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TESTIMONY

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Executive Pay and the Role of Compensation Consultants

Mr. Chairman and Distinguished Members;

Thank you for the opportunity to appear here today and testify on "Executive Pay and the Role of Compensation Consultants." I am a senior research fellow at the Mercatus Center, a research, education, and outreach organization affiliated with George Mason University and located on the Arlington, Virginia campus. The Mercatus Center's mission is to bridge academics and policy: we conduct interdisciplinary research in the social sciences that integrates practice and theory. Toward that end, we have a variety of policy-relevant research programs and also operate the largest economics-based professional development program for congressional staff, called Capitol Hill Campus. My own research focuses primarily on securities and financial markets regulation.

My remarks today will focus on (1) the academic law and economics literature regarding explanations for increased compensation among public company executives; and (2) other empirical findings relevant to potential conflicts of interest among executive compensation consultants.

Corporate Governance Basics

Corporate governance consists of the rules, entities, and processes that govern how corporations use their assets to generate and distribute revenues among shareholders, employees, and other parties. The ultimate goal of any system of corporate governance, and the criterion by which to judge good from bad governance, is promoting the wealth of shareholders.[1] Today, a corporation is primarily governed by its board of directors, which delegates its own decision-making authority and control to top managers who, in turn, delegate their decision-making authority to subordinate managers and employees.[2]

Under U.S. law, both directors and executive officers of public companies owe shareholders a fiduciary duty of care and loyalty. Furthermore, directors are typically responsible for setting executive compensation. The New York Stock Exchange ("NYSE") and NASDAQ listing standards passed in the wake of the Sarbanes-Oxley Act of 2002 require a majority of a company's board to be independent, and the NYSE in particular requires wholly independent compensation committees.[3] Executive compensation decisions may implicate both fiduciary duties. Although executive compensation decisions can be a form of self-dealing or economically excessive in that it decreases the wealth of shareholders, compensation decisions are made in the ordinary course of business and therefore have a tradition of being afforded substantial judicial deference under a long-standing pillar of American corporate law known as the business judgment rule.[4]

Explaining Increased Executive Compensation

It is undisputable that the compensation earned by executives of public companies has risen in recent decades, in both absolute terms and relative to the compensation of others. What is disputed among academic researchers is the precise source of increased executive compensation and its impact on shareholder welfare.

One influential line of thought argues that increased CEO compensation is the result of entrenched CEOs unduly influencing directors to grant themselves excessive pay to the detriment of shareholders.[5] While certainly possible, the managerial entrenchment theory fails to explain why CEO compensation continued to increase even while boards of directors became increasingly independent of management. That is, from 1997 to the present, a period during which executive compensation grew, the percentage of outside directors serving on boards was consistently increasing and the percentage of insider-dominated boards was decreasing.[6] The entrenchment hypothesis thus leaves us with a puzzle: if CEO compensation has increased because management has "captured" boards, then why do more independent boards also increase pay?

There is a second problem with the managerial entrenchment explanation for increased executive pay. To be able to capture a board, a manager would have to actually be employed by the corporation to establish the requisite close ties with directors. However, CEOs promoted from within the company earn about 15% *less than* CEOs hired from the outside, and this premium for external hires actually grew throughout the 1970s, 1980s, and 1990s.[7] If entrenched managers are unduly influencing compensation decisions of the board, then why do CEOs without the ability to capture directors earn more?

A related problem with the entrenchment thesis is that it does not explain the phenomenon of high compensation generally. There are other groups who earn incomes at least as high as public company executives and do not exploit unsophisticated parties such as retail shareholders. Despite their increased pay, top executives accounted for only 6.1% of the top 5% of income earners in 2004, a space also occupied by financial service professionals, corporate lawyers, and professional athletes.[8] In short, some kind of entrenchment is not needed to obtain an executive-level income, so given the other weaknesses of the entrenchment theory, perhaps we should look elsewhere for an explanation of executive pay.

Now just because the managerial entrenchment theory does not explain all of the data does not mean it is completely wrong. In fact, there have undoubtedly been cases where executives negotiated compensation which benefited themselves at the expense of investors. However, as a law and economics scholar, I must look for theories of executive compensation that best explain what is generally true as a rule, not just stories that explain a few outlying cases. If a policy is based on anecdotes rather than a scientific understanding of what is generally true, then that policy does everyone—investors, employees, consumers, and executives—a disservice.

And there are in fact explanations other than managerial self-dealing for the increases in absolute and relative executive compensation. As former Labor Secretary Robert Reich noted, although CEO compensation does not reflect social or moral worth, increased in CEO pay is best explained by "boards of directors choos[ing] their CEOs from a relatively small pool of proven executive talent" and that today, "[u]nder super-competitive capitalism, boards are willing to pay more for CEOs because their rivals are paying more—and the cost of making a bad decision is so much greater than it was decades ago when competition for investors and customers was far less intense and shareholders were far more placid."[9]

While no economic explanation is likely to perfectly explain all data and decisions regarding executive pay, a substantial body of recent empirical corporate governance research finds that executive compensation is primarily the result of the increased value of corporate assets and the increased competitive pressures faced by executives and corporations. Further, the rise in income inequality between top earners and average employees may be explained by technological progress raising the productivity and/or the prices of goods and services supplied by skilled workers relative to less skilled workers.[10] For instance, advances in computing power likely added more value to the activities of executives than it has added value to the activities of manual workers. These results undermine the notion that executive pay hurts shareholders. To the contrary, they suggest that current levels of executive pay reflect the benefits that good CEOs create for shareholders.

The first explanation comes from a basic principle of economics, which states that compensation for any employee, including CEOs, will be proportional to the economic value the employee adds to the company. Accordingly, to the extent a CEO's value to the company increases as the value of a company's assets increase, then so should the compensation paid to CEOs. As researchers at MIT have found, CEO compensation rose in proportion to the increase in the market capitalization of the largest firms between 1980 and 2000.[11] During that time, while the average asset value of the 500 largest firms grew by 500% (or a factor of six), so did CEO pay rise by that amount.[12]

Consistent with the notion that adding value to a company will cause executive pay to increase is a University of Chicago and National Bureau of Economic Research Working Paper finding that top executives' compensation is strongly related to the performance of a company's stock in a sample of over 1700 hundred public companies in both 1994 and 2004.[13] Perhaps even more significant, a long-term study of executive compensation from

1936 to 2005 by researchers at the Federal Reserve found a significant correlation between executive compensation and firm performance over the past 70 years, concluding that "compensation arrangements have served to tie the wealth of managers to firm performance—and perhaps to align managerial incentives with shareholders' interests—for most of the twentieth century."[14]

Another study, last updated in January of 2007 by researchers at the University of Texas, Washington University, and Indiana University, looked at the data on executives' stock-based compensation and found it to be consistent with companies compensating CEOs for greater ability and effort.[15] Indeed, they found the skewed distribution of CEO pay to be explainable by plausible assumptions about the relative talent of the CEO's compared to that of other employees.[16]

Another explanation for the rise in CEO compensation comes from two observations. The first is that in the past three decades, CEO success has depended more upon possessing general managerial skills; that is, skills transferable across companies and industries, in contrast to skills valuable only to a single company. Second, thanks to advances in information technology, company-specific knowledge and data is now much more easily and quickly acquired thereby reducing the importance of possessing company-specific knowledge. As general managerial skill has increased relative to company specific skills, the market for CEOs has become more competitive, and along with that increased competition, the pay of the most talented managers has increased. [17] The increased importance of general managerial skills also explains why, from 1970 to 2000, pay for externally hired CEOs is higher than for incumbents and also higher for CEOs in industries where hiring from the outside is common.[18]

Another study finds that the market for executive talent has also become more competitive due to globalization. In 2006, researchers from the Institute for the Study of Labor in Bonn, Germany found that "the increase in foreign competition resulting from reductions in trade barriers" was a major explanation for increased executive pay.[19] According to these researchers, more competitive product markets have led to an increased use of incentive compensation among executives which has, in turn, led to higher compensation for the managers talented enough to compete on a global scale.[20]

A final reason for increased executive pay in the last several years may be to compensate executives for increased liability and regulatory risk stemming from passage of the Sarbanes-Oxley Act (SOX) in 2002. The Act requires that the CEO and the chief financial officer (CFO) annually certify to the truth of the company's financial and non-financial disclosures, affirm their responsibility for maintaining internal control, and publicly disclose any significant changes in internal controls. It also increased penalties for violations of its mandates, including increased criminal liability for false certifications and other types of fraud.

Several empirical findings support the notion that SOX increased liability to corporate executives. First, it seems that subsequent to SOX, U.S. public companies have undertaken fewer risky activities such as research and development (R&D). Researchers found that after SOX the gap between the ratio of R&D spending to assets for U.S. and U.K. firms decreased; there was a statistically significant decrease in U.S. R&D spending relative to U.K. firms; and stock-based measures of U.S. firm risk decreased most noticeably among high R&D spenders.[21] Another study found that post-SOX the managerial "hurdle rate" has increased.[22] A hurdle rate is the minimum rate of return required to invest in a project, and an increase is consistent with the notion that managers have become more hesitant in their investment decisions. Second, since the passage of SOX, there has been a substantial increase in turnover among CEOs, CFOs, and directors (although turnover rates may be decreasing and not all increases are attributable to SOX).[23] Third, at least one survey has found that CFOs have shifted their attentions away from strategy and increased their focus on regulatory compliance and short-term risk-management.[24] Finally, post-SOX, director and officer insurance premiums have dramatically increased, with one study from researchers at the University of Georgia and Clemson finding that premiums have more than doubled.[25]

Taken as a whole, these studies seem to paint a more accurate picture of the economics underlying executive pay than the entrenchment theory and, at the very least, deeply call into question the assumption that increased executive compensation is due to entrenchment and board capture, and therefore hurts investors.

Potential Conflicts of Interest Among Executive Compensation Consultants

As executive compensation has increased, so has the use of third-party compensation consultation services. Because compensation consultants also provide noncompensation services, a potential conflict may exist to the extent they have an incentive to advocate for excessive compensation in return for obtaining lucrative noncompensation consulting contracts.

Although a conflict may exist in the abstract, it would be unwise to limit or even prohibit the provision of noncompensation services by compensation consultants. Consider the example of outside auditors providing of nonaudit services. Although corporate governance reforms prohibit auditors from providing nonaudit services to audit clients, the empirical record strongly supports the view that auditor independence is *not* jeopardized by providing nonaudit services. In a 2005 review of the empirical literature regarding the provisions of nonaudit services, Yale Law professor Roberta Romano found that the overwhelming majority of the numerous studies on the issue found no relationship between audit quality and the provision of nonaudit services, and in fact three studies found that auditors providing nonaudit services actually improved audit quality.[26] In addition, in 2006 yet another academic study found that the provision of nonaudit services improves audit quality.[27] A general reason why providing nonaudit services may improve audit quality is because auditors benefit in their auditing work from so-called "knowledge spillovers." The knowledge auditors gain about the company from nonaudit services may enable them to conduct a more effective audit.[28]

Thus, if Congress is considering placing limitations upon the ability of compensation consultants to provide noncompensation services based upon an analogy to conflicts of interest in the provision of nonaudit services, its analogy is faulty. The evidence from the auditing industry suggests that allowing compensation consultants to provide noncompensation services may in fact further shareholder interests. The knowledge spillovers from noncompensation consulting may increase the ability of compensation consultants to construct pay packages appropriately tailored to the unique circumstances of the company and the industry in which it operates.

In sum, lessons from the impact on shareholders by the provision of nonaudit services by auditors strongly cautions against legislative or regulatory action regarding the provision of noncompensation services by compensation consultants. Given the dearth of academic research on this particular issue, certainly all interested parties would benefit from more studies before any further action is taken.

I would like to end with a final caution about increased disclosure. Recently, the Securities and Exchange Commission passed a rule requiring public companies to disclose their use of executive compensation consultants. Some might argue that public companies should also disclose whether these same compensation consultants provide other services to the company. While transparency and disclosure are generally beneficial, shareholders are only better off when companies disclose material information, that is, information relevant to the value of the companies' securities. Since there is not adequate research showing that hiring compensation consultants for nonconsulting services affects shareholder value one way or the other, there is little justification at the moment for requiring companies to disclose such information.

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[1] *Katz v. Oak Indus*, 508 A.2d 873, 879 (Del. Ch. 1986) ("Its is the obligation for directors to attempt, within the law, to maximize the long-run interests of the corporation's stockholders."); Jean Tirole, *Corporate Governance*, 69 ECONOMETRICA 1, 1 (2001) ("The standard definition of corporate governance among economists and legal scholars refers to the defense of shareholders' interests."); Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L. J. 439, 411 (2001) (noting the scholarly consensus that "the best means to this end (that is, the pursuit of aggregate social welfare) is to make corporate managers strongly accountable to shareholder interests, and, at least in direct terms, *only to those interests*") (emphasis added); Sanjai Bhagat & Roberta Romano, *Empirical Studies of Corporate Law*, Yale ICF Working Paper No. 05-16, 3 (2005) ("the benchmark for evaluating the benefit of corporate and securities laws is whether they improve investor welfare").

[2] Stephen M. Bainbridge, *Why A Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 4-5 (2002).

[3] NYSE Rules 303A(1)-A(2) (requiring majority board independence), 303A(4)-(6), A(7)(c) (requiring independent audit, nominating/corporate governance and compensation committees); NASDAQ Rule 4350(c).

[4] ARTHUR R. PINTO & DOUGLAS M. BRANSON, UNDERSTANDING CORPORATE LAW, 211-13 (1999).

[5] *See*, *e.g*., Lucian Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. Chicago L. Rev. 751 (2002)

[6] Linck et al., *The Effects and Unintended Consequences of the Sarbanes-Oxley Act, and its Era, on the Supply and Demand for Directors* (University of Georgia Department of Banking and Finance and Clemson University Working Paper, Feb. 14, 2007)
[7] Kevin J. Murphy & Jan Zabojnik, Management Capital and the Market for CEOs, Working Paper, University of Southern California, 2003.
[8] Steven N. Kaplan & Jashua Rauh, *Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?*, University of Chicago Graduate School of Business and NBER Working Paper 37 (September 13, 2006).
[9] Robert Reich, *Why CEO Pay Continues to Soar*, Robert Reich's Blog, November 11, 2007, http://robertreich.blogspot.com/2007/11/why-ceo-pay-continues-to-soar.html.
[10] Steven N. Kaplan & Jashua Rauh, *Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?* University of Chicago Graduate School of Business and NBER Working Paper 38 (September 13, 2006).
[11] Xavier Gabaix & Augustin Landier, *Why Has CEO Pay Increased So Much?*, Massachussets Institute of Technology Working Paper 06-13 (May 8, 2006).
[12] Id. at 12-13.
[13] Steven N. Kaplan & Jashua Rauh, *Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?*, University of Chicago Graduate School of Business and NBER Working Paper 37 (September 13, 2006).
[14] Carola Frydman & Raven E. Saks, *Executive Compensation: A New View from a Long-Term Perspective, 1936-2005* 33, Finance and Economics Discussion Series,
Divisions of Research & Statistics and Monetary Affairs Federal Reserve Board, Washington, D.C. (July 6, 2007).
[15] Nina Baranchuk, Glenn MacDonald & Jun Yang, *The Economics of Super Managers*, Working Paper (January 15, 2007).
[16] *Id*. at 3, 21-25.
[17] Kevin J. Murphy & Jan Zabojnik, *CEO Pay and Appointments: A Market-Based Explanation for Recent Trends*, 94 Am. Econ. Rev. 192 (2004).
[18] Kevin J. Murphy & Jan Zabojnik, *Management Capital and the Market for CEOs*, Working Paper, University of Southern California, 2003.
[19] Vincente Cuñat & Maria Guadalupe, *Globalization and the Provision of Incentives Inside the Firm: The Effect of Foreign Market Competition*, Institute for the Study of Labor (October 2006).
[20] *Id*. at 16-21.
[21] Leonce Bargeron, Kenneth Lehn & Chad Zutter, *Sarbanes-Oxley and Corporate Risk-Taking*, (American Enterprise Institute for Public Policy Research Working Paper, June 18, 2007); Daniel A. Cohen, Aiyesha Dey & Thomas Z. Lys, *The Sarbanes-Oxley Act of 2002: Implications for Compensation and Risk-Taking Incentives of CEOs* 19, 22 (New York University, University of Chicago and Northwestern University Working Paper 21, July 8, 2005).
[22] Qiang Kang & Qiao Liu, *The Sarbanes-Oxley Act and Managerial Risk Taking: A Structural Assessment* 4 (University of Miami and University of Hong Kong Working Paper, March 1, 2007).
[23] *See* Dan R. Dalton & Catherine M. Dalton, *Sarbanes-Oxley and the Guidelines of the Listing Exchanges: What Have We Wrought?* 50 BUS. HORIZONS 93, 95-96 (2007); Telos Demos, *Doesn't Anyone Want to Be a CFO Anymore?*, CNNMoney.com (reporting that public "[c]ompanies with a market cap of at least $1 billion changed CFOs three times more often in 2005 than in 2002" and that "among public companies of all sizes, CFO exits increased from 1,867 in 2005 to 2,302 in 2006."); FINANCIAL OFFICERS' TURNOVER, 2007 STUDY, RUSSELL REYNOLDS ASSOCIATES 1 (noting that after SOX CFO, controller and treasurer "turnover has increased dramatically"); Deloitte, *How CFOs Can Thrive Under Pressure* 1 Breathing Lessons, A Monthly E-newsletter for CFOs (September 2006); Linck et al., *The Effects and Unintended*

Consequences of the Sarbanes-Oxley Act, and its Era, on the Supply and Demand for Directors 36-37 (University of Georgia Department of Banking and Finance and Clemson University Working Paper, Feb. 14, 2007).

[24] FINANCIAL OFFICERS' TURNOVER, 2007 STUDY, RUSSELL REYNOLDS ASSOCIATES 1 (noting that "[s]ince the introduction of Sarbanes-Oxley . . . the role of the CFO has changed from a strategic role to one that carries much more risk and liability than in previous years. . . As the Sarbanes-Oxley dust is settling, a new breed of CFO is emerging: a *regulatory* expert, with the ability to extend knowledge into accounting, strategy and communications.") (emphasis added).

[25] Linck et al., *The Effects and Unintended Consequences of the Sarbanes-Oxley Act, and its Era, on the Supply and Demand for Directors* (University of Georgia Department of Banking and Finance and Clemson University Working Paper, Feb. 14, 2007); Jo Lynne Koehn & Stephen C. DelVecchio, *Revisiting the Ripple Effects of the Sarbanes-Oxley Act*, CPA J. ONLINE, May 2006.

[26] Roberta Romano, *Sarbanes-Oxley and the Making of Quack Corporate Governance*, 114 Yale L. J. 1521, 1535-36 (2005).

[27] Seong-Yeon Cho et al., *Do Nonaudit Services Enhance Value? Evidence from the Capital Markets*, Working Paper, August 2006.

[28] *Id*. at 3.