

Checking the Paychecks

BY DAVID A. PRICE

The Dodd-Frank Act gives shareholders, boards, and regulators new powers over pay

Although the 2010 Dodd-Frank Act is commonly known as a Wall Street reform law, addressing the regulation of financial companies, some of its provisions deal with public companies in general. High on the list of these is a group of provisions that will shape — and in some cases, is already shaping — the way companies set the compensation of their executives. In addition, with regard to financial institutions, the Act gives regulators the authority to directly control the compensation arrangements of both executives and lower-level employees whose pay is based partly on incentives.

The Act's pay provisions emerged in response to the 2008 financial crisis, which policymakers believed was caused in part by incentive programs at financial institutions that encouraged excessive risk-taking on the part of executives, and which rewarded lower-level employees for loan volume more than loan quality and performance. Yet the provisions are also rooted in concerns that existed before the crisis: that of “pay without performance” — in short, a perceived lack of alignment between executives' incentives and the interests of shareholders — and that of income disparity between top-level executives and other employees.

A Long-Simmering Issue

Prior to the 1930s, public companies were not required to disclose the compensation received by any executives, so it rarely became known even to shareholders. Early in that decade, shareholder litigation led to the revelation of executive pay at two major companies, Bethlehem Steel and American Tobacco. Bethlehem's president, the public learned, had received \$1.6 million in 1929 (equivalent to \$20.4 million today), and executives at both companies benefited from bonuses that the public viewed as scandalous. An Interstate Commerce Commission report in 1932 on the high salaries of railroad executives added fuel to the fire at a time when economic suffering was widespread.

“There were years when American Tobacco or Bethlehem Steel were not doing that great, and executives still got big bonuses,” says Harwell Wells, a Temple University law professor who has studied the 1930s-era controversy over executive pay. “At the same time, there was anger about job losses and wage cuts.”

Congress responded by mandating annual disclosures of

executive compensation. Those mandates, incorporated into securities legislation in 1933 and 1934, are still in effect. In addition, Congress enacted large increases in individual income tax rates in 1935, in response to both anger about income inequality and a desire for more federal revenue.

Although the issue of compensation viewed as excessive did not entirely disappear, it became much less prominent from the 1940s to the 1970s as the rate of growth in executive pay slowed down and as postwar prosperity — including a large U.S. manufacturing sector — led to a bidding-up of the wages of less-skilled workers. The issue returned to the public eye in the 1980s, in part, Wells says, in response to developments in the auto industry. “The auto industry got in trouble financially and asked for givebacks from the unions, then its executives paid themselves significant bonuses when the industry started doing better.”

Media attention to the topic intensified in the early 1990s, leading in part to the enactment of tax rules in 1993 that barred companies from deducting compensation expenses above \$1 million for an executive, except for performance-based compensation. Some scholars believe this change had the unintended consequence of accelerating the growth of executive pay, however, as companies responded by shifting a greater proportion of pay from straight salary to stock grants and option grants — the value of which took off during the 1990s stock market boom.

In the time since, executive pay has become a burgeoning area of scholarship, as well as an area in which policymakers have become increasingly confident of their ability to curb potential abuses by determining the best governance practices related to compensation, and, in the case of financial institutions, by regulating actual pay arrangements.

Empowered Shareholders and Fortified Compensation Committees

One governance practice that the Dodd-Frank Act requires of public companies is “say on pay,” a nonbinding vote of shareholders on the pay packages of executive officers. Companies must hold “say on pay” votes at least every three years. (Shareholders vote at least every six years to determine how often the company's “say on pay” votes will take place — every year, every two years, or every three years.)

The first votes took place starting in January 2011. According to the compensation-research firm Equilar, out of the 2,252 companies from the Russell 3000 index that held votes between Jan. 21 and June 30, only 38 saw shareholders reject management's pay packages. Almost 75 percent of firms won with 90 percent or higher approval. In addition, out of 686 companies from the group that presented equity

incentive plans for a vote, only six saw those plans rejected.

Although packages have rarely been disapproved, the process has “pushed the dialogue between companies and shareholders to a new level of clarity,” says Aaron Boyd, Equilar’s head of research. “Companies are trying to do a better job of explaining their pay policies to shareholders.”

The concept has some critics. Before passage of the Act, in a 2009 article in the *Harvard Journal on Legislation*, Jeffrey Gordon of Columbia University Law School argued for an “opt-in” version of the regime, in which federal law would allow shareholders to require their companies to participate — or not. Gordon and others argue that shareholders, especially institutional ones, will rely excessively on proxy advisory firms to determine how to vote.

“A lot of the votes seem to be driven by recommendations from proxy advisory companies,” says Stanford University Business School professor David Larcker. “They have models they’ve developed that make recommendations, and these recommendations are used by mutual funds and other big institutions and sometimes individual shareholders. What’s unknown is whether those recommendations are even remotely correct.”

The Dodd-Frank Act also sets governance rules by mandating that executive pay at public companies be determined by a compensation committee made up of independent board members. The committees have the right to engage their own compensation consultants and legal counsel, a measure that is intended to counterbalance the influence of management’s own consultants and lawyers. The Act aims to further the independence of compensation decisionmaking from management and inside directors, much as the Sarbanes-Oxley Act of 2002 increased the autonomy of the audit function. (Less stringent versions of the compensation-committee requirements had been adopted by the New York Stock Exchange and NASDAQ in 2003.)

These requirements are based in part on a view that management has too much influence on boards, and that increasing the power of independent board members will thus tend to improve the board’s decisionmaking and the company’s performance. But is there actually a positive relationship between the clout of independent board members and company performance?

A number of studies cast doubt on that assumption. For example, a National Bureau of Economic Research paper in 2009 by Andrea Beltratti of Bocconi University and René Stulz of Ohio State University, which looked at 98 banks worldwide with more than \$10 billion in assets in 2006, found that the best-performing banks during the financial crisis actually tended to have less shareholder-friendly boards (as measured by governance “best practices”). The authors noted earlier literature indicating that if shareholders believe a firm will not be allowed to fail, they may prefer that it engage in greater risk-taking. Thus, the excessive risk-taking that led to losses during the financial crisis may have been well-aligned with the perceived interests of

shareholders — and encouraged, rather than restrained, by good-governance-based boards.

Regulating Incentive-Based Pay

The Dodd-Frank Act gives additional attention to pay at certain financial institutions with \$1 billion or more in assets, including banks, broker-dealers, investment advisory firms, and some others. At these institutions, federal regulators must supervise incentive pay practices, not only for executives, but also for lower-level employees to ensure that incentives do not promote undue risk-taking by providing “excessive compensation” and that they do not encourage undue risks that could bring about “material financial loss.”

These provisions are based on a concern that financial institutions have not been considering risk closely enough when setting up incentive compensation programs. Policymakers were particularly concerned that incentives based on short-term measures of revenue or loan volume — without countervailing consequences if the business later led to losses — may have encouraged employees to take imprudent risks.

While there is a large body of literature on compensation of chief executive officers, whose pay is publicly reported under Securities and Exchange Commission regulations, there has been far less research on the effects of incentive pay for loan officers and other lower-level employees, whose pay information is proprietary. Research by Richmond Fed economists Arantxa Jarque and Edward S. Prescott may shed light on risks generated by incentive programs for lower-level employees. In a forthcoming working paper, they find that the issues in regulating loan officers’ pay are highly different from those in regulating the pay of top executives.

“We’re looking at pay for large groups, where no one person makes decisions large enough to make or break the bank,” Prescott says. “When you have lots of people and give them lots of incentive, if the risks are not correlated, the risks may average out. What you have to worry about is loan officers making loans that turn out to be bets on a single thing.”

The lower-level employees are also subject to an organizational structure, Jarque and Prescott note, such as an underwriting department that approves or disapproves the loan applications brought in by the loan officers. On account of the risk-pooling nature of loan officer positions and their institutional setting, Prescott says, paying loan officers hefty performance-based incentives may be no more risky to the bank — and in some circumstances, even less risky — than if loan officers receive a fixed wage.

Although the Fed and other bank regulators have not yet issued final regulations on incentive compensation policies, it is clear that the Dodd-Frank pay rules will have a significant effect on one of the primary tools that boards use to guide and reward senior management, and which management uses to guide and reward lower-level employees. **RF**