May 24, 2006

Statement on the Introduction of the Protection Against Executive Compensation Abuse Act *

The introduction of the Protection Against Executive Compensation Act (the "Act") puts a spotlight on significant problems in our corporate governance system. These problems are ones that would be important to address.

Making Executive Compensation Transparent: Reforming the disclosure of executive compensation is necessary because companies have long taken advantage of "holes" in existing disclosure regulations to "camouflage" large amounts of compensation. Firms should not be permitted to fail to provide investors with a complete, accurate, and transparent picture of pay packages. The introduction of the Act and the recent proposals made by the SEC would hopefully lead to expansion in disclosure requirements that would make executive pay transparent.

A recent study by Robert Jackson and myself highlights the problem of inadequate disclosures.¹ Because firms generally do not report a dollar value for executives' pension plans, their value is omitted from pay figures relied on by investors, the media, and compensation researchers. Companies do, however, disclose information that enables researchers willing to do

* This statement reflects my personal views, which should not be attributed to Harvard Law School or its Program on Corporate Governance. It draws on my written work including my book (co-author with Jesse Fried) Pay without Performance: The Unfulfilled Promise of Executive Pay (Harvard University Press, 2004). *

some work to estimate the plans' value. After deriving estimates for CEOs of S&P 500 companies, our findings with respect to the two-thirds of CEOs with a pension plan were as follows: (i) the executives’ pension plans had a median actuarial value of $15 million; (ii) the ratio of the executives’ pension value to the executives’ total compensation (including both equity and non-equity pay) during their service as CEO had a median value of 34%; and (iii) including pension values increased the median percentage of the executives’ total compensation composed of salary-like payments during and after their service as CEO from 15% to 39%.

In addition, the pension benefits in our sample varied considerably with respect to both their magnitude and their relationship to the executives’ overall compensation. Our findings indicate that firms' failure to report an estimated monetary value for executive pension plans has led to (i) significant underestimation of the magnitude of executive compensation; (ii) severe distortions in comparisons among executive pay packages; and (iii) significant overestimation of the extent to which executive pay is linked to performance.

Investors have been even more in the dark about the benefits executives derive from deferred compensation plans. These enable executives to enjoy tax-free accumulation of investment gains by shifting tax liability to the company. With firms not reporting the amounts their executives have deferred—as current disclosure requirements permit them to do—it is difficult for outsiders to obtain even a rough estimate of executives' gains from such plans.

I should stress that, while retirement benefits have played an important role in camouflaging pay, there are other ways in which firms have provided compensation that is not transparent. Warren Buffett once observed that “executive compensation is the acid test of corporate governance.” Expanded disclosure is essential for investors to evaluate better how companies score on this critical test. Investors should not have to devote significant effort to make their own estimations from a company jigsaw puzzle.

**Increasing Shareholder Power:** The Act seeks not only to improve disclosure requirements but also to increase shareholders' power to act on the basis of this information. While I prefer increasing shareholder power in alternative ways to the particular one specified in the Act, it is important to recognize that moving in the direction of increasing shareholder power is necessary to address the existing problems of executive compensation and corporate governance more generally.

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While improved disclosure is beneficial, it is insufficient because, insulated from shareholders by existing legal arrangements, boards have not been setting pay arrangements solely with shareholder interests and preferences in mind. Investors' powers to influence corporate decisions are rather limited. After all, despite investors’ pressure on companies to improve their disclosures of pay, it appears that outside legal intervention is necessary to get companies to do so.

Board insulation is partly the result of the impediments confronting shareholders seeking to replace the board. Shareholder power to replace directors, which is a key element of our system of corporate governance, is largely a myth. The impediments facing challengers include shareholders' inability to place candidates on the ballot, incumbent's huge financing advantage, and the widespread presence of staggered boards. In recent research, I document that, during the period 1996-2004, incumbents faced challenges from rival slates seeking to manage their firm better as a stand-alone entity in only about 110 cases, roughly 12 a year. For companies with a market capitalization that exceeds $200 million, there were only 20 such cases over this nine-year period, with challengers winning in only 2 cases. Thus, it is important to recognize that, under existing arrangements, the risk of replacement by shareholders that directors face is practically negligible.

Board insulation is also reinforced by the control that boards have over the corporate rules-of-the-game—that is, the governance arrangements to which the board itself is subject. State law has long denied shareholders the power to initiate any changes in the fundamental corporate arrangement—that is, to initiate a charter amendment or a reincorporation. Furthermore, there is substantial uncertainty about the scope of binding by-law amendments that stockholders may place on the corporate ballot and adopt. Thus far, stockholders have been seeking to influence corporate governance arrangements mainly by passing precatory resolutions. But boards may, and commonly ignore, such resolutions. In a recent study, I have found that, during the period 1997-2004, boards elected not to dismantle a staggered board in a substantial fraction of the cases in which precatory resolution calling for such dismantling won majority approval.

The problems of executive compensation reflect the deeper problems of board unaccountability produced by exiting arrangements. Better disclosure is therefore not a substitute for addressing these problems. Shareholders should have not only more information but also the power they need to use such information effectively.

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