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*Executive Compensation: SEC Regulations and
Congressional Proposals*

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December 8, 2008

Abstract. 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. On July 26, 2006, the Securities and Exchange Commission voted to adopt revisions to its rules on disclosure of executive compensation. On December 22, 2006, the SEC announced that it had adopted changes in the July 26 rules. These December 22 changes have become somewhat controversial, with opponents saying that they obfuscate executive compensation and with proponents saying that the changes are necessary to give a truly accurate picture of executive compensation. Congressional proposals have been made concerning stockholder advisory approval of executive compensation and limiting the amount of deferred compensation for tax purposes. One of the major proposals in the 110th Congress is H.R. 1257. On March 28, 2007, the House Financial Services Committee voted to report out H.R. 1257, which would require public companies to give their shareholders an advisory vote on executive compensation. On April 20, 2007, the House passed H.R. 1257. On April 20, 2007, S. 1181, which is very similar to H.R. 1257, was introduced and referred to the Senate Committee on Banking, Housing, and Urban Affairs. On April 15, 2008, S. 2866, the Corporate Executive Compensation Accountability and Transparency Act, was introduced and referred to the Committee on Finance. 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.

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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. On July 26, 2006, the Securities and Exchange Commission voted to adopt revisions to its rules on disclosure of executive compensation. On December 22, 2006, the SEC announced that it had adopted changes in the July 26 rules. These December 22 changes have become somewhat controversial, with opponents saying that they obfuscate executive compensation and with proponents saying that the changes are necessary to give a truly accurate picture of executive compensation. Congressional proposals have been made concerning stockholder advisory approval of executive compensation and limiting the amount of deferred compensation for tax purposes. One of the major proposals in the 110th Congress is H.R. 1257. On March 28, 2007, the House Financial Services Committee voted to report out H.R. 1257, which would require public companies to give their shareholders an advisory vote on executive compensation. On April 20, 2007, the House passed H.R. 1257. On April 20, 2007, S. 1181, which is very similar to H.R. 1257, was introduced and referred to the Senate Committee on Banking, Housing, and Urban Affairs. On April 15, 2008, S. 2866, the Corporate Executive Compensation Accountability and Transparency Act, was introduced and referred to the Committee on Finance. 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. This report will be updated as warranted.

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) has recently issued rules concerning the disclosure of executive compensation. The rules, however, have created a controversy of their own.

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

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.

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 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

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 1934¹⁰ 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

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).

¹⁰ 15 U.S.C. § 78n.

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 amend section 14 of the Securities Exchange Act of 1934¹¹ to add a new subsection which would require a separate 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. The shareholder vote would not be binding on the board of directors and could not be construed as overruling a decision by the board. The bill would also require the disclosure of golden parachute compensation in any proxy solicitation material concerning an acquisition, merger, consolidation, sale, or other disposition. Hearings were held on H.R. 1257 on March 8, 2007. The House Financial Services Committee voted on March 28, 2007, to report out the bill, and the committee issued H.Rept. 110-88. On April 20, 2007 the House passed H.R. 1257. On April 23, 2007, the bill was received in the Senate and referred to the Senate Committee on Banking, Housing, and Urban Affairs. Also in the 110th Congress there is a proposal which would affect the tax consequences of executive compensation. Section 206 of S. 349, the Small Business and Work Opportunity Act of 2007, reported to the Senate and accompanied by Report 110-1 on January 22, 2007, would add an additional requirement to rules governing income inclusion of amounts deferred under a nonqualified deferred compensation plan. Under this proposal, an executive who receives deferrable income such as stock options could not in many cases defer from includible gross income an amount more than the lesser of \$1,000,000 or the individual's annualized includible compensation. Another bill, S. 1181, was introduced on April 20, 2007, and referred to the Senate Committee on Banking, Housing, and Urban Affairs. It is very similar to H.R. 1257.

Also in the 110th Congress, S. 2866, the Corporate Executive Compensation Accountability and Transparency Act, was introduced on April 15, 2008, and referred to the Committee on Finance. This bill would amend the Internal Revenue Code to place an annual limitation on aggregate amounts that may be deferred under nonqualified deferred compensation arrangements. It would amend section 304 of the Sarbanes-Oxley Act of 2002¹² to provide for a longer look-back period for reimbursement of compensation for misconduct by an executive to the issuer. It would amend the Securities Exchange Act of 1934 to provide during an annual meeting for a nonbinding shareholder vote on executive compensation. It would also amend the Federal Property and Administrative Services Act of 1949¹³ to require federal contractors to disclose their executive compensation structures.

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.

¹¹ 15 U.S.C. § 78n.

¹² 15 U.S.C. § 7243.

¹³ 41 U.S.C. §§ 251 *et seq.*

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 allows the Secretary of the Treasury to require that financial institutions whose troubled assets are purchased meet appropriate standards for executive compensation. These standards are 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.

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