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Throwing Out the Baby and Weighing the Bathwater: The Nonsense of Executive Compensation Oversight

Wynn Willard
Stetson University College of Law

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Throwing Out the Baby and Weighing the Bathwater: The Nonsense of Executive Compensation Oversight

Abstract
[Excerpt] CEO pay averages less than 2.5% of after-tax earnings of S&P 500 companies,[i] making it a rounding error on the corporate profit and loss statement (P&L), but it makes headlines and may be the one thing that rouses the passions of those otherwise uninvolved with the corporation.[ii] It is axiomatic that any given issue of The Wall Street Journal reports companies losing money on this or that, yet daily reports of spending far exceeding amounts paid to the CEO or the entire executive team do not generate Congressional action or public rebuke. Further, it does seem to matter just whose pay is at issue. Forbes reports that Tiger Woods is America’s (and the world’s) top-earning athlete, and Tyler Perry the top-earning actor, both at $78 million.[iii] This produced no debate on the floor of either the House or Senate. Madonna and Lady Gaga together pulled in $205 million as the two highest-paid musical acts,[iv] yet public concern appeared not to progress beyond a Yahoo! Answers webpage poll that simply queried “Madonna vs. Lady Gaga?”[v]

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THROWING OUT THE BABY AND WEIGHING THE BATHWATER:
THE NONSENSE OF EXECUTIVE COMPENSATION OVERSIGHT

Wynn Willard

Introduction

CEO pay averages less than 2.5% of after-tax earnings of S&P 500 companies,¹ making it a rounding error on the corporate profit and loss statement (P&L), but it makes headlines and may be the one thing that rouses the passions of those otherwise uninvolved with the corporation.² It is axiomatic that any given issue of The Wall Street Journal reports companies losing money on this or that, yet daily reports of spending far exceeding amounts paid to the CEO or the entire executive team do not generate Congressional action or public rebuke. Further, it does seem to matter just whose pay is at issue. Forbes reports that Tiger Woods is America’s (and the world’s) top-earning athlete, and Tyler Perry the top-earning actor, both at $78 million.³ This produced no debate on the floor of either the House or Senate. Madonna and Lady Gaga together pulled in $205 million as the two highest-paid musical acts,⁴ yet public concern appeared not to progress beyond a Yahoo! Answers webpage poll that simply queried “Madonna vs. Lady Gaga?”⁵

Baby? What baby?

Government has sought to influence the compensation of executives for decades, but with a repetitive result of unintended consequences. Government intervenes through mandated public disclosure of private contracts, restrictive tax policy, and direct interference with corporate governance. This comes despite statutes and well-established case law in place to protect those with ownership rights in these corporations. Government fails to advance any benefit of executive compensation—foremost, the impetus to create value for shareholders and the nation—and instead sees only costs to be reined in. There is no baby—nothing to be grown, nothing worthy of respect—just outrécs and accusations and rules anew. The solution proposed suggests that refocusing on existing corporate governance mechanisms and enforcement by the judiciary, which is designed to conduct appropriate fact-intensive analysis on a case-by-case basis, is superior to further one-size-fits-all federal legislation and regulation.

Protestors, plumbers, publishers, professors, politicians, and proxy advisors all want to oversee executive compensation

CEO pay commentary seems to have ascended to a level in the popular culture equivalent to “how about those Yankees?” banter—everybody has something to interject regardless
of insight or stake. The Occupy Wall Street website states, “U.S. top executives rake in obscene sums by not doing their jobs.” The AFL-CIO, perhaps not that surprisingly, has multiple pages on its website devoted to CEO pay, leading off with statements like “any way you look at it, CEO pay is outrageous,” and asking, “[o]utraged? Join the movement and help make our economy work for everybody.” Two researchers set out to examine Public Opinion and Executive Compensation, and had no difficulty finding more than 26,000 newspaper articles from 1990-2010, and that the articles evidenced a negative tone. In Switzerland, 34% of voters supported drastically capping executive salaries at just twelve times the company’s lowest wage, even though cabinet members and both houses of Parliament urged rejection in fear of driving companies away. Protest groups, unions, newspaper editors, voting public: all demand a say in executive pay.

Academia, ostensibly in the name of “explaining” executive compensation and how it correlates (or not) to company performance, supplies its own slant. Among the top 20 most downloaded papers on executive compensation found on the Social Science Research Network are Paying People to Lie: The Truth About the Budgeting; Managerial Power and Rent Extraction in the Design of Executive Compensation; and Where are the Shareholders’ Mansions? CEOs’ Home Purchases, Stock Sales, and Subsequent Company Performance. Sometimes the methodology is itself an angle: one recent study drew conclusions about Say on Pay regimes across countries by conducting a “laboratory experiment” which recruited 250 undergraduate students to be paired as CEO and representative shareholder to role-play “the investment opportunity set [and] the payoffs.” Yet for all this effort, one paper that reviewed “the recent literature on CEO compensation” determined that neither of the main schools of thought—managerial power or efficient contracting—“is fully consistent with the available evidence.” Another broadly surveyed the actual pay landscape and its study by academia and reached the same conclusion, but offered that government interventions must somehow be included as “both a response to and a major driver of . . . executive compensation.” Net, academia has toiled for years with little to show, unless chastising executives and boards of directors for complicity in greed is one of the measured achievements.

The government interventions appear to achieve no better results than Occupy Wall Street or academia. Referring to IRS Section 162(m), a 1993 addition to the tax code designed to limit executive compensation, while testifying before Congress, then SEC Chairman Christopher Cox and former member of Congress himself said, “I well remember that the stated purpose was to control the rate of growth in CEO pay. With complete hindsight, we can now all agree that this purpose was not achieved. Indeed, this tax law change deserves pride of place in the Museum of Unintended Consequences.”

Protestors and academics do wield power, but less directly than a government empowered to regulate, so government regulation, combined with its unintended consequences, produces something ranging between troublesome and dangerous. Worse, inherent in the nature of “unintended” is that the consequences are not limited only to those purported to be properly regulated. Moreover, government interest in shaping executive pay is both broad—embedded fundamentally in what expenses may be counted to ascertain income and its proper taxation, and deep—found in legislation dating back
100 years\textsuperscript{17} and continuing with notoriety through the recent Dodd-Frank enactments.\textsuperscript{18} For their part, corporations have taken the sweep of government oversight piece-by-piece, methodically guided by Adam Smith’s Invisible Hand and laws of corporate governance, both assimilating and creating unintended consequences as they go.

**Dodd-Frank: “No one will know”**

The Troubled Asset Recovery Program (TARP) of 2008 contained numerous very restrictive measures\textsuperscript{19} governing the compensation of executives in the included firms,\textsuperscript{20} though this author can find little fault in setting conditions for a private sector corporation’s receipt of tens of billions of taxpayer dollars. The Dodd-Frank Act of 2010 gets no such pass.\textsuperscript{21} Dodd-Frank grew out of lingering outrage of the economic events of 2008, and The Washington Post reported the legislation “would leave the financial industry largely intact but facing a more powerful network of regulators.”\textsuperscript{22} President Obama enthused the legislation provided “90 percent of what I proposed when I took up this fight . . . [w]e’ve all seen what happens when there is inadequate oversight and insufficient transparency on Wall Street.”\textsuperscript{23} Senator Dodd himself offered, tearful-eyed, “[n]o one will know until this is actually in place how it works.”\textsuperscript{24} The Washington Post apparently conflates “the financial industry” with all large publicly held companies in the country bound by the Act’s executive compensation pronouncements. President Obama’s “inadequate oversight” seems to betray him as a lackadaisical student of the mass of regulation over which he presides. Perhaps it is Senator Dodd who is most forthright, for the Davis Polk law firm tallied that the Act would enlist eleven agencies to formulate 243 new rules, conduct 67 studies, and create 22 new periodic reports.\textsuperscript{25} Vying for the greatest piece of nonsense, Dodd wins with the truthful but ironic “[n]o one will know.”

In its over 500 sections, the Dodd-Frank Act could not help but range widely, but in its sections covering executive compensation, it focused its excess on the financial industry. Per section 956, the financial industry alone must report whether it is compensating any employee excessively via incentive-based pay.\textsuperscript{26} This is not limited to the CEO, or to top executives, but applies to any employee. At a single large bank it is estimated that includes 25,000 people.\textsuperscript{27} Further, if that compensation is excessive, or may lead to material financial loss to the corporation, it is forbidden.\textsuperscript{28} There can hardly be anything more one-size-fits-all or more sweeping than asking, “does anyone in your company make too much?” and adding, “if they do, it’s illegal.” What is “excessive”? Despite the Act calling for the SEC and six other agencies\textsuperscript{29} to answer that for America within nine months,\textsuperscript{30} following a call for comment to the proposed rulemaking in April 2011,\textsuperscript{31} nothing has been published.

Dodd-Frank’s other rules for executive compensation apply broadly across industries to all large publicly held corporations listed on U.S. exchanges.\textsuperscript{32} Among them are provisions for any current or past executive officer to be subject to clawbacks in the event of restated financials,\textsuperscript{33} new disclosures of “the relationship between executive compensation actually paid and the financial performance of the issuer,”\textsuperscript{34} and the ratio of annual total CEO compensation to that of the median of all other employees in the
corporation. The CEO/median pay measure has been roundly criticized for its apparent malevolent intent, its lack of utility, and its inscrutable calculation. What is it to tell, other than that a CEO earns much more than a vice president/manager/shop foreman/production worker/truck driver/custodian average? Is one firm with a score of 25 better than another with a score of 40? Should a company outsource all of its production to eliminate lower paid workers to flatten the ratio? Commissioner Daniel Gallagher, in his dissent on the day his SEC announced this proposed rulemaking, excoriated the median pay ratio disclosure as “name and . . . shame,” going on to note, “[t]here are no—count them, zero—benefits that our staff have been able to discern.” He called it “another page of the Dodd-Frank playbook for special interest groups who seem intent on turning the notion of materiality-based disclosure on its head.”

**Dodd-Frank passes off to a proxy**

A final area of broad executive compensation regulation contains the Act’s *non-binding requirements*—which concept, per Dodd-Frank, is not an oxymoron. Shareholders shall vote to approve golden parachute payments in any change-in-control transaction; and to approve the corporation’s executive compensation practices, overall, ongoing: i.e., “Say on Pay”; and even also vote how often to vote, i.e., “Say on When.” This regulation stipulates the votes do not have power to bind the board of directors, yet Say on Pay has already proven to impose a one-size-fits-all, belt-and-suspenders solution with all of the costs that come with outsized, redundant rulemaking. On one hand, very few corporations fail the vote, yet all must put the mechanisms in place, which costs the shareholders must bear. On the other hand, the optics of failing a vote, or even passing with a too-slim margin, is sufficiently daunting to cause corporations to fear any adverse recommendation of established third-party “proxy advisory” firms and to kowtow to their directives. The mass of corporations to be evaluated militates that evaluative measures tend toward high level, one-size-fits-all, with the largest proxy advisor, Institutional Shareholder Services (ISS) annually publishing its highly quantitative Say on Pay rating methodology. Despite the distrust of for-profit Corporate America shown by the calls for oversight, these same voices have unwittingly caused immense power to be vested in an oligopoly of for-profit proxy advisory firms such as ISS and Glass Lewis.

Moreover, the ability of proxy advisors to influence boards to change executive pay policies or otherwise face negative recommendations that send stock prices downward is recognized, though not applauded. Defensive costs to hire proxy advisors, compensation consultants, and lawyers rise even with passing votes. Where a Say on Pay vote does fail, notwithstanding Dodd-Frank’s language that the vote is non-binding “and may not be construed . . . to create or imply any change to the fiduciary duties of such issuer or board of directors,” frivolous follow-on shareholder litigation can cause more damage.

ISS recommendations are formulated at a high, generic level to serve most cases, while a company’s board best governs “by ensuring its pay programs are suited to its specific circumstances, challenges and opportunities—which may mean deviating from ISS’ standards.” One compensation consultancy—the type firm boards hire to help design
executive compensation (and now to steer clear of proxy advisor firms’ negative recommendations)—notes eight areas of unintended consequences driving toward “homogenization,” set in motion “to compromise in order to improve external perceptions of the pay program, even though the resulting design may be sub-optimal to both executives and long term shareholders.” It comes down to this: while the proxy advisors’ overarching task is to prove or disprove “overall alignment of CEO pay to company performance,” there is no universally agreed-upon test to determine its existence or strength. For performance, there is a general concession that total shareholder return (TSR) is perhaps the best measure over the long-term, but also that there should be no limit to a single measure to serve all cases. For pay, it is less the measure that is argued than the alternative methodologies of calculation.

Who’s stupid?

In sum, the background of executive compensation oversight is one of unintended consequences. In most cases, corporations find workarounds, many of which push executive compensation in different—and sometimes higher—directions. Executives earn the same or more as before, and shareholders reliably foot the bill for the new administrative costs to get the equivalent of the old results. Why should the private relationship between holders and issuers of shares of ownership be violated if the shareholders mainly were happy with the old results to begin with? One influential answer was provided by Representative Frank, who said, "[i]t turns out . . . that these shareholders, who are wonderfully thoughtful and collectively incisive, become quite stupid when it comes to paying the boss, the guy who works for them."

Then again, another answer may be that the executive compensation subject to so much regulation is reasonably inconsequential to shareholders.

Executive pay costs are dwarfed by the opportunity for value creation

Imagine it’s late 2003 and Steve Jobs, CEO of Apple, approaches you as a wealthy investor to make an inspiring case that he can multiply any money you invest nearly 10 times over in ten years. Your $10 million would be grown to almost $100 million with no further work on your part. Should a thought that he may be paid too much if he is successful for both of you top your concerns? How much would you be willing to pay an industrious business partner who could increase your wealth by nearly $1 million, or $10 million, or $100 million? Half? Just a quarter? A stingy tenth? For S&P 500 companies, the CEO received on average just 2.4% (and never topping 4%) of corporate after-tax earnings for the period 1993-2007. Steve Jobs (and successor Tim Cook, after Jobs’ death in 2011) actually delivered $471,508,000 ten years later for a $10,000,000 investment—nearly a 50 times multiple. Along the way, Apple popularized the infant iTunes and iPod, revitalized their computer line-up with MacBook, and introduced the transformative iPhone and iPad devices.

To further impress the scale of the value creation opportunity, it is instructive to again consider Apple in 2003, but in relation to two competitors, Motorola and Nokia.
Motorola in 2003 was a storied company, having introduced the first car radio in 1930, the first portable two-way radio, and the Dyna-Tac, the first portable cellphone in 1983. Its sixth-year CEO in 2003 was the grandson of the founder, but the press thought him a dud, his board lost confidence, and it turned him out. His successor lasted four years, during which he chose not to address Motorola’s software weakness nor even maintain its onetime strength in technology. He pushed the Razr to become the biggest selling cellphone model ever, first based on style, then price-cutting, but unlike the iPhone against which it began competing in 2007, “it didn’t actually do anything . . . [i]t was just a slimmer cell phone.” Motorola in 2003 had almost a 15% share (second place) of the worldwide cellphone market, but had just lost its share leadership in the U.S. to Nokia, and had no presence in smartphones. Razr sales pushed worldwide share to nearly 21% by the end of 2006, but lack of successful follow-up products and no smartphone presence when iPhone debuted left Motorola’s share at just 12% one year later. Motorola spun off its cellphone business in 2011, and Google purchased it in 2012, since which time Motorola’s market share continued to decline, in 2013 to under 2%. The same $10,000,000 invested in 2003 in Apple that produced $471,508,000 in 2013, if invested in Motorola, would have returned just $15,179,000—including the initial $10,000,000.

Nokia was the 2003 worldwide leader in the market for cellphones with a nearly 35% share, having benefitted from long-time CEO Jorma Ollila’s direction to narrow his conglomerate’s focus to telecommunications. While Motorola had opted for new style with its Razr flip-phone, Nokia focused on new substance, in 2002 making it “a pioneer in the smartphone market, literally introducing consumers to the smartphone.” In 2007, when Apple introduced the iPhone, Nokia held dual worldwide market share leadership with a 40% share for overall cellphones and 51% for smartphones. In the next year it lost 10 percentage points of its smartphone share to Apple. By 2013, its overall cell phone share fell to 14%, ranking second, and its smartphone share fell to under 4%, ranking tenth. For too long, Nokia held onto its outdated smartphone operating system that lacked the Apps capability of iPhone. In September 2013, Nokia announced that it had entered into a deal to sell its cellphone business to Microsoft. The same $10,000,000 invested in 2003 in Apple that produced $471,508,000 in 2013, if invested in Nokia, would have produced $6,036,000, with not only no investment return in ten years, but also 40% of the original funds lost. Meanwhile, Businessweek reported that iPhone revenues alone exceeded that of Procter & Gamble, Boeing, Home Depot, or Microsoft.

Can we keep the baby?

CEO compensation, done correctly, provides the impetus to create value for shareholders; it is not just a cost, it is an investment as tangible as an investment in physical capital. For the individual investor the upside of concentrating on picking a CEO and company to drive visionary, value-creating growth far outdistances picking on a CEO and company for paying too much in executive compensation. Summed across shareholders, the stakes are even more staggering. Taking market capitalization as the most used marker for company value, Table 1 recaps the prior investment figures and goes on to show that the
CEOs of Apple took $9 billion of shareholder investment and turned it into $433 billion, while the CEOs of Motorola and Nokia turned $12 billion into $16 billion, and $43 billion into $25 billion, respectively. Perhaps what separates Occupy Wall Street-ers from Wall Street-ers themselves could hinge on whether their parents invested in Apple, versus Motorola and Nokia!

Table 1
Comparative Returns for Apple, Motorola, Nokia for the 10 Year Period Ending 9/30/13

<table>
<thead>
<tr>
<th></th>
<th>Investment Beg. 9/30/03 ($ million)</th>
<th>Investment End 9/30/13 ($ million)</th>
<th>Return Rate Annual (%)</th>
<th>Return Rate Total (%)</th>
<th>Market Cap Beg. 9/30/03 ($ billion)</th>
<th>Market Cap End 9/30/13 ($ billion)</th>
<th>Value Created ($ billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Apple</td>
<td>10.00</td>
<td>471.51</td>
<td>47.01</td>
<td>4630.0</td>
<td>9</td>
<td>433</td>
<td>424</td>
</tr>
<tr>
<td>Motorola</td>
<td>10.00</td>
<td>15.18</td>
<td>4.26</td>
<td>51.8</td>
<td>12</td>
<td>16</td>
<td>4</td>
</tr>
<tr>
<td>Nokia</td>
<td>10.00</td>
<td>6.04</td>
<td>-4.92</td>
<td>-39.6</td>
<td>43</td>
<td>25</td>
<td>-18</td>
</tr>
</tbody>
</table>

What is the price of freedom?

Does anyone know the real cost of all this regulation? Say on Pay arguably has produced some benefits, with those few firms failing votes changing some suspect practices, but also realizing an advantage from more transparency in communication of compensation rationale. Those with positive votes have likewise become wiser in assessing optics, all the while providing more board documentation, discipline, and process orientation to executive pay decision-making. But those with “winning” non-binding mandatory votes bear the regulatory cost just the same, and they outnumber the “losers” by 50:1. Say on Pay, like much of executive compensation oversight, appears to be a solution in search of a problem.

Finally, cost is not limited to mere economics. Perhaps the greatest cost is to the freedom and rights of the American Dream, as set out in the Declaration of Independence, the Constitution, and over 200 years of jurisprudence. In the area of corporate governance, there is no void for federal regulation to fill, and the Constitution reserves all rights to the states not specifically granted to the federal government. The “fact sheet” that the Treasury Department issued for implementation of Dodd-Frank noting, “shareholders will be granted a Say on Pay . . . [and] management must give shareholders the opportunity to vote” so confounds fundamental principles of corporate governance that it is no less upsetting whether intentional or uninformed. First, management has no power to give the opportunity, only the board does; and second, shareholders are apparently re-“granted” a right by the federal government that state rule of contract and
corporation law has made available all along. Without federal assistance, Disney shareholders in 2009 rejected any need for a Say on Pay vote.\textsuperscript{82} The following year, Congress took away their freedom to choose and required the vote nevertheless. Say on Pay has Congress intervening over the states and declaring all boards either feckless or delinquent and awarding management of the enterprise to shareholders whether they want it or not.

\textbf{Toward a better solution}

There exist six ready solutions for those typically few shareholders who are dissatisfied with the executive compensation practices of their corporations. None requires any federal regulation. First, shareholders may seek to address an issue with a proxy vote put to all shareholders. Second, shareholders may unite to change the bylaws of the corporation to impose enduring new policies. Third, shareholders may join together to change the board. Fourth, even a single shareholder may buy majority control and impose new ways. Fifth, shareholders may sell their stake and withdraw their capital. Sixth, shareholders may sue. All are common paths. Moreover, 67\% of shares are held by institutional investors, which include mutual funds, insurance companies, and pension funds\textsuperscript{83}—capable groups hardly fitting Representative Frank’s description of “quite stupid.”

Legislation by its nature attempts to draw broad rule for the many. In so doing, there is an inherent one-size-fits-all tendency—and federal legislation may be called to do this on a scale fifty times of any state. Federal regulation as conducted by the executive branch may then color in the myriad specifics to govern the many. Unintended consequences abound. Dodd-Frank—as with preceding federal legislative and executive actions on executive compensation—casts a wide net and ensnares all whether they deserve to be caught or not. Further, the politicization of the topic creates its own non-productive flashpoints, as with CEO/median pay ratios, fit of CEO pay and TSR trends, and Say on Pay votes themselves. Politicization also invites to the table non-shareholders to discuss their “rights” to other people’s money, like “heterodox” economists who urge that “[t]o apply the kind of political pressure necessary to actually move the needle on skyrocketing CEO pay, we also need to implement policies that address the concerns of other corporate stakeholders, including taxpayers and workers.”\textsuperscript{84} Notably, there already exists for non-shareholders their own powerful remedy—to continue to decline to invest in ownership.

The reasonability of executive compensation at any given company is best addressed, as required, on a fact-intensive, case-by-case basis. In contrast to the ill-fitting and oversized mantle of legislation and regulation, it is the jurisprudence of the courts that is tailor-made to conduct fact-intensive analysis on a case-by-case basis. The courts draw narrow rule for the parties at bar. Without further federal nonsense, the vast majority of well-governed corporations with well-compensated executives may again devote their full attention to creating wealth for their shareholders. \textit{\&}
Wynn Willard is a Juris Doctor candidate at Stetson University College of Law. He also holds a Bachelor of Science degree from Lehigh University and a Master of Management from Northwestern University’s Kellogg School of Management. Mr. Willard previously served in management roles in large multinational corporations, including Procter & Gamble, Cadbury, and Nabisco—and he has been subject to executive compensation oversight. Mr. Willard would like to thank Professors Joan Catherine Bohl, Clark Furlow and Jason Bent, as well as Derrick Morse, Michael Sepe, and Jason Reily for their assistance.

2 See infra notes 6-19.
4 Id.
15 To regulate executive compensation is to regulate expenditures of the corporation. Shareholders, as owners of the corporation, are directly affected. Customers of the corporation may be affected by any result that changes the price or quality of the goods and services they consume. Society may be affected by any result that causes resources to be spent on one social good to the exclusion of another.
18 The Dodd-Frank Act of 2010 is covered extensively infra.
Murphy, supra note 13, at 104. The measures included tax deductibility of executive pay lowered to $500,000 and applied to non-performance and performance based pay, clawbacks (returns of pay) in the case of material misstatements of financial metrics, and restrictions on golden parachutes.


Id.


Dodd–Frank § 956.


Dodd–Frank Act § 956(b).

§ 956(e).

§ 956(b).


Dodd–Frank §§ 951-957.

§ 954.

§ 953(a)(i).

§ 953(b)(1).


Id.

Across industries to all large publicly held corporations listed on U.S. exchanges.

Dodd–Frank § 951.

§ 951(c).

2013 Say on Pay Report, 1 SEMLER BROSSY (Sept. 4, 2013), http://www.semlerbrossy.com/wp-content/uploads/2013/09/SBCG-2013-Say-on-Pay-Report-2013-09-4.pdf. Only 1.4%-2.6% of companies failed with less than 50% shareholder votes in each of the three years 2011-2013. Companies passing with over 90% approval numbered 72%, 72%, and 77% in those years, respectively.


2013 Say on Pay Report, supra, note 77. The advisory services must review over 2,000 firms and their practices—most during the three-month annual proxy season.


Dodd–Frank § 951(c)(2).

Larcker, supra note 46, at 38-39 n.49.
53 Id.
55 Ford & Zhao, supra note 1.
56 Memoranda from Jason Reilly, CFA, Portfolio Manager, U.S. Trust to author (Oct. 1, 2013) (on file with author).
59 Id.
60 Id.
65 Memoranda, supra note 56.
66 Sharma, supra note 61.
69 Gartner, supra note 62.
71 Id.
75 Memoranda, supra note 56.
77 Memoranda, supra note 56.
78 EXECUTIVE PAY, supra note 52, at 71-78.


