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LAW2012-0236

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URL Conference Papers Series: www.atiner.gr/papers.htm

Printed in Athens, Greece by the Athens Institute for Education and Research.

ISSN **2241-2891**
19/09/2012

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This paper should be cited as follows:

Malloy, M.P. (2012) "***Governing*** **Foolishness:** ***A Comparative Analysis of Executive Compensation Rules***" Athens: ATINER'S Conference Paper Series, No: LAW2012-0236.

Governing Foolishness: *A Comparative Analysis of Executive Compensation Rules*[*]

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Abstract

This paper explores three approaches to limits on executive compensation as responses to the current financial crisis. Each approach has been established or endorsed by a different policy making institution. The first approach is the executive compensation provision of the Dodd-Frank Act, which was enacted as the U.S. Government's principal response to the financial crisis. The second approach is the European Commission's Green Paper on executive compensation, issued just weeks before enactment of the DFA and with much the same intention. The third approach is a set of non-binding guidelines issued by the Basel Committee on Banking Supervision based at the Bank for International Settlements in Basel, Switzerland. Only the third approach is specifically intended for use in the supervision of financial services firms; the other two impose or recommend requirements on executive compensation. Despite a flurry of public attention over a few *causes célèbres*, in which corporate executives had their compensation threatened or actually curtailed, current empirical data on executive compensation strongly suggest that these limitations on executive compensation are of negligible effect. The paper argues that these limits are a distraction from the real issues in the financial services markets, like, for example, fraud, manipulation, gross negligence during the run-up to the crisis.

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 The author wishes to thank Susie A. Malloy, for her insights and suggestions, and Michael E. Malloy for his technical analysis and preparation of the empirical data used in this study.

Introduction

Of all the ways of shooting yourself in the foot, it strikes me that one of the most curious is deciding to make regulation of executive compensation one of the focal points of your response to a devastating economic crisis. Of course, if you were then to make a determined effort not to establish anything effective or even practical as a response, that is likely to be a source of some amusement. That is precisely what policy makers in diverse settings have done with respect to the current financial crisis.[1] This paper explores three responses to the crisis, established or touted by three diverse groups of policy makers, and evaluates the relative ineffectiveness of each approach. The paper argues that limits on executive compensation are a distraction from the real issues in the financial services markets, like, for example, fraud, manipulation, gross negligence in management during the run-up to the crisis.

The paper examines three approaches: (1) the executive compensation provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA),[2] enacted as the principal response of the U.S. Government to the financial crisis; (2) the European Commission's Green Paper on executive compensation,[3] issued just weeks before enactment of Dodd-Frank and with much the same intention; and, (3) the non-binding guidelines, *Compensation Principles and Standards Assessment Methodology*, issued by the Basel Committee on Banking Supervision based at the Bank for International Settlements in Basel, Switzerland.[4] Only the third approach is specifically intended for use in the supervision of financial services firms; the other two impose or recommend requirements in a broader corporate setting.

Three Approaches

Dodd-Frank Wall Street Reform and Consumer Protection Act

It has been argued that extravagant executive compensation practices were a contributing cause of the financial crisis,[5] because, among other things, they created perverse incentives for unreasonable short-term strategies that ignored long-term risks.[6] In response, a little snippet of the DFA requires publicly traded companies – companies registered pursuant to the Securities Exchange

[1]For analysis of the current financial crisis and its legal implications, see Malloy (2010).
[2]Pub. L. No. 111-203, §§ 951-956, 124 Stat. 1376, 1899-1906 (2010) (codified at 15 U.S.C. §§ 78j-3 - 78j-4, 78*l* note, 78n(i)-(j), 78n-1, 5641). For an overview of the DFA, see Malloy (2011a), vol. 1, § 1.04[K].
[3]European Commission (2010).
[4]Committee on Banking Supervision (2010) ('Basel Guidelines'). *See also* Committee on Banking Supervision (2011) (offering technical guidance on implementation of Basel Guidelines).
[5]See, e.g., Bebchuk & Spamann, (2010) (offering extensive analysis of the executive compensation problem); Institute of International Finance (2009).
[6]*But see* Okamoto & Edwards (2010) (rejecting 'myopic focus on [executive] compensation').

Act of 1934 (1934 Act) § 12[1] – to permit their shareholders to have a nonbinding vote, at least once every three years,[2] on executive compensation.[3] The amended act also requires, *inter alia*, disclosure by any person soliciting proxies in favor of a merger or other acquisition of any 'golden parachute' compensation agreement or understanding in favor of departing executives in connection with the merger or acquisition.[4] These provisions do not appear to supersede substantive guidance previously issued by the banking regulators.[5]

It is difficult to understand how such wispy requirements would be expected to have any appreciable effect on management behavior.[6] In fact, as will be discussed in the last part of this section, CEO cash bonuses had already increased markedly in 2010 and 2011, despite public discussion and criticism of executive compensation in the wake of the financial crisis. Indeed, the data appear to suggest that the DFA provisions, and in particular the shareholder voting requirement, are unlikely to have any practical effect on executive behavior and corporate governance.[7]

One might contrast these provisions with the relatively more rigorous provisions concerning corporate governance of credit rating agencies (CRAs). Under DFA § 932(a),[8] at least half of a CRA's board of directors, which establishes policies with respect to how ratings are set and how conflicts of

[1] 15 U.S.C. § 78*l*(a), (g).

[2] The DFA allows for more frequent nonbinding votes, upon approval of the shareholders. *See* DFA § 951, 124 Stat. at 1899-1900 (codified at 15 U.S.C. §78n-1(a)(2)) (permitting, at least once every six years, shareholder vote on frequency of compensation votes).

[3] *Id.* § 78n-1(a)(1).

[4] *Id.* § 78n-1(b)(1). For these purposes, the term "golden parachute" is characterized by the statute as any type of compensation (whether present, deferred, or contingent) that is based on or otherwise relates to the acquisition, merger, consolidation, sale, or other disposition of all or substantially all of the assets of the issuer and the aggregate total of all such compensation that may (and the conditions upon which it may) be paid or become payable to or on behalf of such executive officer." *Id.*

[5] For example, in late June 2010, the Office of the Comptroller of the Currency (regulator of national banks and federal savings associations) (OCC), the Board of Governors of the Federal Reserve System (U.S. central bank and regulator of state-chartered member banks and all banking and savings and loan holding companies) (the Fed), the Federal Deposit Insurance Corporation (deposit insurer and regulator of state chartered non-member banks and state savings associations) (FDIC), and the now abolished Office of Thrift Supervision adopted final guidance designed to ensure that "incentive compensation policies" at banking organizations did not encourage imprudent risk-taking, and that they were consistent with safety and soundness. *Guidance on Sound Incentive Compensation Policies* (2010) 36,405–36,414. The guidance was effective June 25, 2010. 75 Fed. Reg. at 36,395. For explanation of the distinct roles and authority of the OCC, the Fed, and the FDIC, see Malloy (2011a), vol. 1, § 1.03[A]-[D].

[6] EU officials have criticized the U.S. approach to executive compensation as insufficient, at a time when the European Commission has brought legal action against EU member states, including Italy and Spain, for failure to implement EU restrictions on bank bonuses. Kirwin (2011).

[7] Curran and Gundy (2012) make a strong argument that there has been some significant deferral of executive compensation within the banking sector, but this is primarily the result of intervention of the federal regulators enforcing 'safety and soundness' principles, rather than DFA.

[8] DFA, § 932(a), 124 Stat. at 1872-1883 (codified at 15 U.S.C. § 78o-7).

interest are avoided,[1] must be "independent"[2] (meaning that the directors are not associated with the CRA and do not receive compensation from it[3]). The directors' compensation cannot be tied to the CRA's performance.[4] In addition, addition, DFA § 933(b)[5] enhances the liability of CRAs by allowing investors in companies rated by a CRA to sue the CRA for any knowing or reckless failure to investigate the facts relied upon in making the rating, or for failure to obtain reasonable verification of the facts from a credible source.

EC Green Paper

The European Commission released a proposal that raises an interesting contrast to the approach taken by the DFA. In June 2010, the Commission suggested in a green paper that stricter corporate governance and enhanced, positive rights for shareholders of financial service companies would be required to support the effectiveness of any new regulations that the EU might adopt to prevent future financial crises.[6]

A year later, observers were still searching for such rules. In any event, at the time that the Green Paper was issued the EU did not have the kind of integrated, EU-level regulatory apparatus in place to monitor and enforce such rules. In December 2009, EU finance ministers approved a new EU-wide banking and financial services supervisory structure designed to prevent future financial crises, with a sovereignty concession demanded by the UK.[7] The structure includes a "macro-prudential" European Systemic Risk Board (ESRB) and a "micro-prudential" cluster of three new agencies to supervise cross-border activities in the banking, financial services, insurance, and pension sectors.[8] These sectoral agencies would not have the authority to require a member state to rescue a particular financial institution with its headquarters in the member state.[9]

As of January 1, 2011, however, the ESRB and three European sectoral supervisory authorities assumed responsibility for EU-wide supervision of the stability of the financial system as a whole. The ESRB, housed in the European Central Bank (ECB) in Frankfurt, is responsible for early warnings when systemic risks are building up. It is chaired by the ECB president and includes the heads of EU central banks and national and European financial supervisors. The three sectoral supervisory authorities are the European Banking Authority (EBA) based in London, the European Securities and Markets Authority

[1] 15 U.S.C. § 78o-7(t)(3).
[2] *Id*. § 78o-7(t)(2)(A).
[3] *Id*. § 78o-7(t)(2)(B).
[4] *Id*. § 78o-7(t)(2)(C).
[5] DFA, § 933(b), 124 Stat. at 1883-1884 (codified at 15 U.S.C. § 78u-4(b)(2)).
[6] The Green Paper was part of what was 'effectively a programme for reforming the regulatory and supervisory framework for financial markets.' European Commission (2010) 2. Hence, it contemplated the implementation of other elements of the programme, rather than attempting to create a single solution on its own.
[7] Kirwin (2009).
[8] *Id*.
[9] *Id*.

(ESMA) based in Paris, and the European Insurance and Occupational Pensions Authority (EIOPA) based in Frankfurt.

With the ongoing financial crisis and its ‘case by case’ treatment by the EU and international institutions, it remains to be seen whether they will in fact be able to provide efficiently and effectively the kind of early-warning, swift-response approach to systemic financial crisis that was so lacking in the current crisis. In December 2011, the Committee of European Banking Supervisors issued revised guidelines on bank executive bonuses rules that took effect in 2011 in the European Union,[1] under which bank executives and senior management would be required to defer at least half of any bonus for a minimum of three years, depending on the impact the recipient could have on the risk profile of the institution and the responsibilities and tasks performed, and depending on the amount.[2]

Basel Guidelines

The Basel Committee on Banking Supervision, a policy group within the Bank for International Settlements based in Basel, Switzerland,[3] has taken a very serious interest in the issue of executive compensation, particularly as a risk factor for banks. In 2009, the Basel Committee amended the extant capital supervision requirements to require national regulators to monitor executive compensation structures consistent with principles of effective risk management.[4] In January 2010, it issued new supervisory guidelines for determining appropriate restrictions on bonuses and other compensation for bank executives and employees. Primarily, these guidelines are intended as a set of compensation principles and a standards-assessment methodology for the use of national-level financial services supervisory agencies to evaluate bank compliance with nine *Principles for Sound Compensation Practices* adopted by the Financial Stability Board (FSB) in 2009.[5] The principles are intended to

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[1]Committee of European Banking Supervisors (2010).

[2]*Id*.

[3]On the work of the Basel Committee, see Malloy (2011b) §§ 9.7-9.9.

[4]Committee on Banking Supervision (2009) 25-27.

[5]http://www.financialstabilityboard.org/publications/r_090925c.pdf The FSB was established in April 2009, as the successor to the G7’s Financial Stability Forum, to coordinate the work of national financial authorities and international standard setting and regulatory institutions and to develop and promote the development and implementation of effective regulatory, supervisory and other financial sector policies. FSB operations are based in Basel, Switzerland, and hosted by the Bank for International Settlements (BIS). http://www.financialstability board.org/about/overview.htm. Members of the FSB include the central banks, and in many cases ministerial or regulatory bodies, of Argentina, Australia, Australia, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Mexico, the Netherlands, Republic of Korea, Russia, Saudi Arabia, Singapore, South Africa, Spain, Switzerland, Turkey, the United Kingdom, and the United States of America. Members also include the BIS (and certain BIS-affiliated standard-setting bodies), the European Central Bank, the International Monetary Fund, the OECD, and the World Bank, as well as international standard-setting bodies and regulatory associations such as the International Association of Insurance Supervisors, the International Accounting Standards Board, and the International Organization of Securities Commissions. *See* http://www.financialstabilityboard. org/members/links.htm (providing list of FSB members and links to members).

reduce individual incentives for excessive risk that were encouraged by the structure of compensation policies. The Basel Committee guidelines go beyond FSB principles by including practical examples of criteria on which firms could be assessed.

Because of the non-binding character of the Basel Committee guidelines, there is some serious question whether these guidelines will be effective in getting states to converge around a set of sensible, effective rules about executive compensation.[1] This in turn raises the problem of whether disparate approaches among states will in fact detract from the use of such guidelines at all, as has happened with the revision of the Basel II capital supervision guidelines previously issued by the Basel Committee.[2] On the other hand, this is the only approach that seeks to use executive compensation specifically within the administrative context of safety and soundness supervision of financial services firms. To that extent, it may be the one of the three approaches to have the greatest potential for effective implementation. By mid June-2012, almost all FSB member jurisdictions had completed implementation of the *Principles* and their implementing standards.[3]

d. *Empirical Developments*

There has naturally been a great deal of public attention over a few ***causes célèbres*** **in which corporate executives had** their compensation threatened or actually curtailed since the meltdown of the capital markets beginning in

[1] The problem of convergence of legal rules and policies across national borders is one of long standing, and seldom yields to easy resolution. See Bhala (1994) 204 (reviewing collapse of a transborder bank); Malloy (1992) (examining financial services markets); Shyn (1994) (examining commodities markets); Cho (2001) (examining international trade in goods); Cho & Kelly (2012) (reviewing current problems of convergence).

[2] In fact, the Basel Committee moved on from a first revision of the original capital guidelines ('Basel II') to a second version ('Basel III') that remains a source of controversy. This controversy is at least in part a problem of convergence. *See* Malloy (2011a), vol. 3, § 15.02[C][1]:

> [I]n light of the fact that the U.S. regulators never fully implemented Basel II, the very real possibility that they might abandon "Basel III," in whole or in part, continued to be a source of serious concern among European regulators in particular. In contrast, implementation of Basel III has come to be viewed as a critical component of economic and fiscal recovery within Europe, and especially within the Euro Zone. The EU has continued to move forward with implementation of Basel III. In October 2010, the European Commission initiated a consultation process for new rules requiring financial institutions to build "countercyclical" capital buffers during times of robust economic growth, in accordance with Basel III, contemplating higher capital requirements during high-growth periods and lower capital requirements during economic downturns.
>
> (Footnotes omitted.)

[3] Financial Stability Board (2012). Member jurisdictions that had 'significant gaps' as recently as October 2011 – Argentina, India, Indonesia, Russia, and South Africa – are now making progress towards implementation. However, implementing regulations were still 'under review' in Indonesia and Russia. Pruzin (2012).

2008.[1] Nevertheless, current empirical data on executive compensation strongly suggest that limitations on executive compensation are of negligible effect. CEO cash bonuses increased markedly in 2010, with a 28 percent rise in CEO median compensation over 2009, according to a report by Equilar Inc.,[2] an executive compensation research firm, primarily due to individual executives exceeding performance targets rather than increases in the target amounts. By mid-2011, 34 percent of financial executives surveyed by the Financial Executives Research Foundation reported salary freezes in 2011, compared with 57 percent of those surveyed in 2010.[3]

More recent data confirms the resilience of executive compensation in the face public criticism and despite public policy initiatives described previously in this paper. An analysis of final regulatory filings for the 2011 proxy season by the 200 largest registered issuers, commissioned by the *New York Times* from Equilar, provides some sharp insights into post-meltdown corporate behavior.[4] Median pay of the 200 CEOs in 2011 was $14.46 million according to the Equilar study, and the median pay raise for those CEOs was 5 percent. However, the mean average pay raise was $19.8 million, with a mean pay raise of 20 percent. An examination of Figure 1 illustrates the range of total compensation among the 200 CEOs, from $377.99 million (Apple's new CEO) to $10.87 million (Laboratory Corp. of America's CEO).

Figure 2 illustrates that the largest percent increases do not necessarily correlate to the largest CEO salaries.[5] However, in light of the public policy concerns expressed about excessive executive compensation, what is particularly interesting is the incongruity that emerges comparing pay increases and corporate performance. Figure 3 demonstrates that the percent change in total returns of these 200 companies from 2010 to 2011 significantly lags behind the incidence of CEO compensation. Figure 4 illustrates the wide divergence between the rate of CEO compensation increases and the rate of change in corporate returns. The data does not suggest that changes in public attitudes and public policy towards executive compensation have changed corporate behavior to any appreciable extent,

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[1] *See, e.g.,* Silver-Greenberg & Schwartz (2012) (reporting on shareholder's non-binding rejection of Citigroup CEO pay raise); Werdigier (2012a) (shareholder criticism of Barclays); Werdigier (2012b) (resignation of Aviva's CEO); Werdigier (2012c) (non-binding rejection of raise).

[2] *See* http://www.equilar.com/knowledge-network/research-articles/2011/201105-why-bonuses-wentup.php.

[3] For information on the latest survey, see http://www.financialexecutives. org. To obtain the survey, see http://www.ferf.org/bookstore. *See also* Hughes (2011) (reporting on survey).

[4] *See* Popper (2012) (reporting on the New York Times study).

[5] The 2011 pay of the Apple CEO is excluded from this portion of the analysis, since he was a new CEO at the company, following the death of Steve Jobs.

Conclusion

The fact that people can be grossly overreaching and insatiable – and that investors are saps enough to tolerate such behavior in the executive suite – are facts not worth wrangling over, at least not without first securing ample resources to fight fraud and manipulation in the markets and to supervise effectively the safety and soundness of the banking system. Discouraging predatory and conflicted behaviors on the part of executive management is better addressed by imposing significant tax disincentives on such behavior and by attacking fraud and manipulation, rather than "tsk-tsking" over levels of compensation.

Figure 1. *Total Executive Compensation (US$ millions) - 2011: CEOs of 200 Largest Registered Issuers*

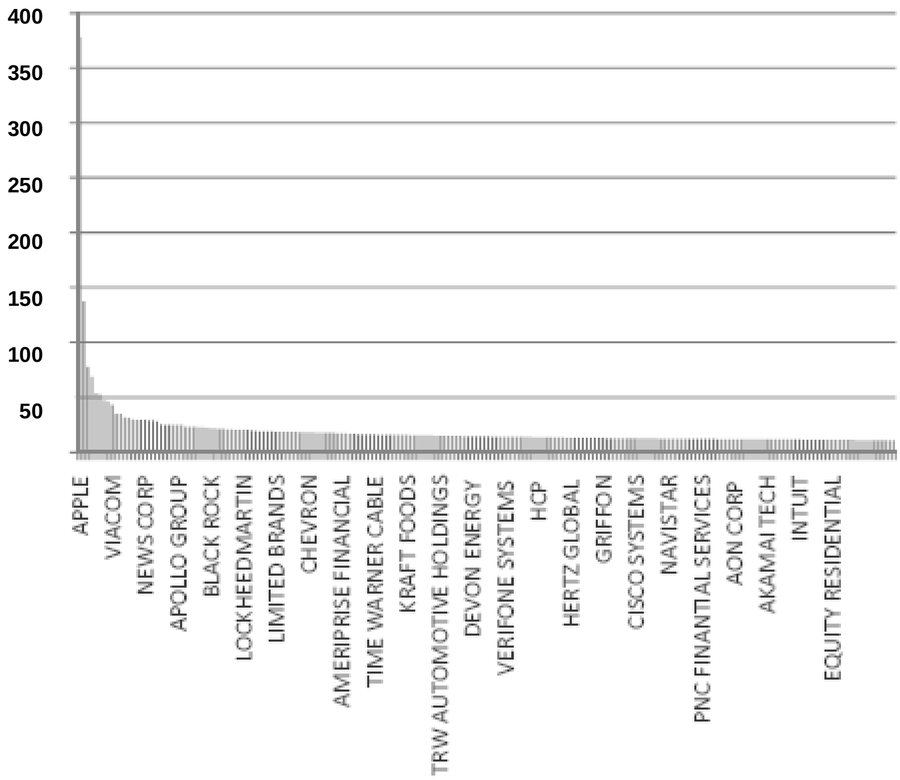


Figure 2. *Total Executive Compensation - 2011: Change from 2010 (± %)*

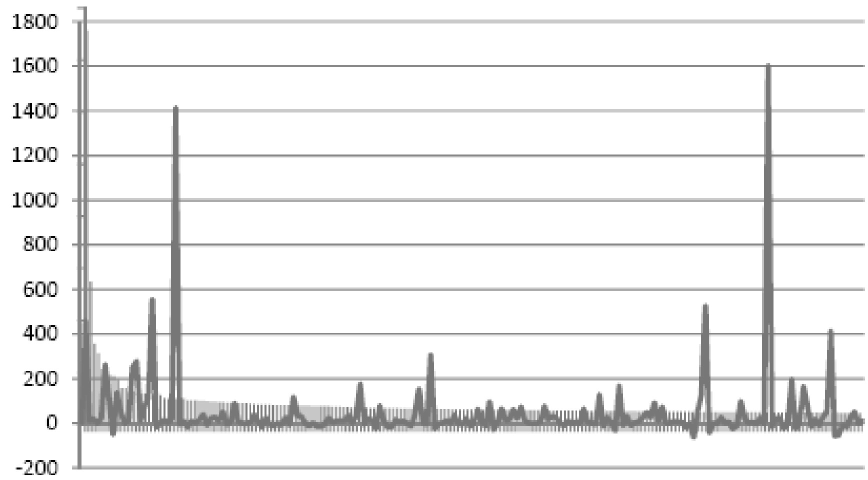


Figure 3. *200 Largest Registered Issuers: Change in Total Return 2010-2011 (± %)*

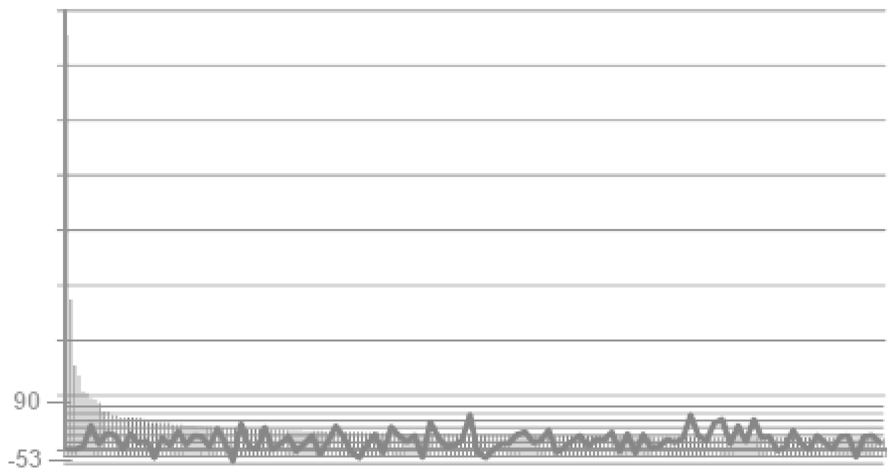
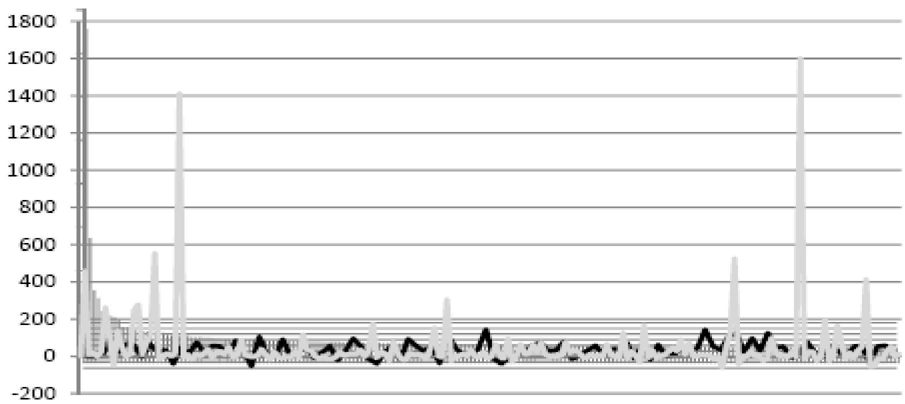


Figure 4. *Executive Compensation and Corporate Returns Change 2010-2011 (± %)*



Δ 2010-2011 Executive Compensation
Δ 2010-2011 Total Corporate Return

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