



## CRS Report for Congress

# Excessive CEO Pay: Background and Policy Approaches

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### Summary

During the past several decades, average pay for non-management workers has stagnated, after adjustment for inflation, falling slightly since the early 1970s. In contrast, compensation of top corporate executives has risen dramatically. Supporters of current CEO pay levels argue that executive compensation is determined by normal private market bargaining, that rising pay reflects competition for a limited number of qualified candidates, and that even the richest pay packages are a bargain compared with the billions in shareholder wealth that successful CEOs create. Others, however, cite instances in which executive pay appears to be excessive. Some see a social equity problem in which CEO pay is seen to embody a troublesome rise in income and wealth inequality. Others see excessive pay as a form of shareholder abuse made possible by weak corporate governance structures and a lack of clear, comprehensive disclosure of the various components of executive compensation. This report describes the major legislative and regulatory proposals that have sought to remedy these perceived problems. It will be updated as events warrant.

### Background

Publicly traded corporations — those required to file financial statements with the Securities and Exchange Commission (SEC) — must in their annual proxy statements disclose the total compensation of the five highest-paid executives. These data, as compiled by various publications, consultants, and information vendors, comprise the basis for all public statistics on executive compensation. Other than the top five individuals, corporations generally provide no information about management pay.

Most accounts of executive compensation are not based on comprehensive statistics, but on samples. For example, *Business Week* for many years published tables of CEO pay at 300 or 400 large corporations. These figures (which are presented in CRS Report 96-187, *A Comparison of the Pay of Top Executives and Other Workers*, by Linda Levine)

show that the ratio of average CEO pay to average non-management worker pay rose from 50:1 in 1980 to 349:1 in 2004. This raises the question: Do public shareholders (i.e., CEOs' employers) get their money's worth?

The results of the numerous academic studies of the relationship between CEO pay and corporate performance are mixed. Few would dispute Warren Buffett's claim that "...it's difficult to overpay the *truly* extraordinary CEO of a giant enterprise. But this species is rare."<sup>1</sup> More controversial, but not without support in the empirical literature, is his additional observation:

Getting fired can produce a particularly bountiful payday for a CEO...Forget the old maxim about nothing succeeding like success: Today, in the executive suite, nothing succeeds like failure.<sup>2</sup>

This may be why CEOs attract more resentment and criticism than wealthy athletes, movie stars, or entrepreneurs — their pay often goes up even when their performance is mediocre or worse, and they preside over organizations created and maintained by others, where their personal contributions are not always easy to discern. The perception that many, if not all, top executives are overpaid leads to questions about the compensation process.

CEOs serve at the pleasure of the board of directors, who represent the interests of — and are elected by — shareholders. Executive pay is set by the board. In principle, boards should bargain on the shareholders' behalf, creating a competitive market for executive services. However, there are several reasons why this might not happen.

Directors are elected by shareholders, but usually nominated by management, and it is extremely rare for management's slate of directors to be voted down. According to various observers, once on the board, directors are reluctant to press managers on pay because unless cordial relationships prevail, the board will find it difficult to function.<sup>3</sup> Rather than haggle, they often hire compensation consultants, who recommend a "best practices" approach, which generally means matching what the most successful companies in the industry pay. Finally, many directors are themselves serving or retired CEOs.

Thus, there is a widespread belief that the market for chief executives is economically inefficient and that market discipline weakens as one nears the top of the corporate pyramid. As a consequence, many argue that CEOs have been the beneficiaries of substantial pay packages that have frequently been achieved at the expense of the 54

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<sup>1</sup> "To the Shareholders of Berkshire Hathaway Inc.," *Berkshire Hathaway 2005 Annual Report*, p. 16.

<sup>2</sup> *Ibid.*

<sup>3</sup> This would help explain why CEO pay never seems to fall even though polls show that significant numbers of directors believe CEOs are overpaid: no one wants to be the first to cut pay.

million American families who own corporate stock.<sup>4</sup> In turn, fueled by publicity over especially lucrative salaries, stock windfalls, retirement benefits, or severance payments, these concerns have prompted a range of legislative and regulatory responses.

## Key Regulatory and Legislative Developments

There have been two general approaches to executive pay reform. First, changes to securities laws and regulations have attempted to strengthen the bargaining position of shareholders by (1) requiring more complete and comprehensible disclosure of CEO pay, (2) making boards more responsive to shareholder interests, or (3) requiring direct shareholder approval of executive pay packages. Some of these initiatives are the result of regulatory initiatives, while others are or were legislatively based. Second, Congress has tried to restrain the growth of executive pay by eliminating the tax deduction for compensation paid in excess of specified caps.

**Disclosure-Based Approaches.** The requirement that publicly traded companies disclose how much they pay top executives dates from the 1930s. The SEC has modified the disclosure format several times, as the forms of CEO pay have become more various and complex. In 1992, the SEC required that proxy statements include tables setting out several categories of pay for the top five executives. These included base salaries, bonuses, deferred, and incentive-based compensation, including stocks and stock options.

**SEC 2006 Disclosure Rules.** By 2006, the SEC had concluded that the 1992 disclosure rules were, in the words of SEC Chairman Christopher Cox, “out of date.... [They] haven’t kept pace with changes in the marketplace, and in some cases disclosure obfuscates rather than illuminates the true picture of compensation.... We want investors to have better information, including one number — a single bottom line figure — for total annual compensation.” In addition, the SEC called for changes that would require firms to use “plain English” in all their proxy statements, information statements, and annual reports.<sup>5</sup>

To this end, the SEC amended its disclosure rules in 2006 to combine what it called a “broader-based tabular presentation with improved narrative disclosure supplementing the tables” in order to give shareholders and board members a “fuller and more useful picture of executive compensation.”<sup>6</sup> Announced on July 22, 2006, further amended on December 22, 2006, and currently under consideration, the revisions would apply to disclosure in proxy and information statements, periodic reports, current reports and other

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<sup>4</sup> The Federal Reserve’s *Survey of Consumer Finances* reports that in 2004, 48.6% of 112.1 million U.S. families owned stock, either directly or through a retirement account.

<sup>5</sup> Christopher Cox, “Speech by SEC Chairman: Chairman’s Opening Statement; Proposed Revisions to the Executive Compensation and Related Party Disclosure Rules,” Jan. 17, 2006, [<http://www.sec.gov/news/speech/spch011706cc.htm>].

<sup>6</sup> “Executive Compensation and Related Person Disclosure,” *Federal Register*, vol. 71, no. 174 (Sept. 8, 2006), p. 53160; “Executive Compensation Disclosure,” *Federal Register*, vol. 71, no. 250 (Dec. 29, 2006), p. 78346.

filings under the Securities Exchange Act of 1934, and registration statements under the Exchange Act and the Securities Act of 1933.<sup>7</sup>

The new and revised tables in the 2006 rules include a

- Revised *Summary Compensation Table*, which was changed to include a “Total” column aggregating the total dollar value of each form of compensation quantified in the other columns;
- New *Director Compensation Table*, which resembles the new Summary Compensation Table, but differs in that it requires companies to present information only with respect to the last completed fiscal year; and
- New *Grants of Plan-Based Awards Table*, which requires companies to disclose information on the fair value of the awards on the day of the grant.

For stock awards and option awards reported in the Summary Compensation Table and Director Compensation Table, the SEC initially required in its July 2006 rules that companies report the total value of an award made in a given year. The December amendments revised that requirement, specifying that companies had to report in the tables only the portions of the awards that vest in the year to which the proxy applies.<sup>8</sup> In addition, the December 2006 amendments require companies to include footnotes in its Director Compensation Table corresponding to the Grants of Plan-Based Awards Table fair value disclosures.

In addition to the new and revised tables, the SEC introduced new rules for narrative disclosure. The narrative disclosure is intended to aid in the understanding of the tabular information. For example, with the Summary Compensation Table, companies must provide information on the material terms of each grant, “including but not limited to the date of exercisability, any conditions to exercisability, any tandem feature, any reload feature, any tax-reimbursement feature, and any provision that could cause the exercise price to be lowered.”<sup>9</sup>

**Shareholder Approval.** H.R. 4291 (109<sup>th</sup> Congress), the Protection Against Executive Compensation Abuse Act, would have required additional compensation disclosures, including a full statement of a company’s compensation plans for its principal executive officers, disclosure of all compensation (current, deferred, and contingent) paid or to be paid to the officers, the estimated market value of any other benefits received by the officers, and a company’s performance measures for determining executive

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<sup>7</sup> “Executive Compensation and Related Person Disclosure,” *Federal Register*, vol. 71, no. 174 (Sept. 8, 2006), p. 53158.

<sup>8</sup> The SEC explained its December 2006 revisions thus: “Disclosing the compensation cost of stock and option awards over the requisite service period will give investors a better idea of the compensation earned by an executive or required disclosure of the sum of the number of securities underlying stock options granted (including options that subsequently have been transferred), with or without tandem stock appreciation rights (SARs), and the number of freestanding SARs.” “Executive Compensation Disclosure,” *Federal Register*, vol. 71, no. 250 (Dec. 29, 2006), p. 78338.

<sup>9</sup> *Ibid.*, p. 78343.

compensation. The bill also called for shareholder approval of all compensation plans. Moreover, the bill aimed to expose golden parachute compensation plans by requiring proxy solicitation material about mergers or the disposition of a company's assets to disclose any agreements with its principal executive officers regarding any compensation based on or related to the transaction.

The following legislative and regulatory developments have also affected CEO pay, although that was not their primary focus.

***The Sarbanes-Oxley Act of 2002 (P.L. 107-204).*** Enacted in the wake of widespread accounting scandals at firms such as Enron and WorldCom, P.L. 107-204 contains a broad range of corporate governance and accounting reforms, some of which are relevant to executive pay. Section 403 of the act requires insiders (defined as officers, directors, and 10% shareholders) to file with the SEC reports of their trades of the issuer's stock before the end of the second business day on which the trade occurred. This provision applies to grants of stock options, a major form of executive compensation. Previously, option grants did not have to be disclosed until 45 days after the end of the fiscal year.

Section 402 of the law makes it unlawful for a public company to make loans, directly or indirectly, to any director or executive officer.

***Changes in NYSE and Nasdaq Listing Standards.*** In 2003, the SEC approved changes to the listing standards of the New York Stock Exchange (NYSE) and the Nasdaq Stock Market that require shareholder approval of almost all equity-based compensation plans. Firms must disclose the material terms of their stock option plans prior to the shareholder vote. The required disclosures include the terms on which stock options will be granted and whether the plan permits options to be granted with an exercise price that is below the market value of the company's stock on the date of the grant.

***FASB's Options Accounting Rule.*** In 2004, the Financial Accounting Standards Board (FASB), a private sector entity that writes accounting standards under the authority of the SEC, released accounting directive FAS 123R, which requires companies to recognize the value of employee stock option grants in their income statements. (Previously, most companies had simply noted the value of options grants in the footnotes to the financial statements.) Recognition of the cost of options has the effect of reducing reported earnings. Companies may reduce this impact by granting fewer stock options to their officers and employees. Thus, FAS 123R may have constrained executive pay even though that was not its primary intent.

***Approaches Involving Caps on Tax Deductibility.*** The second approach to CEO pay reform is to discourage excessive compensation through the tax code, by limiting the deductions available to either the firm or the employee when certain caps are exceeded. While companies may generally deduct all employee compensation from taxable income, various legislative proposals, and enacted legislation place limits on the tax deductibility of certain forms and amounts of pay. Such key approaches are described below.

**The Omnibus Budget Reconciliation Act of 1993 (OBRA).** P.L. 103-66 established code section 162 (m), “Certain Excessive Employee Remuneration,” which imposes a \$1 million cap that applies to the CEO and the four next highest-paid officers. No tax deduction for compensation above the \$1 million limit is permitted, except for “performance-based” pay, such as commissions or stock options, where the ultimate compensation received by the executive depends on the stock price, reported sales or profits, or some other financial indicator.

The OBRA provision is widely believed to have contributed to the increased use of stock options in CEO compensation in the mid- and late 1990s.<sup>10</sup> To the extent that this is true, OBRA may have had the unintended consequence of *increasing* CEO pay.<sup>11</sup>

**Income Equity Act.** Former Representative Martin Olav Sabo introduced legislation in several Congresses (e.g., H.R. 3260, 109<sup>th</sup> Congress) to deny a corporate tax deduction for compensation paid to any individual that was in excess of 25 times the compensation received by the lowest-paid full-time employee of the company. None of these bills was reported out of committee.

**H.R. 2 (Senate Version).** The version of H.R. 2 (the minimum wage bill) passed by the Senate on February 1, 2007, included several tax provisions, one of which applies to executive pay. Current tax rules permit individuals to defer taxes on income that is held in nonqualified deferred compensation plans. Under the Senate version of H.R. 2, an individual could defer no more than \$1million annually from taxable income by contributing to such a plan.<sup>12</sup> The version passed by the House had no similar provision.

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<sup>10</sup> Other factors, such as the wave of public offerings by cash-poor technology firms and the bull market itself, also increased the popularity of options during the 1990s.

<sup>11</sup> For example, see the “Testimony Concerning Options Backdating,” by Christopher Cox, Chairman, SEC, before the U.S. Senate Committee on Banking, Housing and Urban Affairs, Sept. 6, 2006.

<sup>12</sup> Joint Committee on Taxation, *Description of the Chairman’s Modification of the Provisions of the “Small Business and Work Opportunity Act of 2007”* (JCX-5-07), Jan. 17, 2007, p. 25.