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AGENCY

US Securities and Exchange Commission (SEC)

Rule title

Shareholder Approval of Executive Compensation and Golden Parachute Compensation

RIN	3235-AK68
Publication Date	February 2, 2011
Stage	Final

RULE SUMMARY

The regulation implements provisions of the Dodd-Frank Act that require shareholder votes on three topics: executive compensation, the frequency of votes on executive compensation, and golden parachute compensation when shareholders are asked to approve mergers. ("Golden parachute" compensation refers to compensation that executives receive when they depart after mergers, acquisitions consolidations, sales, or other such events.) Companies must display this information in a table and present it to shareholders. Shareholders must then vote on whether to approve the payments or not. The vote is not binding on the board of directors. The regulation also requires companies to disclose how these votes affect their compensation policies and decisions.

COMMENTARY

There is virtually no economic analysis accompanying this regulation. The analysis fails to mention a coherent reason for the regulation, even though it has a section titled "Reasons for, and Objectives of, the Proposed Action." This section just states that the Dodd-Frank law authorized the rule. This is particularly troubling given that asymmetric information and the wide literature on the agency problem are obvious justifications for the rule. The analysis makes no attempt to maximize net benefits and has no serious alternatives. The analysis consists of some assertions that disclosure of how the votes affected corporate practice will make capital markets more efficient by giving investors better and more timely information. The analysis fails to demonstrate that disclosure would be suboptimal in the absence of the regulation, quantifies no benefits, and quantifies only the paperwork cost. There is no evidence that the cursory analysis section had an effect on any decision about the regulation. Finally, the vote required of shareholders is not binding on the board. It would have been interesting to consider what effect a binding vote would have, even though the Dodd-Frank law appears to have required this provision.

This rule's economic analysis was scored by a team of economists as the basis for Jerry Ellig and Hester Peirce's study, "SEC Regulatory Analysis: 'A Long Way to Go and a Short Time to Get There.'"
For more information about Regulatory Report Cards issued by the Mercatus Center at George Mason University, see www.mercatus.org/reportcard.

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OPENNESS	Score	Comments
1. How easily were the RIA, the proposed rule, and any supplementary materials found online?	5	1A
2. How verifiable are the data used in the analysis?	1	1B
3. How verifiable are the models and assumptions used in the analysis?	1	1C
4. Was the Regulatory Impact Analysis comprehensible to an informed layperson?	2	1D
Total Openness (Sum of 1–4)	9	

ANALYSIS	Score	Comments
5. How well does the analysis identify the desired outcomes and demonstrate that the regulation will achieve them?	1	2A
6. How well does the analysis identify and demonstrate the existence of a market failure or other systemic problem the regulation is supposed to solve?	0	2B
7. How well does the analysis assess the effectiveness of alternative approaches?	1	2C
8. How well does the analysis assess costs and benefits?	1	2D
Total Analysis (Sum of 5–8)	3	

USE	Score	Comments
9. Does the proposed rule or the RIA present evidence that the agency used the Regulatory Impact Analysis?	1	3A
10. Did the agency maximize net benefits or explain why it chose another alternative?	0	3B
11. Does the proposed rule establish measures and goals that can be used to track the regulation’s results in the future?	2	3C
12. Did the agency indicate what data it will use to assess the regulation’s performance in the future and establish provisions for doing so?	0	3D
Total Use (Sum of 9–12)	3	

Total Score	**15**	

This analysis was evaluated using the 2008–2012 scoring system, which evaluated regulatory analyses based on 12 criteria.
This analysis was scored on a scale from zero to 60 points.

OPENNESS			
Criterion	**Score**	Com. No.	Comment
1. How easily were the RIA, the proposed rule, and any supplementary materials found online?	5	1	A keyword and RIN search readily turns up the regulation on regulations.gov. It can easily be found on the SEC web site in a list of final rules following the "regulations" link. The economic analysis is in the notice.
2. How verifiable are the data used in the analysis?	1	2	No data are used to estimate anything in the cost-benefit analysis section. Paperwork Reduction Act data are usually sourced to internal estimates that are not explained. Some data came from public comments, while other data came from internal SEC information. Comments are available online. The number of proxy statements submitted to the SEC in 2009 may also be available, but this is not linked.
3. How verifiable are the models and assumptions used in the analysis?	1	3	No literature is cited in the analysis, so it is difficult to verify agency assumptions. There are no models or theories of cause and effect. Disclosure is simply asserted to benefit investors.
4. Was the analysis comprehensible to an informed layperson?	2	4	The conclusions of the rule are fairly straightforward and understandable to a layperson. It was also easy to follow the responses to public comments. But there was virtually no analysis—just assertions that the regulation would have some vague benefits. So there was really no chain of reasoning to follow. Cross-references to different sections and subsections of laws and regulations—even in the economic analysis section—make this part very difficult for anyone to follow except lawyers who have the laws and regulations memorized.
ANALYSIS			
5. How well does the analysis identify the desired outcomes and demonstrate that the regulation will achieve them?	1		
Does the analysis clearly identify ultimate outcomes that affect citizens' quality of life?	2	5A	The analysis asserts the required disclosures will benefit investors by giving them more timely access to better information. The analysis does not link this to any tangible benefit for investors. It asserts the regulation will make capital markets more efficient and competitive by improving information. It also asserts the regulation benefits issuers by removing uncertainty and showing them how to comply with the new Dodd-Frank requirements.
Does the analysis identify how these outcomes are to be measured?	0	5B	No benefits are measured.
Does the analysis provide a coherent and testable theory showing how the regulation will produce the desired outcomes?	2	5C	Providing a table to shareholders that clearly states what golden parachute compensation is being offered to managers should better inform shareholders about what managers are doing. Their voting on the compensation will provide the board with an incentive to not allow excessive compensation in the form of golden parachutes. But effects of the regulation are not well linked to ultimate outcomes that affect citizens' quality of life.
Does the analysis present credible empirical support for the theory?	0	5D	There is no relevant content.

Does the analysis adequately assess uncertainty about the outcomes?	0	5E	The claimed benefits—such as they are—are assumed to occur with certainty.
6. How well does the analysis identify and demonstrate the existence of a market failure or other systemic problem the regulation is supposed to solve?	0		
Does the analysis identify a market failure or other systemic problem?	0	6A	Reasons for requiring the votes are not analyzed at all since Dodd-Frank requires the regulation. There is no discussion of why disclosure might be suboptimal in the absence of the regulation. Nor is there discussion of whether executives are receiving too much or too little compensation at the moment or whether investors currently have difficulty accessing information regarding executive compensation.
Does the analysis outline a coherent and testable theory that explains why the problem (associated with the outcome above) is systemic rather than anecdotal?	0	6B	The analysis provides no relevant theory. This is particularly striking because one possible market failure argument is fairly obvious: asymmetric information. Managers arguably are able to award themselves large golden parachute compensation because shareholders aren't aware of what they are up to.
Does the analysis present credible empirical support for the theory?	0	6C	There is no relevant empirical evidence.
Does the analysis adequately assess uncertainty about the existence or size of the problem?	0	6D	Regulation is assumed to be necessary.
7. How well does the analysis assess the effectiveness of alternative approaches?	1		
Does the analysis enumerate other alternatives to address the problem?	1	7A	The benefit-cost analysis section does not analyze alternatives. Regulatory Flexibility Act section lists some generic alternatives the commission claims to have considered, then lists a few provisions of the regulation that are slightly different for small businesses. The commission apparently made a few changes in response to comments, but these are not analyzed as alternatives.
Is the range of alternatives considered narrow (e.g., some exemptions to a regulation) or broad (e.g., performance-based regulation vs. command and control, market mechanisms, nonbinding guidance, information disclosure, addressing any government failures that caused the original problem)?	1	7B	The range is very narrow, since there is really no alternative to the rule itself. Some modifications to various parts of the rule were considered, but these were very minor and could not really be described as alternatives.
Does the analysis evaluate how alternative approaches would affect the amount of the outcome achieved?	0	7C	No alternatives were actually analyzed.
Does the analysis adequately address the baseline? That is, what the state of the world is likely to be in the absence of federal intervention not just now but in the future?	0	7D	The baseline is never clearly explained. Is it "no disclosure"? "Insufficient disclosure"? "Inaccurate disclosure"?

8. How well does the analysis assess costs and benefits?	1		
Does the analysis identify and quantify incremental costs of all alternatives considered?	2	8A	The analysis considers only the incremental costs of the required disclosures. It excludes any costs associated with the decision to require the votes. None of these cost are actually estimated except paperwork burden.
Does the analysis identify all expenditures likely to arise as a result of the regulation?	2	8B	The analysis qualitatively lists costs associated with preparation of documents, consultants, and negotiation of compensation agreements as possible costs associated with disclosure. The paperwork burden is estimated.
Does the analysis identify how the regulation would likely affect the prices of goods and services?	0	8C	There is no relevant discussion.
Does the analysis examine costs that stem from changes in human behavior as consumers and producers respond to the regulation?	1	8D	The analysis mentions that the rule may increase costs for private companies taking over pubic companies, but it asserts without support that there should be no change in the number of takeovers.
If costs are uncertain, does the analysis present a range of estimates and/or perform a sensitivity analysis?	0	8E	There is no relevant discussion.
Does the analysis identify the alternative that maximizes net benefits?	0	8F	There is no relevant discussion.
Does the analysis identify the cost-effectiveness of each alternative considered?	0	8G	There is no relevant discussion.
Does the analysis identify all parties who would bear costs and assess the incidence of costs?	1	8H	Discussion occasionally mentions issuers, private companies, etc., but it does not quantify any kind of breakdown. It also mentions that executives may receive lower pay.
Does the analysis identify all parties who would receive benefits and assess the incidence of benefits?	1	8I	Investors are mentioned as the main beneficiaries, but benefits are not quantified at all.

USE			
9. Does the proposed rule or the RIA present evidence that the agency used the analysis?	1	9	The cost-benefit analysis section is in the notice, but the SEC makes no claim to have used the results of the exceedingly cursory analysis. There was one commenter who discussed the cost-benefit analysis, and this person's argument was dismissed.
10. Did the agency maximize net benefits or explain why it chose another alternative?	0	10	Benefits and costs were not calculated or estimated, and there is no qualitative discussion suggesting the SEC even considered net benefits qualitatively.
11. Does the proposed rule establish measures and goals that can be used to track the regulation's results in the future?	2	11	No goals or measures were articulated, and the analysis is not nearly extensive enough to generate them. The agency mentioned that it is delaying implementing the rule on small businesses because it wants to see the effects of the rule first. This implies some form of retrospective analysis, but it is not clear what kind of analysis will be done.
12. Did the agency indicate what data it will use to assess the regulation's performance in the future and establish provisions for doing so?	0	12	There is no relevant data.