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The Pay Ratio Disclosure Rule and Stakeholder Pressures May Give Way to Lower CEO Compensation: A Literary Approach

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Abstract

The beginning of the 21st century rocked financial markets with a series of catastrophic corporate scandals and financial meltdowns. First came the wave of corporate governance failures of Enron, Adelphia, WorldCom and Tyco only to be followed, not even a decade later, by the massive credit crisis that caused the bankruptcies of Lehman Brothers and Washington Mutual Bank. These financial meltdowns were caused in part by poor management oversight, a failure of corporate governance and self-interested CEO's who were more focused on their massive paychecks and bonuses than on protecting shareholder value. Each crisis caused a reactionary movement towards restructuring corporate governance and policy to satiate growing stakeholder pressures to reform the system. The Sarbanes Oxley Act and the Dodd-Frank Wall Street Reform and Consumer Protection Act were intended to transform the rules and close any loopholes in order to prevent such economic atrocities from happening ever again. The Dodd-Frank Wall Street Reform and Consumer Protection Act included a particular disclosure – the Pay Ratio Disclosure Rule – that mandated publicly traded companies to produce executive compensation specifics starting in their 2018 filings. The ratio is essentially the median of the annual total compensation of all the company's employees, except the CEO, divided by the CEO's total annual compensation. This paper assesses the new rule's potential impact on CEO compensation through an empirical literary review on Corporate Social Responsibility, stakeholder theory, equity theory, stewardship theory, agency theory and organization theory.

Keywords: Agency theory, CEO pay, corporate governance, corporate social responsibility, equity theory, organization theory, pay ratio disclosure, stakeholder theory, stewardship theory

Introduction

In 2008, the United States was in the grip of a recession as evidenced by severe levels of unemployment and collapsing stock prices (Mitchell, 2015). In the midst of the crisis, the two largest bankruptcies in U.S. history occurred involving Washington Mutual Bank and Lehman Brothers Holdings, Inc. These events contributed to Congress passing the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") in 2010, which in section 953(b) required the Securities and Exchange Commission ("SEC") to disseminate a *Pay Ratio Disclosure Rule* (Saverino, 2016). The new rule required publicly traded companies to report three numbers (a) the median of the annual total compensation of all the firm's employees, except the Chief Executive Officer ("CEO"), (b) the annual total compensation of the firm's CEO, and (c) the ratio of those two amounts (Securities and Exchange Commission, 2015).

Stories about excessive CEO pay have pervaded the news media for nearly three decades and the discourse has only intensified since passage of the Dodd-Frank Act. A few examples of media headlines in recent years include: "CEO Pay Has Grown 90 Times Faster Than Typical Worker Pay Since 1978" (Mishel, & Davis, 2015); "CEOs Make 335 Times What Workers Earn" (Nicks, 2016); "Top CEOs Make More in Two Days Than an Average Employee Does in One Year" (Donnelly, 2017); and "If the CEO's High Salary Isn't Justified To Employees, Firm Performance May Suffer" (Gerdeman, 2018). At the beginning of 2018, the new Pay Ratio Disclosure Rule went into effect and publicly traded firms must begin reporting the pay ratio disclosures (Securities and Exchange Commission, 2017) so that all interested stakeholders can see them. Will the new rule solve the issue and result in lower CEO pay? This review of the empirical literature searches for clues and develops propositions about the effect of the new rule.

Corporate Social Responsibility, Stakeholder Theory and CEO Pay

Perspectives on why businesses exist went through a tremendous transformation over the past 75 years. Beginning with the end of WWII and ending in the late 1960s, a *managerial view* of the firm dominated (Drucker, 1974/1985) whereby management's focus was on production in order to achieve maximum firm performance. By the end of the 1960's an increasing number of institutions were investing in the stock market and these investors began pressuring corporate leaders for more of a say in how firms were being run (Gulati, Mayo, & Nohria, 2017). This produced a shift towards a *shareholder view* of the firm (Fligstein, 2001) whereby management's focus was on achieving the highest stock market valuation in order to satisfy current investors and to attract new investors. In the midst of these changes, society and governments were pressuring firms to do more than merely satisfy the need for profits and goods (Ackerman, & Bauer, 1976). Increasingly, firms were being expected to exhibit corporate social responsibility ("CSR"). In other words, to concern themselves with broader constituencies such as employees, customers, investors, vendors, the immediate community, and the larger community such as state and federal governments, non-government organizations, and the media (Ackerman, & Bauer, 1976). This pressure from constituents, combined with the development of social media and growing internet use, proceeded another shift, this time toward a *stakeholder view* of the firm. Freeman (1984) explained that a stakeholder is "any group or individual who can affect or is affected by the achievement of an organization's purpose" (p. 25). A recent case study, which involved two energy companies, Exxon Corporation ("Exxon") and British Petroleum ("BP"), provides support for a stakeholder view of the firm. Exxon and BP were both involved in oil spills, Exxon in 1989 and PB in 2010. The researchers, van Halderen, Bhatt, Berens, Brown, & van Riel (2016) concluded that when faced with stakeholder pressure, companies gradually give in to stakeholder demands regarding CSR initiatives.

Considering the Pay Ratio Disclosure Rule and its effect on stakeholders, Mohan, Schlager, Deshpande, and Norton (2016) studied one group of stakeholders, consumers. They found that a low pay ratio resulted in improved perceptions for most consumers, while the remaining consumers' perceptions were unharmed (Mohan, et al., 2016). Further, consumers were willing to pay more for products when the producing company showed a lower pay ratio. Consumers wanted to pay less for products produced by companies with higher pay ratios (Mohan, et al., 2016). Another study showed support for the idea that the Pay Ratio Disclosure Rule may result in lower CEO pay. Kelly and Seow, (2016) found that reporting a higher-than-industry pay ratio may create negative perceptions of CEO pay fairness and shame companies into keeping CEO pay levels restrained. Additionally, they found that disclosure of a higher-than-industry pay ratio that increases over time has an indirect negative effect on investor perceptions. This may incentivize firms to restrain CEO pay in order to improve investor perception of CEO pay fairness. (Kelly & Seow, 2016).

Not everyone agrees, Saverino (2016) suggested that the Pay Ratio Disclosure Rule will not be effective and recommended a soft pay cap where "the SEC would mandate annually that the CEOs receive compensation in an amount not to exceed 'X' percent of the companies' net income" (p. 561). According to Larcker, Donatiello, and Tayan (2016), 74 percent of American's believe that CEOs are paid too much and 70 percent believe it is a problem. Furthermore, 62 percent of Americans believe CEO pay should somehow be capped (Larcker, Donatiello, & Tayan, 2016). To top it all off, Americans vastly underestimate the amount CEOs are paid (Larcker, Donatiello, & Tayan, 2016).

We argue that a majority of American's want the gap between CEO compensation and the average worker's compensation to decrease. This expectation from the public in conjunction with the Pay Ratio Disclosure Rule will embarrass company boards into making the pay gap issue into a CSR initiative. However, it is unlikely that firms will increase average worker pay until it is more acceptably in line with CEO pay due to the enormous cost. Therefore, the authors predict that publicly traded firms will gradually give in to stakeholder demands to close the pay gap by lowering CEO pay as the public becomes more informed about the reality of CEO compensation. In addition, there is some evidence that certain stakeholder's favor lower CEO pay ratios. For example, consumers prefer to buy products from manufacturers with lower pay ratios and research suggest that the perceived investment potential of a firm is diminished by a higher-than-industry pay ratio over time. For these reasons, the new Pay Ratio Disclosure Rule will result in successful downward pressure on CEO pay. That is, it will be negatively related to CEO pay (see Figure 1).

Proposition 1: The Pay Ratio Disclosure Rule is negatively related to CEO pay at publicly traded firms.

Gebaix and Landier (2008) found the growth in average firm size between 1980 and 2003 accounted for about half of the rise in CEO pay during those years. They hypothesized that the remaining difference was due to overpayment of CEOs by a small number of firms, which further exacerbated the rise in CEO pay (Gebaix, & Landier, 2008) deepening the pay inequality between CEOs and between average workers and CEOs.

Equity Theory

Adams (1963) defined inequity as existing for a person (or group of people) whenever his or her perceived job inputs and/or outcomes stand psychologically in an obverse relation to what he or she perceives are the inputs and/or outcomes of some other person (or group of people). Adams (1963) theorized the following: first, a "person may increase his inputs if they are low relative to [another's] inputs and to his own outcomes" (p. 427). Second, a "person may decrease his inputs if they are high relative to [another's] inputs and to his own outcomes" (p. 428). Third, a "person may increase his outcomes if they are low relative to [another's] outcomes and to his own inputs" (p. 428). Fourth, a "person may decrease his outcomes if they are high relative to [another's] outcomes and to his own inputs" (p. 428). Fifth, a "person may 'leave the field' when he experiences inequity of any type" (p. 428). Sixth, a "person may psychologically distort his inputs and outcomes, increasing or decreasing them as required" (p. 428). Seventh, a "person may increase, decrease, or distort the inputs and outcomes of others, or force [another] to leave the field" (p. 429). Eighth, a "person may change his referent other when inequity exists" (p. 429). In other words, human beings will take actions to respond to perceived inequity, although the results of those actions will vary. However, research studies have produced mixed results (Gupta, Conroy, & Delery, 2012; Rouen, 2017). For example, Shin (2016) found the earnings for lower paid CEOs were not impacted by the inequality of higher paid CEO's.

Rouen (2017) developed a theory to explain the discrepancies found in prior studies and observed that when pay disparity is explained (economically justified), then firm performance is high. However, when pay disparity is not explained (not economically justified), then firm performance and employee satisfaction are both lower. What CEOs and employees earn at other similar firms may also play a role in perception and reaction to pay disparity. Rouen (2017) theorized that the negative relation of unexplained compensation to performance is further enhanced when the CEO is overpaid (received additional unexplained pay compared to CEOs at similar firms) and employees are underpaid (received less than expected pay compared to those at similar firms). In addition to stakeholders such as consumers and investors applying pressure to lower CEO pay as previously discussed, employees can also apply their own pressure to lower CEO pay through decreased performance at work. If unexplained pay disparity between the CEO and employees can negatively affect employee performance and company performance, then ultimately it will upset investors as well. To counter stakeholder negative perceptions regarding unexplained pay, Rouen (2017) suggested that firms disclose detailed information to justify pay ratios economically.

The purpose of the new Pay Ratio Disclosure Rule is to highlight existing CEO pay disparity and to make it known to a greater number of constituents, in other words to make it known to as many stakeholders as possible. Although many firms will try, the authors are not convinced that CEO pay disparity will be easy to justify economically. We argue that any unexplained CEO pay disparity between a firm's CEO and its employees will strengthen the effect of the Pay Ratio Disclosure Rule. In other words, unexplained pay disparity will act as a moderator, increasing the strength of the negative relationship between the Pay Ratio Disclosure Rule and CEO pay by increasing the downward pressure on CEO pay (see Figure 1). Further, the increased downward pressure on CEO pay will be even greater if the firm's CEO also exhibits unexplained (higher) pay disparity compared to the CEO of a similar firm (see Figure 1). We therefore make the following proposition.

Proposition 2a: The negative relationship between the Pay Ratio Disclosure Rule and CEO pay at publicly traded companies is made more negative by unexplained pay disparity between the CEO's annual total compensation and the median annual employee's total compensation, especially if there is also unexplained (higher) pay disparity between the CEO's annual total compensation and the annual total compensation of a CEO at a similar firm.

CEOs, like other individuals, may find intrinsic rewards more motivating than extrinsic rewards like bonuses and other forms of compensation. Contributing to the betterment of society and creating a legacy for family and friends are powerful drivers for many corporate leaders. Unbridled greed may provide a catchy storyline for a Hollywood movie, but maybe, just maybe it is rarer than we think.

Stewardship Theory

Stewardship theory claims that individuals, including corporate leaders, are not opportunistic and want to do 'the right thing' (Davis, Schoorman, & Donaldson, 1997; Donaldson and Davis 1991; Francoeur, Melis, Gaia, & Aresu, 2017). Francoeur, Melis, Gaia, & Aresu (2017) used the Sustainable Investment Research International Company ("SIRI") for their research, which specializes in socially responsible investment analysis. Firms included on SIRI's SiriPro database are environmentally friendly (Cheng & Courtenay, 2006). Francouer et al. (2017) found that environmentally friendly firms rely less on incentive-based pay than other firms do, paying their CEOs less.

The empirical literature suggests that CEOs at environmentally friendly firms are intrinsically motivated to act in the interests of the greater good. They are less motivated by extrinsic rewards such as bonuses for cutting costs and increasing revenues if it means damaging the environment. This allows CEOs at these companies to accept lower levels of compensation because they are motivated primarily by being good stewards. Therefore, the authors speculate that a firm's status as environmentally friendly will further contribute to downward pressure on CEO pay because these firms place an emphasis on good stewardship, rather than on financial incentives. If a firm is classified as environmentally friendly on SIRI's SiriPro database, it will strengthen the effect of the Pay Ratio Disclosure Rule. In other words, a firm's status as environmentally friendly will act as a moderator, increasing the strength of the negative relationship between the Pay Ratio Disclosure Rule and CEO pay by increasing the downward pressure on CEO pay (see Figure 1).

Proposition 2b: The negative relationship between the Pay Ratio Disclosure Rule and CEO pay at publicly traded companies is made more negative by a firm's status as environmentally friendly.

Thinking about stewardship at a publicly traded firm brings several questions to mind about leadership at these companies. What is the best structure for the board of directors? What, if any, role should the CEO play on the board of directors? What affect have current rules and regulations had on CEO pay? With these questions in mind, the authors reviewed the empirical literature on corporate governance next.

Corporate Governance

Two of the largest bankruptcies in U.S. history at the time, the Enron Corporation in 2001, and Worldcom, Inc. in 2002, contributed to the passage of the Sarbanes-Oxley Act of 2002 ("SOX") and subsequent new listing rules on the New York Stock Exchange ("NYSE") and on the National Association of Securities Dealers Automated Quotations ("NASDAQ") exchange. The goal of SOX and the new exchange rules was to decrease the likelihood of future corporate scandals and accounting fraud through improved corporate governance oversight in the United States. This law and the new exchange rules led to heightened public pressure on firms to increase board independence (Dah, Frye, & Hurst, 2014; Zorn, Shropshire, Martin, Combs, & Ketchen, Jr., 2017). However, defining "independent director" is difficult. Although aligned in purpose SOX, NYSE, and NASDAQ all have their own rules and definitions. As an illustration of the complexity, an excerpt from the NYSE American Company Guide, Section 803 on Independent Directors and Audit Committees is provided here. It defines what an independent director is and what an independent director is not and explains the requirement:

(A1) Each issuer must have a sufficient number of independent directors on its board of directors (a) such that at least a majority of such directors are independent directors (subject to the exceptions set forth in section 801) and (b) to satisfy the audit committee requirements set forth below.

(A2) 'Independent director' means a person other than an executive officer or employee of the company. No director qualifies as independent unless the issuer's board of directors affirmatively determines that the director does not have a relationship that would interfere with the exercise of independent judgement in carrying out the responsibilities of a director.

In addition to the requirements contained in this Section 803A: (i) directors serving on audit committees must also comply with the additional, more stringent requirements set forth in Section 803B(2) below; and (ii) directors serving on compensation committees and, in the case of a company that does not have a compensation committee, all independent directors, must also comply with the additional, more stringent requirements set forth in Section 805(c) below. The following is a non-exclusive list of persons who shall not be considered independent:

(a) A director who is, or during the past three years was, employed by the company, other than prior employment as an interim executive officer (provided the interim employment did not last longer than one year)

(b) A director who accepted or has an immediate family member who accepted any compensation from the company in excess of $120,000 during any period of twelve consecutive months within the three years preceding the determination of independence, other than the following:

(i) compensation for board or board committee service,

(ii) compensation paid to an immediate family member who is an employee (other than an executive officer) of the company,

(iii) compensation received for former service as an interim executive officer (provided the interim employment did not last longer than one year) (See Commentary .08), or

(iv) benefits under a tax-qualified retirement plan, or non-discretionary compensation;

(c) A director who is an immediate family member of an individual who is, or at any time during the past three years was, employed by the company as an executive officer;

(d) A director who is, or has an immediate family member who is, a partner in, or a controlling shareholder or an executive officer of, any organization to which the company made, or from which the company received, payments (other than those arising solely from investments in the company's securities or payments under non-discretionary charitable contribution matching programs) that exceed 5% of the organization's consolidated gross revenues for that year, or $200,000, whichever is more, in any of the most recent three fiscal years;

(e) A director who is, or has an immediate family member who is, employed as an executive officer of another entity where at any time during the most recent three fiscal years any of the issuer's executive officers serve on the compensation committee of such other entity; or

(f) A director who is, or has an immediate family member who is, a current partner of the company's outside auditor, or was a partner or employee of the company's outside auditor who worked on the company's audit at any time during any of the past three years.

(A3) In the case of an investment company, in lieu of Sections 803A(2) (a) through (f), a director who is an "interested person" of the investment company as defined in Section 2(a)(19) of the Investment Company Act of 1940, other than in his or her capacity as a member of the board of directors or any board committee (NYSE, 2018).

Although establishing rules and defining independent director is complicated, SOX, NYSE, and NASDAQ rules are in accord that only a majority of independent directors is required. Despite this mutual assessment, firms have been increasingly adopting a *lone-insider board structure* (Gordon, 2007; Linck, Netter, & Yang, 2008). In fact, more than half of S&P 1500 companies have lone-insider boards (Zorn et al., 2017). This means the CEO is "the only current employee [serving] on the board of directors" (Zorn, et al., 2017, p. 2,623). Dah et al. (2014) proposed that public opinion and public pressure were the impetus for this change in board structure. For example, Zingales (2000) explained how public opinion and pressure were used at Sears to make the firm change its corporate governance to a lone-insider board structure. Other studies also found firms decreased the number of insider directors or increased the number of independent directors on the board in response to public pressure and concerns over firm reputation (Dah, et al., 2014; Wu, 2004).

Despite the growing trend toward a lone-insider board structure at publicly traded firms, there is support for the idea that it leads to higher CEO pay (Staw, McKechnie, & Puffer, 1983; Westphal & Zajac, 1994). Additionally, when there are other insiders on the board, CEO pay is lower. In their research study, Zorn et al. (2017) found that one or more inside directors beyond the CEO added value by contributing to lower CEO pay, lower pay gaps between the CEO and the top management team, lower occurrences of financial misconduct, and better firm performance.

To recap, our review of the literature shows that publicly traded firms have been slowly responding to public pressure to move towards employing fewer inside directors on their boards. In many instances, this is taken to the extreme where all members of the board of directors are independent except for the lone-insider CEO. This occurs despite the fact that SOX, NYSE, and NASDAQ rules only require a majority of independent directors. Further, empirical evidence shows that having at least one additional insider on the board of directors, besides the CEO, contributes to lower CEO pay and other benefits. Therefore, the authors argue that the negative relationship between the Pay Ratio Disclosure Rule and CEO pay will be moderated, that is made more negative, by the presence of at least one inside director besides the CEO because this will apply further downward pressure on CEO pay. However, the majority of board members must remain independent (see Figure 1).

Proposition 2c: The negative relationship between the Pay Ratio Disclosure Rule and CEO pay at publicly traded companies is made more negative by the presence of one or more inside directors beyond the CEO, as long as the majority of board members remain independent.

The idea that the board of directors should be comprised of a majority of independent directors (outsiders) as expressed by SOX, NYSE, and NASDAQ rules is supported further by agency theory.

[Figure 1 about here]

Agency Theory

As a matter of fact, one of the key tenants of agency theory is that boards must be comprised of a majority of outsiders, in other words directors employed neither by the firm nor from affiliated firms that depend on the company (Bednar, 2012; Fama, 1980). However, a majority of outsiders does not mean all outsiders except for the CEO, which would make the CEO the lone-insider. This is because lone-insider CEOs are able to use their power to justify higher pay by claiming credit for high performance, while simultaneously blaming external causes for poor performance (Staw, McKechnie, & Puffer, 1983; Westphal & Zajac, 1994). In fact, some studies suggest that lone-insider boards can actually weaken corporate governance (Liu & Jiraporn, 2010; Adams, Almeida, & Ferreira, 2005).

Our review of the empirical literature indicates that a lone-insider CEO on the board of directors allows the CEO too great an advantage over the board when it comes to personal compensation. This is because the lone-insider CEO is truly the only expert on the company board due to being the only insider. A board that consists of all outsiders may bring interesting new ways of seeing things, but little expertise. Thus, the board of directors will rely heavily on the CEO for guidance. When the board relies heavily on the CEO, he or she becomes more entrenched. As previously discussed, even the presence of one other company insider on the board of directors can reduce the CEO's power over personal compensation. Therefore, the authors argue that the negative relationship between the Pay Ratio Disclosure Rule and CEO pay is made more positive by the presence of a lone-insider CEO on the board of directors. That is to say, it will have the opposite effect of the Pay Ratio Disclosure Rule because it will place upward pressure on CEO pay (see Figure 1).

Proposition 2d: The negative relationship between the Pay Ratio Disclosure Rule and CEO pay at publicly traded companies is made more positive by the presence of a lone-insider CEO on the board of directors.

According to Homroy (2016) increased stakeholder interest in corporate governance has coincided with higher levels of CEO turnover. He studied samples from the S&P 1500 indices between 1993 and 2011 (Homroy, 2016). He found that the rapid rise in CEO compensation during those years was due to an increase in forced turnover risk by investigating CEOs who received higher than average severance pay entitlements (Homroy, 2016). He found that these CEOs received higher levels of annual compensation in addition to higher severance packages (Homroy, 2016).

The authors argue that if a CEO experiences an increased threat of being fired for any reason, then it places upward pressure on the CEO's pay. An increase in forced turnover risk, is evidenced by a higher severeance package. This is sometimes referred to as a *golden parachute* because it protects the executive in the event of termination. This arrangement is also given to executives when there is a high probability that a merger or acquisition will take place. Regardless, if there is a higher risk that the CEO may be terminated for any reason, then the CEO's pay will be higher. For this reason, the authors propose that the negative relationship between the Pay Ratio Disclosure Rule and CEO pay will be offset by elevated forced turnover risk for the CEO. In other words, the increased risk of being fired will have a positive relation with (will apply upward pressure on) the CEO's pay (see Figure 1).

Proposition 2e: The negative relationship between the Pay Ratio Disclosure Rule and CEO pay at publicly traded companies is made more positive by CEO elevated forced turnover risk.

It is interesting to note that a majority of severance packages are cash not company stock options and that increased pay incentives from forced turnover risk include cash as well as non-cash items (Homroy, 2016). In this way, the CEO is further protected from the volatility associated with company ownership.

Mazur and Wu (2016) found a relationship between executive ownership and CEO pay. They studied firms on the S&P 600 SmallCap Index between 2002 and 2005 and found lower CEO incentive pay in family owned firms, "where the founder or a descendant of the founder sits on the board and/or is a blockholder" and where "at least two board members are related either by blood or marriage" (p. 1,103). A blockholder is a large-percentage shareholder in a firm (Holderness, 2009). Additionally, Mazur and Wu (2016) found that CEO incentive pay decreased even more with higher levels of executive ownership (Mazur and Wu, 2016). They explained that at family owned firms, the average ownership stake is about 17%, while blockholders held an average of 39% of the company's stock (Mazur and Wu, 2016). It is interesting that in general as CEO company ownership has decreased, CEO pay has increased. Jensen and Murphy (1990) pointed out that median stock holdings of inside CEOs declined during the years 1938 to 1984 from 0.3 % to 0.03%, respectively, and it does not appear to have increased since then. Interestingly, substantial increases in CEO pay began to occur in the late 1970s (Mishel & Davis, 2015) and has continued to this day.

To reiterate, our review of the literature shows that CEO pay has increased simultaneously as CEO ownership in firms has declined. Additionally, the empirical literature suggests that higher levels of CEO ownership (and corresponding dependence on increased dividends) and less compensation in the form of bonuses will result in lower CEO pay. Therefore, the authors argue that the negative relationship between the Pay Ratio Disclosure Rule and CEO pay is moderated, that is made more negative, by higher levels of executive ownership because it will apply additional downward pressure on CEO pay (see Figure 1). Therefore, we make the following proposition.

Proposition 2f: The negative relationship between the Pay Ratio Disclosure Rule and CEO pay at publicly traded companies is made more negative by high levels of executive ownership.

Agency theory (Fama, & Jensen, 1983) also claims that in firms where CEO duality does not exist, in other words when the roles of CEO and Chairman of the Board are kept separate, the company will lack a unity in leadership but it gains increased independent oversight (Boyd, 1995; Finkelstein, & D'Aveni, 1994; Rechner & Dalton, 1991). This lines up with the ideas of organization theory.

Organization Theory

Classical organization theory claims that when CEO duality exists in a firm, meaning the role of CEO and Chairman of the Board are combined, the company will enjoy clear leadership (Boyd, 1995; Fayol 1949/1967) but with a heightened risk of managerial entrenchment (Finkelstein, & D'Aveni, 1994; Krause, Withers, & Semadeni, 2017). Managerial entrenchment contributed to the rapid rise of CEO pay (Bebchuk & Fried, 2003) because these managers possess enough power to extract higher levels of compensation from the firm.

Both agency theory and classical organization theory on CEO duality have been tested with little empirical support found for either idea (Dalton, Daily, Ellstrand, & Johnson, 1998; Dalton, Hitt, Certo, & Dalton, 2007). As pointed out by Larcker and Tayan (2015) empirical evidence does not support the idea that the chair of the board should always be independent; no relationship was found between chair independence and operating performance (Baliga, Moyer, & Rao, 1996; Boyd, 1995). However, one study found evidence that forced separation of the CEO from the chair position due to investor pressure resulted in subsequent decreased operating performance (Dey, Engel, & Liu, 2011).

There is a third theoretical option. Preserving CEO duality (Krause, Withers, & Semadeni, 2017) while also appointing a *lead independent director*, which is a leader chosen from among the independent directors (Lipton & Lorsch, 1992). The lead independent director serves as adviser to the CEO, is responsible for the CEO's performance review, and can fill in for the CEO should the CEO quit or be terminated. Krause, Withers, & Semadeni (2017) proposed this idea as a way to preserve leadership unity while allowing for increased oversight. They found that "lead independent director appointment can improve firm performance, but only if the CEO is not very powerful" (Krause, Withers, & Semadeni, 2017, p. 2,260). CEO power is difficult to define. There is no consensus in the scholarly literature. However, the authors believe that power is determined by how entrenched the CEO is. For example, if the board of directors perceives the CEO as difficult to replace, then the CEO is entrenched, and can demand higher pay among other things. On the other hand, if the board perceives the CEO as replaceable, then the CEO has less power because he or she is less entrenched.

The impact of a lead independent director on CEO pay is yet to be investigated, but it seems rational that if the CEO is not entrenched, a lead independent director could assist in the containment of the CEO's pay. As previously explained, research does show that the presence of one or more insiders on the board beyond the CEO, as long as the majority of board members are independent, does contribute to lower CEO pay. Therefore, it stand to reason that the presence of a lead independent director will further reduce CEO pay do to his or her closeness with the CEO and increased influence over other board members, but only if the CEO is not very powerful. Meaning, the CEO is not entrenched (see Figure 1).

Proposition 2g: The negative relationship between the Pay Ratio Disclosure Rule and CEO pay at publicly traded companies is made more negative by the presence of a lead independent director, but only if the CEO is not entrenched.

Summary

The implementation of the Pay Ratio Disclosure Rule will inform a wide variety of stakeholders about pay disparity between CEOs and the employees who work for them at many publicly traded firms. As a result, firms will experience increased public pressure from stakeholders to reduce pay disparity in the United States. Firms will respond to the increasing pressure by slowly making the effort to lower CEO pay a CSR initiative. The literature indicates that public opinion and public pressure on firms can result in changes even at the highest levels of organizations. This supports the idea that stakeholder pressure on firms to lower CEO pay will actually work. Additional moderating variables will either increase or decrease the downward pressure on CEO pay (see Figure 1). The authors believe five factors will add to the downward pressure on CEO pay. Two factors will cause CEO pay to move higher, offsetting the effects of the Pay Ratio Disclosure Rule at publicly traded firms.

Conclusions

Considering corporate governance policy, the rules provided by SOX, NYSE, and NASDAQ only require a majority of independent directors. Further, they define what an independent director is and is not. However, the rules fall short in preventing the occurrence of lone-insider boards. This is despite the fact well established theory and empirical evidence show lone-insider boards yield higher occurrences of financial misconduct, lower company performance, and higher CEO pay at publicly traded firms. The rules need updating to include the meaning of "majority of independent directors." New rules should be implemented to establish how many directors a publicly traded firm should have based on company net asset value or some other quantifiable means. The new rules should also require a minimum number of inside directors beyond the CEO in order to prevent loan-insider boards while maintaining a majority of independent directors. The evidence also indicates that a rule should be created requiring the independent directors at a firm to choose from amongst themselves a lead independent director to serve as an adviser to the CEO. As an adviser, the lead independent director will provide additional oversight, which will help reduce financial misconduct, increase company performance, and lower CEO pay at publicly traded firms.

Boards of directors need to be more active in self-monitoring. The authors recommend the formation of a self-governing body similar to the American Institute of Certified Public Accountants (AICPA), which oversees the public accounting industry. This governing body of board directors could set policies and procedures regarding topics such as CEO compensation and executive ownership allowing capitalism an opportunity to fix itself. It may be cliché to suggest that the rich are getting richer and the poor are getting poorer. However, when it comes to executive pay, the evidence is overwhelming. Corporate leaders should come together and find a solution, or the government will likely do it for them.

Limitations

First, changes in U.S. laws including SOX and the Dodd-Frank Act created a divergence in the regulations governing U.S. corporations in comparison to foreign corporations. Non-U.S. governments made different changes to their laws making the divergence even greater (Welsh, Spender, Fannon, & Hall, 2014). This means that a study on the impact of the Pay Ratio Disclosure Rule will be limited to the United States. However, stakeholders in other countries should be interested in the outcome of the rule in the United States as similar laws might yield similar results abroad. Second, there may be other moderating factors, which have not been captured in the current literature review. Third, the gap between CEO and worker pay can also be reduced by increasing worker pay while keeping CEO pay unchanged, or by lowering CEO pay and simultaneously increasing worker pay. However, the authors are not convinced that the exponential growth of CEO pay since the 1980's can be offset by increases in worker pay in any meaningful way. Nonetheless, those effects should be investigated further. Finally, it may be necessary to wait for several years before the true effect of the Pay Ratio Disclosure rule can be measured due to firm leadership inertia, which will gradually give way to stakeholder pressure (van Halderen, et al., 2016).

Contribution

This literature review and its propositions contribute to CSR theory, stakeholder theory, corporate governance theory, agency theory, organization theory, and equity theory in regards to CEO pay and corporate governance structure. Further, a majority of Americans care about CEO compensation. The authors hope corporate leaders and others involved in setting rules and policies on corporate governance are informed and influenced by our findings. Our suggestions to update the rules and establish a self-governing body to oversee boards of directors in the United States could have a substantial effect on a variety of stakeholders, such as consumers, investors, employees, and many others.

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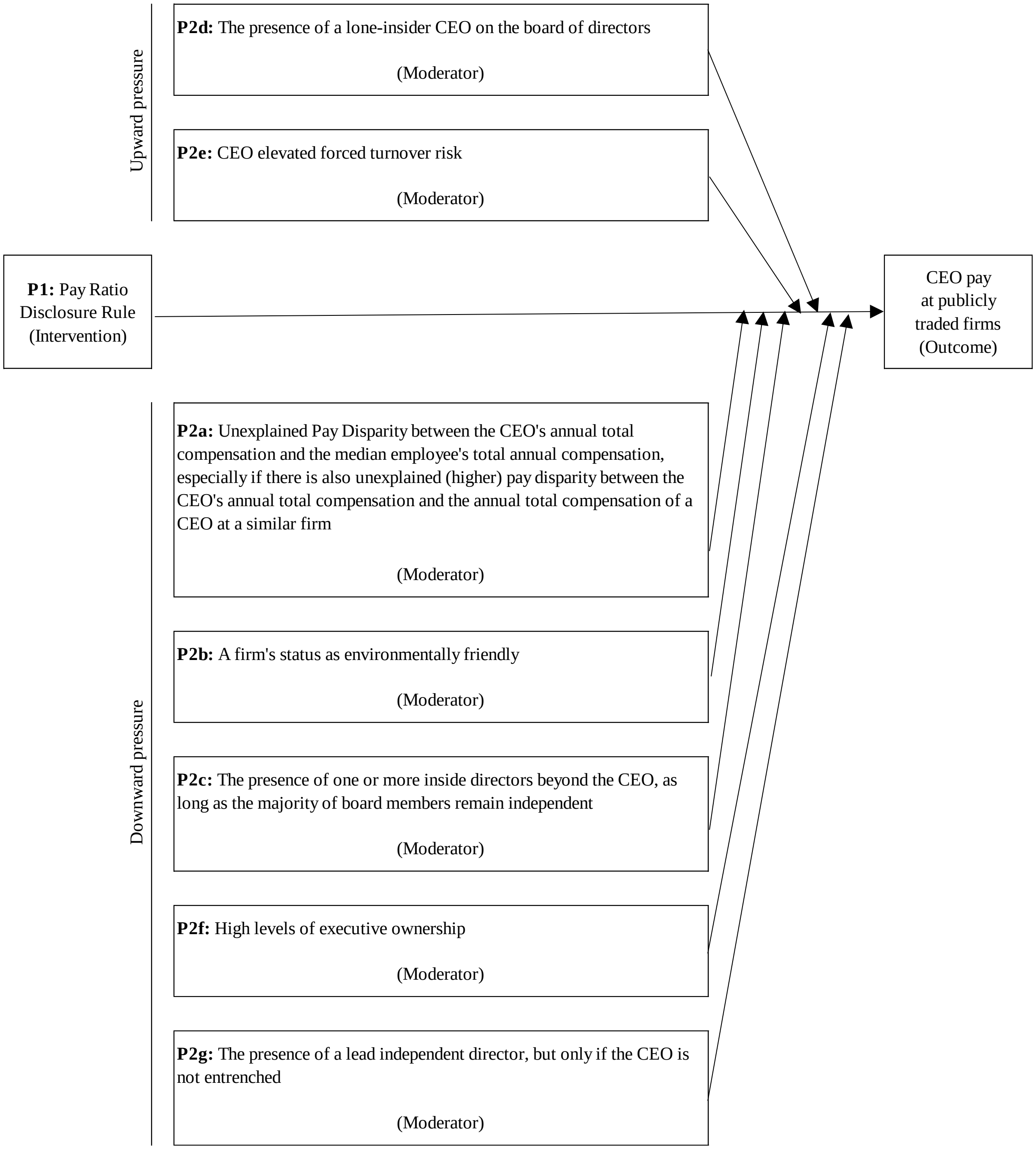

Figure 1. Model of the Pay Ratio Disclosure Rule and seven moderating variables influencing CEO pay at publicly traded firms.