

DM EXTRA!

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New Executive Compensation Disclosure Rules in 2006?

Boards with sound pay practices are already prepared.

Director
Summary >

On January 2, 2006, when the 109th Congress begins its second legislative session, legislators will address the controversial topic of executive compensation, responding to a bill proposed by **Rep. Barney Frank** (D-MA). And whether or not Congress passes any legislation, the **Securities and Exchange Commission** (SEC) will undoubtedly also consider action on this front under new chairman **Christopher Cox**. What can corporate directors expect in 2006, and how can they prepare for it? **This DMX describes the Frank bill, assesses its chances for passage next year, and suggests what boards can do about executive compensation now.**

The Frank Bill

In 2006, Congressman Frank will be seeking passage of the Protection Against Executive Compensation Abuse Act (H.R.4291: "to amend the Securities Exchange Act of 1934 to require additional disclosure to shareholders of executive compensation"). Introduced on November 10, this bill is currently with the House Committee on Financial Services, which must approve it before it goes to the floor of Congress for a vote. Many bills do languish in committee indefinitely (such as the bill on federal employee pay that Rep. Frank introduced last February, still with the Committee on Government Reform), but this bill may move quickly.

About NACD

National Association of Corporate Directors (NACD), an independent not-for-profit organization founded in 1977, is the country's only membership organization devoted exclusively to improving corporate board performance. The NACD conducts educational programs and standard-setting research, and provides information and guidance on a variety of board governance issues and practices. Membership comprises board members from U.S. and overseas companies ranging from large publicly held corporations to small over-the-counter, closely held, and private firms. NACD lists all interested members on The Director's Registry, which is used by member companies and others that seek qualified directors. With chapters in many major cities providing educational programs and networking opportunities, NACD operates at both a national and local level. To educate the corporate community and to provide networking links among NACD members, the NACD holds an annual Corporate Governance Conference, where it presents a Director of the Year Award.



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Fortunately, the main provisions of the Frank bill are *already in effect* for most companies under existing regulations or commonly accepted best practices.

— Plan Disclosure

The bill would require a company's annual report and proxy statement to provide a "comprehensive statement of the issuer's compensation plan¹ for principal executive officers,² including any type of compensation (whether present, deferred, or contingent) paid or to be paid to such principal executive officers, including—

- An estimate of the present value of any accrued pension of such officers,
- The estimated market value of any other benefits received by such officers,
- Any agreements or understandings concerning any type of compensation,
- The short- and long-term performance measures that the issuer uses for determining the compensation of such principal executive officers and whether such measures were met by such officers during the preceding year, and
- The policy of the issuer adopted pursuant to the rules promulgated under [this section].

Recognizing the utility of the Internet, the bill would require that companies make clear and simple disclosures about their compensation filings on their websites.

— Plan Approval

The Frank bill would also require public companies to obtain *shareholder approval* for the company's plan as described here. A separate section of the bill requires shareholder approval of pay plans developed in the context of a change of control ("golden parachute" plans).

— Gains Disgorgement

Finally, the Frank bill would require disclosure of a *company policy for recapturing any form of incentive compensation* that subsequent financial results show are unjustified, such as when the company pays bonuses or grants stock options to executives for meeting performance targets, and later learns that these numbers were inaccurate and must be restated.

Close Precedents

In a general sense, these requirements are already a fact of life for many public companies.

As for *plan disclosure*, ever since the well-known Section 162(m) entered the tax code in 1993, companies have been unable to deduct executive compensation for over \$1 million without obtaining shareholder approval. Specifically, Section 162(m) provides that compensation paid to certain officers in excess of \$1,000,000 cannot be deducted by the company for federal income tax purposes unless, in general, (1) compensation is performance-based, established by a committee of outside directors and objective, and (2) the plan or agreement providing for such performance-based compensation has been approved in advance by stockholders. Some performance plans already include the level of detail mandated in the Frank bill, and such details seem appropriate. Exhaustive disclosure was a key recommendation of the December **2003 NACD Blue Ribbon Commission** report on executive compensation, described further below. The report was purchased by more than 2,200 directors and board advisors since its release, and distributed in dozens of NACD in-boardroom programs in leading companies.

As for *plan approval*, as mentioned, Section 162(m) includes a shareholder approval feature. Furthermore, shareholder approval is already mandated for equity-based plans of companies listed on the New York Stock Exchange and NASDAQ Stock Market (since June 30, 2003).³ (It is unclear from the language of the bill whether cash bonus plans that supplement the company's incentive plan, following a general policy stated in the plan, would require additional approval. This would be something for the SEC rulemakers to decide after public comment.)

Finally, as for *return of compensation*, there is a regulatory precedent—namely Section 304 of Sarbanes-Oxley. This section requires the CEO and CFO of a company to disgorge their bonuses and other incentive compensation where (1) the company must prepare an accounting restatement due to material noncompliance with any financial reporting requirement under the securities laws, and (2) the noncompliance results from misconduct, which requires such disgorgement following a discovery that financial statements were fraudulent. It is possible, pending SEC interpretations, that a company could comply with this proposed provision by stating that it conforms to Section 304 of Sarbanes-Oxley, but does not recapture compensation following discrepancies where the compensated officers acted without fraudulent intent (or similar language to be approved by counsel).

Will This Bill Pass?

Although passage of the bill appears to be unlikely at this time (it still has only five cosponsors according to Rep. Frank's website), speedy action is possible. Given the controversial nature of executive pay, this bill could go onto the floor for debate in early 2006—and could even lead to Congressional action in the event of scandal. If one or more major corporations declare an unexpected bankruptcy following optimistic financial forecasts and high CEO pay, we could see a sequel to Sarbanes-Oxley, signed into law July 2002. That bill took less than seven months to move from inception to signing, motivated and propelled by the bankruptcies of Enron (December 2001) and WorldCom (May 2002). Indeed, the legacy of those two scandals factors in here, because in both cases executives received high pay that contributed to public outrage.

In October 2003, following his June appointment as the head of the Public Accounting Oversight Board (a legacy of Sarbanes-Oxley), **William McDonough** issued a warning to directors on the subject of executive compensation:

The American people are sufficiently angry that if the private sector doesn't get its act together, reasonably soon, and at a considerably faster pace than is noticeable to date, you're going to get Sarbanes-Oxley number 2, number 3, number 4, and it will curl your hair. I have been asked by many members of Congress if I could figure out a way that they could pass a law controlling compensation. Can you imagine that? When you consider that each and every company really is unique—in the true meaning of what the word unique is, to only one of them—you couldn't pass a law to save your soul to control compensation. But that does not mean that one won't get passed if the American people stay angry enough. And there has not been a whole noticeable amount of restraint on the part of corporate executives or their boards in this matter. Some, but it sure isn't very widespread.⁴

If the Frank bill passes, the SEC will be in charge of applying it, with the help of its primary standard-setter, the **Financial Accounting Standards Board** (FASB). Although the SEC and the FASB can move slowly on some issues, such as accounting for options as an expense (a concept that took a decade to move from conception to implementation), the two can also move rapidly. Again, the experience of Sarbanes-Oxley is instructive. That law gave the SEC 50 rulemaking assignments, but the SEC completed all its work less than 18 months, following intensive public comment on each of its proposed rules.

Shortly after being appointed to head the SEC, Chairman Cox predicted SEC action on compensation disclosure:

Executive compensation is much in the news and there have been some very notorious cases of apparent excess. It should be, of course, in the main up to shareholders to discipline that kind of activity, but in order for shareholders to do that, they've got to have good information. I think you can look in the near future to the SEC for some *improved rules on disclosure* to make sure that, for example, shareholders can have one number, that the different kinds of executive compensation add up to a number that's comparable executive to executive and company to company and at the same time that this information is provided in a timely way before rather than after the fact. (Emphasis added.)⁵

The Importance of Good Shareholder Relations

The Frank bill has already attracted attention from shareholder activists such as **Nell Minow**, the editor of *The Corporate Library*, who recently sent legislators a message of support (posted on the website of the House Financial Services Committee http://www.house.gov/banking_democrats/ExecutiveCompensation.html):

The Corporate Library's new survey on CEO compensation found that the median year-on-year increase in CEO compensation doubled from 15.04 percent in last year's survey of proxy filings to over 30 percent in this year's survey. The average increase in this year's survey was 91 percent, driven by 27 CEOs receiving compensation over 1,000 percent greater than their previous year's pay. ... These pay packages are a failure of capitalism and the free market, and I applaud Congressman Frank's proposal to give the power back to the people who provide the capital by improving disclosure and giving them a chance to reject proposals that undermine the company's sustainability.

Nell Minow's findings and opinions are not isolated ones. Other studies indicate that senior executive pay (at least CEO pay) is continuing to rise relative to other pay. A recent study by two advocacy groups found that the 2004 ratio of average chief executive pay to worker pay was 431 to 1, up from 301 to 1 the previous year. The groups, **United for a Fair Economy** and the **Institute for Policy Studies**, noted that average chief executive pay at the nation's largest companies last year was \$11.8 million.⁶

In addition to the gap between CEO pay and worker pay, there may be a gap between director attitude and

investor attitude. Preliminary findings from a survey from **Watson-Wyatt** suggests that there is now as “large a gap as I have seen between what institutional investors and boards think about executive compensation,” according to Watson-Wyatt partner **Ira Kay**. “Boards think they are doing a good, shareholder-friendly job; institutional investors do not.”⁷

What Boards Can Do Now

The primary problem directors face is the one they have in their own boardrooms. Are directors really paying attention to executive compensation? This question is urgent.

To be sure, it is not easy to attract and keep top talent for major public companies, and boards have made great progress in linking pay to compensation. Use of stock options has subsided, and use of performance-based equity grants is increasing. But progress has been slow. Despite all attempts by boards to link pay to performance by using predetermined, quantifiable performance objectives, and to stick to them rigorously, the improvements have been slow.

“It took many years and a number of influences to create the situation, and it will take years to get it back into balance,” says NACD Chairman **B. Kenneth West**. In 2001, before excessive executive compensation became a public issue, he warned in a *Directors Monthly* article, “Despite its beneficial impact, equity can be a double-edged sword, leading to overpayment in times of market exuberance and underpayment in times of market retreat. Directors can take certain steps and institute appropriate policies to avoid these outcomes.” <http://www.nacdonline.org/publications/dmDetails2.asp?dmID=333>

Boards can begin by making sure they have best practices for compensation—expressed in the NACD’s Blue Ribbon Commission report on executive compensation, which expressed five principles:

- Independence
- Fairness
- Long-Term Shareholder Value
- Link to Performance
- Transparency

For the full report, see <http://nacdonline.org/publications/pubDetails.asp?pubID=223>. For the executive summary, see <http://www.nacdonline.org/publications/dmDetails2.asp?dmID=38> See also, *Delaware Discourses, Volume 1: Executive Compensation*. <http://nacdonline.org/publications/pubDetails.asp?pubID=230>. Note: The SEC has voted to propose rules that would allow companies to send annual reports and proxy statements via the Internet (<http://sec.gov/news/press/2005-166.htm>).

Conclusion

“The question of executive compensation transcends pay. It is a matter of maintaining the trust of the public,” says **Roger W. Raber**, CEO and President of NACD. He continued:

At our Annual Conference of 2005, we heard strong admonitions from many influential voices, including those who have decided many of the nation’s leading legal cases: Chancellor **William Chandler** of the **Delaware Chancery Court**, and **E. Norman Veasey**, former Chief Justice of the **Delaware Supreme Court**. They spoke out on executive compensation, as did **William McDonough**, returning to our Annual Conference following his first two successful years overseeing public company auditing. They all said, in effect, ‘If corporate boards do not correct the abuses of executive pay, the regulators will.’ How sad would that be? Until boards have the courage to say no to rewarding CEOs with excessive compensation or for non-performance, we will never be able to restore the public’s trust in corporate boards. Frankly, it is going to take the leadership of the CEOs of the largest firms to say ‘no,’ and as corporate directors we must hold fast to this goal. We will not tolerate corporate greed.

Endnotes

- 1 The bill uses “plan” in the singular. It is unclear how it would apply to companies that have multiple plans—for example a long-term incentive plan and an annual cash bonus plan.
- 2 The term ‘principal executive officer’ means CEOs for all companies. For companies with revenues of more than \$250 million but less than \$500 million, it means the two most highly paid officers; and for companies that make more than \$500 million, it means the four most highly paid officers.
- 3 For a free report on the “equity stake” held by executives of major companies, go to <http://www.pearlmeyster.com/reseq.html>.
- 4 Source: William McDonough, “Restoring Public Trust in Corporate Accounting and Corporate America.” Address to the 2003 NACD Annual Corporate Governance Conference, Oct. 20, 2003.
- 5 August 10, 2005, Nightly Business Reports, Public Broadcasting System.
- 6 http://www.faireconomy.org/press/2005/EE2005_pr.html.
- 7 The source of the Ira Kay quote is “Too Many Turkeys,” *The Economist*, November 24, 2005. For a *Framework and Tools for Improvement of Board-Shareowner Relations: A report from the Council of Institutional Investors and the National Association of Corporate Directors*, see http://www.cii.org/library/publications/nacd_cii_taskforce.htm, or <http://www.nacdonline.org/images/White-CIITaskForce-2004-2-26-04.pdf>.