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Taking Stock:

Why Executive Pay Results in an Unstable and Inequitable Economy

White Paper by
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This paper draws on ideas developed in William Lazonick, "Profits Without Prosperity: How Stock Buybacks Manipulate the Market, and Leaves Most Americans Worse Off," Harvard Business Review, September 2014 (forthcoming).

EXECUTIVE SUMMARY

Over the past three decades, U.S. executive pay has exploded. In 2012, the 500 highest paid executives in Standard and Poor's ExecuComp database (drawn from company proxy statements) averaged $30.3 million in total compensation, with 42 percent from stock options and 41 percent from stock awards. This amount of compensation is almost three times the level of inflation-adjusted compensation in the early 1990s, when executive pay was already excessive. Market forces did not bestow these riches on top executives; their boards of directors did. Dominated by CEOs of other companies who have a common interest in increasing executive pay, boards have stuffed senior executive pay packages with stock options and stock awards. These same boards have approved multibillion stock buyback programs that enable executives to benefit from the manipulation of their companies' stock prices.

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KEY ARGUMENTS

- The American public has long been aware of the excessive compensation of top executives, but insufficient attention has been focused on how the stock-based components of this pay have encouraged CEOs to distribute cash to shareholders at the expense of investment in innovation and provision of secure, well-paid jobs.
- The estimated $3.6 trillion that Standard and Poor's 500 companies have spent on buybacks since 2001, in addition to $2.4 trillion in dividends, is a major reason for the ongoing erosion of middle-class employment opportunities in the U.S.
- Since the early 1980s, the Securities and Exchange Commission (SEC), which is supposed to protect against the manipulation of financial markets, has legalized the use of stock buybacks to manipulate the stock market.
- The SEC must regulate rather than encourage stock-market manipulation, and boards of directors, which have permitted excessive executive pay and massive distributions to shareholders, instead must represent all economic interests – including taxpayers and workers – whose investments are at risk in the business corporation.

Taking Stock: Why Executive Pay Results in an Unstable and Inequitable Economy

By William Lazonick, June 5, 2014

EXPLODING EXECUTIVE PAY

In 1991 compensation expert Graef S. Crystal published a best-selling book, *In Search of Excess: The Overcompensation of the American Executive*. The blurb on the front dust cover reads: "In the last 20 years the pay of American workers has gone nowhere, while American CEOs have increased their own pay more than 400 percent. This is how they've done it."[1] Crystal explained how CEOs of major U.S. corporations availed themselves of compliant boards of directors and for-hire compensation consultants (himself included) to justify ever-increasing pay packages for themselves and the senior executives closest to them.

At the center of this feat of self-remuneration was, and remains, stock-based pay in the forms of stock options and stock awards.[2] Remarkably, as Crystal showed, even decreases in a company's stock price serve to ratchet up executive pay over time. When a company's stock price falls, the board stuffs even more stock options and stock awards into top-executive pay packages to make sure, they argue, that these key employees will not take their services elsewhere, and so that senior executives will be amply incentivized to do whatever is necessary to boost the company's stock price back up.

If in the early 1990s the compensation of the American executive was excessive, then what Crystal identified was only an initial eruption in an ongoing explosion of U.S. executive pay that has yet to reach its limits. In 1992, the first year for which the ExecuComp database is available, average total compensation of the 500 highest paid executives was $8.9 million in 2012 dollars, with 59 percent from the *realized gains on stock options* (RG-SO) and 9 percent from *the fair value of stock awards* (FV-SA).[3] In 2012, at $24.4 million the comparable measure of executive pay was almost three times higher in inflation-adjusted dollars than in the early 1990s, with 52 percent from RG-SO and 26 percent from FV-SA. But the much more relevant measure of executive pay is one that, along with RG-SO, also includes realized gains on stock awards (RG-SA), a statistic that is only available since 2006 (see Table 1). When both RG-SO and RG-SA are included as components of executive compensation, the average compensation of the 500 highest paid executives was $30.3 million, with 42 percent from RG-SO and 41 percent from RG-SA

When the stock market booms, executive pay rises with it, setting new benchmarks for how high executive remuneration can go. The new norm then makes remuneration in a declining stock market seem low, which in turn provides boards with a justification for giving out more options and awards to make up for "lost" pay. The

[1] Graef S. Crystal, *In Search of Excess: The Overcompensation of the American Executive*, Norton, 1991.

[2] These stock awards may be restricted stock or, as is increasingly the case, performance shares that are tied to earnings per share or stock price. Executives realize gains on stock options when they exercise them and on stock awards when they vest.

[3] In their proxy statements since 2007 (with data for the previous fiscal year), companies have provided two measures for each of the two components of stock-based pay, stock options and stock awards. One measure is the fair value at the time of grant of options (FV-SO) or awards (FV-SA). The other measure is the actual realized gains on options when they are exercised (RG-SO) or awards when they vest (RG-SA). Given (as I outline in this paper) the ways in which senior executives "manage" the accrual of these realized gains and the importance of realized gains to the process of ratcheting up the general level of executive pay over time, the realized-gains measure is of far more relevance than the fair-value measure for quantifying executive pay at a point in time and its increase over time. Prior to 2007, however, companies reported the realized gains only for stock options. Hence, for a comparison of total executive pay from 1992 (the first year for which the ExecuComp database is available) to the latest published year, we must use a hybrid measure of the gains from stock-based pay with RG-SO and FV-SA as the components. From fiscal year 2006, however, the relevant measure of executive pay is one that uses RG-SO and RG-SA.

Table 1. Mean total direct compensation of the 500 highest-paid executives named in U.S. corporate proxy statements and component percentages of total compensation

		Percentage shares of components of total direct compensation						
	Mean Total Direct Comp. $m.	Salary	Bonus	Non-Equity Incentive Plan	All Other Comp.	Deferred Earnings	Realized Stock Option Gains	Realized Stock Award Gains
2006	**27.4**	3.3	7.0	7.6	5.9	0.5	58.9	16.8
2007	**30.0**	3.0	4.1	6.9	7.6	0.1	58.8	19.6
2008	**22.9**	4.1	4.2	8.7	4.1	0.1	43.9	34.9
2009	**14.4**	7.0	4.8	14.9	7.4	0.1	39.9	25.9
2010	**18.5**	5.5	4.8	15.0	6.2	0.1	40.3	28.1
2011	**19.4**	5.5	3.8	12.3	4.3	0.2	40.9	33.0
2012	**30.3**	3.6	2.7	8.2	3.2	0.1	41.5	40.7

Source: Standard and Poor's ExecuComp database, with calculations by Matt Hopkins of The Academic-Industry Research Network

highest level of top executive pay from 1992 through 2012 was in 2000, at the height of the Internet stock-market boom, when the average total compensation of the top 500 was $41.5 million in 2012 dollars, with 80 percent from RG-SO and 6 percent from FV-SA. The financial crisis of 2008-2009 drove down stock prices and with them realized executive pay, but in 2009 the pay of the top 500 was, inflation-adjusted, still almost twice its level 15 years earlier. With stock prices rising in 2012, executive compensation just surpassed its pre-crisis level in current dollars, and we can expect that when the 2013 data become available it will be even higher.

This paper offers a guide to how CEOs and other senior executives of major U.S. corporations – each of them acting in his or her own self-interest but also as members of a privileged and powerful club – sustain the upward trajectory of their pay. In the process, we can envision the types of public policy responses that will be needed to govern the remuneration of top executives so that what they receive reflects their fair share in relation to the income shares that their companies' workers receive. The problem, as we shall see, is not just how much top corporate executives get paid but also the incentive that stock-based compensation creates for them to allocate corporate resources in ways that contribute to employment instability and income inequity in the economy as a whole.

MANAGING THEIR WAY TO HIGHER EXECUTIVE PAY

The following is our six-step guide to how a U.S. CEO pumps up his or her own pay.

1. Appoint a compliant board of directors made up predominantly of other top executives who all have an interest in increasing the level of executive compensation;
2. Hire compensation consultants to establish benchmarks based on the pay of other CEOs, who are hiring the same consultants for the same purpose;
3. Get paid in a currency – the company's stock – that the board can dole out abundantly in stock options and stock awards, with more options and awards when stock prices fall, thus ratcheting up pay when stock prices rise;
4. Potentially benefit from a regulatory authority – the Securities and Exchange Commission (SEC) – that since 1982, through Rule 10b-18 of the Securities Exchange Act, has permitted a corporation to give manipulative boosts to its stock price through large-scale open-market stock repurchases;

5. Potentially benefit from the SEC's reinterpretation in 1991 of Section 16(b) of the Securities Exchange Act that enables top executives as insiders to profit from the immediate sale of stock acquired through exercising stock options rather than having to wait six months as had been the case since 1934;
6. Legitimize these actions and outcomes by invoking, and indeed promulgating, the ideology that "maximizing shareholder value" results in superior economic performance.

Let us look briefly at the implementation of these six steps.

1. Boards of Directors

It has long been known that, whatever the formalities of the election of the directors of a U.S. corporation, it is the CEO who chooses its board members.[4] A CEO does not want to be beholden to directors who fail to appreciate his or her talent to run the company. Occasionally, the disastrous performance of a company or a scandal might result in a previously compliant board ousting a CEO. In general, however, when a board keeps a CEO and his or her top people in place, it marks its stamp of approval with generous compensation packages.

2. Compensation Consultants

It is the role of compensation consultants to justify the remuneration that the board deems CEOs deserve. Consultants, hired by the CEO at the expense of the firm, collect data on the compensation of other CEOs of comparable firms. Then they recommend pay packages for the CEOs for whom they are working and the members of his or her team of senior executives. Consultants will almost invariably recommend that "their" CEO be paid well above the median of the other CEOs surveyed – a sign that their particular client is no ordinary executive. Over time, this benchmarking exercise inevitably boosts the pay of all CEOs. Given that CEOs are key members of each other's boards, they rarely complain that a fellow CEO is being overpaid.[5]

3. Stock-Based Pay

Salaries and bonuses are *not* the causes of the explosion of executive compensation. Rather the stock-based components of their compensation packages must take the blame. As shown in Table 1 above, in 2012 salaries accounted for 3.6 percent and bonuses for 2.7 percent of the total compensation of the 500 highest paid executives named in company proxy statements, amounting to $1.9 million of their average total compensation of $30.3 million. By far, the largest two components of total compensation were, as also shown in Table 1, realized gains from exercising stock options and realized gains from the vesting of stock awards, which together amounted to $24.9 million of the average compensation of the 500 highest-paid executives named in proxy statements.

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[4] See Jay W. Lorsch with Elizabeth MacIver, *Pawns or Potentates: The Reality of Corporate Boards*, Harvard Business School Press, 1989. For a recent discussion of CEO power vis-à-vis the board, and its decline in the face of hedge-fund activism and certain regulatory changes, see Marcel Kahan and Edward Rock, "Embattled CEOs," *Texas Law Review*, 88, 2010: 87-1051. This alleged decline in CEO power manifests itself in top executives becoming ever more committed to "maximizing shareholder value," which in turn gets translated into increases in their stock-based pay. The reason why the "hostile" takeovers that marked the late 1980s have largely disappeared is because there is no longer any hostility between what used to be called corporate raiders and top corporate executives. As I discuss below, both parties stand ready to disgorge cash to shareholders through stock buybacks and dividends. On the rise and dominance of shareholder value ideology and its implications for corporate resource allocation and executive pay, see William Lazonick, "Innovative Enterprise and Shareholder Value," *Law and Financial Markets Review*, 8, 1, 2014: 52-64.

[5] See Crystal, *In Search of Excess*; Lucian Bebchuk and Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, Harvard University Press, 2004; Roger L. Martin, *Fixing the Game: Bubbles, Crashes, and What Capitalism Can Learn from the NFL*, Harvard Business Review Press, 2011; Mihir Desai, "The Incentive Bubble," *Harvard Business Review*, March 2012: 124-133. For the recent case of compensation at Coca Cola, a company in which stable investor Warren Buffett holds 9 percent of the shares, see Rana Foroohar, "Why Warren Buffett should vote 'no' on Coke," *Time*, April 24, 2014; Joe Nocera, "Buffett punts on pay," *The New York Times*, April 25, 2014.

Unlike stock options, which have no value if the market price of the stock remains below the option exercise price, stock awards always have some value because they are awarded at no cost to the executive. It is often the case, however, that stock awards only vest if the company's stock price or earnings per share reaches a stipulated level. More generally, the higher the price of a company's stock – *even if it turns out to be a temporary spike* – the more both options and awards can contribute to exploding executive pay.

Let us look at how executive stock options work. An executive (or employee) stock option gives the holder the right to purchase a share of the company at the price of the stock at the time the option was granted (the exercise price) after waiting a stipulated vesting period (virtually always a minimum of one year with portions of an option grant vesting over a series of years). An option typically expires only after nine or ten years from the grant date so that, if the executive remains with the company, there is a long window during which he or she can exercise the option. By the same token, once an option is exercised, the executive will have an interest in selling the acquired stock right away to avoid risking a drop in the stock price. In the U.S., there are rarely performance requirements other than stock price – for example, that the company's stock price must rise more than that of a group of comparator companies – that must be met before an option can be exercised. If, for whatever reason, the stock price rises, even if it is just temporary, the executive with vested stock options can gain.

But don't stock-price increases reflect good news? Not always. There are three possible drivers of the stock price of a publicly traded company: innovation, speculation, and manipulation. Innovation can generate profits on a sustainable basis, and once the investing public recognizes this good news, the demand for its stock typically increases, and its stock price rises. Innovation-driven demand, however, often gives way to speculation that the company will be able to sustain its increase in stock price. However, once speculators become mainly concerned about whether a "greater fool" stands ready to buy the stock at a still higher price, speculation takes on a life of its own, detached from the actual profit potential of the company. The stage is now set for bad news when the "greater fools" disappear, and the stock-price bubble bursts.

Manipulation, which can take the form of the deliberate intervention by insiders in the stock market to increase the demand for a company's stock, comes into play either to sustain the good news of stock-price increases or offset the bad news of stock-price declines. Open-market stock repurchases, or buybacks, are a systemic mode of stock-price manipulation, making use of cash generated by a company's profit-making capability, including in many cases cash flow made "free" by downsizing workers whose skills and efforts made possible the company's profits in the first place. Within the scope of a board-authorized buyback program that sanctions an aggregate dollar amount of repurchases over a stipulated number of years or open-ended period of time, the CEO and CFO have the power to decide the amount and timing of *actual* open-market stock repurchases on any particular day.

4. Stock Buybacks

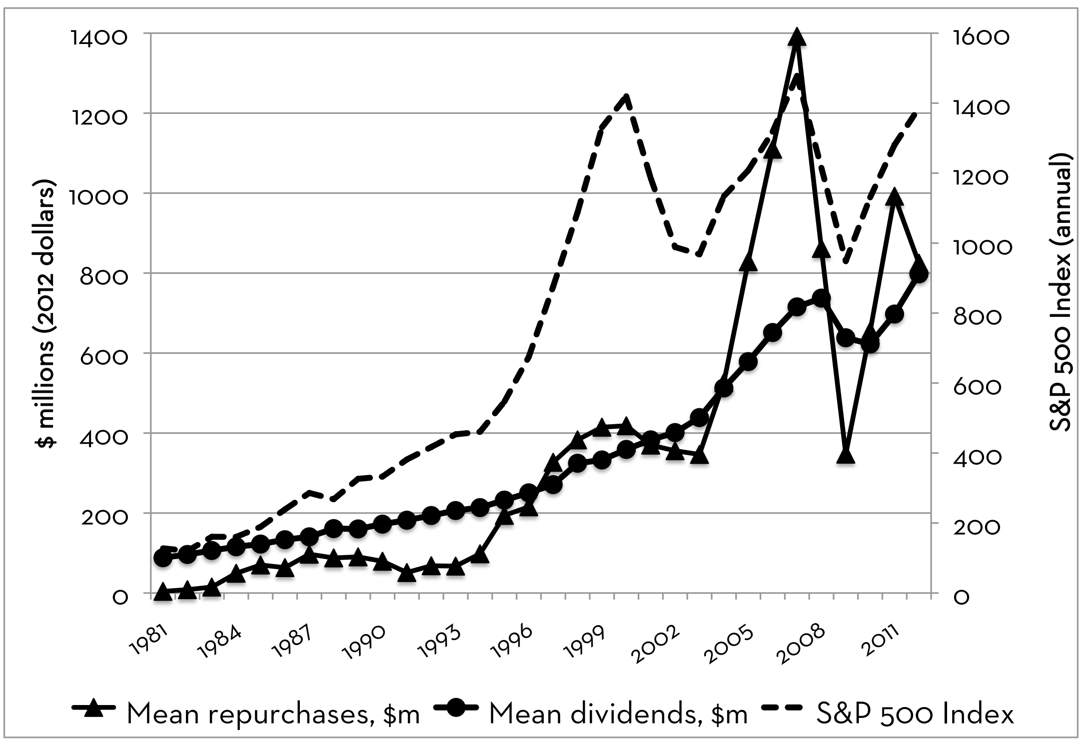
Stock buybacks are not only systemic; they are massive, amounting to an estimated $3.6 trillion for the companies in the Standard and Poor's (S&P) 500 Index from 2001 through 2013, in addition to about $2.4 trillion that these companies paid out in dividends. In the early 1980s, the corporate-finance debate among academics, regulators, and executives was still about how much dividends a company could distribute to shareholders while retaining sufficient earnings to invest in the company's productive capabilities.[6] At that time, buybacks were of minor importance, and those that were done were mainly in the form of tender offers, the purpose of which is generally to acquire shares at low prices for the sake of long-term shareholders rather than, as in the case of open-market repurchases, to give stock prices manipulative boosts so short-term shareholders can sell their shares in a rising stock market.

[6] See, for example, the final speech of Harold Williams as chairman of the SEC before resigning his position in view of the election of Ronald Reagan to the U.S. Presidency. Harold M. Williams, "The Corporation as Continuing Enterprise," address delivered to the Securities Regulation Institute, San Diego, California, January 21, 1981, at www.sec.gov/news/speech/1981/012281williams.pdf. Williams had previously been a corporate lawyer, business executive, and dean of the UCLA business school.

By the mid-1980s, however, open-market repurchases by major U.S. corporations became, like dividends, an important form of distributing cash to shareholders. In 1997, in aggregate for U.S. corporations, buybacks (about an estimated 90 percent of which were open-market repurchases) surpassed dividends, although both were on the rise. Indeed, there has never been a significant tradeoff of dividends for buybacks; both have increased over the past three decades, although dividends have been the more stable form of distribution across booms and busts. The data also show that, especially over the past decade, companies have tended to do stock buybacks in a booming stock market, and have cut back on them when the market has turned down, thus undermining one of the most oft-cited justifications for buybacks, namely that companies do them when their top executives view the stock as undervalued by the market. In 1999, at the peak of the New Economy boom, Berkshire Hathaway CEO Warren Buffett warned in his letter to shareholders that “repurchases are all the rage, but are all too often made for an unstated and, in our view, ignoble reason: to pump or support the stock price.”[7]

Tracking dividends and buybacks for the 251 companies in the S&P 500 Index in January 2013 that were publicly listed back to 1981, the buyback payout ratio (BPR) – that is, repurchases as a proportion of net income – was less than 5 percent in 1981-1983, while the dividend payout ratio (DPR) was 50 percent (see Figure 1). In 2010-2012,

Figure 1. Mean stock repurchases (RP) and cash dividends (DV) in 2012 dollars and as percentages of net income (NI) for 251 companies in the S&P 500 Index in January 2013, publicly listed from 1981 through 2012; and a comparison of the levels of distributions to shareholders with the S&P 500 Index



Source: Standard and Poor’s Compustat database, corrected from 10-K filings by Mustafa Erdem Sakinç of The Academic-Industry Research Network

[7] Warren Buffett, “Letter to the shareholders of Berkshire Hathaway, Inc.,” at http://www.berkshirehathaway.com/letters/1999.html.

Table 2. Repurchases (RP) and dividends (DV) as percentages of net income (NI), 10 largest repurchasers for the decade 2003-2012

Company Name	NI $b	RP $b	DV $b	%RP/ NI	%DV/ NI	%(RP+DV)/ NI
EXXON MOBIL	347	207	80	60	23	**83**
MICROSOFT	148	114	71	77	48	**125**
IBM	117	107	23	91	20	**111**
CISCO SYSTEMS	64	75	2	118	3	**121**
PROCTER & GAMBLE	93	66	42	71	46	**116**
HEWLETT-PACKARD	41	64	9	155	21	**177**
WAL-MART STORES	134	62	35	46	27	**73**
INTEL	79	60	27	76	34	**109**
PFIZER	84	59	63	71	75	**146**
GENERAL ELECTRIC	165	45	87	28	53	**81**

Source: Standard and Poor's Compustat database, corrected from company 10-K filings by Mustafa Erdem Sakinç, The Academic-Industry Research Network.

BPR was 39 percent and DPR 33 percent, with sharply rising profits that moderated the size of these ratios. In the intervening decades, the three-year peak of BPR was 70 percent in 2006-2008, during which time DPR was 44 percent. For the decade 2003-2012, the combined ratios were 84 percent. If the DPR was already too high in the early 1980s to sustain investment in productive capabilities, the problem has become far worse since then as major corporations have treated shareholders to buybacks as well.

What is more, large amounts of corporate profits are held overseas, unavailable for investment in productive capabilities in the U.S.[8] Encouraged by a tax concession passed by Congress in 1960 that enables U.S. corporations to defer payment of U.S. taxes on corporate profits made abroad until those profits are repatriated to the U.S., at the beginning of 2014, U.S. corporations were holding an estimated $2 trillion in earnings abroad, of which at least $650 billion was in cash.[9] Many of the companies that are the largest repurchasers in the U.S. also have the largest accumulations in earnings abroad. Indeed, even cash-rich companies such as Intel and Microsoft have borrowed billions of dollars in the U.S. for the purpose of buybacks rather than repatriate profits from abroad and pay corporate taxes on them.[10]

Table 2 shows the top 10 stock repurchasers for 2003-2012 and the proportions of net income that each company spent on buybacks and dividends over the decade. In most cases, total distributions to shareholders exceeded net income. Almost all of these repurchases were in the open market, done anonymously through the company's broker. These buybacks may amount to hundreds of millions of dollars on any given day. If a company

[8] William Lazonick, "The global tax dodgers: How big business keeps money overseas instead of creating jobs at home," *AlterNet,* August 31, 2011; William Lazonick, "The Financialization of the U.S. Corporation: What Has Been Lost, and How It Can be Regained," *Seattle University Law Review*, 36, 2013: 857-909, at pp. 900-903. See also Dhammika Dharmapala, C. Fritz Foley, and Kristin J. Forbes, "Watch What I Do, Not What I Say: The Unintended Consequences of the Homeland Investment Act,“ *Journal of Finance*, 66, 3, 2011: 753–87.

[9] International Strategy and Investment (ISI), "Accounting and Tax Research: Cash & Earnings Parked Overseas," ISI report, March 17, 2004.

[10] Lazonick, "The Financialization of the U.S. Corporation," pp. 895-896.

wants to generate momentum in its stock price or hit end-of-quarter earnings per share targets, its top executives can order repurchases on this scale, day after trading day.

By creating demand for its stock, a company can boost its stock price without the public knowing that it is doing so. Companies announce when their boards have approved repurchase programs; for example, Apple's announcement in April 2013 that it intended to buy back $60 billion by December 2015 and its announcement in April 2014 that it intends to do an additional $30 billion by that date. But companies do not announce when they are actually conducting buybacks. Only the top executives who make these resource-allocation decisions, and their brokers who execute the orders, have that information.

But, one might ask, if stock buybacks permit massive manipulation of the stock market, why does the SEC permit them?[11] After all, as a centerpiece of New Deal legislation, this regulatory agency was set up in 1934 to eliminate manipulation and fraud in the operation of securities markets. In line with this mission, in 1970, 1973, and 1980, the SEC proposed Rule 13e-2 that, had it been adopted, would have a) restricted open-market stock repurchases on any one day to 15 percent of the average daily trading volume over the previous four weeks (ADTV), b) required a company to disclose the amount of daily buybacks that were actually done, and c) charged the company with manipulation if it exceeded the 15 percent ADTV daily limit.

On November 17, 1982, however, in what was called a "regulatory about-face,"[12] the SEC withdrew Rule 13e-2 and promulgated Rule 10b-18, which gives a company a safe harbor against manipulation charges in open-market repurchases.[13] Whereas Rule 13e-2 would have charged a company with manipulation of its stock price if it exceeded 15 percent ADTV on any given day, the Rule 10b-18 safe harbor assures a company that it will not be charged with manipulation if its buybacks on any single day are no more than 25 percent ADTV. Under Rule 10b-18, moreover, there is no presumption of manipulation should the corporation's repurchases exceed the 25 percent ADTV limit.[14] As well, a company is not required to disclose the volume of buybacks that it is doing or has done on any given day. Whereas Rule 13e-2 sought to regulate stock-price manipulation through open-market repurchases, since 1982, SEC Rule 10b-18 has given top executives license to use buybacks to manipulate the market.

This "regulatory about-face" resulted from the 1980 election of Ronald Reagan as U.S. President on a platform of government deregulation and his appointment in 1981 of John Shad, vice-chairman of the stock brokerage firm E. F. Hutton, to head the SEC. Shad had been the first Wall Street executive to back Reagan for President and had served as head of fundraising in New York State for the Reagan campaign.[15] Not since Joseph Kennedy served as the inaugural chair of the SEC in 1934-35 had a Wall Street executive led the agency. In line with "Reaganomics" and Chicago-school free-market economics, Shad saw the role of the SEC as a promoter rather than regulator of financial markets.[16] A *Wall Street Journal* article on the SEC's adoption of Rule 10b-18 noted that Shad hoped that buybacks would help to fuel increases in stock prices, and thus be beneficial to shareholders.[17]

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[11] The following paragraphs are based on research that I am conducting with Ken Jacobson on the SEC's adoption of Rule 10b-18 and its significance for understanding how, during the Reagan Presidency, the SEC ceased to be an effective regulator of financial markets.

[12] Lloyd H. Feller and Mary Chamberlin, "Issuer Repurchases," *Review of Securities Regulation*, 17, 1, 1984: 993-998.

[13] Securities and Exchange Commission, "Purchases of Certain Equity Securities by the Issuer and Others; Adoption of Safe Harbor," November 17, 1982, *Federal Register*, Rules and Regulations, 47, 228, November 26, 1982: 53333-53341.

[14] http://www.sec.gov/divisions/marketreg/r10b18faq0504.htm. For the safe harbor to be in effect, Rule 10b-18 also requires that the company refrain from conducting buyback at the beginning and end of the trading day, and that all buybacks be conducted through one broker only.

[15] See Jeff Gerth, "Shad of S.E.C. favors bright corporate image," *The New York Times*, August 3, 1981, p. D1.

[16] David A. Vine and Steve Coll, *Eagle on the Street*, Collier Books, 1992.

[17] Richard L. Hudson, "SEC eases way for repurchase of firms' stock," *The Wall Street Journal*, November 10, 1982, p. 2.

A 2003 amendment to Rule 10b-18 included previously-excluded block trades within the 25 percent ADTV safe harbor because the SEC noted that, as a result of block trades, "during the late 1990s, it was reported that many companies were spending more than half their net income on massive buyback programs that were intended to boost share prices – often supporting their share price at levels far above where they would otherwise trade." The SEC went on to warn that the unregulated use of block trades in buybacks could exacerbate "the potential for manipulative abuse" and "mislead investors about the integrity of the securities trading market as an independent pricing mechanism."[18]

Yet given a four-fold escalation in buybacks among S&P 500 companies after 2003, it is clear that the 2003 amendment did nothing to bring "the potential for manipulative abuse" under control. For the 251 major U.S. corporations whose financial behavior I have tracked, the BPR for 2005 through 2008 was 64 percent, far higher than the 45 percent it had been in 1997 through 2000, a period in which the SEC had viewed buybacks as possibly contributing to market manipulation. Compared with 1997-2000, the absolute value of buybacks in inflation-adjusted dollars was 2.2 times higher in 2005-2008 and 1.4 times higher in 2009-2012, a four-year period that includes the sharp fall in buybacks in 2009 that resulted from the financial crisis.

5. Maximizing Executive Compensation

In 1991, reflecting its permissive attitude to stock buybacks, the SEC made it much easier for top executives who are privy to the company's repurchasing activity to use this inside information to time their option exercises and stock sales to increase their pay**.** Until 1991, Section 16(b) of the 1934 Securities Exchange Act prevented top executives from reaping short-swing profits when they exercised their stock options. Under Section 16(b), if an insider sold shares acquired by exercising stock options within six months of the exercise date, the gains had to be forfeited to the corporation. In 1991, by arguing that a stock option is a derivative, the SEC determined that henceforth the six-month waiting period would begin at the option's *grant* date, not the exercise date. Since the option grant date is always at least one year before the option exercise date, this reinterpretation of Section 16(b) meant that top executives, as company insiders, could now sell the shares acquired from stock options immediately upon exercise.[19]

We do not know to what extent executives trade on the inside information of stock buybacks because the SEC does not require that companies disclose the days on which they have done open-market repurchases, even after the fact. What we do know is that, to paraphrase a 1960 *Harvard Business Review* article,[20] executive compensation has gotten out of hand. The 10 largest repurchasers shown in Table 1 did a combined $859 billion in buybacks equal to 68 percent of their net income in 2003-2012. During the same decade, led by John Chambers of Cisco with $297 million in total direct compensation, their CEOs received a 10-year average of $168 million apiece in pay, of which 34 percent was from stock options and 24 percent from stock awards. The 10-year total-compensation average for the other four highest paid executives at these 10 companies was $77 million apiece, of which 27 percent came from stock options and 29 percent from stock awards. Stock-based pay creates a strong incentive for corporate executives to distribute corporate cash to shareholders, not only in the traditional form of dividends that reward shareholders for, as the name says, holding stock, but also in the deregulation-era form of buybacks that reward so-called shareholders to exit this status by becoming sharesellers.

6. Shareholder Value Ideology

Top executives give a number of reasons for stock buybacks that imply that this mode of corporate resource allocation improves the performance of not only the company but also the economy of which it is a part.[21] All of

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[18] Securities and Exchange Commission, "Purchases of Certain Equity Securities by the Issuer and Others," (November 10, 2003), *Federal Register*, Rules and Regulations, 68, 221, November 17, 2003: 64952-64976.

[19] Carole Gould, "Shaking up executive compensation," *The New York Times*, April 9, 1989, p. F13; Jan M. Rosen, "New regulations on stock options," *The New York Times*, April 27, 1991, p. 38.

[20] Ervin N. Griswold, "Are Stock Options Getting Out of Hand?" *Harvard Business Review* 38, 6, 1960: 49–55.

[21] Lazonick, "Innovative Enterprise and Shareholder Value."

these justifications for buybacks rely on the ideology put forth by free-market economists – known as agency theorists – that business corporations should be run to "maximize shareholder value" (MSV). And like MSV, these arguments are wrong.

The fundamental assumption of MSV is that shareholders are the only participants in the economy who bear risk by investing in the economy *without a guaranteed return*. Given that risk-taking is essential for achieving superior economic performance, MSV ideology that public shareholders are the *only* economic actors who take risks implies that they are the economic actors best positioned to allocate productive resources to their best alternative uses.[22] By disgorging the corporation's "free" cash flow in dividends and buybacks, corporate executives as agents permit public shareholders as principals to perform this resource-allocation role. Agency theorists argue that stock-based pay aligns the incentives of corporate executives and public shareholders, resulting in the allocation of resources to maximize shareholder value, and hence enable the economy to achieve superior economic performance.

As a theory of resource reallocation, MSV is fundamentally flawed.[23] Public shareholders are not the only economic actors who invest in the economy without guaranteed returns. *Taxpayers,* through government agencies that invest in infrastructure and knowledge-creation make risky investments in productive capabilities on a regular basis, without guaranteed returns. So too do *workers,* through the firms that employ them to engage in collective and cumulative learning – which is the essence of the innovation process. As risk bearers, taxpayers whose dollars support business enterprises and workers whose efforts generate productivity improvements have claims on corporate profits if and when they occur.[24]

MSV can ignore the claims of taxpayers and workers on profits – or what agency theorists call the "residual," a label which itself reveals that these economists lack a theory of the source of profits – because they adhere to the neoclassical theory of the market economy in which the distribution of income is determined by the self-regulating forces of supply and demand. Into this fictitious theory of the market economy, agency theorists introduce the reality of the large corporation, despite the fact that they have absolutely no theory of how, through innovation, these firms attained dominant positions in their industries.[25] Then, again despite their lack of a theory of innovative enterprise, they posit that public shareholders are the only participants in the economy who make investments in the corporation without guaranteed returns, and from this assumption deduce that public shareholders are the only actors in the economy who have an interest in the allocation of the so-called "residual" to its most productive uses. MSV then becomes an ideology for disgorging corporate cash to public shareholders, as has indeed been the case since the 1980s.

The irony – or, more correctly, the ignominy – of MSV is that the public shareholders whom agency theory holds up as the economy's only risk-bearers typically never invest in the value-creating capabilities of the company at all. Rather they invest in outstanding shares in the hope that they will rise in price on the market. And, following the directives of MSV, a prime way in which corporate executives fuel this hope is by conducting large-scale buybacks to manipulate the market. The more one delves into the reasons for the huge increase in open-market repurchases since the mid-1980s, the clearer it becomes that the only plausible reason for this mode of resource allocation is that the very executives who make the buyback decisions have much to gain personally through their stock-based pay.

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[22] Michael C. Jensen, "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers," *American Economic Review* 76, 2, 1986: 323-329.

[23] Lazonick, "Innovative Enterprise and Shareholder Value." My critique of agency theory builds on arguments that I have been making for more than two decades. See William Lazonick, "Controlling the Market for Corporate Control: The Historical Significance of Managerial Capitalism," *Industrial and Corporate Change*, 1, 3, 1992: 445-488; William Lazonick and Mary O'Sullivan, "Maximizing Shareholder Value: A New Ideology for Corporate Governance," *Economy and Society*, 29, 1, 2000: 13-35.

[24] Lazonick, "Innovative Enterprise and Shareholder Value."

HOW EXECUTIVE PAY AFFECTS ECONOMIC PERFORMANCE

For years on its Executive Paywatch website, the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) has tracked the ratio of CEO pay to that of the average worker, documenting its climb from about 40:1 in the early 1980s to a peak of over 500:1 in 2000 and then settling at its new normal of over 300:1 in recent years.[26] The Executive Paywatch ratios for the 350 highest paid CEOs are 354:1 for 2012 and 331:1 for 2013.[27] The ExecuComp database (which is not yet complete for 2013) shows that the 350 highest paid executives (not all of whom were CEOs) averaged $37.5 million in total direct compensation in 2012, which implies an average-worker wage of more than $100,000 to get a 350:1 ratio. Whatever the precise ratio, there is no doubt that CEO pay is obscenely high, and that it is an important reason for the record concentration of income among the top 0.1 percent of U.S. households over the past decade.[28]

But the problem with the explosion of executive pay goes beyond the obvious fact that it is unfair. As I have argued in detail elsewhere, the toxic combination of stock-based executive pay and open-market stock repurchases has contributed to not only the growing concentration of income at the top but also the failure of the U.S. economy to sustain existing middle-class jobs and create new ones.[29] Until government policy-makers eradicate this debilitating combination of stock-based pay and stock buybacks, unstable employment and inequitable income will be the result.

MSV ideology argues that the combination of stock-based pay and stock buybacks results in superior economic performance. But the MSV argument lacks a theory of the commitment of financial resources to innovative investment strategies.[30] Retained earnings have always been the foundation for investment in innovation, the essence of which is collective and cumulative learning within business organizations. The argument that buybacks represent "free cash flow," as agency theorists contend, is typically an excuse for avoiding investments in innovation.

Research carried out under my direction by The Academic-Industry Research Network and the UMass Center for Industrial Competitiveness has revealed the negative impacts on innovation of this "financialization" of the U.S. industrial corporation in critical high-tech industries, including information and communication technology, biotechnology, and clean technology.[31] When, as shown in Table 2 for the 10 largest repurchasers in 2003-2012, those who exercise strategic control over resource allocation in the nation's major corporations distribute all of their earnings and more to shareholders, we have to question what innovative investment opportunities they are failing to fund.

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[25] See Lazonick, "Controlling the Market for Corporate Control"; William Lazonick, "The Chandlerian Corporation and the Theory of Innovative Enterprise," *Industrial and Corporate Change*, 19, 2, 2010: 317-349; and Lazonick, "Innovative Enterprise and Shareholder Value." See also Lazonick and O'Sullivan, "Maximizing Shareholder Value"; and William Lazonick and Mariana Mazzucato, "The Risk-Reward Nexus in the Innovation-Inequality Relationship: Who Takes the Risks? Who Gets the Rewards?" *Industrial and Corporate Change*, 22, 4, 2013: 1093-1128.

[26] AFL-CIO Executive Paywatch, at http://www.aflcio.org/Corporate-Watch/CEO-Pay-and-You/.

[27] AFL-CIO Executive Paywatch, at http://www.aflcio.org/Corporate-Watch/Paywatch-2014

[28] Lazonick, "The Financialization of the U.S. Corporation."

[29] Ibid.

[30] Lazonick, "The Chandlerian Corporation"; William Lazonick, "The Theory of Innovative Enterprise: A Foundation of Economic Analysis," AIR Working Paper Series #13-05/01.

[31] See the websites of The Academic-Industry Research Network, and the UMass Center for Industrial Competitiveness. This research as been funded by grants from the Upjohn Institute for Employment Research; Ford Foundation; and Institute for New Economic Thinking.

Given the importance of these companies in the industries in which the 10 top repurchasers operate, this type of financial behavior has enormous economic costs.[32] Here are three examples from among these largest repurchasers:

International Business Machines (IBM)
In the post-World War II decades through the 1980s, IBM had a "lifelong employment" policy that exemplified the employment norm of a career with one company characteristic of most established "Old Economy" companies.[33] Yet from 1990 to 1994, IBM's worldwide employment dropped from 374,000 to 220,000. By 1994, IBM's top executives had deliberately obliterated the system of lifelong employment. From the mid-1990s, focusing on software and services, and shedding its manufacturing capabilities, IBM led the U.S. offshoring movement. By 2008, the company employed 398,000 people, but only 30 percent of them were in the U.S., down from 52 percent in 1996. In 2011, with its operating earnings per share (EPS) at $13.44, IBM announced its "2015 EPS Road Map," the objective of which is to reach at least $20 EPS by the end of 2015.[34] Along with revenue growth and operating leverage, IBM cited stock repurchases as a driver in achieving its EPS objective. One way in which IBM is increasing "operating leverage," and hence higher EPS, is through layoffs of U.S. employees. IBM is also following the 2015 EPS Road Map through stock buybacks.[35] In addition to the $107 billion in buybacks that IBM did from 2003 through 2012 as shown in Table 2 above, IBM did $13.9 billion in 2013 and another $8.2 billion in the first quarter of 2014. For 2003-2012, the total combined pay of those who occupied the IBM CEO position was $247 million, of which 29 percent came from options and 35 percent from awards, while the 10-year take for the other four highest paid IBM executives averaged $92 million each, with 30 percent from options and 45 percent from awards.

Hewlett-Packard (HP)
HP was once an icon of American innovation that, like IBM, provided stable careers and equitable pay to its employees as a foundation for continuous innovation, as described by founder David Packard in his 1995 book, *The HP Way*.[36] But in 1999, it spun off its engineering division as Agilent, and then did away with employment security, becoming known as a "hire-and-fire" company that engaged in "employee churn."[37] From 2004 to 2011, HP spent $61.4 billion on buybacks, equal to 120 percent of its net income, along with $6.8 billion in dividends. Unlike IBM, however, HP largely failed in its attempt to shift from selling hardware to high-margin software and services.[38] After spending $11.0 billion on buybacks in 2010 and $10.1 billion in 2011, the company took a $12.7 billion loss in 2012. In 2013, HP had stagnant revenues but restored its profitability by cutting its labor force from 349,600 to 331,800, with another 32,500 layoffs announced as of May 2014. Meanwhile over the decade 2003-2012, those who occupied the CEO position at HP received a combined $210 million, with 15 percent from options and 22 percent from awards. The other four highest paid HP executives averaged $101 million in total compensation over these 10 years, with 25 percent from options and 22 percent from awards.

Cisco Systems
In the 1990s, Cisco Systems, founded in Silicon Valley, was the fastest growing company in the world as it captured more than 70 percent of the global Internet router market. Using its stock as an acquisition currency,

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[32] For other examples, not presented here, see William Lazonick, "Profits Without Prosperity: How Stock Buybacks Manipulate the Market, and Leave Most Americans Worse Off," paper presented to the annual conference of the Institute for New Economic Thinking, Toronto, April 11, 2014.
[33] William Lazonick, *Sustainable Prosperity in the New Economy? Business Organization and High-Tech Employment in the United States* (Upjohn Institute for Employment Research, 2009), ch. 3; William Lazonick, "The New Economy Business Model and the Crisis of US Capitalism," *Capitalism and Society,* 4, 2, 2009, article 4.
[34] IBM Annual Report 2011. http://www.ibm.com/annualreport/2011/ghv/#five
[35] Heidi Moore, "IBM fires small-town workers for Wall Street numbers," *The Guardian*, March 2, 2014.
[36] David Packard, *The HP Way: How Bill Hewlett and I Built Our Company*, HarperBusiness, 1995.
[37] Lazonick, *Sustainable Prosperity*, ch. 3.
[38] Rachelle Dragani, "HP Rearranges Chairs in Hopes of Propelling Turnaround," *E-Commerce Times*, August 23, 2013.

from 1993 through 2000, Cisco did 71 acquisitions for more than $35 billion, of which 98 percent was paid in its shares. In March 2000, Cisco had the highest market capitalization in the world, but by September 2001, despite increased revenues, Cisco' stock price had fallen to just 14 percent of its peak.[39] At that point, Cisco started buying back its stock, and from 2002 through 2013 expended an amount equivalent to 107 percent of its net income on buybacks. In the first two quarters of 2014, it did another $7.6 billion in buybacks. In the process, Cisco has eschewed investment in sophisticated communication technologies, despite the fact that it was well positioned to do so at the beginning of the 2000s. Many of Cisco's new products have quickly become commodities, and in recent years the company has engaged in rounds of large-scale layoffs to sustain its buyback habit. In global competition, the relatively young company that made the high-end investments in communication technology that Cisco ignored was Huawei Technologies, a Chinese employee-owned company founded in 1988 that is now challenging Sweden's Ericsson – another company that does not do buybacks – for top spot in the global communication equipment industry.[40] Despite all its buybacks, over the past three years, Cisco's stock price has underperformed the S&P 500 Index. Yet its CEO, John Chambers, collected $297 million in total compensation for 2003-2012, of which 89 percent came from options and 3 percent from awards, while the other four highest paid executives at the company averaged $69 million over the decade, with 60 percent from options and 13 percent from awards.

As these three cases show, profits that should be returned to taxpayers and workers for their contributions to the innovations that generated them, instead go to shareholders who have made no productive contributions at all. The history of Apple Inc. is a case in point.[41] The only money that Apple ever raised from public shareholders was $97 million in its initial public offering in 1980. In the past two years, hedge-fund activists David Einhorn and Carl Icahn, neither of whom has made any contribution whatsoever to Apple's success, have purchased large blocks of shares on the stock market, and have pressured the company to "unlock value" for shareholders by authorizing the largest buyback programs in corporate history. In convincing Apple to commit to this use of its cash, the hedge-find activists have been aided and abetted by Apple's top executives, including Steve Jobs' successor, Timothy J. Cook, who in his first two years as CEO in 2011 and 2012 took home $159 million in compensation, of which 96 percent came from stock awards.

DETOXIFYING THE CORPORATE ECONOMY

Over the past three decades, the U.S. economy has had ample experience of the disastrous economic and social consequences of the government deregulation that began in the Reagan era.[42] Both stock buybacks as legal means of manipulating the stock market and stock-based pay as incentives to engage in this type of corporate financial behavior are products of Reaganomics.[43] This toxic combination is at the core of the failure of the U.S. economy to achieve stable and equitable economic growth.

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[39] Marie Carpenter, William Lazonick, and Mary O'Sullivan, "The Stock Market and Innovative Capability in the New Economy: The Optical Networking Industry," *Industrial and Corporate Change*, 12, 5, 2003: 963-1034.

[40] Bob Bell, Marie Carpenter, Henrik Glimstedt, and William Lazonick, "Cisco Systems: The Virtues and Vices of the New Economy Business Model," paper presented at the Business History Conference, Frankfurt, Germany, March 15, 2014.

[41] William Lazonick, Mariana Mazzucato, and Öner Tulum, "Apple's Changing Business Model: What Should the World's Richest Company Do With All Those Profits?" *Accounting Forum*, 37, 4, 2013: 249-267.

[42] The explosion of executive pay is a prime reason for the increased concentration of income among the richest households in the United States, as documented in Thomas Piketty, *Capital in the Twenty-First Century*, Harvard University Press, 2014. For an illuminating empirical analysis of the proportion of the top one-tenth of one percent of households in the U.S. income distribution who are "salaried" executives of non-financial public companies, see Jon Bakija, Adam Cole, and Bradley T. Heim, "Jobs and Income Growth of Top Earners and the Causes of Changing Income Inequality: Evidence from U.S. Tax Return Data," working paper, April 2012, available at http://econ.williams.edu/people/jbakija.

[43] The role of John Shad and the SEC in the implementation of Reaganomics is the subject of work-in-progress with Ken Jacobson.

In its release on the amendment to Rule 10b-18 in 2003, the SEC articulated clearly why it needs to get rid of Rule 10b-18. "In summary," wrote the SEC, "Rule 10b-18 is intended to protect issuer repurchases from manipulation charges when the issuer has no special incentive to interfere with the ordinary forces of supply and demand affecting its stock price. Therefore, it is not appropriate for the safe harbor to be available when the issuer has a heightened incentive to manipulate its share price."[44]

Yet stock-based pay gives U.S. corporate executives "a heightened incentive to manipulate its share price." The American public should demand that the federal government agency that is supposed to regulate the stock market rescind the "safe harbor" that enables corporate executives to manipulate stock prices, secure in the knowledge that their actions are government tested and approved. More than that, let the SEC conduct a Special Study, on the scale of its 1963 study of securities markets that resulted in the creation of NASDAQ,[45] of the possible damage that open-market repurchases have done to the U.S. economy over the past three decades. The fact that the SEC has facilitated, and even encouraged, a mode of resource allocation in which trillions of dollars of corporate profits have been thrown away on buybacks indicates that there is a pressing need for a major rethinking of the relationship between how the stock market functions and capital formation.[46]

The American public should also demand that the SEC restore the prohibition that existed from 1934 to 1991 against top executives as insiders reaping short-swing profits. Although this piece of regulation would not in and of itself prevent U.S. corporate executives from reaping what they have not sown, it could help launch a much-needed discussion in the U.S. of the meaningful reform of executive compensation that goes beyond reforms of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act's "Say-on-Pay" that view the *financial sector* as the source of inequity and instability, with nothing to say about the much more fundamental *financialization of the industrial sector* that is the prime focus of this paper.[47]

That discussion would take up the need for changes in the composition of boards to include representatives willing and able to take a stand against excessive executive pay and the squandering of corporate resources on stock buybacks. Legal scholars have debunked the argument that corporate boards have a legal obligation to maximize shareholder value.[48] In fact, under U.S. common law, boards have an obligation to make sound business decisions under the business judgment rule.[49] U.S.-style stock-based pay and open-market stock repurchases reflect unsound business judgment. It follows that there is a need to break up the club that, with its MSV mantra, has made unsound business judgment the overriding rule.

It is often argued that the appointment of "independent" directors to corporate boards is needed to restrain the power of corporate executives who are lining their pockets at the expense of shareholders.[50] But, in line with MSV ideology, that argument typically accepts that companies should be run for the benefit of shareholders. Once it is recognized that top corporate executives have been lining their pockets at the expense of taxpayers and workers – who by investing in productive capabilities have taken risks but have not reaped the rewards – Americans might want to rethink whose interests those independent directors should represent.

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[44] SEC, "Purchases," (2003), p. 64953.

[45] Securities and Exchange Commission Historical Society. "The Bright Image: The SEC, 1961-1973," http://www.sechistorical.org/museum/galleries/tbi/special_a.php

[46] See William Lazonick, "The New Economy Business Model and the Crisis of US Capitalism*," Capitalism and Society*, 4, 2, 2009: article 4.

[47] William Lazonick, "How GE and Jeff Immelt are failing to reinvigorate the U.S. economy," *The Globalist,* May 3, 2011, at http://www.theglobalist.com/how-ge-and-jeff-immelt-are-failing-to-reinvigorate-the-u-s-economy/

[48] See Lynn Stout, *The Shareholder Value Myth*, Berrett-Koehler Publishers, 2012.

[49] Ibid., pp. 29-31. For a recent discussion of the business judgment rule, see Lyman Johnson, "Unsettledness in Delaware Corporate Law: Business Judgment Rule, Corporate Purpose," *Delaware Journal of Corporate Law*, 38, 2, 2013: 405-451.

[50] See Jeffrey N. Gordon, "The Rise of Independent Directors," *NACD Directorship*, 34, 1, 2008: 58-63.

Back in 1929, Robert S. Brookings, a businessperson, philanthropist, and public intellectual whose name adorns the eponymous D.C. research institute that he helped to create, made a very sensible argument that should be central to the U.S. corporate governance debate:

> Capital, *not* labor, should be treated by management as a commodity in industry, to be fairly compensated in order to retain it in industry in competition with other forms of investment. As labor is so largely interested in, and is so largely responsible for industrial results, it should be given the authority of a liberal representation on the board of directors.[51]

Given the ongoing concentration of income at the top and loss of middle-class employment opportunities that have come to characterize the U.S. economy in the era of MSV, now is a good time for serious public debate on by whom and for whom the modern business corporation should be governed.

[51] Robert S. Brookings, *Economic Democracy: America's Answer to Socialism and Communism*, Macmillan, 1929.