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SEC CEO Median Pay Ratio Disclosure: A Critical Evaluation

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Abstract:

Last year, the SEC CEO median pay ratio disclosure ruling, proposed in 2013 was adopted and became US law. It continues to generate a great deal of controversy. On the one hand, CEO pay has risen sharply in recent years, especially in the US. However, on the other hand, there is ongoing resentment by major US businesses and indeed non-US businesses over the perceived negative implications of the relevant ruling. This paper therefore seeks to critically evaluate the key issues arising from the disclosure, including simulation from the vantage points of the relevant regulatory bodies in the US and the UK. It is noted that CEOs and Boards do not need to rely on CEO median pay ratio disclosure in order to ascertain the suitability or otherwise of CEO pay. Moreover, it is worth bearing in mind on this point that CEOs and Boards do not necessarily need a mandated CEO median pay ratio disclosure to assess whether executive compensation packages are justified. Moreover, the methodology surrounding the final SEC pay ratio is seen to be somewhat arbitrary. Different conclusions are reached concerning the desirability of mandated CEO median pay ratio disclosures for both the US and the UK.

Keywords: SEC, median, philosophy, implementation, judgement, CEO, governance

1. A Description of the Philosophy behind the Securities and Exchange Commission (SEC) CEO Median pay Disclosure and what it is Intended to Accomplish

As suggested by Abdullah and Valentine (2009), the various corporate governance theories cannot singly explain in a convincing and robust fashion the variety and complexity of corporate governance in practice. A pragmatic and culture-bound approach is therefore indicated in the first instance, regarding the underlying philosophy behind the contentious SEC CEO median pay ratio disclosure ruling.

It is also important to remember that corporate governance in practice always takes place in both a social and political context, especially at the regional and national level. Increasingly, of course, corporate governance guidelines are being developed and refined at an international level, as indicated by OECD (2004a) and OECD (2004b).

However, there can be little doubt that CEO pay growth in recent years has been staggeringly high, as Figure 1 below clearly indicates, regarding the USA. It is both sobering and striking that CEO pay growth handily beats that of the S&P 500, along with corporate profits, over the same period.

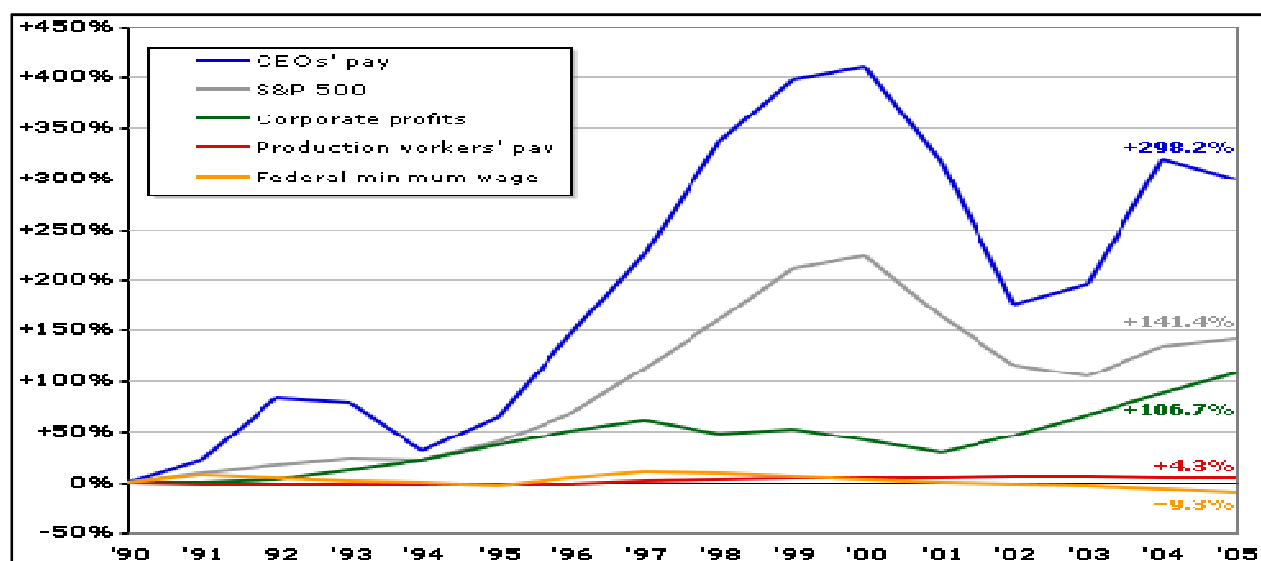


Figure 1: CEO Pay
Data source: Excess (2006)

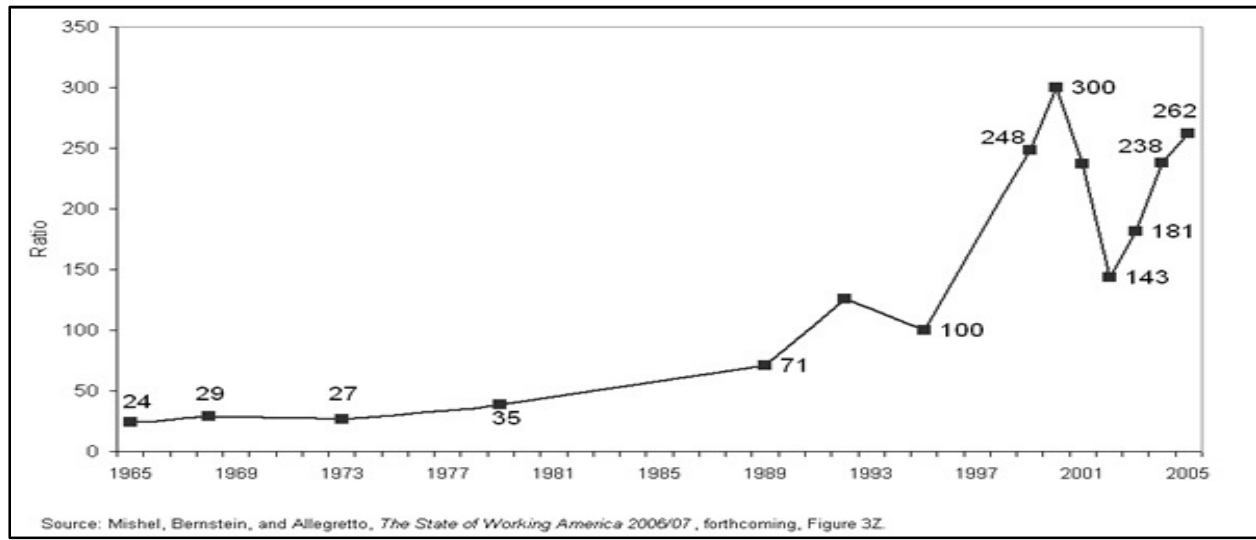


Figure 2: Ratio of CEO to average worker pay, 1965-2006
Data source: Mishel, Bernstein and Allegretto (2007)

Figure 2 above provides another perspective on CEO pay, with the increase in the CEO to average worker pay ratio from 24 in 1965 to 262 in 2005, representing an extremely large percentage increase of roughly 992%! Moving on, a review of the relevant literature, specifically SEC (2015), indicates that the SEC believes that the pay ratio disclosure stipulated by the Dodd-Frank Act has the purpose of helping investors and issuers to make a more informed assessment of a public company’s executive pay arrangements. Moreover, there is a clear connection between the CEO median pay disclosure ruling and the ‘say on pay’ voting rights given to shareholders in light of the Dodd-Frank Act.

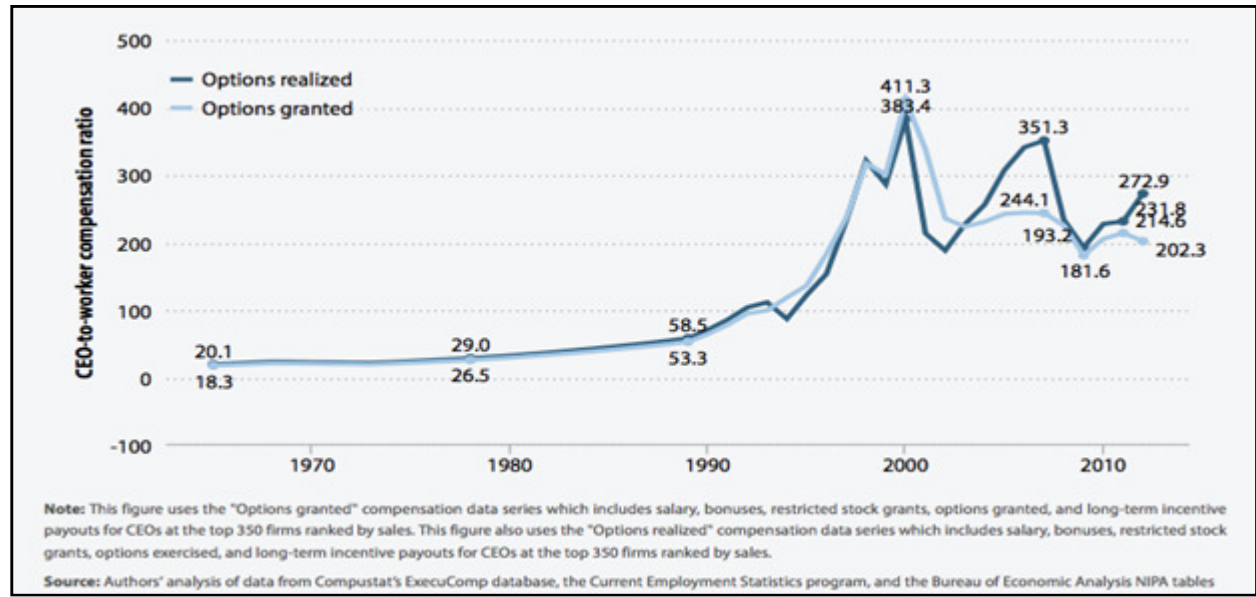


Figure 3: CEO- to-worker compensation ratio, with options granted and options realized, 1965-2012
Data source: Atlantic (2013)

In Figure 3 above, which use data for the USA, one can see that there is a very close correlation between the CEO-to-worker compensation ratio with options granted and that with options realized over the relevant time period. Either way, the CEO-to-worker compensation ratio increases from an average of 19 in 1965 to 208 in 2012, representing an extremely large percentage increase of roughly 995%.

Furthermore, it is important to note that the CEO median pay ratio devised by the SEC has the key advantage, in their eyes at least, of providing shareholders with quantitative information that can be used to assess CEO pay. Frydman & Jenter (2010) find that managerial power and competitive market forces are important determinants of CEO pay. Whilst it might be sensibly argued that overweening managerial power is likely to lead to excessive CEO pay, competitive market forces should serve to constrain such tendencies, especially if the market for managerial talent is relatively liquid.

Lo (2003) tends to suggest that the economic consequences of federal stipulations regarding executive compensation disclosure are negative, unless compensation disclosure is viewed as a public good. The possibility of compensation disclosure being a public good is very much both a philosophical issue.

If compensation disclosure is regarded as a public good then disclosure must be both mandated and suitably stipulated in order to ensure that all companies disclose information that is useful to all stakeholders, not just investors.

The preceding points and contentions suggest that one of the three key strands of the philosophy underpinning the relevant disclosure is the need for increased transparency over executive pay arrangements, which therefore suggests that the market for top managerial talent is far from perfectly competitive or otherwise highly liquid. The second key strand of the philosophy underpinning the relevant disclosure, in one's opinion, is the perceived desirability of corporate governance being brought increasingly more under the control of the federal government; therefore political concerns over the conduct and operation of companies, especially public companies, also impinge critically on the philosophy behind the relevant disclosure. The third key strand of the philosophy underpinning the relevant disclosure follows logically from the first two key strands already outlined, namely the presumption or, at the very least, broad determination that in some way the principal-agent problem has not been effectively addressed.

It is conceivable that the SEC CEO median pay ratio disclosure could put downwards pressure on CEO pay by employees being aware of how much the top bosses of their companies are earning relative to themselves and boards therefore becoming more cautious about executive compensation package awards.

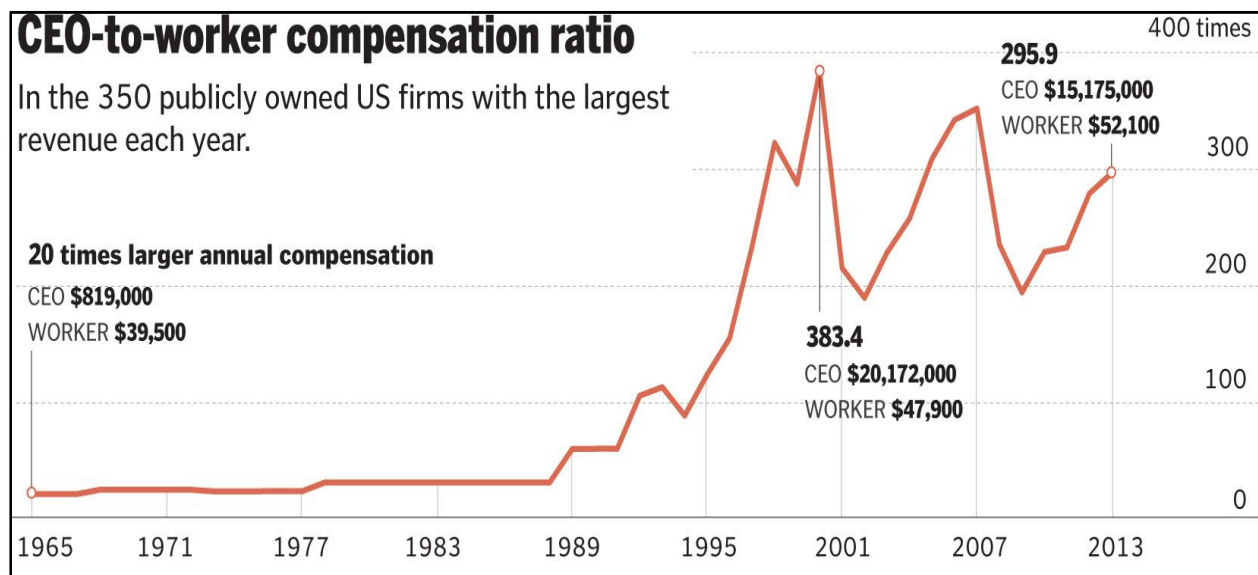


Figure 4: CEO-to worker compensation ratio
Data source: Boston Globe (2014)

In Figure 4 above, it is worth noting that although the CEO-to-worker compensation ratio fell significantly immediately after 2001 (from an all-time high of 383.4), almost certainly due to the events of the 11th of September 2001 to begin with, and then again after 2007 (from roughly 350), almost certainly due to the global financial crisis of 2008-9, it has recovered noticeably in recent years, reaching 295.9 in 2013.

Moreover, it is worth bearing in mind on this point that CEOs and Boards do not necessarily need a mandated CEO median pay ratio disclosure to assess whether executive compensation packages are justified. For example, if a company is suffering from weakened performance, both in general terms and relative to its peers, a highly principled CEO might feel it is improper to accept shares or share options previously agreed, since the indicative reward is clearly not aligned with the company's current performance.

In closing, it is important to stress that those in favour of the SEC mandated disclosure ruling in question argue that it will provide greater clarity regarding disparities in the distribution of income.

2. A Description of the Implementation of the Philosophy and what the Regulation Requires of Companies

Firstly, regarding Section 953(b) of Dodd-Frank, the relevant research literature confirms that:

"...the final SEC pay ratio rules establish a prescribed format for comparing the total compensation of the registrant's principal executive officer ("PEO") to the median compensation paid to the registrant's covered employees. New Item 402(u) of Regulation S-K requires issuers to disclose:

- the median of the annual total compensation of all employees of the registrant (except the registrant's PEO) (the "Median Compensation");
- the annual total compensation of the registrant's PEO (the "PEO Compensation"); and
- the ratio of the Median Compensation to the PEO Compensation (the "Ratio")" (Shearman and Sterling, 2015, p. 1).

It is worth noting that the above three points are referred to as the "pay ratio" disclosure by the SEC.

Secondly, also regarding Section 953(b) of Dodd-Frank, the relevant research literature confirms that:

“...the Ratio must be presented as either:

- a ratio in which the Median Compensation equals one; or
- a narrative in terms of the multiple that the PEO Compensation bears to the Median Compensation” (Shearman and Sterling, 2015, p.2).

Thirdly, again pertaining to Section 953(b) of Dodd-Frank, the relevant research literature confirms that:

“The first pay ratio disclosure for a new registrant will follow the first full fiscal year beginning after the registrant has (1) been subject to the requirements of Sections 13(a) or 15(d) of the Securities Exchange Act of 1934 (the “Exchange Act”) for a period of at least 12 months beginning on or after January 1, 2017 and (2) filed at least one annual report pursuant to those same sections of the Exchange Act that does not contain the pay ratio disclosure” (Shearman and Sterling, 2015, p.3).

Fourthly, also concerning Section 953(b) of Dodd-Frank, the relevant research literature confirms that there is not a required methodology for determining the median employee, specifically:

“Each registrant is provided flexibility to choose a method to identify the median employee based on the registrant’s facts and circumstances. The chosen methodology may use reasonable estimates.” (Shearman and Sterling, 2015, p.4).

3. Considered Judgment Regarding SEC CEO Median pay Disclosure as Sitting Member of the United States (SEC) Board

Millstein et al (2005) stresses the importance of credible deterrence in order to achieve effective enforcement, which is seen as essential for effective corporate governance, and therefore orderly and efficient financial market conduct.

Moreover, the primary purpose of the SEC (Securities and Exchange Commission) is generally recognised as ensuring that the US securities market works well, protecting investors and holding issuers accountable. It is in this context, in what follows, that the desirability of the SEC ruling in favour of a mandatory CEO median pay ratio disclosure for US public companies will be assessed.

In terms of the relevant voting, it is a matter of public record that Chair White and Commissioners Aguilar and Stein voted to approve the final rule, with Commissioners Gallagher and Piwowar dissenting (SEC, 2013).

3.1. Pros

On the one hand, in thinking some more about the advantages of the CEO median pay disclosure proposition, the conclusion of the public statement made by SEC Commissioner Aguilar (Aguilar, 2015) is striking:

“...today’s pay ratio adopting release incorporates many discretionary decisions made by the Commission consistent with the Dodd-Frank statutory mandate. These decisions were designed to facilitate compliance with the rule in a manner that is reasonable and workable for issuers, while still providing for increased transparency and greater accountability in executive compensation matters...”. Of course, it is a moot point whether the ruling is indeed ‘reasonable’ and ‘workable’, but a focus on increased transparency and accountability in matters of corporate governance arguably suggests a ‘best practice’ approach.

Indeed, in principle, the SEC CEO median pay ratio disclosure will make it easier for a company’s stakeholders (including the general public) to see how executive compensation arrangements contribute to income inequality, at least on the surface. On this point, it is worth noting that for capital markets in general to work as efficiently as possible, information access is key, whilst information asymmetry generally leads to less competitive and less efficient markets, unless effective potential solutions are devised and implemented. As the relevant research literature notes, a “...potential solution to the information asymmetry problem is regulation that requires managers to fully disclose their private information” (Healy & Palepu, 2001, p. 408).

In any case, the existence of information asymmetry strikes one as being a particularly striking reason for why the principal-agent problem might not be satisfactorily resolved or otherwise suitably mitigated, since there are powerful incentives for companies not to fully disclose their private information, especially in order to maintain competitive advantage and because of the existence of various conflicts of interest. Crucially, the work of Bebchuk and Fried (2003), makes a very powerful case for why it is so difficult to principals to control agents satisfactorily, in the context of executive pay.

Fried & Shilon (2011) indicates problems with excessive payouts for executives, not only in terms of its likelihood but also in terms of the ability to get back the money.

Bebchuk & Fried (2003) suggests that market forces may not be sufficiently strong so as to ensure executive pay is moderated. In one’s view, much of the problem stems from the fact that managers are likely to see themselves as ‘insiders’, whilst shareholders may effectively be ‘outsiders’ (since much of the information they seek comes directly from within companies themselves), even though they jointly own the companies in question.

Lo (2003) indicates that if proposed executive compensation disclosure is likely to harm the ability of the senior managers in question to extract the desired rent from their compensation arrangements with their companies, one should not be surprised if they are resistant to such changes.

Thomas et al (2012) tends to suggest that the passing of the Dodd-Frank Act facilitates a stronger and more informed dialogue between executives on the one hand and shareholders on the other regarding executive compensation practices, this being a good thing.

Murphy (1999) points to a variety of factors that serve to underscore the importance of executive pay. It also confirms both the popular perception of a negative relationship between CEO pay and general employment levels, stemming from the 1980s, along with strong empirical evidence that executive compensation increases with company size.

Bebchuk et al (2002) find that managerial power and associated rent extraction play a significant role in explaining executive compensation, as opposed to the optimal contracting approach, which is seen as the historically more popular and leading alternative

approach to the study of executive compensation. The research therefore indicates that executive compensation arrangements, rather than helping to resolve the agency problem, or at the very least, minimise agency costs, as indicated by the optimal contracting approach, may actually be a result of the agency problem. The findings also agree with other relevant research literature (Bebchuk & Fried, 2003; Bebchuk, 2004; Bebchuk & Fried, 2005; Booth, 2005).

3.2. Cons

On the other hand, in thinking some more about the disadvantages of the CEO median pay disclosure proposition, the dissenting comments of Gallagher (2015) and Piwowar (2015a) are especially illuminating.

In his dissenting statement, regarding the SEC CEO median pay ratio disclosure, Commissioner Gallagher made it clear that he wanted the CEO median pay ratio disclosure to focus on U.S. full-time employees only and strongly indicated he was of the opinion that the measure had an inappropriate effect on corporate speech (Gallagher, 2015). The second contention is serious as this suggests a contradiction with the First Amendment with its focus on freedom of speech for individuals (which can be usefully applied to businesses).

In his dissenting statement, regarding the SEC CEO median pay ratio disclosure, Commissioner Piwowar outlined his concerns over the lack of a clear or persuasive justification for the rulemaking (Piwowar, 2015a). Moreover, later, Commissioner Piwowar issued additional dissenting comments highlighting further perceived flaws in the pay ratio disclosure rulemaking act, given the significant limitations to using pay ratio information for such purposes (Piwowar, 2015b).

Fisch (2012), in arguing against greater federal involvement stemming from the Dodd-Frank Act in corporate governance, in the context of Delaware corporate lawmaking, more generally suggests that a centralised approach to corporate governance is problematic and a primarily state-specific approach to corporate governance is more suited to the varying situations and specific features of businesses. Importantly, Fisch (2012) also suggests that the benefits of greater federal involvement may be outweighed by the associated costs.

Bainbridge (2010) is quite scathing in denouncing both SOX and the Dodd-Frank Act, both of which it clearly sees as ill-considered corporate governance. It may well indeed be that institutional investors are highly motivated by Dodd-Frank's executive compensation stipulations but this is not necessarily a bad thing, given what is at stake and the context within which Dodd-Frank was formulated.

In particular, it is suggested that the global financial market meltdown of 2008-9 is perceived by the general public to be at least partly attributable to a combination of hubris and excess originating within corporate America itself, certainly in light of the extensive media coverage of the major problem during the relevant period.

As for whether a weakening of Board power, and indeed primacy, over the operation of companies is a bad thing or indeed a good thing, this is a moot point. However, Bainbridge (2010) clearly suggests that a weakening of Board power is a bad thing.

Indeed, Booth (2005) suggests that if CEOs are seen more as partners and owners and less as managers, this helps to explain why executive pay has increased so dramatically in recent years, especially with compensation in the form of equity forming a more significant percentage of an executive's total compensation (especially if the executive in question is the CEO).

The findings of Craighead et al (2004) are equivocal regarding the desirability of mandated compensation disclosure, particularly because it is not necessarily cost-effective. It is worth bearing in mind that making CEO compensation public increases career risk for CEOs, due to increased and more stringent performance monitoring; therefore, it can be expected that they will seek higher returns for their contributions, leading to even higher CEO pay-outs. The work of Hoskisson et al (2009) provides research literature support for this contention.

Moreover, Conyon (2006) finds that US CEO pay is not significantly different from that in the UK, when risk-adjusted.

3.3. Tentative Conclusion

As a sitting member of the SEC, one would recommend a mandatory CEO median pay ratio disclosure for public companies operating in the USA. The main reason for this is because of the various provisions in the Dodd-Frank Act from which it stems. In itself, one does not believe that the CEO median pay ratio disclosure by itself will do much to improve corporate governance in the US in general, but it also should not greatly harm corporate governance practice in the US in general.

Although it is recognised that the market for top managerial talent is global and highly competitive, one does share the concerns of some commentators about executive pay being 'too high' in the USA in general (certainly when compared to other developed countries). One wishes to contend that if the CEO median pay ratio disclosure was made voluntarily, it would almost certainly not be taken seriously by most US companies (especially if they are uncomfortable with revealing the relevant ratios).

Moreover, Bebchuk and Fried (2003) indicate that there is an agency problem regarding executive compensation. One is therefore worried that to not make the disclosure of the CEO median pay ratio mandatory would effectively undermine the already deeply contested Dodd-Frank Act, and would simply give too much ground to 'rent-seeking' interest groups, especially lobbyists and various chambers of commerce.

In closing, it is contended that one's personal judgement also reflects the modus operandi of the SEC, which has been given significant enforcement powers by the US government in order to make the US securities market safe and fair for investors and issuers. It is expected to be tough, not toothless and simply polite. Moreover, executive pay in the USA is not simply and only a political issue. As Buffett (2004) indicates, it is a major issue regarding the health of American businesses in general. Figures 5, 6 and 7 below bear eloquent testimony to the scale of the challenge. For the good of the American economy, one therefore contends that remedies to the issue should not be watered down or dismissed out of hand – the Dodd-Frank Act, 'Say on Pay' and CEO median pay ratio disclosure together are arguably a step in the right direction.

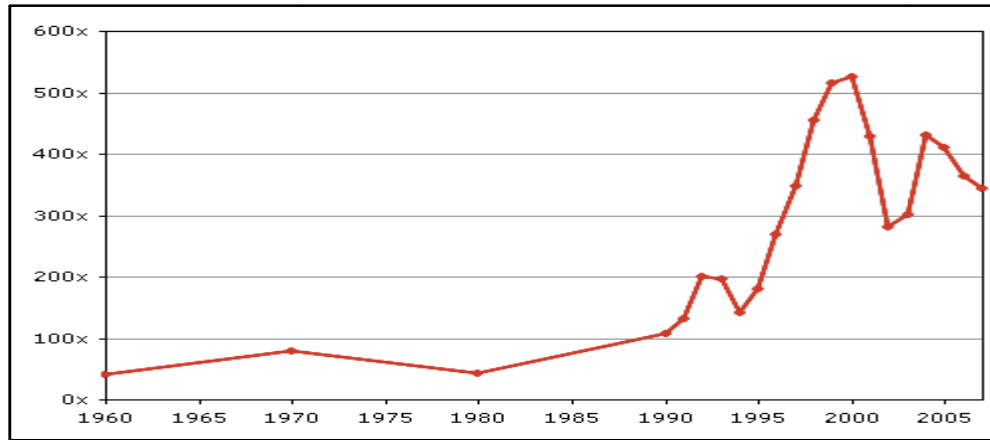


Figure 5: CEO's pay as a multiple of the average worker's pay, 1960-2007)
Data source: Excess (2008)

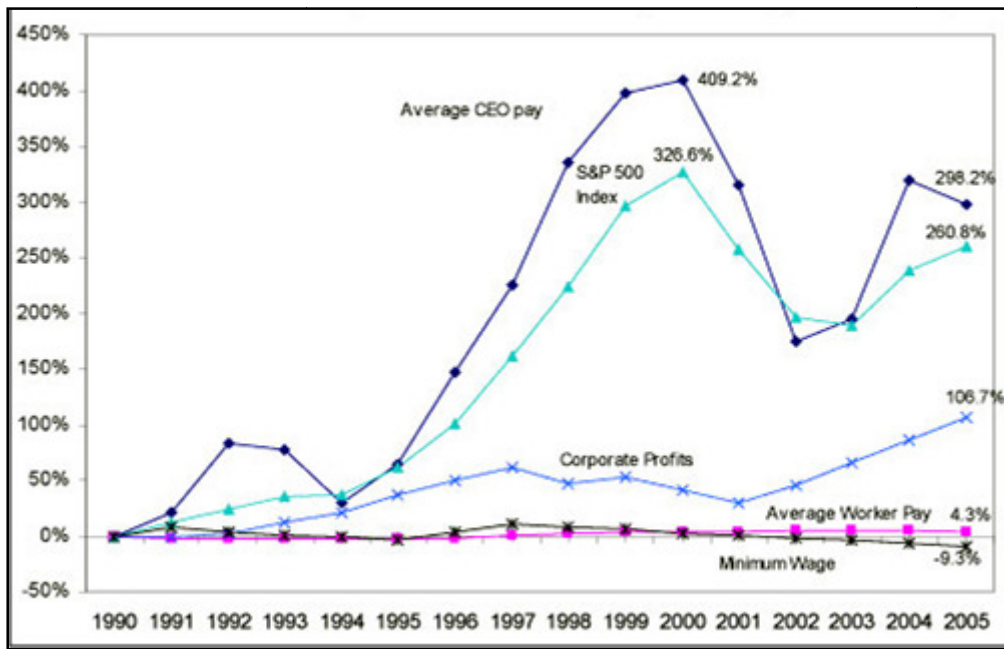


Figure 6: Cumulative Percent Change in Economic Indicators, from 1990 (in 2005 dollars)
Data source: Excess (2006)

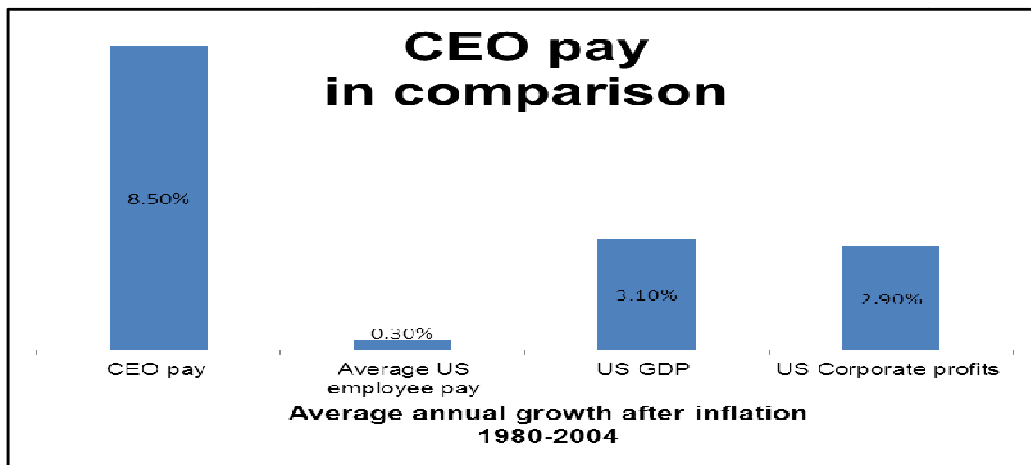


Figure 7
Data source: Bogle (2008)

4. Considered Judgment Regarding SEC CEO Median pay Disclosure as Sitting Member of UK Financial Reporting Council (FRC)

The FRC (Financial Reporting Council) is the UK's independent corporate governance regulator, "...responsible for promoting high quality corporate governance and reporting to foster investment" (FRC, 2014a, p. 2). Its approach is facilitative and principles-based, especially in connection with the UK Corporate Governance Code (FRC, 2014b) and UK Stewardship Code (FRC, 2012). FRC (2006) sheds further useful light on its underlying philosophy regarding corporate governance, along with the relevant historical underpinnings/case studies.

4.1. Pros

On the one hand, it could be argued that the equivalent of a mandatory CEO median pay ratio disclosure for public limited companies operating in the UK, as stipulated by the FRC (Financial Reporting Council), could aid investors in reviewing executive compensation arrangements in companies they are particularly interested in.

Furthermore, Bebchuk (2004) argues most forcefully in favour of executive compensation arrangements being generally out of line with corporate performance.

Moreover, Bebchuk & Fried (2005) suggests that contracting at arm's length of boards vis-à-vis executives can be expected to be neither fair nor rigorous, due to managerial influence. Indeed, 'perverse incentive' executive compensation arrangements might be struck in this context, such as top managers being awarded bonuses for acquisitions, even though these may be value-destroying.

Generally, Bebchuk & Fried (2005) find that executives are overpaid, their overall compensation not typically warranted by customary metrics of corporate performance, focused on shareholder value maximisation.

Coffee (2012) also serves to shed useful light on why it is important for regulators to move quickly with changes to legal frameworks after crises such as the global financial meltdown of 2008-2009 (especially because of bounded rationality, the opacity of financial regulation, and powerful business interest groups tending to reassert themselves over technical policy implementation issues sooner rather than later).

Moreover, Conyon et al (2009) suggests that concerns over high CEO pay are justifiable.

It is also worth noting that Bogle (2008) makes a number of counterpoints regarding the findings of Kaplan (2008), which are extremely supportive of current levels of CEO pay.

There is further support in the relevant research literature regarding the SEC mandated CEO median pay disclosure ruling:

"With respect to the materiality of the information, ratios have particular importance in the era of "say on pay." An advisory vote on compensation gives shareholders an opportunity to comment on the reasonableness of CEO pay. Reasonableness, however, requires context. Metrics that allow for a comparison of pay practices among public companies can assist in providing the requisite context. Moreover, the ratios provide a mechanism for the first time for assessing the reasonableness of the compensation within each particular company" (Brown, 2011, p.97).

4.2. Cons

However, on the other hand, it could also be argued that a mandatory CEO median pay ratio disclosure could lead to CEO's of public companies becoming increasingly the target of public criticism, and that this is unwarranted. It is not proven that CEO pay is far too high, so as to justify 'naming and shaming' the relevant individuals. Moreover, it is by no means clear whether this is an appropriate role for a financial regulator, given the political implications.

Moreover, it is worth stressing that Kaplan (2008) is very much in support of current US executive pay practices, indicating that executives are appropriately rewarded for corporate performance. The findings of Kaplan (2008) are therefore in stark contrast to those of Bebchuk (2004) and Bebchuk & Fried (2005).

More recently, Kaplan (2012) serves to build on the position mapped out in Kaplan (2008) regarding the justification for high levels of CEO pay, also drawing considerable attention to the political dimension of the issue.

The mandated compensation disclosure ruling in question is arguably the wrong remedy to the perceived problem of 'excessive' CEO pay, vis-à-vis the phenomenon of income inequality. It is perhaps better to increase the power of shareholders by augmenting proxy access procedures. Also, it is arguably both more efficient and more effective to simply give shareholders authority to decide as a bloc on executive compensation packages. After all, they collectively own the companies in question.

Regarding one's thoughts on other cons of the equivalent of a mandatory CEO median pay ratio disclosure for public limited companies operating in the UK, it is clear that:

- i) The disclosure would not guarantee change, since there are no enforcement provisions;
- ii) The disclosure would have no standardised methodology, and therefore no way to meaningfully compare ratios of different companies;
- iii) The 'noble intention' of curbing 'excessive' CEO pay might actually backfire, with a significant number of CEO's using the same disclosure information in order to justify further increases in CEO pay, so that they do not perceive themselves to be earning a significantly lower CEO median pay ratio than their contemporaries (regardless of the fact that there is no standardised methodology).

4.3. Tentative Conclusion

As a sitting member of the FRC, one would not recommend a mandatory CEO median pay ratio disclosure for public limited companies operating in the UK. Rather, as a sitting member of the FRC, one would welcome a voluntary median pay ratio for public limited companies in the UK.

It is generally contended that the market for top managerial talent is global and highly competitive,; this is certainly considered to be the case for the UK. Moreover, one is not of the considered opinion that executive pay is 'too high' in general. As one can see from Figure 8 below, the ratio of average CEO pay to average worker wages for the UK appears quite modest when compared with that for other leading Western countries, especially the USA. Furthermore, one believes that even if executive pay is considered to be 'too high', this does not imply that the imposition on public limited companies in the UK of the duty to calculate and publish the relevant CEO median pay ratio will necessarily help to address the issue. Indeed, it may prove to be a very big and costly distraction for public limited companies, and a wholly unjustified political intrusion into corporate governance issues.

In closing, it is felt that the personal judgement reflected above also reflects the modus operandi of the FRC, in that it does not generally 'boss' companies around, but rather works 'through them', seeking to 'shepherd' good corporate conduct by example and wise guidance.

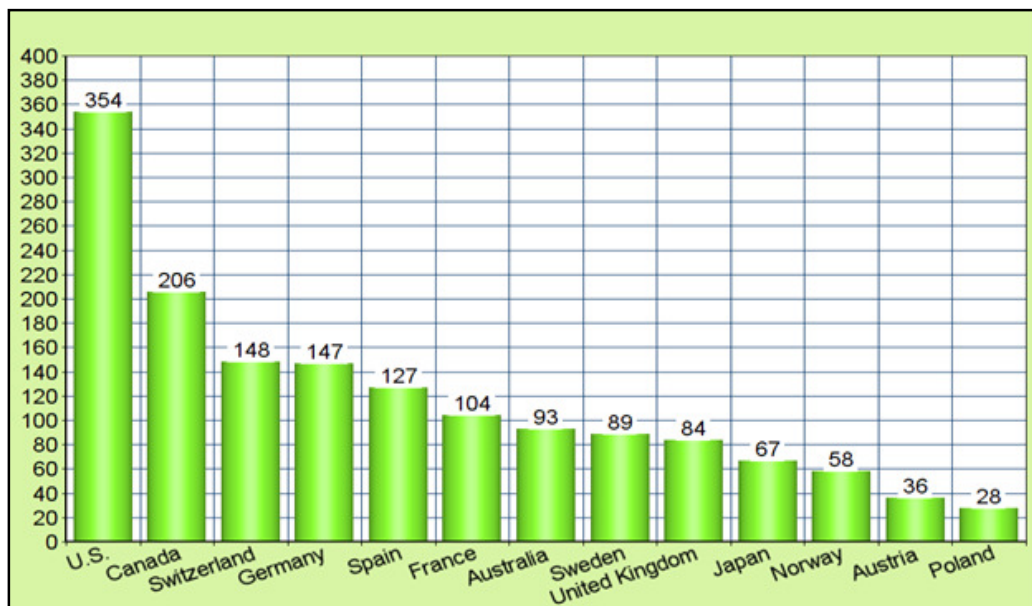


Figure 8: Ratio of Average CEO Pay to Average worker Wages
Data source: Washington Post (2014)

5. Way Forward

The above discussion suggests that important issues could be addressed in further research in the future. Three areas stand out as being particularly noteworthy. The first area concerns the generation of additional empirical evidence on the relationship between CEO pay and corporate ethics. The second area concerns the production of more robust results concerning the causality of the relationship between CEO pay on the one hand, and the tangible and intangible worth of firms on the other hand.

Regarding the third area, it is still unclear from the literature to what extent managerial power as opposed to optimal contracting influences executive compensation. As such, relevant theoretical and empirical work would help to shed greater light on this area, and indeed may lead to the development of novel ways of explaining and understanding executive pay.

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