Toward Fairness in Compensation of Management and Labor: Compensation Ratios, A Proposal for Disclosure

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I. INTRODUCTION

The thesis of this article is that fairness in the compensation of executives, managers, and employees would be advanced by the disclosure of the ratio between what is earned by the average employee and manager compared to what is earned by top executives in any given publicly owned enterprise. There has been a hue and cry in recent years over the excessive compensation paid to the chief executive officers of some of America's corporations. This hue and cry arises from the fact that there is no perceived sense of fairness in what these executives are paid as compared to what other managers and employees earn.

A small homogenous group of people at the top decide what they are worth based primarily upon personal justification. The rest to the corporate work force is shackled by the idea that though they are a safe distance from the minimum wage, they are required by circumstances to be satisfied with having less than their fair share of the revenues they produce. This is an outdated way of compensating employees and managers.

How does one advance fairness in compensation on all levels of today's Corporate Workforce? It is, here, proposed, that the Securities and Exchange Commission ("SEC") adopt a disclosure rule to require registrants to provide a "Compensation Ratio" in their SEC filings. That compensation ratio would be expressed in terms of what the top executive officers earn compared to what the average employee and manager earns. For example, the CEO earns X, and that amount is fifty times the earnings of the average employee or average manager in the company. Such a ratio, as an accepted

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part of the financial evaluation of the company by investors and potential
employees of the company, would introduce fair compensation practicum to
the Directors and Officers of the company.

This article will discuss the general history of executive compensation,
then the concept of "excessive compensation" as it has developed in
corporate America. Current SEC disclosure requirements will be described
and the regulation the article proposes to be amended has been set out in
Appendix A. Current disclosure requirements are significant in their detail
and the significant amount of information available. But the information
means nothing to the average investor, employee or general public and very
little to the professional investor since he or she is part of the same "class." However, it is essentially meaningless because it has no context by which
to measure its efficiency within a firm. Next, the development and use of
ratios as a tool of financial analysis is discussed to establish the legitimacy
of ratios as an acceptable form of analysis and that it takes usage to
 appreciate its value. The article then describes in detail the proposed
compensation ratio and the benefits to be derived from its adoption by the
SEC. Finally, there is a stockholder proposal which could be proposed by
interested stockholders to their corporations to further the use of the
compensation ratio.

II. HISTORY OF EXECUTIVE COMPENSATION DISCLOSURE

Executive compensation as a specific area of study and concern began
with the development of the modern corporation early in the 20th century.
The first state to pass legislation which provided for the formation of
corporations was New Jersey in 1896.1 Prior to 1896, it was only possible
to incorporate on an individual basis. Incorporation was accomplished
by the introduction and passage of a bill by the state legislature.2 United
States Steel Corporation was the first major corporation to become formally
organized as such.3 It was not long before the preferred business organiza-
tional structure became the corporation.4 "The advantages of the corporate
form such as limited liability and perpetual existence were obvious and soon

2. Thomas L. Hazen, The Corporate Persona, Contract (and Market) Failure, and
1987). U.S. Steel was the first company that listed itself as having a billion dollars in
assets, although about a third of that was "good will." Id.
4. Id.
states were competing to become the state of incorporation for as many corporations as possible in light of the tax base they represented.\textsuperscript{5}

Early in this century, some of the great corporations were formed and developed by entrepreneurs. By the middle of the century a new class of people called the "executive class" had formed and taken control of the great companies.\textsuperscript{6}

It seems reasonable that the entrepreneur who creates and thereby contributes to society and its betterment should reap all of the rewards of that inventiveness. And it just doesn't seem right that a manager, whose skill is organization, not invention or creation, should receive the high compensation that some do today. Management skills differ in name only between public and private industry.

"The class of managers that has evolved consists invariably of urban, White, Protestant and, of course, males."\textsuperscript{7} More than 70\% of the CEO's fathers had been business or professional men, as had most of their paternal grandfathers.\textsuperscript{8} A distinct group was then defined. During their fathers' lifetimes only 11\% of the male population had been business or professional men; in their grandfathers' day, only 9\%.\textsuperscript{9} "By 1950, only 6\% of the top ten executives had entrepreneurial backgrounds, and the typical CEO had worked for the same company since age twenty-nine."\textsuperscript{10}

The special talent of today's CEO is bureaucratic skill, the ability to rise through the corporate hierarchy to the office of chief executive officer.\textsuperscript{11} "It is a useful talent (Bureaucratic Survival Skill — "BSS"), to be sure, but not one that benefits the greater society."\textsuperscript{12} CEOs are not becoming wealthy because of what they contribute, because their contribution is negligible in real terms, but rather because of the position they occupy at the top of the salary scale.\textsuperscript{13} Enriching a group according to the

\textsuperscript{5} Id.
\textsuperscript{7} C. Wright Mills, \textit{The Power Elite} 127 (paper ed. 1956). Mills, a professor of sociology at Columbia University, was one of the most influential sociologists of his time. Mills found corporate executives to be motivated primarily by profit and security and corporations to be totalitarian and dictatorial. After 25 years dealing with corporate executives at various levels, I agree with this conclusion.
\textsuperscript{8} Bogus, \textit{supra} note 6, at 9.
\textsuperscript{9} Id.
\textsuperscript{10} Id. at 10-11.
\textsuperscript{11} Id. at 17.
\textsuperscript{12} Id.
\textsuperscript{13} Id.
position they hold rather than genuine contribution and in the magnitude it is done has profound social, political and economic consequences.\textsuperscript{14}

BSS seems to tilt our frame of reference and places value on that which is not comparatively as valuable as the invention or creation being managed, at least to the degree that the average CEO is compensated today.

There are unacceptably few female CEOs of America’s thousand largest companies,\textsuperscript{15} and even fewer African-Americans have ever headed such companies.\textsuperscript{16} “Today CEOs are generally Protestant, most often either Presbyterian or Episcopalian.”\textsuperscript{17} Certainly this is due, in substantial part, to gender and racial discrimination. Another part is the nature of survival in a bureaucracy. Bureaucracy places a high premium on thinking, acting and looking alike, traits which do not lead to innovation.

These new BSS managers typically graduated from some well-known university,\textsuperscript{18} worked for their present company for a substantial number of years, and made their way to the top of the executive suite through the finance, accounting or marketing department,\textsuperscript{19} which is the reason for the sameness and group thinking that is prevalent.

Compensation packages for executives have evolved during the last 100 years in response to changes in the structure of business and how it is conducted by American firms.\textsuperscript{20} No longer are there owner-managers; in their place are the professional managers who are essentially salaried executives who are also employees.\textsuperscript{21} It has been said that most owner-managers preferred to take the rewards of their hard work through the appreciation of the stock of the company.\textsuperscript{22} “Salaried executives, on the other hand, had little incentive to provide services at a level greater than that required to retain their positions.”\textsuperscript{23} In response, corporations developed, for some as yet unclear reason, incentive compensation plans based on some measure of corporate profits.\textsuperscript{24} At some point in this history the concept of “excessive compensation” began to be recognized. However, there has never been and there is not today a clear standard by which to judge

\begin{itemize}
  \item \textsuperscript{14} Id.
  \item \textsuperscript{15} Id. at 18, n.87.
  \item \textsuperscript{16} Id. at 17.
  \item \textsuperscript{17} Id.
  \item \textsuperscript{18} Id. at 17.
  \item \textsuperscript{19} Id.
  \item \textsuperscript{21} Id. at 61.
  \item \textsuperscript{22} Id.
  \item \textsuperscript{23} Id.
  \item \textsuperscript{24} Id. at 62.
\end{itemize}
whether or not compensation for any position has been "excessive."\textsuperscript{25} There is clearly a need for some objective method of determining what is excessive compensation and what is fair compensation for the professional manager.

The most recent serious attempt at defining and controlling excessive compensation of executives is the 1993 Tax Act, which added to the IRS Code a controversial provision. "Section 162(m) disallows a corporations federal income tax deduction for compensation to certain executives in excess of $1 million during a corporate taxable year."\textsuperscript{26} "This $1 million deduction limit covers all types of compensation, including cash, property, and the spread on the exercise of options."\textsuperscript{27} "However, there are a series of important exceptions which create serious loopholes in the section."\textsuperscript{28} The section has been criticized as "an unwise exercise in political and social engineering and an embodiment of manifestly unsound tax policy [which] deserves ... quick repeal ..."\textsuperscript{29}

It is the author's belief that one reason for the non-existence of an objective standard for determining excessive compensation has to do with the historical separation of management and labor. The author believes the separation of management and labor is becoming obsolete. As the

\textsuperscript{25} There is a provision in the Internal Revenue Code which allows for the disallowance of "excessive compensation" as a business deduction in a closely held corporation. In Val Cleave v. United States, 718 F.2d 193 (6th Cir. 1983), a taxpayer brought suit for a refund. The United States District Court entered judgment for the government, and the taxpayer appealed. The Court of Appeals held that the taxpayer who included "excessive compensation" in his return for the year compensation was received and, in the subsequent year, paid back excessive compensation to the corporation which employed him, was entitled to exclude excessive compensation from his income in the year received, thereby reducing his tax liability for that year and receiving credit against his tax liability for the subsequent year. \textit{Id.}

Thus, there is some control of closely held corporations with respect to "excessive compensation."

\textsuperscript{26} Levin, Javars & Welke, \textit{Code Section 162(m) — $1 Million Deduction Limit on Executive Compensation}, \textit{TAX NOTES}, May 9, 1994, at 723, 724.

\textsuperscript{27} \textit{Id.} at 723.

\textsuperscript{28} \textit{Id.} at 724. The exceptions are: (1) compensation paid by a privately held corporation; (2) compensation paid by a publicly held corporation under a plan or agreement that existed before the corporation was publicly held; (3) compensation paid to an executive other than one of the corporation's top five officers; (4) performance-based compensation that is keyed to a preestablished, objective, nondiscretionary formula and also meets certain shareholder and outside director approval requirements; and (5) compensation covered by a pre-February 18, 1993, binding contract that has not been materially modified, and compensation which is deductible in a corporate tax year beginning before January 1, 1994. \textit{Id.}

\textsuperscript{29} \textit{Id.} at 735.
management/labor separation becomes obsolete, the separation between the
top executive and the average employee should grow smaller both financially
and managerially in an enterprise with a single purpose, profits. The
CEO should be less expensive when seen in the context of other contributors
to the success of the enterprise.

Historically the executive and/or his peers have determined their worth
based on their judgment about themselves. At the other end of the
employment spectrum, labor or employees have been told what they are
worth by the management class whose purpose was paying as little as
possible. Hence, the Fair Labor Standards Act was the first step to provide
a minimum wage as well as other protections for labor.3° It is a spectacle
to see vigorous opposition to raising the minimum wage by politicians and
interest groups who tolerate excessive increases in compensation for
themselves. Fifty cents an hour poses threats to employment while several
billion dollars spread over a small class of executive is never discussed in
terms of threats to employment even though workers are frequently laid off.

III. THE CONCEPT OF EXCESSIVE EXECUTIVE COMPENSATION

The notion that someone could be excessively compensated for
performing essentially salaried work is mysterious in its origins.31 CEO

30. 29 U.S.C. § 201 et. seq. The Fair Labor Standards Act of 1938 stands as one of
the cornerstones of federal labor legislation, establishing for a broad range of workers
federally mandated minimum wage and premium wage rates for overtime work. The Act,
however, exempts from its coverage all employees who work in a "'bona fide executive,
administrative, or professional capacity.'[citation omitted] ...Congress never made explicit
its reasons for exempting managerial and professional employees when it enacted the [statute
in 1938]. Today, managerial and professional employees still constitute a privileged stratum
of the workforce, generally enjoying wages and benefits superior to those of the rank and
file." Peter D. DeChiara, Rethinking the Managerial-Professional Exemption of the Fair

31. The landmark case regarding executive compensation is Rogers v. Hill, 289 U.S.
582 (1933). A Supreme Court case arising out of shareholder action against the American
Tobacco Company, alleging that the company's top officers had been paid unreasonably large
salaries and seeking restitution. Bogus, supra note 6, at 47.

One year later, a New York court handed down a decision in an action that
shareholders brought against the National City Bank of New York challenging sums that top
executives received under a predetermined incentive compensation plan. Gallin v. National
City Bank of New York, 152 Misc. 679, 273 N.Y.S. 87 (Sup.Ct. 1934). The court set forth
the applicable legal standard as follows:

The rule is established that directors of a corporation acting as a body in good faith
have a right to fix compensation of executive officers for services rendered to the
corporation, and that ordinarily their decision as to the amount of compensation is
final except where the circumstances show oppression, fraud, abuse, bad faith, or
compensation has fascinated many scholars, and in one form or another it has been studied by economists, sociologists, accountants and experts in management and industrial relations. Even Aristotle had something to say about excessive compensation as it might be understood in the ancient world. There is a substantial collection of information available on the subject. "What is both surprising and highly significant, however, is that there is a general consensus on what is perhaps the most important single point: there is little, if any, relationship between what top executives make and how they perform."

other breach of trust. If clear oppression, bad faith, or other breach of trust is shown, the courts will give redress and determine to that extent the compensation is excessive. But plaintiffs must bring the case within one of the exceptions that are in each case predicated on a breach of legal duty with consequent damages to the corporation.

Id. at 117.


33. In his Nicomachean Ethics, Book V, Chapter 9, 1136, Aristotle says:

Of the questions we intended to discuss two still remain for discussion; (1) whether it is the man who has assigned to another more than his share that acts unjustly, or he who has the excessive share, and (2) whether it is possible to treat oneself unjustly. The questions are connected; for if the former alternative is possible an the distributor acts unjustly and not the man who has the excessive share, then if a man assigns more to another man than to himself, knowingly and voluntarily, he treats himself unjustly which is what modest people seem to do, since the virtuous man tends to take less than his share . . . the person in whom lies the origin of the action, and this lies in the distributor, not in the receiver . . . he who gets an excessive share does not act unjustly, though he "does" what is unjust.

From this passage in the Nicomachean Ethics one could certainly argue that to distribute or accept excessive compensation would have been condemned by Aristotle as lacking virtue, i.e. the highest of man.

34. Bogus, supra note 6, at 11. See FERDINAND LUNDBERG, THE RICH & THE SUPER-RICH 441 (1968), who reviewed the data available to him in the 1960s and concluded: "There is in fact no consistent relationship between high executive pay and company success." Id.

In general, researchers equate CEO performance with company performance. This allows them to use objective yardsticks — such as company profits or shareholders' return on equity — to measure CEO performance. "Some fundamental assumptions are, however, being made when CEO performance is equated with company performance. While the assumptions are probably valid for large groups analyses, they are questionable in individual situations." Bogus, supra note 6, at 11.

35. Id.
How much should an executive be paid? As a theoretical question, it is not hard to answer. Two, or perhaps three, criteria should be used to set a top executive's pay.\textsuperscript{36} First, any company should buy the services of its executives as inexpensively as possible; just as it should try to purchase any service or product, or hire any employee, as cheaply as possible.\textsuperscript{37} Second, a company should pay its executives in the most cost-effective way that will maximize their performance.\textsuperscript{38}

Finally, an employer might consider fairness, although this is a debatable criterion and subject to interpretation.\textsuperscript{39}

"After considering these criteria, it is possible to state a succinct definition as follows: Excessive executive compensation is compensation that is higher than is necessary to (1) hire or retain the executive, (2) provide the optimum incentive to the executive, or (3) be fair."\textsuperscript{40} Applying this definition, the salaries paid to many senior executives at many Fortune 500 companies are patently excessive.\textsuperscript{41}

Conventional wisdom suggests most people will accept a promotion for a 10% raise, but it is possible for an executive to receive a 300% raise when he is promoted to CEO.\textsuperscript{42} This is the critical problem. How does anyone suddenly become worth 300% more to the stockholders for doing what he has always done, i.e. manage people and make decisions? The answer seems to be: His peers are doing it and getting away with it, so he should do the same. Experience seems to confirm that this answer is right. In today's world, however, there is developing a troublesome problem for the CEO being paid 300% more than the average employee. The employee is smarter, knows more and is more valuable. There is more disclosure which, among other things, leads to a sense that someone is kidding someone about what the guy at the top is doing or is worth. It is almost a standing joke

\textsuperscript{36} Id.
\textsuperscript{37} Id. at 28.
\textsuperscript{38} Id.
\textsuperscript{39} Id. "An employee who puts forth a special effort may 'deserve' extra money even if the premium is not necessary to retain the employee or keep him happy, or an employee's salary might be raised to make it equivalent to that of other employees with the same job even if (theoretically) he never would have discovered a difference. This is a questionable criterion because it violates the rule that the company should buy services at the lowest possible cost, but in the real world fairness is generally good business because it is important to employee morale." Id.
\textsuperscript{40} Id. at 28-29.
\textsuperscript{41} Id. at 29.
\textsuperscript{42} See Graef S. Crystal, The Great CEO Pay Sweepstakes, FORTUNE, June 18, 1990, at 94. See also Charles A. O'Reilly et al., CEO Compensation Tournament and Social Comparison: A Tale of Two Theories, 33 ADMIN. SCI. Q. 257 (1988).
among some executive compensation people the author has known that the "guys are not worth it" but, if you can get away with it, why not?

Generally, the salaries being paid to chief executives exceed what is necessary to hire or retain them. One could almost create a formula which would say that when an executive is being paid 15% more than the average group of vice presidents from which he was promoted he is being paid excessively. The truth is that if the system was not so skewed it would not be difficult to hire almost any CEO for 10% to 15% more than what he is presently making, especially since the perks that go along with being on top are numerous. How would such a proposal fare in the current economic and executive compensation climate?

The amounts paid to chief executives violate any common sense understanding of what is required to motivate someone to put forward his best effort. Will someone work harder or more creatively to get a $500,000 bonus than a $250,000 bonus? Will he work even harder for a million dollar bonus, and harder still for five million dollars? Few people would think so. Once the proverbial carrot is big enough to encourage total effort, a bigger carrot is wasteful. Moreover, it is unnecessary to depend only on financial incentives; people are also motivated by pride, by satisfaction from doing their job well, by appreciation and by respect.

It was the author’s experience that when attending personnel meetings regarding motivation of employees, salary was never on the top of the list. It only increased my interest in executive pay to realize that the senior people who knew this, took advantage of employees by telling them about it and then, in effect, voted themselves mammoth pay raises. To prepare a proxy statement and examine the compensation of the top five officers and

43. Bogus, supra note 6, at 30.
44. The CEO labor market is highly restricted because the expertise of running a particular company is often specific to that company, or to a few other companies in its industry. See Detlev Vagts, Challenges to Executive Compensation: For the Markets or the Courts?, 8 J. CORP. L. 231, 237 (1983). This expertise is not easily transferable. CEOs have generally worked their way up through the ranks in the company they head. Id. On the average, they work for the same company for 25 years. See Robert Mims & Ephraim Lewis, A Portrait of the Boss, BUS. WK., Oct. 20, 1989, at 23. More than 42% have never worked for another firm. See James D. Cox & Harry L. Munsinger, Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion, LAW & CONTEMP. PROBS., Summer 1985, at 83, 95 n.57 (reporting a 1975 study that showed that 42.5% of 400 top executives in the 300 largest corporations had worked for only one company).
45. There is reason to believe that CEOs are not significantly motivated by their compensation packages. See New Heresy: Maybe Pay Doesn’t Motivate, FORTUNE, June 18, 1990, at 102.
all officers as a group without any knowledge of what others in the organization were earning was somehow exploitative on the part of top management.

"J.P. Morgan reportedly believed that no one should be paid more than 1.3 times as much as those on the next lowest rank." 47 One management expert has said that a chief executive should not make more than twenty times as much as the company's lowest-paid employee, 48 another believes that no one is worth more than $300,000 a year. 49

It seems absurd to hear an argument that it is fair for chief executives of individual business corporations to be paid more than the President of the United States, the Vice-President, the Attorney General, the Secretaries of State and Defense, the Speaker of the House of Representatives and all nine justices of the United States Supreme Court combined. 50 It is beyond reasonable dispute, therefore, that most of the nation's largest corporations are paying their top executives more than is necessary for corporate purposes. 51

So what is to be done? How is this battleship of excessive compensation and corporate waste to be turned from its course?

IV. DISCLOSURE OF EXECUTIVE COMPENSATION

The Securities Act of 1933 52 and the Securities Exchange Act of 1934 53 are two pieces of legislation which express the public policy that disclosure is the best protection for the investing public and that so long as accurate information is available the investing party will be well served. Consistent with that public policy, current Securities and Exchange Commission rules require disclosure of the most relevant information with

50. This calculation is based on the fact that CEOs at the largest 200 companies have an average annual pay of $2.4 million. Byrne, supra note 48, at 93. The annual salaries of federal officials are: President of the United States, $200,000; Vice President of the United States, $160,600; members of the cabinet, $138,000; Speaker of the House, $160,600; Chief Justice of the United States Supreme Court, $160,000; Associate Justices of the United States Supreme Court, $153,600. See THE 1991 INFORMATION PLEASE ALMANAC 41 (44th ed. 1990).
51. Bogus, supra note 6, at 32.
regard to executive compensation, but they do not require that the disclosed information be readily understandable to the reader. Not only are the rules difficult to digest but it is the goal of most executive compensation personnel to obscure the pay of high executives as much as possible. No CEO wants to look like a "fat cat," although in recent times some have obviously taken a "who cares" attitude. Compensation tables which state the amount of salaries and bonuses paid to a company's top five executives are required to be included in proxy materials for stockholders, but there is no requirement to include the value of stock options. The proxy rules do require the disclosure of option compensation, but it may be disclosed in narrative form. The narrative text is usually written in such a way as to render it incapable of being understood by the average investor. According to SEC Chairman Richard Breeden, one major U.S. automaker's incentive compensation plan was described in sixteen pages and required "a Ph.D. in Finance to begin to understand what was paid." The information that is disclosed, generally, will not fairly represent the true facts as to the executive compensation. "Managers may easily manipulate accounting figures to reflect higher earnings for a given period," thus justifying salary or bonus increases. 

It is well known that Generally Accepted Accounting Principles can be used to legally misrepresent the actual size and cost to a company of stock option compensation.

56. Id.
59. Barris, supra note 20, at n.201.
60. "Information on stock options must be disclosed, but not necessarily in a meaningful way because a company need not take a charge to earnings when it issues stock options, as it must do with cash compensation. Consequently, net income figures for the
The Financial Accounting Standards Board (FASB), charged with the responsibility of monitoring corporate accounting and reporting practices and developing standard operating accounting rules, is acknowledging the pressure from institutional investors to reexamine the issue and make revisions.

It is important to appreciate the fact that the FASB obtains more than a third of its revenues from donations from corporations and accounting firms. The conflicts of interest are self-evident and may, once again, delay or curtail any efforts to change the current system. With this complex and detailed disclosure required and available to the investing public and as interesting and informative as it is, there is no basis for judgment as to when it is excessive or wasteful. Is it fair and reasonable and by what standards do you judge whether it is fair and reasonable? The fact is nobody believes it to be fair and reasonable. Prior to 1992 shareholders were prevented from raising questions about executive compensation through the only mechanism available to them, the shareholder proposal. On February 13, 1992, the SEC announced a major change in its policy regarding executive compensation issues. With the announcement, shareholder proposals that were giving advice and expressing the views of shareholders with regard to compensation matters would be treated as “major policy issues,” which, unlike ordinary business, are includable in proxy materials. Along with its announcement, the SEC issued ten no-action letters concerning previously submitted shareholder proposals, allowing the pending proposals to be included in proxy materials.
The ten companies affected are Aetna Life and Casualty Co., Baltimore Gas and Electric, Battle Mountain Gold Co., Bell Atlantic Corp., Black Hills Corp., Chrysler Corp., Eastman Kodak Co., Equimark Corp., Grumman Corp., and IBM. The actions by the SEC was an attempt to prevent passage of legislation to force the SEC to make this change in its rules. In announcing the new policy, SEC Chairman Richard Breeden said, "Hopefully, this decision will bring a market solution to a market problem by allowing the affected private sector groups — management, directors, and shareholders — to resolve the compensation questions in each company on a case-by-case basis without government regulation."

With the new SEC rules concerning shareholder proposals, it was now possible for shareholders to consider and vote on issues involving executive compensation. If intelligent decisions are going to be made by shareholders, they must have sufficient understandable information about executive compensation practices of companies in which they have invested. Perhaps, an insubstantial amount of shareholder apathy can be attributed to a lack of intelligible information provided by corporations.

The Securities and Exchange Commission has developed a rather elaborate system of disclosure of executive compensation with no system for determining whether or not the compensation is excessive or otherwise fair and reasonable to stockholders. The problem of compensation is that to determine fairness one needs a comparison group. The homogeneous group of corporate executives who determine their own compensation (in somewhat of a vacuum) tends to distort the compensation picture. It is safe to say that no reasonably prudent person believes that another human being who manages a corporation should actually be paid more than the President of the United States who is the Commander-in-Chief of the largest and most powerful Armed Forces in the world. And yet it is tolerated because there is no comparison group. Importantly the President's salary is set by a third party, Congress. In the corporate world the Chief Executive sets his compensation, not directly but indirectly, by the selection of Board Members who are selected because they are intelligent, experienced, successful and understand how things are done in the board room.

Present day chief executives have extraordinary responsibilities. It is often said that they manage tens of thousands of employees, which is not
true, since they apply the concept of “span of control.” They balance the conflicting demands of customers, lenders, workers, governmental agencies, the press, and the public, through the use of extensive staffs; manage enormous pressure from financial analysts for information and shareholders who want to increase share value; and at the same time remain current about technological change and foreign competition. Chief executives are somewhat unique to each company that employs him with a somewhat tailored job description. You will hear executives, and only executives, claim that this justifies their pay, however high it is.

No one really objects to executives being paid reasonably well depending on the fortunes of the firm. If a company has the right CEO, with “energy, brains, diligence, daring, and capacity for hard work,” any reasonable salary is probably a bargain. A growing number of critics are more forcefully pointing out the missing link between the performance of many executives and the total compensation they receive.

For an extraordinarily large salary to appear to be both fair and acceptable to shareholders and the public, compensation must be more clearly related to the actual responsibility the executive has and the quality of the executive’s actual contribution to the business, and it should be judged against what others are paid for like work and like performance in the same or similar industry. If an executive receives a large annual bonus because the corporation showed a profit, that profit should be substantially related to the actual efforts of the executive. This is where the athletic analogy breaks down. A professional athlete makes millions because of his individual talent. An executive is just one player on a very big team. He plays the role of leader but it is impossible to accurately assess his individual contributions, like that of a quarterback, to an overall successful business with 50,000 employees. When a quarterback throws a touchdown pass to an end, the contribution is obvious and clear for all to see.

73. Id. at 65-66.
74. Id. at 65.
75. Barris, supra note 20, at 65.
76. Id.
77. Donald B. Thompson, Are CEOs Worth What They’re Paid?, INDUSTRY WK., May 4, 1981, at 65 (quoting U.S. Steel Vice President J. Bruce Johnston).
78. Id. at 65.
79. Barris, supra note 20, at 65.
80. Id.
81. Id.
82. Id.
83. Id.
84. Id.
What is unanticipated in the data and enormously significant is that there seems to be a consensus with respect to what is possibly the most significant fact: there is almost no relationship between what top executives earn as compensation and how they actually perform their jobs.85

In 1990, two other scholars — who are considered conservatives on the subject and argue that CEOs may be underpaid — concluded that whatever the metric, CEO compensation is independent of business performance.86 In independent studies, Professor Graef S. Crystal of the University of California at Berkeley found some correlation between pay and performance, but he concludes nonetheless that “in a disheartening number of other cases, no claim to superior corporate performance supports the CEOs’ exceedingly high pay.”87

It generally takes a catastrophic decline of more than 70% before average CEO compensation shows any decline, if at all.88 CEOs are seldom if ever fired for inadequate job performance.89 “Two recent studies examined more than 500 management changes and found only twenty cases where CEOs were terminated for poor performance.”90 The average CEO will spend more than ten years in his job and will only leave after reaching retirement age or beyond, if he can get away with it.91

If pay is not related to performance, to what, if anything, is it related? First, studies seem to show that executive compensation has something to do with the size of the company; i.e., the larger the company, the higher the

85. See LUNDBERG, supra note 34, who reviewed the data available to him in the 1960s and concluded that: “There is in fact no consistent relationship between high executive pay and company success.” Lundberg, supra note 34, at 441.

In general, researchers equate CEO performance with company performance. This allows them to use objective yardsticks — such as company profits or shareholders return on equity — to measure CEO performance. Some fundamental assumptions are, however, being made when CEO performance is equated with company performance. While the assumptions are probably valid for large groups analyses, they are questionable in individual situations. Bogus argues that courts should not assume that, in an individual case, a particular company’s performance necessarily reflects the CEO’s performance. Bogus, supra note 6, at 82-83.

86. John A. Byrne et al., Is the Boss Getting Paid Too Much?, BUS. WK., May 1, 1989, at 46, 48, 52.

87. Crystal, supra note 42, at 95. Researchers, including Professor Crystal, report additional studies that “show modest positive effects” of return on equity and sales on CEO compensation. See O’Reilly, supra note 42, at 266.

88. Bogus, supra note 6, at 12-13.


90. Bogus, supra note 6, at 13.

91. Id.
CEO's pay.92 There are three factors frequently used to measure a company's size: assets, sales volume and number of employees.93 CEO compensation seems to correlate only with sales volume; there is no significant relationship with assets and there is apparently a negative correlation between CEO pay and the number of company employees.94

"The relationship between CEO pay and another variable is even more interesting: there is a positive correlation between CEO compensation and the salaries of outside members of the company's board of directors."95 "For every increment of $100,000 in the average annual salary of the outside directors on the compensation committee, the salary of the company's CEO can be expected to rise $51,000."96 The salary of the director who chairs the compensation committee seems to set a real standard for the CEO's salary. According to Professor Charles A. O'Reilly III of the University of California at Berkeley, "If the chairman of the compensation committee has a high salary, we can predict that the CEO will, too."97

Economists have made several attempts to develop theories to explain the gap in compensation between CEOs and vice presidents.98 But, the explanation is very simple: People who set their own salaries will of course set them high, which is really not surprising.99

Although the SEC's ruling is a step in trying to solve the problem it still leaves it up to a rather disparate and basically uninterested group (stockholders) to attack a difficult problem in a concerted fashion. What is needed is an idea that will cause stockholders, employees and managers to coalesce and inject a standard that is readily understandable and can be acted upon.

92. Id. at 14.
93. Id.
94. Id.
95. Id. at 14-15.
96. The SEC and the Issue of Runaway Executive Pay: Hearings on S. 1198 Before the Subcomm. on Oversight of Government Management, Comm. on Governmental Affairs, 102d Cong., 1st Sess. 8 (1991) (statement of Graef S. Crystal, Adjunct Professor of Organizational Behavior and Industrial Relations, University of California at Berkeley).
97. Bogus, supra note 6, at 15.
98. One theory is that the vice presidents have all tacitly entered into a type of tournament, each accepting reduced compensation in order to contribute to the ultimate prize — the CEO position — for which they are all competing. Bogus, supra note 6, at 15. See also O'Reilly et al., supra note 42.
V. DEVELOPMENT AND USE OF RATIOS IN FINANCIAL ANALYSIS

The principal tools for the analysis of a company and its record of performance are financial ratios. Ratios of various kinds are used to evaluate stock prices, whether a financial risk is worth taking, whether a merger candidate is acceptable, whether a company is in financial distress, and what bond yields can be expected. The widespread use and universal reliance on financial ratios testifies to their accepted usefulness when making decisions concerning financial affairs.

Ratios express a degree of relationship between two things which are similar and therefore are excellent tools of analysis. These relationships, expressed as ratios, rates, or percentages, make clear comparisons and reduce large groups of unintelligible figures to numbers which are more easily understood and retained. Using ratios for analysis facilitates the understanding of the financial condition of a company and the results of its operations. The information provided by ratios is essential to the public consisting of stockholders, investors, management, credit grantors, and the government.

A ratio must consist of a fraction containing a numerator and a denominator and both must create a fraction concerning items which have an inherent and comparable relationship to each other. This is necessary for the ratio to be a logical instrument for measuring numerical relationships. Ratios must be used within the range of their efficiency to prevent misuse. The expression of a ratio will tend to focus judgments when there is an effort to interpret dynamic aspects of any financial activity. Because ratios are by definition summary statistical data, it is critical that the financial analyst consider the possibility that changes in calculation due to the alteration of two summarized economic variables.

101. Id.
102. Id.
104. Id.
105. Id.
106. Id.
107. Id.
108. BROWN, supra note 103, at 6.
109. Id.
110. Id.
order to overcome this limitation it is essential to have a good understanding of the original data being analyzed.\textsuperscript{111}

To determine the performance of one enterprise against another enterprise, several standards of comparison must be available.\textsuperscript{112} One of the best standard ratio comparisons is the ratios of selected competitors whose operations and economic conditions are similar.\textsuperscript{113} It is obviously not possible to have perfect comparability between enterprises but the standard ratio is not intended to achieve such an ideal.\textsuperscript{114} The standard ratio is an average which shows proportions existing in various industries at a particular time, or during a specific period of time, and it can be used to show similarity in performance.\textsuperscript{115} All of this helps the mental processes of an analyst which should terminate in some detailed understanding of the differences between several enterprises.\textsuperscript{116}

Comparing ratios from financial period to financial period is very helpful in detecting trends in a business and provides some objective evidence of potential problems in financial operations which vary from the norm for that business.\textsuperscript{117} The ratio alone does not provide solutions to any problems.\textsuperscript{118} The ratio can only be an indicator or a symptom as to the accuracy of the figures that go into developing the ratio.\textsuperscript{119} For these reasons, businesses needed more accurate financial information before a meaningful use of ratios could become a reality in the analysis of financial statements.\textsuperscript{120}

Alexander Wall began to study the use of ratios to analyze financial statements in 1912 and over a period of years determined the eight ratios to be most helpful in the analysis and interpretation of financial statements.\textsuperscript{121} By applying these ratios to a large number of similar enterprises, Wall established the standards for each ratio in particular industry groups.\textsuperscript{122}

In pursuing his study, Wall realized that the financial statement data would not be sufficiently significant unless it were applied according to

\begin{itemize}
  \item \textsuperscript{111} \textit{Id.}
  \item \textsuperscript{112} \textit{Id.}
  \item \textsuperscript{113} \textit{Id.}
  \item \textsuperscript{114} BROWN, \textit{supra} note 103, at 6.
  \item \textsuperscript{115} \textit{Id.}
  \item \textsuperscript{116} \textit{Id.}
  \item \textsuperscript{117} \textit{Id.} at 7.
  \item \textsuperscript{118} \textit{Id.}
  \item \textsuperscript{119} \textit{Id.}
  \item \textsuperscript{120} BROWN, \textit{supra} note 103, at 7.
  \item \textsuperscript{121} \textit{Id.} at 14-15.
  \item \textsuperscript{122} \textit{Id.} at 15.
\end{itemize}
industry groups and then broken down geographically for several industries.\textsuperscript{123}

James Harris Bliss maintains that there are normal relationships which exist within a business if it is to be profitable.\textsuperscript{124} By applying certain ratios they provide a measure of efficiency within the firm and the manager can determine what relations are out of proportion and corrective action can be pursued.\textsuperscript{125}

All of the above demonstrates to the author that maybe the best possible way of getting executive pay into some sort of rational relationship to the firm's productivity along with other productive employees of the firm is to develop ratios, i.e. a "compensation ratio" along the lines discussed above.

It is commonly accepted in the financial world today that certain ratios are used regularly to evaluate the performance of a corporation and to determine how financially healthy it is. There are numerous examples of commonly used ratios for financial analysis.\textsuperscript{126} The following are some

\begin{itemize}
\item (1) Cash/current debts;
\item (2) Cash/sales;
\item (3) Cash/total assets;
\item (4) Cash/total debt;
\item (5) Cash flow from operations/sales;
\item (6) Cash flow from operations/total assets;
\item (7) Cash flow from operations/total debt;
\item (8) Cost of goods sold/inventory;
\item (9) Cost of goods sold/sales;
\item (10) Current assets/current debts;
\item (11) Current assets/sales;
\item (12) Current assets/total assets;
\item (13) Current debts/total debts;
\item (14) Inventory/current assets;
\item (15) Inventory/sales;
\item (16) Inventory/working capital;
\item (17) Long-term debts/total assets;
\item (18) Operating income/sales;
\item (19) Operating income/total assets;
\item (20) Operating income/total debts;
\item (21) Operating income/plus depreciation/sales;
\item (22) Operating income plus depreciation/total assets;
\item (23) Operating income plus depreciation/total debts;
\end{itemize}

\textsuperscript{123} Id.
\textsuperscript{124} Id. at 23.
\textsuperscript{125} Id.
\textsuperscript{126} In the study in KETZ, et al., \textit{supra} note 100, thirty-two financial ratios are studied. They were chosen on the basis of their popularity, their usage in previous studies, and their usage in practice. The financial ratios are as follows:
examples of these commonly accepted ratios: Pre-tax Profit Margin; Current Ratio; Liquidity Ratio; Capitalization Ratios; Sales to Fixed Assets; Sales to Inventories; and Net Income to Net Worth. These comprise Mr. Wall’s original eight.127

The Pre-tax Profit Margin is the ratio of profit, before interest and taxes, to sales.128 It is expressed as a percentage of sales and is found by dividing the operating profit by sales.129

Current (or Working Capital) Ratio is probably the most generally used for industrial companies; this is the ratio of current assets to current liabilities.130 A 2-to-1 ratio is the standard.131 A gradual increase in the current ratio usually is a healthy sign of improved financial strength.132 Ordinarily, a ratio of more than 4-to-1 or 5-to-1 is regarded as unnecessary and may in fact be the result of an insufficient volume of business to produce a desirable level of earnings.133

The Liquidity Ratio is the ratio of cash and equivalent (marketable securities) to total current liabilities.134 It is also expressed as a percentage figure and results from dividing cash and equivalent by total current liabilities.135 This ratio is important as a supplement to the current ratio because the immediate ability of a company to meet current obligations or

| (24) Quick assets/current debts; |
| (25) Receivables/inventory; |
| (26) Receivables/sales; |
| (27) Sales/receivables; |
| (28) Sales/total assets; |
| (29) Total debts/total assets; |
| (30) Working capital from operations/sales; |
| (31) Working capital from operations/total assets; |
| (32) Working capital from operations/total debts. |

Id. at 1. The above list presents the variety of ratios used in business analysis. The addition of cop ratio would only shed new light on a previously closed area of the financial health of a firm. In short, is the salary expense too great or small as it affects the bottom line?

127. Understanding Financial Statements, NEW YORK STOCK EXCHANGE, 1986-87, at 15. Alexander Wall has been acknowledged the pioneer in ratio work, not because he was the first to use ratios, but because he was the first to present a ratio method of analysis. BROWN, supra note 103, at 15.


129. Id.

130. Id. at 16.

131. Id.

132. Id.

133. Id.


135. Id.
pay larger dividends may be impaired despite a higher current ratio.  

A decline in liquidity ratio often takes place during a period of expansion and rising prices because of heavier capital expenditures and larger accounts payable. If the decline persists, it may mean that the company will have to raise additional capital, but unless the decline in the liquidity ratio is drastic, it is no cause for concern.

Capitalization Ratios are the percentages of each type of investment in the company to the total investment. Capitalization consists of long-term debt, preferred stock, common stock and surplus. In financial circles, the word "capitalization" sometimes is loosely used to cover only the outstanding securities, but the surplus or retained earnings is an important part of the ownership interest.

Sales to Fixed Assets is computed by dividing the annual sales by the value before depreciation and amortization of the plant, equipment and land at the end of the year. The ratio is important because it helps point out whether or not the funds used to enlarge productive facilities are being spent wisely.

Sales to Inventories is computed by dividing the year's sales by the year-end inventories. The so-called "inventory turnover" is important as a guide as to whether or not the enterprise is investing too heavily in inventories. In this event a setback in sales or a drop in commodity prices would be particularly unfavorable. The nature of the industry determines, in part, whether a ratio is "high" or "low."

Net Income to Net Worth is another ratio given as a percentage and is derived from dividing net income by the total of the preferred stock, common stock and surplus accounts. This is one of the most significant of all the financial ratios wherein lies the answer to the relevant question: "How much is the company earning on the stockholders' investment?"

136. Id.
137. Id.
138. Id.
139. Id.
140. Understanding Financial Statements, supra note 127, at 17.
141. Id.
142. Id.
143. Id.
144. Id.
145. Id.
146. Understanding Financial Statements, supra note 127, at 17.
147. Id.
148. Id. at 18.
149. Id.
These ratios are reviewed not because they are like the proposed "compensation ratio" but because they are ratios that have, over time, become accepted as a necessary part of financial analysis. The author believes that the proposed compensation ratios described below can have the same effect if, and only if, the Securities and Exchange Commission requires its disclosure. By requiring its disclosure, the SEC will ensure the compensation ratio will be available and discussible, and thereby can become an acceptable tool of financial analysis.

VI. PROPOSED COMPENSATION RATIOS

The author proposes that the SEC amend Regulation S-K, Item 10\textsuperscript{150} to require the regular disclosure of the compensations ratios which follow. In today's world where information is the lifeblood of our society, investors, managers and employees should know the actual worth of their contribution to an organization. Today, individual salary is probably not the best estimate of an individual's actual worth to an organization. Doesn't it make sense for an employee to know the average compensation in his company and how that relates to him and the top executives in his company? This information should be available with respect to other companies in his industry. It should probably be factored into the decision one makes as to whether one wants to work for a particular company. Would investors feel that their firm is doing its best if they knew who was being paid 100 times what his average employee is being paid as compared to others in the industry who are paying 75 times what the average employee is earning?

The author does not view these compensation ratios as solving the problem of excessive executive compensation. They are a tool that may very well bring some reasonable balance to the area of compensation both for executives and for employees and managers over time.

The author believes that the regular disclosure of a compensation ratio, industry by industry, will foster the development of what a reasonable compensation ratio should be and thus an industry standard. New investors and hires will want to know what the compensation ratio is and may very well base investment and employment decisions on the ratio. The author believes the disclosure of the compensation ratio will have a significant impact by either lowering the excessive executives' compensation or raising the average compensation of employees and managers.

Twenty-five years ago environmental disclosure was non-existent. Today it is a vital part of the disclosure of all companies. Investment decisions as well as employment decisions are made based on the environ-

\textsuperscript{150} See infra Appendix A.
ment conscious of the companies. The compensation ratio could achieve a similar status.

The compensation ratio should not inhibit the performance of chief executives since they do not prevent them from receiving high salaries. It just makes the executives sensitive to the fact that they are not alone in making the organization a success and can be judged and compared more objectively by potential stockholders, employees and the public.

The compensation ratio may well make obsolete and unnecessary the ridiculous notion of an "outside director." There is no such thing as an outside director and it is absurd to call them that just because they do not receive a salary. They receive more than enough perquisites to secure their bias in favor of incumbent CEOs.

One can imagine the stockholders meeting or a meeting with the financial press and a CEO being asked, "Why is the compensation ratio for your employees so low or high in comparison to ABC corporation? Shouldn't you consider a cut in pay so that your employees get a fair share of the results of their work? Or shouldn't you be working to improve the salaries in your company? Why hasn't the Compensation Committee adopted a proposed Compensation Ratio goal for all executives?" These questions may only be embarrassing or awkward until industry adjusts to them.

Over time compensation ratios may well begin to have their effect in court rooms. A problem that courts have in corporate waste cases is how to identify "excessive compensation" when they see it. If there are industry norms that begin to develop in terms of compensation ratios then the problem should be easier for the courts to tackle.

The proposed Compensation Ratios are as follows:

1) CEO & Executive Ratio. The CEO's gross salary plus bonuses and value of stock options as of a date. The gross salary, bonuses and value of options, as of the same date, of the top executive officers together excluding the CEO.

The ratio would be expressed as follows: The CEO is paid X times the average annual amount paid to the four top executives, other than the CEO.

2) CEO & Management Ratio. The CEO's gross salary plus bonuses and value of stock options as of a date. The annual average salary, bonuses

151. An "outside director" is one who is only a director and not a director/employee. They are, in the first instance selected by the CEO, and then elected by the Board of Directors. They are psychologically beholden to the CEO for selecting them to be presented to the Board. They are well compensated for what they do and receive generous "perks" for the job. They are not sufficiently "outside" to judge the performance of the CEO, but they are the best that the current system will provide.
and value of stock options of all management employees who are not officers of the corporation.

The ratio would be expressed as follows: The CEO is paid X times the average annual amount paid to the average management employee.

3) CEO & Employee Ratio. The CEO's gross salary plus bonuses and value of stock options as of a date. The average annual salary, bonuses and value of stock options of all other employees.

The ratio would be expressed as follows: The CEO is paid X times the average annual amount paid to the average employee.

Proxy Statement language might look something like this:

Mr. Jones, who earns $$,$$,$$, is paid 25 times what is paid to his top four executives who are paid an average of $$,$$.

Mr. Jones is paid 50 times the amount paid to the average management employee in the company.

Mr. Jones is paid 100 times what is paid to the average employee in the company.

The effect of the ratio is to disclose to the public and pose these questions to investors: Is the stock going up (or down as the case may be), and are the other employees in the company benefiting or suffering consistent with their positions in the organization? Is a small group, year in and year out, enriching themselves at the expense of others? If the stock goes up, should the executives be the only ones to benefit or should it also be somehow reflected in the salaries of the regular employees?

The author believes a major problem with executive compensation is that it bears little relationship to what other employees of the company actually contribute to the success of the enterprise. Mandatory disclosure of these ratios would be the first step and only the first step in a long process of the development of a fair and reasonable standard for the compensation of executives. Remember, these are not entrepreneurs; they are just managers. They do not really create new products that improve society; they just manage the creators and makers.

VII. THE BENEFITS OF THE COMPENSATION RATIOS

While the cost-per-share to the stockholders of a corporation for a multi-million dollar compensation package is small when compared to gross revenues, the cost to the business in terms of employee effectiveness is much greater and difficult to measure. The oversized compensation packages which provide certain employees with incentives create anti-

152. See Barris, supra note 20, at 91.
incentives for employees. Clearly overblown executive compensation packages undercut key economic issues: employee morale and productivity.

It is nearly impossible for any workers to feel part of the team when the CEO’s salary is fifty times the average worker’s pay. While executive paychecks have been increasing steadily, without regard to economic realities, the “real earnings” for their workers, adjusted for inflation, have been decreasing. What is even more incredible is that at the same time boards of directors, which are made up of executives, are voting themselves huge salary increases, they have the bad judgment to lay off workers. When workers perceive that top management is on a “gravy train,” morale suffers, especially when hard times hit and the suffering is not shared. As resentment in the workplace rises, labor-management relations deteriorate.

This problem is really about more than just the bad feelings of workers. The competitiveness in American industry also suffers, due in large part to employee discontent. “American manufacturing wages languish behind Switzerland, Germany, Sweden, Canada, Japan, Belgium, and the Netherlands, while executive salaries are nearly double the pay of any foreign peer,” a detail not lost on American workers. The production of goods and services for society is a social task, not an individual one. Teamwork and trust are absolutely essential, which is exactly what oversized executive paychecks discourage. Employees generally will not follow executives they cannot trust, and they cannot trust executives who see to it that they are overpaid.

Restraining and balancing executive pay will not have an immediate direct impact on the competitiveness of American firms, but it would

153. Id. at 71.
154. Id. at 70.
155. Byrne, supra note 48, at 93.
156. Barris, supra note 20, at 90, 91.
157. Id. at 70.
159. Barris, supra note 20, at 93.
160. Id. at 70.
161. Id.
162. Laurent Belsie, Executive Make Hay, but the Sun is Not Shining, CHRISTIAN SCI. MONITOR, Feb. 13, 1992, at 8.
163. Barris, supra note 20, at 70.
164. Id.
166. Barris, supra note 20, at 71.
probably raise employee morale significantly, which would indirectly make companies stronger.\textsuperscript{167} It would be an indication that the executives’ fate was, to some degree, related to the workers.\textsuperscript{168}

“Few companies are beginning to acknowledge the correlation: an official of the Colgate-Palmolive Company recently admitted that the biggest barrier to teamwork is executive pay.”\textsuperscript{169} But a substantial number of corporations continue to grant executive pay increases, generous bonuses, and massive stock options while making regular announcements of cost-cutting measures which include layoffs.\textsuperscript{170}

One of the benefits of the compensation ratio is that it will, to a large extent, force boards of directors and executives to consider what the other employees in the firm are earning when setting their own salaries. To a large extent it will embarrass them into trying to do the right thing rather than face questions at the stockholders meeting or at a meeting of financial analysts. Embarrassment is a rather large factor among a group that considers itself to be as special as this one does. The self-image of the executive class is such that to be caught doing something that is clearly unfair or unwarranted and that may tarnish the image is to be avoided at almost any cost.

Mr. Crystal predicts that, left unchecked, the average option gains of $1 million, at the end of the 1990s will have tripled to about $2.9 million per option grant.\textsuperscript{171} The future costs to shareholders of the grants which are now being handed out like candy is potentially staggering. “The potential social costs cannot be estimated or ignored as executives start cashing in these megagrants and report earnings of 100 or 200 times the average worker’s pay, instead of the eighty-five times that is causing consternation today.”\textsuperscript{172} Clearly these types of ratios are patently excessive compensations and tantamount to the looting of the corporation by executives. The industry average of a particular compensation ratio would at least begin to guide the courts when stockholders attempt to challenge such outrageous amounts and are met with the “business judgment rule,”\textsuperscript{173} which the courts apply to allow them to do nothing about the problem.

\begin{thebibliography}{9}
\bibitem{167} Id. at 70.
\bibitem{168} Belsie, supra note 162, at 8.
\bibitem{169} Barris, supra note 20, at 71.
\bibitem{170} Id.
\bibitem{172} Barris, supra note 20, at 73.
\bibitem{173} “In carrying out their managerial roles, directors are charged with an unyielding fiduciary duty to the corporation and its shareholders. The business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to ... directors.” Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985). The rule itself “is a
America has had a long history of paying big salaries to top business leaders — and complaining about it. But the current flap runs deeper than envy.

There is one example where a voluntary compensation ratio was adopted and apparently successful. But the compensation ratio as a standard financial analysis ratio may not be successful unless a substantial number of ratios are available for the investing public.

At Ben & Jerry's Homemade, Inc., in Waterbury, Vt., for example, top people get no more than seven times what the lowest-paid full-time person earns. Many Americans are annoyed at the huge salaries paid to chief executives. But some U.S. businesses are preaching restraint. Sacrifice, they say, begins at the top. “Everyone’s critical to the success of this company,” says Rob Michalak, a Ben & Jerry’s spokesman. “One way we express that is through the compensation ratio.”

When Americans began to wake up to the competitive threat from Japan a decade or so ago, many blamed the problem on overpaid blue-collar workers. In the mid-1980s, the blame shifted to middle managers. The argument was that there were too many. So companies, which had confronted their unions, began to strip out layers of middle management.

Attempting to impose some rationality on executive pay will not have a direct impact on U.S. competitiveness, compensation experts agree. But it would help the morale of the average employee and thereby contribute to strengthening the company.

“Straightening out executive pay is not going to be the centerpiece of what it’s going to take to make us globally strong,” says Donald Hambrick, professor of business at Columbia University. There has to be much more of a sense of shared fate between executives and workers.

From the standpoint of legitimate shareholder concerns, the logic of disclosure (of compensation ratio) is not to permit shareholders to decide

preference that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

174. See Belsie, supra note 162, at 8.
175. Id.
176. Id.
177. Id.
178. Id.
179. Id. at 9.
181. Id.
182. Id.
183. Id.
whether particular executives are overpaid or underpaid, but rather to give shareholders information relevant in monitoring the performance of the potentially acquiescent board of directors. 184

Public disclosure of compensation ratios effectively ensures that executive contracts in publicly held corporations are not a private matter between employers and employees, but are influenced by the media, labor unions, and by political forces operating inside and outside companies. 185 Compensation committees — elected by, but not perfect agents for, shareholders — will respond to the political pressures by implicitly or explicitly imposing a ceiling on pay that, in turn, reduces the relation between pay and performance. 186 These important, but often ignored, costs of disclosure must be weighed against the benefit of better monitoring of directors to determine the optimal degree of pay disclosure for top managers. 187 When the top people are on this gravy train, morale suffers down below, especially when hard times hit and the suffering is not shared.

VIII. A STOCKHOLDER PROPOSAL

In conjunction with proposing to the SEC that Item 404 of Regulation S-K be amended to provide for the disclosure of the compensation ratio of registered companies, the author would also suggest to any shareholders of registered companies that they take the opportunity to submit stockholder proposals advocating the voluntary disclosure of compensation ratios in some form. The author proposes the following language for such a proposal:

RESOLVED that the Board of Directors adopt a policy of disclosing in the Annual Report to Stockholders, Compensation Ratios as follows:

1) CEO & Executive Ratio. The CEO’s gross salary plus bonuses and value of stock options as of a date. The gross salary, bonuses and value of options, as of the same date, of the top executive officers together excluding the CEO.

The ratio would be expressed as follows: The CEO is paid X times the average annual amount paid to the four top executives, other than the CEO.

2) CEO & Management Ratio. The CEO’s gross salary plus bonuses and value of stock options as of a date. The annual average salary, bonuses and value of stock options of all management employees who are not

185. Id.
186. Id.
187. Id.
officers of the corporation.

The ratio would be expressed as follows: The CEO is paid X times the average annual amount paid to the average management employee.

3) CEO & Employee Ratio. The CEO’s gross salary plus bonuses and value of stock options as of a date. The average annual salary, bonuses and value of stock options of all other employees.

The ratio would be expressed as follows: The CEO is paid X times the average annual amount paid to the average employee.

The compensation ratios could be expressed as follows:

CEO & Executive Ratio: Mr. Jones, who earns $$$$ is paid 25 times what his paid to his top four executives who are paid an average of $$$$$.

CEO & Management Ratio: Mr. Jones is paid 50 times the amount paid to the average management employee in the company, who is paid an average of $$$$$.

CEO & Employee Ratio: Mr. Jones is paid 100 times what is paid to the average employee in the company.

IX. CONCLUSION

In conclusion, the author, after a number of years preparing proxy statements and compensation tables came to believe that they just didn’t make sense to the “average investor.” And that although the amount of disclosure available pursuant to Regulation S-K, Item 402 is quantitatively substantial, it is made in such a way that the average investor cannot make heads or tails of it. That seems to be fundamentally unfair to everyone except the executives who get the benefit of the obtuseness of the disclosures in their proxy statements.

It is the writer’s hope that one day the Compensation Ratio will be a standard tool of financial analysis of the performance of a company registered with the SEC and traded on a stock exchange.
APPENDIX A

The executive compensation disclosure rules relevant to this article are found in the Rules and Regulations Under Securities Exchange Act of 1934, 17 C.F.R. §§ 240-. More specifically Rule 14a-3. Information to Be Furnished to Security Holders, which provides in relevant part,

"(a) No solicitation subject to this regulation shall be made unless each person solicited is concurrently furnished or has previously been furnished with a publicly-filed preliminary or definitive written proxy statement containing the information specified in Schedule 14A..."

Schedule 14A, 17 C.F.R. §240.14a-101, Item 8, Compensation of directors and executive officers, provides:

"Furnish the information required by Item 402 of Regulation S-K if action is to be taken with regard to:

(a) the election of directors;

(b) any bonus, profit sharing or other compensation plan, contract or arrangement in which any director, nominee for election as a director, or executive officer of the registrant will participate;

(c) any pension or retirement plan in which any such person will participate; or

(d) the granting or extension to any such person of any options, warrants or rights to purchase any securities other than warrants or rights issued to security holders as such, on a pro rata basis. However, if the solicitation is made on behalf of persons other than the registrant, the information required need be furnished only as to nominees of the persons making the solicitation and associates of such nominees..."

Item 402 or Regulation S-K, General Rules Regarding Disclosures: Regulation S-K — Standard Instructions for Filing Forms Under Securities Act of 1933 and the Securities Exchange Act of 1934, is the heart of the SEC executive compensation disclosure requirement and is set out in full without the detailed instructions which go with each item because they are not relevant to this article. This recitation is important to appreciate the enormous disclosure that is required and yet they are numbers that are really in the abstract without a context which a compensation ratio would provide to the "ordinary investor" who wants to determine if there is in fact "excessive compensation" being paid to the CEO and others.

"Item 402. Executive Compensation

(a) General—(1) Treatment of specific types of issuers—(i) Small business issuers. (Omitted)

(ii) Foreign private issuers. (Omitted)"
(2) All Compensation covered. This item requires clear, concise and understandable disclosure of all plan and non-plan compensation awarded to, earned by, or paid to the named executive officers designated under paragraph (a)(3) of this item, and directors covered by paragraph (g) of this item by any person for all services rendered in all capacities to the registrant and its subsidiaries, unless otherwise specified in this item. Except as provided by paragraph (a)(5) of this item, all such compensation shall be reported pursuant to this item, even if also called for by another requirement, including transactions between the registrant and a third party where the primary purpose of the transaction is to furnish compensation to any such named executive officer or director. No item reported as compensation for one fiscal year need be reported as compensation for a subsequent fiscal year.

(3) Persons covered. Disclosure shall be provided pursuant to this item for each of the following (the "named executive officers"): 

(i) all individuals serving as the registrant's chief executive officer or acting in a similar capacity during the last completed fiscal ("CEO"), regardless of compensation level;

(ii) the registrant's four most highly compensated executive officers other than the CEO who were serving as executive officers at the end of the last completed fiscal year; and;

(iii) up to two additional individuals for who disclosure would have been provided pursuant to paragraph (a)(3)(ii) of this item but for the fact that the individual was not serving as an executive officer of the registrant at the end of the last completed fiscal year.

(b) Summary Compensation Table.

(1) General. The information specified in paragraph (b)(2) of this item, concerning the compensation of the named executive officers for each of the registrant's last three completed fiscal years, shall be provided in a Summary Compensation Table, in the tabular format specified below. (Table Omitted)

(2) The Table shall include:

(i) The name and principal position of the executive officer (column (a));

(ii) Fiscal year covered (column (b));

(iii) Annual compensation (columns (c),(d) and (e), including:

(A) The dollar value of base salary (cash and non-cash) earned by the named executive officer during the fiscal year covered (column (c));

(B) The dollar value of bonus (cash and non-cash) earned by the named executive officer during the fiscal year covered (column (d)); and

(C) The dollar value of other annual compensation not properly categorized as salary or bonus, as follows (column (e)):
(1) Perquisites and other personal benefits, securities or property, unless the aggregate amount of such compensation is the lesser of either $50,000 or 10% of the total of annual salary and bonus reported for the named executive officer in columns (c) and (d);

(2) Above-market or preferential earnings on restricted stock, options, SAR's (stock appreciation rights) or deferred compensation paid during the fiscal year or payable during that period but deferred at the election of the named executive officer;

(3) Earnings on long-term incentive plan compensation paid during the fiscal year or payable during that period but deferred at the election of the named executive officer;

(4) Amounts reimbursed during the fiscal year for the payment of taxes; and

(5) The dollar value of the difference between the price paid by a named executive officer for any security of the registrant or its subsidiaries purchased from the registrant or its subsidiaries (through deferral of salary or bonus, or otherwise), and the fair market value of such security at the date of purchase, unless that discount is available generally, either to all security holders or to all salaried employees of the registrant.

(iv) Long-term compensation (columns (f), (g) and (h), including:

(A) The dollar value (net of any consideration paid by the named executive officer) of any award of restricted stock, including share units (calculated by multiplying the closing market price of the registrant's unrestricted stock on the date of grant by the number of shares awarded) (column (f));

(B) The sum of the number of securities underlying stock options granted, with or without tandem SARs, and the number of freestanding SARs (column (g)); and

(C) The dollar value of all payouts pursuant to long-term incentive plans ("LTPs") as defined in paragraph (a)(7)(iii) of this item (column (h)).

(v) All other compensation for the covered fiscal year that the registrant could not properly report in any other column of the Summary Compensation Table (column (i)). Any compensation reported in this column for the last completed fiscal year shall be identified and quantified in a footnote. Such compensation shall include, but not be limited to:

(A) The amount paid, payable or accrued to any named executive officer pursuant to a plan or arrangement in connection with:

(1) The resignation, retirement or any other termination of such executive officer's employment with the registrant and its subsidiaries; or
(2) A change in control of the registrant or a change in the executive officer's responsibilities following such a change in control;

(B) The dollar value of above-market or preferential amounts earned on restricted stock, options, SARs or deferred compensation during the fiscal year, or calculated with respect to that period, except that if such amounts are paid during the period, or payable during the period but deferred at the election of a named executive officer, this information shall be reported as Other Annual Compensation in column (e). [See Instructions 3 and 4 to paragraph 402(b)(2)(iii)(C) of this item (Omitted)]

(C) The dollar value of amounts earned on long-term incentive plan compensation during the fiscal year, or calculated with respect to that period, except that if such amounts are paid during that period, or payable during that period at the election of the named executive officer, this information shall be reported as Other Annual Compensation in column (e);

(D) Annual registrant contributions or other allocations to vested and unvested defined contribution plans; and

(E) The dollar value of any insurance premium paid by, or on behalf of, the registrant during the covered fiscal year with respect to term life insurance for the benefit of a named executive officer, and, if there is any arrangement or understanding, whether formal or informal, that such executive officer has or will receive or be allocated an interest in any cash surrender value under the insurance policy, either:

(1) The full dollar value of the remainder of the premiums paid by, or on behalf of, the registrant; or

(2) If the premiums will be refunded to the registrant on termination of the policy, the dollar value of the benefit to the executive officer of the remainder of the premium paid by, or on behalf of, the registrant during the fiscal year. The benefit shall be determined for the period, projected on an actuarial basis, between payment of the premium and the refund.

(c) Options/SAR Grants Table.

(1) The information specified in paragraph (c)(2) of this item, concerning individual grants of stock options (whether or not in tandem with SARs), and freestanding SARs made during the last completed fiscal year to each of the named executive officers shall be provided in the tabular format specified below: (tabular format omitted)

(2) The Table shall include, with respect to each grant:

(i) The name of the executive officer (column (a));

(ii) The number of options and SARs granted (column (b));

(iii) The percent the grant represents of total options and granted to employees during the fiscal year (column (c));
(iv) The per-share exercise or base price of the options or SARs granted (column (d)). If such exercise or base price is less than the market price of the underlying security on the date of grant, a separate, adjoining column shall be added showing market price on the date of grant;

(v) The expiration date of the options or SARs (column (e)); and

(vi) Either (A) the potential realizable value of each grant of options or freestanding SARs or (B) the present value of each grant, as follows:

(A) The potential realizable value of each grant of options or freestanding SARs assuming that the market price of the underlying security appreciates in value from the date of grant to the end of the option or SAR term, at the following annualized rates:

(1) 5% (column (f));
(2) 10% (column (g)); and
(3) If the exercise or base price was below the market price of the underlying security at the date of grant, provided an additional column labeled 0%, to show the value at grant-date market price; or

(B) The present value of the grant at the date of grant, under any option pricing model (alternative column (f)).

(d) Aggregated option/SAR exercises and fiscal year-end option/SAR value table.

(1) the information specified in paragraph (d)(2) of this item, concerning each exercise of stock options (or tandem SARs) and freestanding SARs during the last completed fiscal year by each of the named executive officers and the fiscal year-end value of unexercised options and SARs, shall be provided on an aggregated basis in the tabular format specified below: (Table omitted)

(2) The table shall include:

(i) The name of the executive officer (column (a));
(ii) The number of shares received upon exercise, or, if no shares were received, the number of securities with respect to which the options or SARs were exercised (column (b));
(iii) The aggregate dollar value realized upon exercise (column (c));

(iv) The total number of securities underlying unexercised options and SARs held at the end of the last completed fiscal year, separately identifying the exercisable and unexercisable options and SARs (column (d)); and

(v) The aggregate dollar value of in-the-money, unexercised options and SARs held at the end of the fiscal year, separately identifying the exercisable and unexercisable options and SARs (column (e)).
(e) Long-Term Incentive Plan ("LTIP") awards table.
(1) The information specified in paragraph (e)(2) of this item, regarding each award made to a named executive officer in the last completed fiscal year under any LTIP, shall be provided in the tabular format specified below: (Table omitted)
(2) The Table shall include:
(i) The name of the executive officer (column (a));
(ii) The number of shares, units or other rights awarded under any LTIP, and, if applicable, the number of shares underlying any such unit or right (column (b));
(iii) The performance or other time period until payout or maturation of award (column (c)); and
(iv) For plans not based on stock price, the dollar value of the estimated payout, the number of shares to be awarded as the payout or a range of estimated payouts denominated in dollars or number of shares under the award (threshold, target and maximum amount) (columns (d) through (f).

(f) Defined benefit or actuarial plan disclosure.
(1) Pension plan table.
(i) For any defined benefit or actuarial plan under which benefits are determined primarily by final compensation (or average final compensation) and years of service, provide a separate Pension Plan Table showing estimated annual benefits payable upon retirement (including amounts attributable to any defined benefit supplementary or excess pension award plans) in specified compensation and years of service classifications in the format specified below. (Table omitted)
(ii) Immediately following the Table, the registrant shall disclose:
(A) The compensation covered by the plan(s), including the relationship of such covered compensation to the annual compensation reported in the Summary Compensation Table required by paragraph (b)(2)(iii) of this item, and state the current compensation covered by the plan for any named executive officer whose covered compensation differs substantially (by more than 10%) from that set forth in the annual compensation columns of the Summary Compensation Table;
(B) The estimated credited years of service for each of the named executive officers; and
(C) A statement as to the basis upon which benefits are computed (e.g., straightlife annuity amounts), and whether or not the benefits listed in the Pension Plan Table are subject to any deduction for Social Security or other offset amounts.

(2) Alternative pension plan disclosure. For any defined benefit or actuarial plan under which benefits are not determined primarily by final
compensation (or average final compensation) and years of service, the registrant shall state in narrative form:

(i) The formula by which benefits are determined; and
(ii) The estimated annual benefits payable upon retirement at normal retirement age for each of the named executive officers.

(g) Compensation of Directors.

(1) Standard arrangements. Describe any standard arrangements, stating amounts, pursuant to which directors of the registrant are compensated for any services provided as a director, including any additional amounts payable for committee participation or special assignments.

(2) Other arrangements. Describe any other arrangements pursuant to which any director of the registrant was compensated during the registrant's last completed fiscal year for any service provided as a director, stating the amount paid and the name of the director.

(h) Employment contracts and termination of employment and change-in-control arrangements. Describe the terms and conditions of each of the following contracts or arrangements:

(1) Any employment contract between the registrant and a named executive officer; and

(2) Any compensatory plan or arrangement, including payments to be received from the registrant, with respect to a named executive officer, if such plan or arrangement results or will result from the resignation, retirement or any other termination of such executive officer's employment with the registrant and its subsidiaries or from a change-in-control of the registrant or a change in the named executive officer's responsibilities following a change-in-control and the amount involved, including all periodic payments or installments, exceeds $100,000.

(i) Report on repricing of options/SARs.

(1) If at any time during the last completed fiscal year, the registrant, while a reporting company pursuant to section 13(a) or 15(d) of the Exchange Act has adjusted or amended the exercise price of stock options or SARs previously awarded to any of the named executive officers, whether through amendment, cancellation or replacement grants, or any other means ("repriced"), the registrant shall provide the information specified in paragraphs (i)(2) and (i)(3) of this item.

(2) The compensation committee (or other board committee performing equivalent functions or, in the absence of any such committee, the entire board of directors) shall explain in reasonable detail any such repricing of options and/or SARs held by a named executive officer in the last completed fiscal year, as well as the basis for each such repricing.

(3)(i) The information specified in paragraph (i)(3)(ii) of this item, concerning all such repricing of options and SARs held by an
executive officer during the last ten completed fiscal years, shall be provided in tabular format specified below: (Table omitted)

(ii) The Table shall include, with respect to each repricing:
   (A) The name and position of the executive officer (column (a));
   (B) The date of each repricing (column (b));
   (C) The number of securities underlying replacement or amended options or SARs (column (c));
   (D) The per-share market price of the underlying security at the time of repricing (column (d));
   (E) The original exercise price or base price of the cancelled or amended option or SAR (column (e));
   (F) The per-share exercise price or base price of the replacement option or SAR (column (f); and
   (G) The amount of time remaining before the replaced or amended option or SAR would have expired (column (g)).

(j) Additional information with respect to Compensation Committee Interlocks and Insider Participation in compensation decisions.

Under the caption “Compensation Committee Interlocks and Insider Participation,”

(1) The registrant shall identify each person who served as a member of the compensation committee of the registrant’s board of directors (or board committee performing equivalent functions) during the last completed fiscal year, indicating each committee member who:
   (i) Was, during the fiscal year, an officer or employee of the registrant or any of its subsidiaries:
   (ii) Was formerly an officer of the registrant or any of its subsidiaries; or
   (iii) Had any relationship requiring disclosure by the registrant under any paragraph of Item 404 of Regulation S-K. In this event, the disclosure required by Item 404 shall accompany such identification.

(2) If the registrant has no compensation committee (or other board committee performing equivalent functions), the registrant shall identify each officer and employee of the registrant or any of its subsidiaries, and any former officer of the registrant or any of its subsidiaries, who, during the last completed fiscal year, participated in deliberations of the registrant’s board of directors concerning executive officer compensation.

(3) The registrant shall describe any of the following relationships that existed during the last completed fiscal year:
   (i) An executive officer of the registrant served as a member of the compensation committee (or other board committee performing
equivalent functions or, in the absence of any such committee, the entire board of directors) of another entity, one of whose executive officers served on the compensation committee (or other board committee performing equivalent functions or, in the absence of any such committee, the entire board of directors) of the registrant;

(ii) An executive officer of the registrant served as a director of another entity, one of whose executive officers served on compensation committee (or other board committee performing equivalent functions or, in the absence of any such committee, the entire board of directors) of the registrant; and

(iii) An executive officer of the registrant served as a member of the compensation committee (or other board committee performing equivalent functions or, in the absence of any such committee, the entire board of directors) of another entity, one of whose executive officers served as a director of the registrant.

(4) Disclosure required under paragraph (J)(3) of this item regarding any compensation committee member or other director of the registrant who also served as an executive officer of another entity shall be accompanied by the disclosure called for by Item 404 with respect to that person.

(k) **Board compensation committee report on executive compensation.**

(1) Disclosure of the compensation committee’s compensation policies applicable to the registrant’s executive officers (including the named executive officers), including specific relationship of corporate performance to executive compensation is required with respect to compensation reported for the last completed fiscal year.

(2) Discussion is required of the compensation committee’s bases for the CEO’s compensation reported for the last completed fiscal year, including the factors and criteria upon which the CEO’s compensation was based. The committee shall include a specific discussion of the relationship of the registrant’s performance to the CEO’s compensation for the last completed fiscal year, describing each measure of the registrant’s performance, whether qualitative or quantitative, on which the CEO’s compensation was based.

(3) The required disclosure shall be made over the name of each member of the registrant’s compensation committee (or other board committee performing equivalent functions or, in the absence of any such committee, entire board of directors). If the board of directors modified or rejected in any material way any action or recommendation by such committee with respect to such decisions in the last completed fiscal year, the disclosure must so indicate and explain the reasons for the boards actions, and be made over the names of all members of the board.
(1) *Performance graph.*

(1) Provide a line graph comparing the yearly percentage change in the registrant’s cumulative total shareholder return on a class of common stock registered under section 12 of the Exchange Act (as measured by dividing (i) the sum of (A) the cumulative amount of dividends for the measurement period, assuming dividend reinvestment, and (B) the difference between the registrant’s share price at the end and the beginning of the measurement period; by (ii) the share price at the beginning of the measurement period) with

(i) the cumulative total return of a broad equity market index assuming reinvestment of dividends, that includes companies whose equity securities are traded on the same exchange or NASDAQ market or are of comparable market capitalization; Provided, however, That if the registrant is a company within the Standard & Poors 500 Stock Index, the registrant must use that index; and

(ii) The cumulative total return, assuming reinvestment of dividends, of:

(A) A published industry or line-of-business index;
(B) Peer issuer(s) selected in good faith. If the registrant does not select its peer issuer(s) on an industry or line-of-business basis, the registrant shall disclose the basis for its selection; or
(C) Issuer(s) with similar market capitalization(s), but only if the registrant does not use a published industry or line-of-business index and does not believe it can reasonably identify a peer group. If the registrant uses this alternative, the graph shall be accompanied by a statement of the reasons for this selection.

(2) For purposes of paragraph (1)(1) of this item, the term “measurement period” shall be the period beginning at the “measurement point” established by the market close on the last trading day before the beginning of the registrant’s fifth preceding fiscal year, through and including the end of the registrant’s last completed fiscal year. If the class of securities has been registered under section 12 of the Exchange Act for a shorter period of time the period covered by the comparison may correspond to that time period.

(3) For purposes of paragraph (1)(1)(ii)(A) of this item, the term “published industry or line-of-business index” means any index that is prepared by a party other than the registrant or an affiliate and is accessible to the registrant’s security holders; provided, however, that registrants may use an index prepared by the registrant or affiliate if such index is widely recognized and used.

(4) If the registrant selects a different index from an index used for the immediately preceding fiscal year, explain the reason(s) for this
change and also compare the registrant's total return with that of both the newly selected index and the index used in the immediately preceding fiscal year."

It is at this point that my proposed "compensation ratio" would be appropriate. Once all of this information is available as to the compensation of executive officers it seems fair to merely compare it to how the executives are doing compared to how other employees in the organization are doing.