Executive Compensation: SEC Regulations and Congressional Proposals

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Summary

Concern about shareholder value, corporate governance, and the economic and social impact of escalating pay for corporate executives has led to a controversy regarding the practices of paying these executives. Proposals have been made in the current and recent Congresses to limit executive compensation and the amount of deferred compensation for tax purposes. In the 110th Congress, two laws containing executive compensation provisions were enacted: P.L. 110-289, the Housing and Economic Recovery Act of 2008, and P.L. 110-343, the Emergency Economic Stabilization Act of 2008. Bills have also been introduced in the 111th Congress concerning limiting executive compensation. In the 111th Congress, Title VII of P.L. 111-5, the American Recovery and Reinvestment Act of 2009 (ARRA), sets forth restrictions on the compensation of executives of companies during the period in which any obligation arising from financial assistance provided under the Troubled Assets Relief Program (TARP) remains outstanding. In July 2009 the House Committee on Financial Services circulated a discussion draft of H.R. 3269, the Corporate and Financial Institution Compensation Fairness Act of 2009. On July 31, 2009, the House passed an amended version of H.R. 3269, which is included as Title II of H.R. 4173, passed by the House on December 11, 2009. The Senate considered a proposal of a financial regulatory reform bill, of which Subtitle E of Title IX concerned executive compensation.

Both the House and the Senate passed bills with provisions applying to executive compensation. The House- and Senate-passed executive compensation provisions differed, in some cases significantly. The House and Senate conferees on Wall Street reform passed an executive compensation subtitle. On June 30, 2010, the House agreed to the conference report for H.R. 4173, now referred to as the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). The Senate agreed to the conference report on July 15, 2010. The President signed the bill into law as P.L. 111-203 on July 21, 2010.

In the 112th Congress, H.R. 3606, eventually a combination of several House bills, passed both the House and the Senate and is titled the Jumpstart Our Business Startups Act (JOBS Act). The bill has a provision which would exempt certain companies with annual gross revenues of less than $1 billion from complying with many of the executive compensation provisions of Dodd-Frank for up to five years. The President signed the bill on April 5, 2012.

On March 3, 2009, the United States Supreme Court granted certiorari in *Jones v. Harris Associates*, a case which challenged the fees charged by a mutual fund's investment advisers as excessive and a breach of fiduciary duty. Interest in this case from the executive compensation angle centered on the possibility that the decision might provide a hint as to what the Court could consider excessive executive compensation. On November 2, 2009, the Court heard oral argument in this case. On March 30, 2010, the Court held that, in order to be successful in holding that an adviser misled the fund's directors and thereby violated his fiduciary duty, investors must show that an investment adviser has charged a "fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining."

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Introduction

Concern about shareholder value, corporate governance, and the economic and social impact of escalating pay for corporate executives has led to a controversy regarding the practices of paying these executives. In a stated attempt "to provide investors with a clearer and more complete picture of compensation to principal executive officers, principal financial officers [and] the other highest paid executive officers and directors,"[1] the Securities and Exchange Commission (SEC or Commission) issued rules in 2006 concerning the disclosure of executive compensation. The rules, however, have created a controversy of their own. Separate from the SEC, Congress has also examined ways to address concerns relating to executive compensation.

SEC Regulations

On July 26, 2006, the SEC voted to adopt revisions to its rules concerning disclosure of executive compensation.[2] These compensation disclosure rules were particularly focused upon companies' providing investors with details about executives' stock-option grants and corporate stock-option programs. The rules required companies to prepare a principles-based Compensation Discussion and Analysis section in their proxy statements, annual reports, and registration statements.[3]

In these July 26 rules, the Commission required companies "to make tabular and narrative disclosure about all aspects of stock option grants and ... provid[e] additional guidance about the disclosure of company stock-option practices."[4] The tables would have to contain such information as the grant date fair value, the Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards Rule No. 123 (FAS 123R) grant date, the closing market price on the grant date if the closing market price is greater than the exercise price of the award, and the date on which the board of directors or the compensation committee took action to grant the award if the action date is different from the grant date.

On December 22, 2006, the Commission announced that it had adopted changes in its July 26 executive and director compensation disclosure rules "to more closely conform the reporting of stock and option awards to Financial Accounting Standards Board Statement of Financial Accounting Standards No. 123 (revised 2004) Share-Based Payment (FAS 123R)." The amendment was made in the form of interim final rules that would become effective upon publication in the Federal Register.[5] The Commission went on to state that

> FAS 123R requires recognition of the costs of equity awards over the period in which an employee is required to provide service in exchange for the award. Using this same approach in the executive compensation disclosure will give investors a better idea of the compensation earned by an executive or director during a particular reporting period, consistent with the principles underlying the financial disclosure statement.[6]

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[1] 71 Fed. Reg. 78,338, 78,339 (December 29, 2006).

[2] 71 Fed. Reg. 53,158 (September 8, 2006), amending 17 C.F.R. Parts 228, 229, 232, 239, 240, 245, 249, and 274.

[3] 71 Fed. Reg. 53,158, 53,164 (September 8, 2006).

[4] BNA, *Daily Report for Executives*, July 28, 2006, at G-7.

[5] The interim final rules were published in the December 29, 2006, Federal Register at 71 Fed. Reg. 78,338.

[6] *Id.*

The SEC briefly summarized some of the important provisions of the amendment as follows:

> The dollar values required to be reported in the Stock Awards and Option Awards columns of the Summary Compensation Table and the Director Compensation Table are revised to disclose the compensation cost of those awards, before reflecting forfeitures, over the requisite service period, as described in FAS 123R. Forfeitures are required to be described in accompanying footnotes.
>
> The Grants of Plan-Based Awards Table is revised to require disclosure of the grant date fair value of each individual equity award, computed in accordance with FAS 123R, and the Director Compensation Table required under Item 402 of Regulation S-K is revised to require footnote disclosure of the same information.
>
> The Grants of Plan-Based Awards Table is revised to require disclosure of any option or stock appreciation right that was re-priced or otherwise materially modified during the last completed fiscal year, including the incremental fair value, computed as of the re-pricing or modification date in accordance with FAS 123R, and the Director Compensation Table required under Item 402 of Regulation S-K is revised to require footnote disclosure of the same incremental fair value information.[7]

These December 22 amendments have resulted in criticism by some investor groups. Investor groups' criticism has focused on what they believe to be the obfuscation of executive pay packages. An example given is the following:

> Say the Chief executive of American Widget gets a $24 million option grant on December 1 of this year, with the options vesting—meaning they may be exercised—over four years. He is not eligible for retirement, perhaps because he joined the company only a few years ago, or perhaps because he has not reached the company's minimum retirement age of 60.
>
> In the summary table, the value of that option will be shown as $500,000. That is because he has worked just one month of the 48 months needed for the option to become fully exercisable.
>
> Over at National Widget, American's main competitor, the chief executive gets an inferior options package on the same day. It is worth $5 million, with the same four-year schedule. But that executive is eligible to retire, although he has no intention of doing so. The compensation summary will show he got a $5 million option.
>
> The reality is that one man received options worth nearly five times what the other one was awarded. The appearance is very different.[8]

On the other hand, some business groups claimed that the executive compensation disclosure requirements as originally proposed by the SEC needed to be revised because they did not provide a completely accurate picture of actual annual executive compensation.[9]

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[7] http://sec.gov/news/press/2006/2006-219.htm.

[8] Floyd Norris, "Does S.E.C. Know What It Is Doing?" *New York Times*, December 29, 2006, at C1.

[9] *See, e.g.*, comments submitted to the SEC by Steve Odland, Chairman and CEO, Office Depot, Inc., and Chairman, Corporate Governance Task Force, Business Roundtable, Washington, DC (April 10, 2006).

On December 16, 2009, the SEC adopted rule changes titled "Proxy Disclosure Enhancements."[10] The provisions addressing disclosures of executive compensation require a discussion of overall employee compensation policies and practices if risks arise that are reasonably likely to have a material adverse effect upon the company.

Congressional Proposals

Congressional proposals concerning executive compensation may be classified into two broad categories: additional disclosure of executive compensation to shareholders and limiting for tax purposes the amounts deferred under a nonqualified deferred compensation plan.

An example of additional disclosure is H.R. 4291, 109th Congress. This bill would have amended Section 16 of the Securities Exchange Act of 1934[11] to require that each reporting issuer must include in the annual report and in any proxy solicitation a comprehensive statement of the issuer's compensation plan for the principal executive officers, including any type of compensation, the short- and long-term performance measures that the issuer uses for determining compensation, and the policy of the issuer concerning other specified measures of compensation. The proxy solicitation materials would have been required to have a separate shareholder vote to approve the compensation plan. The bill would also have required the disclosure of golden parachute compensation in any proxy solicitation material concerning an acquisition, merger, consolidation, or proposed sale.

In the 110th Congress, H.R. 1257, the Shareholder Vote on Executive Compensation Act, referred to the House Committee on Financial Services, would have amended Section 14 of the Securities Exchange Act of 1934[12] to add a new subsection which would have required a separate, nonbinding shareholder vote in any proxy or consent or authorization for an annual meeting to approve the compensation of executives as disclosed in accordance with the SEC's compensation disclosure rules. Also in the 110th Congress there was a proposal which would have affected the tax consequences of executive compensation. Section 206 of S. 349 would have added an additional requirement to rules governing income inclusion of amounts deferred under a nonqualified deferred compensation plan.

Also in the 110th Congress, S. 2866 would have amended the Internal Revenue Code to place an annual limitation on aggregate amounts that could be deferred under nonqualified deferred compensation arrangements. It would have amended Section 304 of the Sarbanes-Oxley Act of 2002[13] to provide for a longer look-back period for reimbursement of compensation for misconduct by an executive to the issuer. It would have amended the Securities Exchange Act of 1934 to provide during an annual meeting for a nonbinding shareholder vote on executive compensation. It would have also amended the Federal Property and Administrative Services Act of 1949[14] to require federal contractors to disclose their executive compensation structures.

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[10] Available at http://www.sec.gov/rules/final/2009/33-9089.pdf.

[11] 15 U.S.C. §78n.

[12] 15 U.S.C. §78n.

[13] 15 U.S.C. §7243.

[14] 41 U.S.C. §§251 *et seq*.

In the 110th Congress, two laws containing executive compensation provisions applicable to executives of specific types of businesses were enacted: P.L. 110-289, the Housing and Economic Recovery Act of 2008, and P.L. 110-343, the Emergency Economic Stabilization Act of 2008.

Sections of P.L. 110-289 concern restrictions on compensation for executives of federal home loan banks, Fannie Mae, and Freddie Mac. Section 1117 allows the Secretary of the Treasury, in exercising temporary authority to purchase obligations issued by any federal home loan bank, Fannie Mae, and Freddie Mac, to consider limitations on the payment of executive compensation. Sections 1113 and 1114 allow the Director of the Federal Housing Finance Agency to prohibit and withhold executive compensation from executives of federal home loan banks, Fannie Mae, and Freddie Mac if wrongdoing has occurred. There is also authority for limiting golden parachute payments to these executives.

Section 302 of P.L. 110-343 prohibits the tax deduction of excessive employee remuneration. Section 111 of P.L. 110-343 allowed the Secretary of the Treasury to require that financial institutions whose troubled assets are purchased met appropriate standards for executive compensation. These standards were required to include limits on incentive-based compensation for unnecessary and excessive risks, recovery of bonuses and incentive compensation based on criteria later proven to be materially inaccurate, and a prohibition on golden parachutes.

Bills concerning executive compensation limits have been introduced in the 111th Congress. Among these bills are H.R. 851, which would require any institution provided with assistance under the Emergency Economic Stabilization Act of 2008 to meet standards for executive compensation and corporate governance, and H.R. 857 and S. 360, which would prohibit any officer or employee of an entity receiving funds under TARP from being compensated more than the President of the United States.

In the 111th Congress, Title VII of P.L. 111-5, the American Recovery and Reinvestment Act of 2009 (ARRA), amended Section 111 of P.L. 110-343 to set forth somewhat different and more detailed restrictions on the compensation of executives of companies during the period in which any obligation arising from financial assistance provided under the Troubled Assets Relief Program (TARP) remains outstanding. The Secretary of the Treasury is required to develop appropriate standards for executive compensation. The standards must include the following:

- Limits on compensation that exclude incentives for the five highest paid executives of the TARP recipient to take unnecessary and excessive risks.
- A provision for the recovery by the TARP recipient of any bonus, retention award, or incentive compensation paid to the five highest paid executives and the next 20 most highly compensated employees of the TARP recipient, based upon criteria that are later found to be materially inaccurate.
- A prohibition on the TARP recipient's making any golden parachute payment to the five highest paid executives or any of the next five highest paid employees of the TARP recipient.
- A prohibition on a TARP recipient's paying a bonus, retention award, or incentive compensation, except that the prohibition shall not apply to paying long-term restricted stock, so long as this stock does not fully vest during the period in which the TARP recipient has outstanding financial assistance, has a value not greater than one-third of the total amount of the annual compensation of the employee receiving the stock, and is subject to other conditions that the Secretary

of the Treasury may determine to be in the public interest. The prohibition is not to be construed to apply to a bonus payment required to be paid according to a written employment contract executed on or before February 11, 2009. The prohibition applies to the highest paid person of a financial institution receiving $25 million or less in financial assistance, to at least the five highest paid employees of a financial institution receiving between $25 million and $250 million in financial assistance, to the five highest paid executive officers and at least the next 10 highest paid employees of a financial institution receiving between $250 million and $500 million, and for a financial institution receiving financial assistance of $500 million or more to the five highest paid officers and at least the next 20 highest paid employees.

- A prohibition on any compensation plan encouraging manipulation of the reported earnings of a TARP recipient to enhance the compensation of any of its employees.
- A requirement for the establishment of a Board Compensation Committee.

The chief executive officer and the chief financial officer of each TARP recipient must certify that the TARP recipient has complied with the standards issued by the Secretary of the Treasury and file the certification with the SEC if the company's securities are publicly traded or with the Secretary of the Treasury if the company's securities are not publicly traded.

The Board Compensation Committee which each TARP recipient is required to establish must be made up of independent directors and must review employee compensation plans. The Board must meet at least semiannually to discuss and evaluate employee compensation plans. If the TARP recipient's stock is not registered with the SEC and it has received $25 million or less of TARP assistance, the Board Compensation Committee's duties shall be performed by the recipient's board of directors.

The board of directors of each TARP recipient must have a policy concerning excessive or luxury expenses, including entertainment, office renovations, transportation services, and other unreasonable expenditures.

Any annual or other meeting of the shareholders of a TARP recipient must permit a separate shareholder vote to approve the compensation of executives. The vote shall be nonbinding and cannot be construed to overrule a decision by the board of directors.

The Secretary of the Treasury is required to review bonuses, retention awards, and other compensation paid to the five highest paid executives and the next 20 highest paid employees of each company that received TARP assistance before February 17, 2009 (the act's date of enactment), to determine whether any payments were inconsistent with the purposes of TARP or contrary to the public interest. Payments determined to be excessive shall be reimbursed to the federal government.

In consultation with the appropriate federal banking agency, the Secretary of the Treasury shall permit a TARP recipient to repay any assistance provided to the financial institution, without regard to whether the financial institution has replaced the funds from any other source or to any waiting period. When the assistance is repaid, the Secretary of the Treasury shall liquidate warrants associated with the assistance at the current market price.

On June 10, 2009, the Treasury Department issued a rule concerning executive compensation for firms that have received assistance under TARP.[15] Bonuses and golden parachute payments are limited to executives of all entities which have received bailout funds, not just to financial firms. Along with the rule, Treasury has appointed a special master responsible for reviewing any compensation paid to top executives and highly paid employees of companies which have received exceptional assistance from the federal government.

On June 9, 2009, Treasury and the SEC issued two broad proposals that would provide the SEC with more authority over executive compensation at all publicly traded companies.[16] These proposals would give to the SEC the authority to require nonbinding shareholder votes on executive compensation and authority to ensure that corporate compensation committees are more independent.

With the acknowledgment by AIG of the payment of bonuses to a number of its employees, bills have been introduced to recover at least some of the bonuses paid. These bills would use different ways in recovering the bonuses. For example, H.R. 1575 would authorize the Attorney General to recover excessive compensation paid by entities which have received federal financial assistance on or after September 1, 2008. Other bills would impose a high rate of taxation upon the bonuses paid. For example, H.R. 1586, passed by the House, would impose a 90% tax on many bonuses paid by businesses receiving TARP assistance. S. 651 would impose an excise tax on some bonuses paid by companies receiving federal emergency economic assistance and would limit nonqualified deferred compensation that employees of companies receiving federal emergency economic assistance may defer from taxation. H.R. 1664, passed by the House, would amend the Emergency Economic Stabilization Act of 2008 to prohibit unreasonable and excessive compensation and compensation not based on performance standards paid by companies receiving direct capital investments of taxpayer money.

Bills introduced in the 111th Congress more generally on executive compensation include S. 1074, which would apply a say-on-pay rule to all publicly traded companies, and S. 1006, which would require 60% of shareholders to give their approval to pay packages larger than 100 times the average annual compensation of a company's employees.

The House Committee on Financial Services circulated a discussion draft of H.R. 3269, the Corporate and Financial Institution Compensation Fairness Act of 2009.[17] The draft had four major parts: Say-on-Pay, Independent Compensation Committee, Incentive Based Compensation Disclosure, and Compensation Standards for Financial Institutions. On July 31, 2009, the House passed an amended version of the bill. The bill is included as Title II of H.R. 4173, passed by the House on December 11, 2009.

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[15] Available at http://www.treas.gov/press/releases/reports/ec%20ifr%20fr%20web%206.9.09tg164.pdf. See also 31 C.F.R. §30.16.

[16] Available at http://www.treas.gov/press/releases/reports/fact_sheet_say%20on%20pay.pdf and http://www.treas.gov/press/releases/reports/fact_sheet_indepcompcmte.pdf.

[17] Available at http://www.house.gov/apps/list/press/financialsvcs_dem/pressd_071709.shtml.

Section 2002 of the House-passed bill, concerning shareholder votes on executive compensation disclosures, would amend Section 14 of the Securities Exchange Act[18] by adding subsection (i), which would require every annual shareholder meeting to have a separate shareholder vote to approve the compensation of executives. The shareholder vote would not be binding and could not be construed as overruling a decision made by the board of directors. In addition, any proxy or consent solicitation material in which shareholders are asked to approve an acquisition, merger, consolidation, or proposed sale of an issuer would have to disclose any agreements or understandings that executive officers have concerning compensation based upon the acquisition, merger, consolidation, or sale of the issuer, so-called golden parachute agreements. There would have to be a nonbinding shareholder vote on this compensation. Every institutional investment manager would be required to disclose how it voted on executive compensation and golden parachutes. The SEC could exempt certain categories of issuers from the shareholder vote requirements and, in determining these exemptions, would need to take into account the potential impact upon smaller companies.

Section 2003 of the House-passed bill would require that every national securities exchange or association prohibit the listing of equity securities of an issuer not having a compensation committee of the board of directors. Every member of the compensation committee would have to be independent, meaning that he or she could not accept any consulting, advisory, or other compensatory fee from the issuer. A compensation committee would have the authority to retain a compensation consultant and independent counsel. A compensation consultant or other adviser to an issuer's compensation committee would have to meet the independence standards established by the SEC by regulation.

Section 2004 of the House-passed bill would require federal regulators to issue regulations requiring covered financial institutions to disclose the structures of all incentive-based compensation arrangements offered by the institutions so as to determine whether the structures are aligned with sound risk management, structured to consider risks over time, and meet other criteria to reduce unreasonable incentives offered to employees to take excessive risks that could threaten the safety and soundness of financial institutions or could have adverse effects upon economic conditions or financial stability. The federal regulators covered are the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Board of Directors of the Federal Deposit Insurance Corporation, the Director of the Office of Thrift Supervision, the National Credit Union Administration Board, the Securities and Exchange Commission, and the Federal Housing Finance Agency. Covered financial institutions are a depository institution or depository institution holding company, a broker-dealer, a credit union, an investment adviser, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and any other financial institution that the federal regulators determine should be treated as a covered financial institution. The Comptroller General would be required to carry out a study to determine whether there is a connection between compensation structures and excessive risk taking.

Subtitle E of Title IX of the Chairman's Mark on financial regulatory reform of the Senate Committee on Banking, Housing, and Urban Affairs concerns executive compensation. The proposal requires that, in a proxy for a shareholder meeting, there be a separate resolution to approve executive compensation. The vote shall not be binding and may not be construed as overruling a decision by the board of directors. The proposal requires that the SEC prohibit the

[18] 15 U.S.C. §78n.

listing of any security of an issuer that does not comply with the rules of the SEC concerning an issuer's compensation committee. The proposal's provision on executive compensation disclosures mandates the SEC to require by rule that each issuer disclose in the annual proxy statement a clear description of disclosed compensation, including information showing the relationship between executive compensation and the financial performance of the issuer. In the event of an accounting restatement due to material noncompliance of the issuer with financial reporting requirements, the issuer will recover incentive-based compensation. The proposal requires each issuer to disclose in the annual proxy statement whether employees are allowed to purchase hedging instruments related to equity securities granted to employees as part of employee compensation. With respect to compensation standards for holding companies of depository institutions, there are prohibitions on excessive compensation and compensation that could lead to material financial loss.

As part of their financial regulatory reform legislation, both the House and the Senate passed bills with provisions applying to executive compensation. The House- and Senate-passed executive compensation provisions differed, in some cases significantly.

The House and Senate conferees on Wall Street reform passed an executive compensation subtitle. On June 30, 2010, the House agreed to the conference report for H.R. 4173, now referred to as the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).[19] The Senate agreed to the conference report on July 15, 2010. The President signed the bill into law as P.L. 111-203 on July 21, 2010.

In the 112th Congress, H.R. 3606, eventually a combination of several House bills, passed both the House and the Senate and is titled the Jumpstart Our Business Startups Act (JOBS Act). The bill's Section 102(a) exempts for up to five years certain companies with annual gross revenues of less than $1 billion, called emerging growth companies, from complying with the requirement of Dodd-Frank concerning the nonbinding shareholder vote on the approval of executive compensation. The President signed the bill on April 5, 2012.

Jones v. Harris Associates

On March 3, 2009, the United States Supreme Court granted certiorari in *Jones v. Harris Associates*.[20] In this case shareholders in a mutual fund brought suit against a fund's investment advisers for charging excessive fees in violation of Section 36(b) of the Investment Company Act of 1940.[21] This provision in part states that an investment adviser of a registered investment company has a fiduciary relationship concerning compensation for services and that fund shareholders can bring a claim for breach of that fiduciary duty. The lower court decision[22] stated that "[s]ection 36(b) does not say that fees must be 'reasonable' in relation to a judicially created standard. It says instead that the adviser has a fiduciary duty."[23] The lower court held that the fees in this instance were not excessive because they were roughly in line with fees that other funds of

[19] For additional information on the executive compensation provisions in Dodd-Frank, see CRS Report R41319, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Executive Compensation*, by (name redacted).

[20] No. 08-586.

[21] 15 U.S.C. §80a-35(b).

[22] 527 F.3d 627 (7th Cir. 2008).

[23] *Id.* at 632.

similar size and investment goals paid their advisers and because the shareholders could not show that the adviser misled the fund's directors. The question before the Supreme Court is whether the lower court erred in holding that a shareholder's claim of excessive fees under Section 36(b) cannot be recognized unless the shareholder can show that the adviser misled the fund's directors. Interest in this case from the executive compensation angle centers on the possibility that the decision may provide a hint as to what the Court could consider excessive executive compensation if it has before it a case concerning, for example, government actions limiting executive compensation. On November 2, 2009, the Court heard oral argument in this case. On March 30, 2010, the Court held that, in order to be successful in holding that an adviser misled the fund's directors and thereby violated his fiduciary duty, investors must show that an investment adviser has charged a "fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining."[24]

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[24] *Jones v. Harris Associates*, No. 08-586, slip op. at 9 (USSC March 30, 2010).