disapprove rule changes and to change rules unilaterally.[268] The SEC must act, however, "in furtherance of the purposes of the Exchange Act."[269] Because Sarbanes-Oxley greatly expanded the SEC's authority over corporate governance matters under the Exchange Act, the SEC may attempt to use listing rules to regulate corporate governance matters generally and executive compensation specifically.[270]

Based on this history, it is worth speculating about the likelihood of further federal involvement in executive compensation regulation.[271] The SEC could potentially act under existing authority or Congress could pass new legislation. Thus far, the business community (and the CEOs in particular) has discouraged the SEC from attempting more substantial reforms in the corporate governance area under its existing authority.[272] The SEC's recent attempt to increase shareholder involvement in the nomination of directors was met with marked opposition from the business community.[273] The SEC abandoned the effort after extensive opposition. No similar initiatives of a substantive nature are underway in the corporate governance area.

If the SEC perceives that abuses in the compensation area remain, it could return to substantive rulemaking. Alternatively, the SEC could indirectly regulate compensation committees or shareholder involvement in compensation decisions, perhaps by using its authority over SRO listing rules.[274] As Professor Roberta Karmel has observed: "[T]he SEC is an

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[268]Exchange Act § 19(b)-(c), 15 U.S.C. § 78s(b)-(c) (2001). Typically, the SROs submit rule changes to the SEC, which reviews them for approval. *See* Bus. Roundtable v. SEC, 905 F.2d 406, 409 (D.C. Cir. 1990).

[269]*Bus. Roundtable*, 905 F.2d at 409-17 (emphasis and brackets omitted). In *Business Roundtable*, the court invalidated an SEC rule regarding the one share, one vote standard in corporate affairs because it lacked authority over voting power. *Id.*

[270]The SEC most recently changed its stance on internet publication of SRO rules. Proposed Rule Changes of Self-Regulatory Organizations, 69 Fed. Reg. 60,287 (Oct. 8, 2004).

[271]*See supra* Part IV.

[272]The Business Roundtable prepared a lengthy opposition to the SEC's proposed rules on "Security Holder Direct Nominations," 68 Fed. Reg. 60,784 (Oct. 23, 2003), that would have increased shareholder access to the nomination process. *See* Letter from Henry A. McKinnell, Chairman, The Business Roundtable, to Jonathan Katz, Secretary, Securities and Exchange Commission (Dec. 22, 2003), *available at* http://www.sec.gov/rules/proposed/s71903/s71903-381.pdf; *see also* Lucian Arye Bebchuk, *The Case for Shareholder Access: A Response to the Business Roundtable*, 55 CASE W. RES. L. REV. 557 (2005) (arguing against the Business Roundtable's rationale for opposing the SEC proposed rule changes on shareholder access).

[273]Letter from McKinnell, *supra* note 272.

[274]In 2003, the SEC proposed rules concerning corporate governance that would allow nominations of directors by certain shareholders in limited circumstances where the nomination would be part of the company's proxy materials. Security Holder Director Nominations, 68 Fed. Reg. 60,784 (Oct. 23, 2003). No final action has occurred on this proposed rule.

agency with a very long institutional memory that has always acquired more power in response to crisis and scandal, and the future use it may make of the additional power it has acquired pursuant to Sarbanes-Oxley is unknown."[275]

If outrage over executive compensation persists and the SEC concludes that it does not have further authority under the Exchange Act, Congress may enact new federal laws. In fact, the House introduced the Protection Against Executive Compensation Abuse Act, H.R. 4291,[276] in 2005. H.R. 4291 would have amended the Exchange Act, requiring specific disclosures of compensation figures and shareholder approval of compensation and golden parachute plans.[277] H.R. 4291 would also mandate executives to return to companies any compensation received: (1) that was not approved by the shareholders; (2) when the executive does not meet the stated job performance measures; (3) that is incentive compensation or bonuses received by the executive "within 18 months before any negative material restatement by the issuer;" or (4) that is "related to fraud or misrepresentation" by the executive.[278]

There are certainly advantages to substantive-based federal regulation of executive compensation. William O. Douglas, an early and influential SEC chairman, envisioned a general system of federal regulation of corporate affairs.[279] Federal regulation of executive compensation, most likely under the Exchange Act, would achieve regulatory uniformity, whereas state laws vary. Moreover, the SEC is already involved in monitoring and reporting many corporate matters under the Exchange Act. The SEC could certainly monitor compliance with new executive compensation regulations. In fact, the SEC already has substantive regulatory involvement with executive compensation through existing loan prohibitions and other provisions of Sarbanes-Oxley. Finally, the SEC already has an enforcement apparatus available to sanction corporations that do not comply.

Investor confidence is at the heart of the goals of the 1933 Act and the Exchange Act.[280] To the extent states and the SROs do not eliminate perceived abuses in the area of executive compensation, the area remains ripe for further federal substantive regulation. Sarbanes-Oxley came about

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[275]Karmel, *supra* note 42, at 143.

[276]*See* Protection Against Executive Compensation Abuse Act, *supra* note 29 (referring to the Committee on Financial Services and in committee as of this writing).

[277]*Id.*

[278]*Id.*

[279]Douglas, *supra* note 254, at 523-24.

[280]Karmel, *supra* note 42, at 144.

at a time when the federal government needed to respond to corporate scandals that resulted in the loss of jobs and individual investments, particularly retirement savings. One of the many lessons of Sarbanes-Oxley is that after-the-fact regulation works well to punish wrongdoers and restore investor confidence, but it does not restore retirement savings.[281] Investors may expect the federal government to respond to executive compensation scandals in the corporate world by enacting substantive-based regulation if needed at some time in the future. What is less certain is whether the SEC or Congress will act to head off known problems and secure investor confidence. If so, what type of involvement with executive compensation is likely?

2. Statutory Alternatives

The federal government could substantively regulate executive compensation without setting executive compensation levels directly.[282] Further regulation of executive compensation would most likely require action by Congress (or state legislatures).[283] Although state law gives shareholders great latitude to tailor charter provisions away from the default statutory rules, Professor Henry Hansmann has explained the preference for statutory defaults as follows:

> The provisions of corporate law are essentially contract terms that can be repeatedly reformed by a third party—the state—to adapt them to changing circumstances. Thus, paradoxically, the great advantage of law over contract in organizing corporations is that rules of law are more easily changed.[284]

Statutory possibilities tend to fall into one of three categories: (1) shareholder involvement in setting executive compensation; (2) shareholder

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[281] *Id.*; *see also* Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 27 n.129 (2003) (noting that there is an intense urge to "do something," i.e., political regulations, immediately subsequent to a drop in financial markets) (citing Stuart Banner, *What Causes New Securities Regulation? 300 Years of Evidence*, 75 WASH. U. L.Q. 849, 850 (1997)).

[282] These statutory alternatives could also be accomplished at the state level.

[283] There is some question about whether the SEC has further rule-making authority in this area. The SEC's attempt to enhance shareholder involvement in the nomination process was met with opposition, including complaints of lack of authority. For a discussion of this opposition to the SEC's attempts, see Bebchuk, *supra* note 272, at 567-68. Whether the SEC has additional rulemaking authority is beyond the scope of this article.

[284] Henry Hansmann, *Corporation and Contract*, 8 AM. L. ECON. R. 1, 2 (2006).

involvement in setting director compensation; and (3) greater shareholder involvement in the election of directors.

Direct shareholder involvement in compensation matters could include measures such as those envisioned by H.R. 4291. H.R. 4291 would give shareholders direct involvement in compensation matters by mandating shareholder approval of executive compensation agreements on an annual basis. This measure would surely give the shareholders an ability to challenge compensation that is perceived to be extravagant, presuming that disclosure of all amounts occurs under the Revised Regulations and that the shareholders can make an informed decision. Of course, issues of boilerplate, complexity, and information overload are likely to persist, making it a challenge for shareholders to become fully informed such that participation in the compensation process is meaningful.[285]

"Directors are . . . supreme during their time. . . . [D]irectors, while in office, have almost complete discretion in management; and most of the general corporation acts in terms so provide."[286] Perhaps the most effective way to police executive compensation is to empower shareholders by giving them more power vis-à-vis the directors generally.[287] Legislation should attempt to ensure that director interests are aligned with the shareholders, rather than with the executives. For these types of reforms to be fully effective, statutes must seek to limit the CEO's influence over the directors' decision making.[288] So long as CEOs maintain influence over the compensation process and other factors induce directors to remain on good terms with the CEO, arm's-length bargaining over compensation may be troublesome.

Increased shareholder power could be accomplished by giving shareholders a greater role in setting director compensation, such as a statutory provision that requires shareholder approval of director compensation packages.[289] It is not a coincidence that the Revised Regulations tackle disclosure of both executive and director compensation.[290] Even independent directors might expect that their generosity regarding CEO compensation might be returned with higher director compensation.[291] In fact, recent empirical work suggests a correlation between high director

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[285] *See supra* notes 228-32 and accompanying text.

[286] ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 139-40 (1933).

[287] *See, e.g.*, Bebchuk, *supra* note 256.

[288] *Id.* at 203.

[289] *See* BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 1, at 202-06.

[290] *See supra* note 162 and accompanying text.

[291] Lucian A. Bebchuk & Jesse M. Fried, *Pay Without Performance: Overview of the Issues*, 30 J. CORP. L. 647, 656 (2005).

compensation and high executive compensation.[292] Involving shareholders in the director compensation process has the potential to realign director interests with the shareholders.[293] A shareholder mindset may operate to provide greater checks on executive compensation by reducing management influence.[294]

There are drawbacks to empowering shareholders through engagement in director compensation decisions. One concern would be the ability of shareholders to make effective director compensation decisions, even if recommendations are made by corporate insider groups. Even though the Revised Regulations would vest the shareholders with considerable information about director compensation, the same issues of boilerplate, complexity, and information overload are likely to persist. It would be a challenge for shareholders to become fully informed, such that participation in the director compensation process would be meaningful.[295]

Alternatively, the shareholders might also have a more meaningful role in the appointment and reelection of the board.[296] The SEC has previously tried to increase shareholder involvement in the nomination process.[297] Similar to engaging shareholders in the director compensation process, allowing shareholders access to the ballot for directors could increase accountability by aligning director interests with those of the shareholders.[298] Some have complained that allowing greater shareholder involvement in the director election process "would facilitate special interest directors, disrupt and polarize boards, discourage qualified candidates from serving on boards, encourage the likelihood of costly election contests and result in director nominees who do not meet legal requirements, and diminish board accountability by bypassing companies' nominating committees."[299] While some shareholders would certainly be able to make good nominations to the board, allowing shareholder nominations might create new problems of shareholder responsibility to

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[292]*See* Ivan E. Brick et al., *CEO Compensation, Director Compensation, and Firm Performance: Evidence of Cronyism?*, 12 J. CORP. FIN. 403 (2006).

[293]*Id.*; *see* Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 134-35 (1996).

[294]*See* Elson, *supra* note 293, at 130.

[295]*See supra* notes 227-31 and accompanying text.

[296]BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 1, at 207; Bebchuk, *supra* note 256; Deutsch, *supra* note 225, sec. 3, at 7.

[297]*See supra* notes 279-82 and accompanying text.

[298]*See* Summary of Comments in Response to the Commission's Proposed Rules Relating to Security Holder Director Nominations, *available at*, http://www.sec.gov/rules/extra/s71903summary.htm (last visited Feb. 5, 2007); Bebchuk, *supra* note 272, at 567-68.

[299]*See* Summary of Comments in Response to the Commission's Proposed Rules Relating to Security Holder Director Nominations, *supra* note 298, at 23.

replace ineffective board members.[300] Furthermore, "[m]any of these shareholders are short-term traders who have no real interest in a corporation's long-term business success."[301] Not all shareholders are concerned with the long-term prospects of the company.[302] Would nominating shareholders owe duties to the other shareholders when acting in a nominating capacity?

Reinvigorating the director election process could go a long way in improving executive compensation decision making by establishing a check on the alignment of director-shareholder interests.[303] Yet these potential changes would still leave core decision making on compensation matters with the board and compensation committees, which is consistent with the authority of the board to manage corporate affairs. Even if shareholders do not always vote on all matters before them on a regular basis, shareholders might be more active if there were alternatives to sitting directors or an ability to withhold votes from a sitting director who has voted in favor of an excessive compensation package.

A primary disadvantage that these alternatives share is that they do not tackle the problem at the decision-making level with the compensation committee.[304] This would seem to call for some type of merit review of compensation decisions. Moreover, it is uncertain whether shareholders, as a group, would be motivated to sift through the voluminous disclosure contemplated by the Revised Regulations and react by challenging corporate policy and decision makers.[305] Further, having shareholders undertake this role diverges from the state law concept of a corporate board that is empowered to manage for shareholders who have ownership rights.[306] These alternatives might impact executive compensation decision making, but may not lead to optimal results for shareholders who do not desire a substantial role in decision making.

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[300]*See* Karmel, *supra* note 42, at 141-42; Letter from Henry A. McKinnell, Chairman, The Business Roundtable, to Jonathan Katz, Secretary, Securities and Exchange Commission (Dec. 22, 2003), *available at* http://www.sec.gov/rules/proposed/s71903/s71903-381.pdf.

[301]Karmel, *supra* note 42, at 141.

[302]*See id.*

[303]BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 1, at 207-08.

[304]*See supra* Part IV.A.

[305]Randall S. Thomas & Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CIN. L. REV. 1021, 1033 (1999) ("Compensation plans are complex, technical documents that cannot be readily understood without a substantial amount of knowledge about the intricacies of different types of pay programs.").

[306]*Id.* at 1030-33 (asking whether shareholders should be engaged in the supervision of executive compensation matters).

One also must question whether expanding the federal role in corporate governance is the optimal response to remaining issues after the Revised Regulations are finalized. Because corporate governance is generally a matter left to state law, the federal government is not the best initial line of defense for reforming executive compensation matters. Corporate governance concerns a variety of matters, such as the duty of care and duty of loyalty, that go beyond executive compensation. Federal involvement would simply carve one more piece of corporate governance—executive compensation—out of state law. The piece-by-piece gradual federalizing of corporate governance raises new concerns, such as consistency in governance as a whole. Reformation of executive compensation would be better done in the context of the existing corporate governance structure covering a variety of matters. This would be a matter of state, rather than federal, law. Federal regulation of compensation is more naturally a measure of last resort. Of course, the SEC could, and arguably should, work with state governments or SROs on this issue.

B. *State Interest in Regulating Executive Compensation*

The limits of state regulation of executive compensation is highlighted by *In re Walt Disney*'s strict adherence to procedural review of decision making, notwithstanding the good faith and waste analyses.[307] States could engage in more substantial regulation of executive compensation. The United States Supreme Court has observed that "[c]orporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation."[308] The Revised Regulations give shareholders substantial disclosure under federal law. Not only are corporate enterprises formed under state, rather than federal, law, but investors presume their ongoing "contract" is controlled by the state's default statutory rules.[309] Challenges to executive compensation decision making logically reside in state law, unless preempted by federal action. Potential state law remedies designed to fill the gap that exists between federal and state regulation of executive compensation fall into two general areas: (1) increased court review, and (2) statutory

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[307]*See In re Walt Disney Co.*, 906 A.2d at 51-75.

[308]Cort v. Ash, 422 U.S. 66, 84 (1975).

[309]Hansmann, *supra* note 284, at 2 ("[P]rovisions of corporate law are essentially contract terms that can be repeatedly reformed by a third party—the state—to adapt them to changing circumstances.").

measures, discussed above. Court review and other state issues are discussed here.

A primary state law alternative to fill the regulatory gap would be to give courts additional tools to review compensation decisions.[310] *In re Walt Disney* will encourage corporate counsel to advise compensation committees to hire experts and follow "best practices." It will not, however, encourage directors to undertake serious, arm's-length negotiations with CEOs and to reject excessive packages. Increased judicial scrutiny of the merits of compensation decisions would encourage boards to negotiate for more "defensible" packages with CEOs.[311] "If the courts act, even occasionally, to trim compensation it will, in turn, be easier for compensation committees to tell executives that they simply cannot gratify their pocketbooks and egos as much as the executives demand."[312]

Courts could treat executive compensation decisions more like self-dealing transactions and submit them to a fairness or other higher standard of review.[313] Raising the standard of review in litigation for such transactions would arguably increase the likelihood of success in excessive compensation cases and change the way compensation committees make decisions. There are already instances where courts evaluate the merits of corporate decision making. For example, courts undertake a "reasonableness" evaluation in the area of corporate takeovers.[314] Similarly, there is also precedent in the tax arena for employing a "reasonableness" standard to judge the deductibility of executive compensation in close corpora-

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[310]*See, e.g.*, Linda J. Barris, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay*, 68 IND. L.J. 59, 87 (1992) (stating that courts should test reasonableness of compensation by comparison); Detlev Vagts, *Challenges to Executive Compensation: For the Markets or the Courts?*, 8 J. CORP. L. 231, 252-61 (1983) (same); Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 COLUM. L. REV. 1867, 1897-99 (1992) (reviewing GRAEF CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES (1991)) (proposing that courts use an intermediate level of scrutiny in reviewing compensation packages).

[311]*See* Thomas & Martin, *supra* note 52, at 599-600.

[312]Vagts, *supra* note 310, at 276.

[313]*See, e.g.*, Yablon, *supra* note 310, at 1897-99 (reviewing CRYSTAL, *supra* note 310) (arguing for an intermediate level of scrutiny in reviewing compensation packages); Vagts, *supra* note 310, at 252-61 (arguing for testing of the reasonableness of compensation by comparing compensation levels with those of similar firms); Barris, *supra* note 310, at 59 (same). *See generally* Thomas & Martin, *supra* note 52, at 599-605 (discussing the arguments on both sides).

[314]*See, e.g.*, Paramount Commc's, Inc. v. Time, Inc., 571 A.2d 1140, 1154-55 (Del. 1990); Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1371-87 (Del. 1995); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955-59 (Del. 1985).

tions.[315] The tax courts' use of a variety of factors and tests to determine reasonableness suggests, however, that this might be a difficult task for courts to undertake consistently. Professors Randall Thomas and Kenneth Martin have suggested that courts could require companies to justify significant deviations from medial levels of executive compensation:

> [T]he strongest case in favor of courts looking closely at executive pay at public corporations is that they are best positioned to police abuses of the executive compensation process. . . .
>
> A more difficult argument can be made in favor of courts policing the substance of outlier pay packages. This proposal is more likely to provoke claims of judicial incapacity and overreaching. . . . While this change would do little to stop the apparently inexorable rise in the levels of executive pay over the last decade, it would give angry shareholders a more direct method of challenging extraordinary pay packages.[316]

The arguments against court involvement in policing compensation practices are plentiful.[317] The main argument against court involvement is that courts are ill-suited to evaluate executive compensation in public companies.[318] A further point of contention is that boards, not the courts, are the best monitors of compensation practices.[319] Still another is that allowing court review of the merits of compensation decisions will result in more shareholder litigation.[320] The problem with these positions is that they do not provide an alternative for ensuring accountability when directors have strayed too far with compensation packages. Implementing this type of court review of compensation packages, however, would prove difficult.[321]

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[315] *See, e.g.*, Labelgraphics, Inc. v. Comm'r of Internal Revenue, 221 F.3d 1091, 1095-1100 (9th Cir. 2000) (applying five-factor test to determine reasonableness of compensation); Pfeiffer Brewing Co. v. Comm'r of Internal Revenue, 11 T.C.M. (CCH) 586, 596-97 (1952) (comparing compensation levels within the specific industry).

[316] Thomas & Martin, *supra* note 52, at 604-05.

[317] *Id.* at 603-05.

[318] Yablon, *supra* note 310, at 1896-97 n.79.

[319] Ronald J. Gilson, *Executive Compensation and Corporate Governance: An Academic Perspective*, 792 PLI/Corp. 647, 672-73 (1992).

[320] Thomas & Martin, *supra* note 52, at 604-05.

[321] *Id.*

With respect to statutory alternatives, state statutes would lend themselves more naturally to substantive regulation of executive compensation issues.[322] State statutes already require shareholder approval for a number of board decisions.[323] The same statutes could easily be amended to require shareholder approval (or even nonbinding review) of executive or director compensation packages, or at least ones that include specified features.[324] Alternatively, state statutes could allow shareholders to pass resolutions on executive compensation policies that are binding on the board, rather than precatory.[325] If shareholders could act collectively, there is also the possibility of passing corporate bylaws related to executive compensation.[326] Finally, state law already contains provisions regarding election of directors, which could be amended to provide greater shareholder involvement in the nomination and ultimate election of directors.

Those who believe that executive compensation needs further policing can expect the proponents of the existing state corporate governance regime to say that there is no problem with executive compensation practices, and that allowing shareholders greater involvement in corporate affairs is a bad idea.[327] In the wake of corporate scandals, state law has remained unchanged. But even with Delaware's pro-business history, that might be a difficult position if public outrage over executive compensation continues or corporate scandals persist. States have the most natural and direct ability to intervene in the executive compensation process, but they might ultimately leave reform to the federal government and the SROs.

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[322]For a discussion of specific statutory alternatives, see *supra* Part V.A.2.

[323]*See supra* notes 182-85 and accompanying text.

[324]BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 1, at 196-97 ("Allowing shareholders to vote on compensation agreements that include certain potentially problematic features might be useful."); Loewenstein, *supra* note 1, at 28 (recommending use of nonbinding advisory votes annually on executive compensation matters); Thomas & Martin, *supra* note 305, at 1043-48 (1999) (suggesting that even advisory resolutions of shareholders on compensation measures have an effect on subsequent compensation decisions).

[325]BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 1, at 198.

[326]Thomas & Martin, *supra* note 305, at 1047-48 (stating shareholders can use state corporate law to amend corporation bylaws to address executive compensation issues); *see also* DEL. CODE ANN. tit. 8, § 109 (2001) (stating that shareholders have the power to amend corporate bylaws); N.Y. BUS. CORP. LAW § 601 (McKinney 1986) (stating that shareholders, by a majority, can adopt, amend, or repeal bylaws); MODEL BUS. CORP. ACT § 10.20 (1996) (same).

[327]The Business Roundtable responded to the SEC's efforts to increase shareholder access to the ballot with a letter arguing that there is no need for reform and that it would actually be bad to let shareholders have greater access to the election process. Letter from McKinnell, *supra* note 272. For a critique of this position, see Bebchuk, *supra* note 272.

C. *The Potential for Self-Regulated Organizations*

Corporate governance has traditionally been left to the "province of state corporate law and subject to public scrutiny under the disclosure requirements of the federal securities laws."[328] Perhaps this tradition is changing.[329] With the corporate scandals of recent times, the corporate community has become more engaged with corporate governance, including executive compensation. This involvement has been primarily through listing requirements of SROs, such as the New York Stock Exchange, Inc. (NYSE) and the National Association of Securities Dealers Automated Quotations, Inc. (NASDAQ).[330] Further amendments by SROs to the listing rules could provide increased accountability for compensation decisions by imposing substantive requirements that are absent in the Revised Regulations and *In re Walt Disney*.

One area of progress by SROs is increased independence requirements for the board members making compensation decisions. For instance, NYSE rules require members to have a majority of "independent" directors.[331] The NYSE explains: "Effective boards of directors exercise independent judgment in carrying out their responsibilities. Requiring a majority of independent directors will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest."[332] The NYSE independence rules generally provide that independent directors are those members without "material" relationships to the company, giving specific examples where independence is lacking.[333] Companies must staff both the compensation and nominating committees with independent

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[328]R. William Ide, *Post-Enron Corporate Governance Opportunities: Creating a Culture of Greater Board Collaboration and Oversight*, 54 MERCER L. REV. 829, 834 (2003).

[329]*See* Robert B. Thompson, *Collaborative Corporate Governance: Listing Standards, State Law, and Federal Regulation*, 38 WAKE FOREST L. REV. 961, 962-63 (2003) (arguing that listing standards have become an important regulator of corporate governance).

[330]Though not discussed here, the Business Roundtable and Conference Board's discussion of good corporate practice also contribute to awareness of governance issues.

[331]*See* NYSE, Listed Company Manual, P 303A.00, *available at* http://www.nyse.com/RegulationFrameset.html?nyseref=&displayPage=/listed/1022221393251.html (last visited Feb. 6, 2007) [hereinafter NYSE]; BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 1, at 11.

[332]*See* NYSE, *supra* note 331, at P 303A.01, commentary.

[333]*Id.* at P 303A.02. Independence would be lacking, for instance, where the director: (1) was an employee of the company in the last three years; (2) has received in any twelve month period in the last three years more than $100,000 in compensation (other than as a director); (3) is employed by the company's auditor; (4) was a CEO of another company and the executives of the listed company are members of the other's compensation committee; (5) is employed by a company that has received revenues or made payments to the company exceeding the greater of $1 million or 2% of gross revenues in the last three years. *Id.*

directors.[334] Additionally, the compensation committee must have a charter and the committee must review and approve company goals related to executive compensation.[335] NASDAQ rules are similar, but less stringent.[336]

More recently, the SROs enacted new listing standards in an attempt to expand shareholder approval requirements for certain executive compensation plans.[337] Recently amended NYSE listing rules require shareholder approval: (1) for equity compensation plans; (2) prior to the issuance of common stock to directors, officers, and related parties in the event that such issuance exceeds 1% of the number of shares of common stock of the company or 1% of the voting power prior to issuance; and (3) prior to the issuance of common stock if the stock will have voting power exceeding 20% of the voting power or 20% of the common stock.[338] NASDAQ Rule 4350(i) is similar and mandates shareholder approval of certain equity compensation plans.[339]

Although these efforts improve executive compensation decision making, they do not represent considerable progress. First, the independence rules make clear that the NYSE is not identifying situations where a director is, in fact, independent.[340] This recognizes that determining director independence is far more complicated than a series of financial tests and employment relationships. Ultimate determinations of independence are made by the board itself, which adopts standards for independence. The strength of board independence rests heavily on the ability of the board to evaluate complicated relationships involving its directors. For instance, WorldCom's directors would have satisfied current definitions of

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[334]*See id.* at P 303A.05; BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 1, at 11.

[335]NYSE, *supra* note 331, at P 303A.05.

[336]NASDAQ, Summary of NASDAQ Governance Proposals, *available at* http://www.nasdaq.com/about/Web_Corp_Gov_Summary%20Feb-revised.pdf (Feb. 26, 2003).

[337]*See* NYSE, *supra* note 331, at P 303A.08; NASDAQ, Marketplace Rules, IM 4350(i), *available at* http://nasdaq.complinet.com/nasdaq/display/display.html?rbid=1705&element_id=18 (last visited Feb. 6, 2007) [hereinafter NASDAQ]; *see also* Janice Kay McClendon, *Bringing the Bulls to Bear: Regulating Executive Compensation to Realign Management and Shareholders' Interests and Promote Corporate Long-Term Productivity*, 39 WAKE FOREST L. REV. 971, 1000-01, 1006-12 (2004) (concluding that these measures do address some abuses but do not change the executive compensation decision-making process).

[338]NYSE, *supra* note 331, at P 312.03.

[339]NASDAQ, *supra* note 337, at IM4350-5(i).

[340]NYSE, *supra* note 331, at P 303A.02, commentary ("It is not possible to anticipate, or explicitly to provide for, all circumstances that might signal potential conflicts of interest, or that might bear on the materiality of a director's relationship to a listed company.").

independence.[341] Second, the listing standards do not seem to take into account other factors that result in the CEO having significant bargaining power over compensation matters and hinder the board's ability to enter into arm's-length dealing with the CEO over compensation matters.[342]

While the shareholder approval policy increases shareholder involvement in compensation matters, it does so only on a marginal basis, with respect to a specific equity compensation plan.[343] Even for these plans, shareholder involvement in determining the awards made under such plans is contemplated only in a limited situation where the award is enough to strike the 1% threshold, an unlikely scenario for most publicly held companies. The rules do not give shareholders authority over general issuances of stock to the CEO or board members. For these reasons, the SRO rules related to equity compensation plans do not create meaningful accountability to shareholders for compensation decisions and will not result in needed changes to executive compensation practices more broadly.

Existing SRO rules leave executive compensation practices, as a whole, undisturbed. Yet the SROs are particularly suited to making just the kinds of rules needed for comprehensive reform in a manner that would be flexible to an ever-changing business climate.[344] Professor Melvin Eisenberg has observed that "the Exchange has an economic interest in the adoption of rules that maximize shareholder wealth and attract investment in stock. Accordingly, the Exchange has had both an interest in curing defects in state law and the power to do so."[345] In addition to increasing shareholder involvement in executive and director compensation decisions and increasing shareholder involvement in the director nomination process, discussed above, the SROs have a wide range of requirements they could impose on members. For instance, the SROs could limit CEO power by:

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[341]Richard C. Breeden, Restoring Trust, Report to the Hon. Jed S. Rakoff, at 20 (Aug. 2003), *available at* http://www.sec.gov/spotlight/worldcom/wcomreport0803.pdf ("At least 80% of WorldCom's directors during the Ebbers era would probably meet today's standards for director independence, as well as the standards of the time.").

[342]*See supra* notes 181-89 and accompanying text.

[343]McClendon, *supra* note 337, at 1012.

[344]*See* Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1455 (1997) (arguing that listing standards could be used as an effective regulator); McClendon, *supra* note 337, at 1013-14 (listing reasons why SROs are better situated to enact the necessary reforms through listing standards); A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 964- 65 (1999) (arguing that SROs are positioned to serve as a regulator); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2399-401 (1998) (explaining that regulations by exchanges would be effective); Thompson, *supra* note 329, at 972-73 (arguing that listing standards could be used as an effective regulator).

[345]*See* Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1514 (1989).

(1) having a nonexecutive chairman with substantial responsibility; (2) restricting executive involvement and access to the compensation process; (3) requiring compensation committee members to have greater familiarity and experience with compensation matters; (4) increasing the independence of compensation consultants hired by the compensation committee; and (5) assessing the effect of board ownership of company stock on board independence.[346] While it might be possible for listing requirements to be substantially amended to address remaining executive compensation issues, no such reforms appear to be on the horizon.

The SROs have long had the ability to reform executive compensation, yet they have failed to take action. Even the corporate governance reforms of recent time cannot be effective without strong enforcement mechanisms.[347] Furthermore, many changes to the listing standards have been made at the urging of the SEC.[348] Despite shareholder calls for increased disclosure, the SROs have not responded, and most companies are only responding to the threat of SEC requirements under the Revised Regulations.[349] Moreover, CEOs have demonstrated opposition to some measures, such as greater shareholder involvement in the director nomination process, that would increase accountability for compensation decisions. If past practice is any indicator, the SROs and the member companies will not make substantial changes to executive compensation practices without SEC pressure, even in the face of shareholder objections, once enhanced disclosure is required under the Revised Regulations.[350]

VI. CONCLUSION

The Revised Regulations, along with the shortcomings discussed above, have become final regulation. Even if the prospect of revising executive compensation accountability is not immediately at hand, the newly mandated disclosure is meaningful, and companies will have to

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[346]McClendon, *supra* note 337, at 1013-16 (discussing alternatives for SRO listing standards and arguing that reforms to listing requirements could potentially cure many of the problems with executive compensation).

[347]*See, e.g.*, John F. Olson, *How to Really Make Audit Committees More Effective*, 54 BUS. LAW. 1097, 1100 (1999) ("The author knows of at least half a dozen instances in recent years where companies listed on the major markets did not meet even today's more limited governance requirements and where, despite continued violations, the market in question took no action.").

[348]Thompson, *supra* note 329, at 977-80 (giving examples of SEC involvement in listing standards).

[349]Bebchuk, *supra* note 256, at 2.

[350]*Id.*

comply. One can anticipate some problems in applying the Revised Regulations to specific compensation agreements, perquisites and retirement and severance benefits. The problems with disclosure and information overload, and the looming challenge of boilerplate, remain to be resolved.

As we address the broader issues raised by ever-rising executive compensation packages, we must recognize that using information disclosure as a primary regulatory approach is an unrealistic approach to resolving the excessive compensation conundrum and that it may not be workable in the absence of other measures. While the lesser goal of the Revised Regulations—increasing disclosure—is within reach, some of the issues, such as defining compensation elements present under the Existing Regulations, will remain. Companies will be subject to an increased burden of information disclosure because a filed document creates liability for misstatements under the Exchange Act. While the information is intended to help the public understand executive compensation packages and practices, there is no specific remedy for shareholders who object to compensation practices, absent a state law claim for lack of due care, good faith or waste. *In re Walt Disney* demonstrates the limits of state law evaluation of procedural decision making as a remedy for aggrieved shareholders. A looming gap remains between the disclosure required by the Revised Regulations and the available shareholder remedies under *In re Walt Disney.*

The federal government has traditionally been involved with information disclosure of the type set forth in the Regulations, but has increasingly entered the realm of corporate governance more directly. Corporate governance as a whole, however, was traditionally a matter for state government regulations. Further reforms in the executive compensation area might be most naturally made under state law. Nevertheless, creating a system of corporate governance where the decision makers dealing with executive compensation matters are accountable to the shareholders represents a daunting task for state or federal regulators or the SROs. While finalizing the Revised Regulations may temporarily have a calming effect on a public that objects to compensation packages unconnected to executive performance, a closer examination reveals that much work remains in addressing executive compensation issues.