged position compared to non-registrant[90].

The competitive disadvantages raise the costs of raising capital through public trading markets and thereafter discourage companies to go public. The additional monetary cost obviously makes an initial public offering ("IPO") less attractive mean to raise capital though the negative impact might not constitute a fatal factor that would kill the IPO[91]. However a CEO would feel reluctant to list the company because of the threatening embarrassment of pay ratio disclosure. Therefore the pay ratio exerts a negative effect on IPOs.

G. Net Profit/ CEO's Compensation Ratio- An Alternative

[89] See p. 5.

[90] Id. at 104.

[91] The author checked the number of IPOs from 1970 through 2004 and focused on the points around the time when a SEC executive compensation disclosure rule came out. Compared to the macroeconomic condition at those points, only the pass of Sarbanes-Oxley Act in July 2002 had a chilly effect on the number of companies going public though the S&P rose during that period. It is not clear the declines of the number of IPO at the following time points were caused by the roll-out of disclosure rules or glooming economic environment, December 1978, September 1983, October 1992, and November 1993. See Jay R. Ritter, Initial Public Offerings: Updated Statistics, Table 8, (Nov. 15, 2013) http://bear.warrington.ufl.edu/ritter/IPOs2012Statistics.pdf; and S&P Index (1960-Present Weekly), http://stockcharts.com/freecharts/historical/spx1960.html.

It is uncertain that the pay ratio will bring shareholders any benefit while it will cause high cost and impose negative impacts on the corporation control. It has been shown that the pay ratio does not seem a promising way to solve CEO's overcompensation. But the failure of the pay ratio does not implicate non-disclosure or a total free market. Without regulatory restraints, CEOs would increase their compensations crazily in this one-side game in spite of the weak compensation committee[92]. So far the distorted CEO market cannot cure the CEO overcompensation reality by itself[93].

I propose to use net income/ CEO compensation ratio instead of the pay ratio to evaluate whether a CEO is overcompensated or not. The smaller the ratio is, the larger share of profits the CEO receives. First shareholders and the board of directors may take this ratio seriously because it indicates whether the CEO takes a large proportion of profits from the shareholders and how well the CEO manages the company. The alternative ratio links the company's performance, the CEO's productivity y, and CEO's pay together. According to the survey mentioned in Part II section C, the net profit/ CEO compensation ratio should at least exceed 1.667[94]. By comparing a company's net income/ CEO compensation ratio with another company's ratio, the board can have a good sense of whether it gives this CEO a large β. Also the board shall have a direct view

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[92] Thomas, supra note , at 1175. Cf. Joy Sabino Mullane, Perfect Storms: Congressional Regulation of Executive Compensation, 57 Vill. L. Rev. 589, 591 (2012) (alleging that any executive compensation disclosure regulation has correlated to economic turmoil, rising unemployment, and an executive pay controversy and the resulting legislation is a serious flaw).

[93] See p. 10 & 12.

[94] See fn. 35.

on how the profit distribution has changed through a vertical comparison of the ratios of the same CEO during different time periods.

Second, my proposed ratio does not incur any additional calculation cost but can still make employees feel happy and fair. A registrar does not have to devote any extra money to compute the net income/ CEO compensation ratio because it computes the two numbers even without the new rule[95]. If the ratio increases and the profits grow, shareholders and employees will both be happy about the good company performance despite of the large number of the CEO compensation. Shareholders can expect big dividends and employee large bonuses from the growing profits.

Third, the net profit/CEO compensation ratio creates an upward momentum to push CEOs to compete with other CEOs to drive up the ratio. In contrast, the pay ratio put out a CEO's passion to work for the company because it threatens the CEO's pay no matter how large profits the CEO leads employees to make.

Conclusion

The SEC proposed the pay ratio disclosure rule which is designed to resolve the CEO's overcompensation issue. Hiring a CEO is almost the second important decision of the board after a merger and acquisition decision. The majority believes CEOs are generally overpaid because boards of directors are captured by CEOs. The Congress and SEC hope the unreasonable pay

[95] Every registered company must calculate its annual net income in preparation for the basic financial statements and the total CEO compensation is a required item on the company's summary compensation table. See p. 13 & 3.

ratio of CEO and median employees will embarrass boards of directors and make them cut CEOs' pay checks.

However the pay ratio does not provide material information to investors and boards of directors regarding the relationship between a company's performance and a CEO's compensation. A CEO may create other ways to shrink the pay ratio without actually reducing his own compensation. The pay ratio may promote social equality and reduce certain types of compensation litigations but at the expense of CEOs' wise operational decisions and high capital costs. Due to the overcompensation reality and the undesirable pay ratio, the author propose net profit/CEO compensation ratio as an alternative item to be disclosed by registrars. The alternative ratio provides reasonable valuation of the CEO pay and his productivity while avoids the high calculation cost. The SEC should adopt the net profit/CEO compensation disclosure rule to offer shareholders useful information that enables them make informed investment decisions.