Testimony Concerning the Oversight and Regulation of Executive Compensation

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Before the United States House of Representatives Committee on Financial Services

June 11, 2009

Introduction

Good morning Chairman Frank, Ranking Member Bachus, and members of the Committee. As a Deputy Director of the Securities and Exchange Commission's Division of Corporation Finance, I am pleased to be with you today to testify on behalf of the Commission so that I may share with you our thoughts on the topic of executive compensation.

I appreciate the opportunity to discuss with you the Commission's ongoing efforts in this area. As the landscape of compensation practices continues to change, the Commission is committed to keeping the disclosure rules we administer up to date so that investors have the information they need to make informed investment and voting decisions.

Background

As you know, in recent years the issue of executive compensation has garnered significant public attention. There are numerous news stories about executives who have been enriched while the value of their companies has declined precipitously. As these revelations about executive compensation come to light, claims have been made that bonuses and severance packages at some companies have been exorbitant. Executive compensation has been a lightning rod, amplified by the recent financial crisis, for concerns about the accountability and responsiveness of some boards of directors to the interests of their shareholders. These concerns have included whether boards are exercising appropriate oversight of management; whether boards are appropriately focused on shareholder interests; and whether boards need to be held more accountable for their decisions, particularly regarding such issues as compensation structure and risk management. Although these concerns have not been raised with regard to all public companies and the conduct of certain headline-grabbing companies should not be used to unfairly brand the actions of all boards or all board members, questions exist regarding the executive compensation market itself. For example, some have noted that compensation consultant recommendations are made by firms that may have conflicts of interest[1] and others have noted that compensation at one company may tend to inflate compensation at others because compensation is sometimes set by reference to comparable packages, creating a positive feedback loop.[2]

In order for public markets to function properly, it is crucial that shareholders – the owners of the company – be able to make informed decisions about their investments and boards of directors be accountable to shareholders for their decisions. This system is frustrated if shareholders are not provided with adequate information about their companies, including the compensation paid to management, or if they are unable to exercise effectively their rights to elect directors that they believe will best promote the

1 See, for example, Comment Letter of James F. Reda on SEC File No. S7-03-06 (Proposed Rules on Executive Compensation and Related Party Disclosure), Apr. 6, 2006.

interests of shareholders. Disclosure in these areas also provides shareholders with information that is helpful when they choose to exercise their rights under state law because they believe that directors may have breached their fiduciary duties.

Executive Compensation Rules

Consistent with this approach, the Commission's rules governing the disclosure of executive compensation are designed to elicit comprehensive and detailed information about all elements of a company's compensation practices and procedures with respect to senior executives. The Commission's focus is on requiring companies to provide high quality, material and understandable information to investors. We believe that the information about executive compensation in disclosure documents must be straightforward and meaningful so that investors can properly assess the information. Armed with that information, investors can better judge whether the board of directors has acted appropriately in allocating assets for compensation and setting incentives and rewards for management. In keeping with this agency's mission, the design and purpose of the rules are to protect and advance the interests of shareholders. We seek to help shareholders receive the information they need to make informed voting and investment decisions.

Complementing the mandated disclosure of executive compensation, the Commission's proxy rules also provide shareholders with a mechanism to voice their views on compensation. Under the Commission's shareholder proposal rule, a shareholder can have a properly-structured proposal – for example, a proposal for "say on

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[2] See Viral V. Acharya and Paolo F. Volpin, Corporate Governance Externalities (2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1140556.

pay" – included in the company's proxy materials. Indeed, during the most recent proxy season, approximately 125 shareholder proposals relating to executive compensation were included in the proxy statements of U.S. public companies.[3]

Notwithstanding the Commission's current rules, we recognize that there is an ongoing, vigorous debate between those who believe that there should be more substantive constraints on pay and those who believe that the federal government should never, or rarely, set pay parameters. It is important to note, however, that this debate is significantly more meaningful as a result of our disclosure rules. Without the Commission's rules, compensation information, which is the basis for the debate, would not be publicly available and the compensation practices that have been so controversial may never have come to light.

Consistent with the model developed by Congress in the securities laws, the Commission has mandated disclosure of compensation throughout its long history. Indeed, the Commission has had a form of compensation disclosure rules since the very early days of the agency in the late 1930s.[4] However, the challenge the Commission has always faced in promulgating and administering its executive compensation disclosure rules is that compensation practices are never static. Over the years, the manner and types of compensation have continually evolved and become increasingly complex. As a

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[3] Based on information publicly available from RiskMetrics Group, these proposals have received on average 42.7 percent support at meetings for which voting results are available, with at least 16 say-on-pay proposals receiving majority support.

[4] In 1938, the Commission adopted Regulation X-14, the predecessor of current Schedule 14A, which set forth specific disclosure requirements for proxy statements. Item 7(b) of these regulations required specified disclosure of compensation received by nominees if action was to be taken for director elections or other officials. For more information, see Securities and Exchange Act Release 1823, August 11, 1938.

consequence, the Commission has revised its disclosure rules as necessary to keep pace with new developments in compensation practices.[5]

Comprehensive 2006 Amendments

Most recently, in 2006, the Commission adopted a comprehensive package of amendments to the executive compensation rules that was intended to significantly improve the existing regime of executive and director compensation disclosure. The Commission took this action to once again keep pace with the changes in the marketplace. Prior to adopting the rules, the Commission and its staff conducted an exhaustive reassessment of the agency's previous disclosure requirements.

Building on the strengths of the previous disclosure requirements, the 2006 amendments combined a broader-based tabular presentation with improved narrative disclosure that is designed to give investors and shareholders information about how and why a company arrived at specific executive compensation decisions and policies. Among the more significant changes, the 2006 revisions included:

- the revision and reorganization of existing tabular disclosure of executive compensation, including requiring companies to provide disclosure of annual total compensation to named executive officers[6] and directors, distilled in one "bottom line" number;

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[5] See, for example: Securities Exchange Act Release No. 3347 (Dec. 18, 1942); Securities Exchange Act Release No. 4185 (Nov. 5, 1948); Securities Exchange Act Release No. 4775 (Dec. 11, 1952); Securities Exchange Act Release No. 4979 (Jan. 6, 1954); Securities Exchange Act Release No. 7775 (Dec. 22, 1965); Securities Act Release No. 5949 (Jul. 28, 1978); Securities Act Release No. 6003 (Dec. 4, 1978); Securities Act Release No. 6261 (Nov. 14, 1980); Securities Act Release No. 6486 (Sept. 23, 1983); Securities Act Release No. 6940 (Jun. 23, 1992); and Securities Act Release No. 8655 (Jan. 27, 2006).

[6] The definition of "named executive officer," often referred to by its acronym, "NEO," is provided in Item 402(a)(3) of Regulation S-K and includes:

- enhanced disclosure about executive perquisites;
- a new "Compensation Discussion and Analysis" section intended to serve as an overview of the material elements, policies and decisions related to the named executive officers' compensation;
- improved disclosure of retirement benefits; and
- detailed descriptions of payments that could be made to executives in the event of their termination or a change in control.

Shortly after implementation of the revised rules, in the spring of 2007, the staff of the Commission's Division of Corporation Finance undertook a review of the proxy statements of 350 public companies in an effort to both evaluate compliance with the revised rules and provide guidance on how companies could enhance their disclosures in this area. After the staff completed its review, it prepared a report of its observations of the quality of the disclosure and presented a summary of how it thought companies could improve. In the report, which was published (and is still available) on the Commission website,[7] the staff disclosed the principal comments it provided to companies that were subject to the review. Overall, the staff noted at the time that companies generally made a good faith effort to comply with the new rules, and investors had benefited from the

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(i) All individuals serving as the registrant's principal executive officer or acting in a similar capacity during the last completed fiscal year ("PEO"), regardless of compensation level;

(ii) All individuals serving as the registrant's principal financial officer or acting in a similar capacity during the last completed fiscal year ("PFO"), regardless of compensation level;

(iii) The registrant's three most highly compensated executive officers other than the PEO and PFO who were serving as executive officers at the end of the last completed fiscal year; and

(iv) Up to two additional individuals for whom disclosure would have been provided pursuant to paragraph (a)(3)(iii) of this Item but for the fact that the individual was not serving as an executive officer of the registrant at the end of the last completed fiscal year.

[7] The report is available at http://www.sec.gov/divisions/corpfin/guidance/execcompdisclosure.htm.

new disclosures.[8] At the same time, the staff's comments highlighted areas where it believed companies may need to provide additional or clearer disclosure in future filings. For example, the Commission made clear in adopting the rules in 2006 that it was looking for more than just the value of the components of compensation and a total value of compensation. Therefore, the staff emphasized in its report that companies should provide investors with a more robust discussion of the basis and the context for granting different types and amounts of executive compensation. The staff stressed that the reasons *why* boards arrived at specific executive compensation decisions, policies and awards are just as important as the disclosure of the particular awards themselves. In addition, the staff also encouraged companies to continue thinking about how executive compensation information – from the big picture to the details – can be better organized and presented for both the lay reader and the professional, in order to make the disclosure as useful and meaningful as possible.

The review of executive compensation disclosure remains a focal point of the Division's disclosure program and the staff continues to provide companies with individualized comments on how they can enhance their disclosure.

Upcoming Rulemaking Proposals

The adoption of the 2006 rule revisions significantly expanded the extent and strengthened the caliber of compensation disclosure that shareholders receive, but the Commission is once again considering possible enhancements.

[8] See remarks from former Director of Corporation Finance, John White, dated Jan. 23, 2008, available at http://www.sec.gov/news/speech/2008/spch012308jww.htm and Oct. 9, 2007, available at http://www.sec.gov/news/speech/2007/spch100907jww.htm.

It has been suggested that, at some companies, executive compensation has become disconnected from long-term company performance because the interests of management, in the form of incentive compensation arrangements, and the interests of some classes of investors are not sufficiently aligned. Critics have complained that, in some cases, the incentive structure created by executive compensation may have driven management to make decisions that significantly, and inappropriately, increase company risk, without commensurate risk to management's compensation should the decision prove costly to the company. Companies, and in turn shareholders, can be negatively impacted where the design or operation of their compensation programs creates incentives that drive behavior inconsistent with the overall interests of the company and its shareholders. Indeed, one of the many contributing factors cited as a basis for the current market turmoil is the misalignment at a number of large financial institutions of management's financial interests with those of shareholders. It has been argued that risk in these cases was not calibrated with the long-term value of the company in mind and compensation structures may have incentivized risk-taking for short-term rewards, at the expense of the long-term health and viability of the company. For instance, the particular application of some stock-based compensation plans or undue concern with analyst expectations may encourage speculation by employees and a focus on short-term stock price movements to the detriment of the long-term interests of the company.

Compensation policies and incentive arrangements represent just one of the issues that the Commission plans to take up next month when it considers a broad package of proxy disclosure enhancements. Many of these enhancements are designed to provide shareholders with additional information about their company's key policies, procedures and practices. For example, the Commission plans to consider whether greater disclosure is needed about how a company – and the company’s board in particular – manages risks, including in the context of establishing compensation plans and setting compensation levels. The Commission also plans to consider whether greater disclosure is needed about a company's overall compensation approach, in particular as it relates to a company’s risk-management and risk-taking, beyond decisions with respect only to the highest paid executive officers. Enhanced disclosure about compensation practices for those outside of the executive suite could provide important insights into the relationship between risks and rewards and the behaviors that those compensation practices encourage. The Commission also plans to consider proposing new disclosure requirements regarding compensation consultant conflicts of interest in order to better equip investors to assess the advice provided by these consultants.

In addition to these disclosure enhancements related to executive compensation, the Commission also plans to consider proposals related to the directors themselves. For example, it plans to consider whether to enhance disclosure of director nominee experience, qualifications and skills, so that shareholders can make more informed voting decisions. The Commission also plans to consider proposed disclosures to shareholders about why a board has chosen its particular leadership structure – such as whether that structure includes an independent chair or combines the positions of CEO and chair – so that shareholders can better evaluate the board.

Shareholder Director Nomination Process and Disclosure

A fundamental precept of corporate law is that a company’s board of directors is accountable to its shareholders, who in turn have the authority to elect the directors.

Thus, boards are accountable for their decisions concerning, among other things, executive pay, and for their oversight of the companies' management and operations, including the risks that these companies undertake. For many years, shareholders have used the shareholder proposal process outlined in the Commission's proxy rules to voice concerns about executive compensation and other matters. There is a long-standing debate, however, about whether such precatory proposals provide a sufficient mechanism for shareholders to influence companies' boards, because individual shareholders, who generally have a right under corporate law to nominate candidates for a company's board of directors, often lack the resources to effectively run a proxy contest to have their nominees elected and unseat existing board members. Thus, over a number of decades, the Commission has repeatedly considered requiring that public companies allow shareholders to list their nominees for director in the companies' proxy statements and place their nominees on the companies' proxy ballots.

The value of the executive compensation disclosure the Commission mandates and shareholder proposals concerning executive compensation is minimized if shareholders are unable to exercise effectively their fundamental right to nominate and elect members to company boards of directors. The Commission's proxy rules seek to improve the corporate proxy process so that it functions, as nearly as possible, as a replacement for actual in-person participation at a meeting of shareholders, given that such meetings are no longer a feasible way for most shareholders to exercise their franchise rights. Yet those very proxy rules may place unnecessary burdens on this right, at the expense of the board's accountability to shareholders. Absent an effective way for shareholders to exercise their right to nominate and elect directors – a right that state corporate law presumes shareholders have – the election of directors can become a self-sustaining process of the board determining its members, with little actual input from shareholders. Without more effective competition for director positions, directors may be less accountable to shareholders and may lose sight of their proper role as representatives of the company.

Accordingly, on May 20, the Commission voted to approve[9] for notice and comment proposals that are designed to help give shareholders a meaningful opportunity to effectuate the rights that they already have under state law to nominate directors.[10] Under the proposals, shareholders who otherwise have the right to nominate directors at a shareholder meeting would, subject to certain conditions, be able to have a limited number of nominees included in the company proxy materials that are sent to all voters. To have a nominee or nominees included in a company's proxy materials, a shareholder would have to meet certain security ownership requirements, meet specified criteria including independence standards, provide certifications about the shareholder's intent and file a notice with the Commission of its intent to nominate a candidate, which includes specified disclosure about themselves and their nominee, for inclusion in the company's proxy materials. This aspect of the proposals is designed to provide important

[9]The Commission's vote was 3-2 in favor of the proposal, with Chairman Schapiro and Commissioners Walter and Aguilar voting to approve the staff's recommendation to propose rules, and Commissioners Casey and Paredes voting not to approve the staff's recommendation. For the Commissioners' statements regarding the proposal at the Commission meeting at which the proposal was considered, see http://www.sec.gov/news/speech.shtml#chair.

[10] Regulation of the proxy process and disclosure is a core function of the Commission and is one of the original responsibilities that Congress assigned to the Commission in 1934. Section 14(a) of the Exchange Act stemmed from a Congressional belief that "[f]air corporate suffrage is an important right that should attach to every equity security bought on a public exchange."

information to all the shareholders about qualifying shareholder board nominees, so that shareholders can make a more informed voting decision.

To further facilitate shareholder involvement in the director nomination process, the Commission proposed amending the “election exclusion” of the shareholder proposal rule. Currently, that provision allows a company to exclude from its proxy materials a shareholder proposal that relates to a nomination or an election for membership on the company’s board of directors or a procedure for such nomination or election. The “election exclusion” therefore prevents a shareholder from proposing amendments to a company’s governing documents that would address the company’s procedures for inclusion of shareholder nominees in company proxy materials or disclosures related to those shareholder nomination provisions. Under the proposed amendment to the shareholder proposal rule, companies would have to include such proposals in their proxy materials, provided the other requirements of the rule are met.

If adopted, these new rules would afford shareholders a stronger voice in determining who will oversee management of the companies that they own. Although shareholders have the right to elect directors, the Commission's proxy rules may in some cases frustrate shareholders in carrying out that function. Strengthening the ability of shareholders to hold boards of directors accountable to them – including for their oversight of compensation and risk management – should further empower shareholders and help to restore investor trust in our markets, which has been badly damaged in the current economic climate.

We recognize that the issue of shareholder access is controversial, and that there will be many who oppose the proposal, in whole or in part. The proposing release (which is available on the Commission's website) includes dozens of questions that are designed to elicit both positive and negative comments. The Commission sincerely wants to hear from all interested parties, and I have no doubt that the rulemaking process will be better because of the comments.

Conclusion

Thank you again for inviting me to appear before you today. On behalf of the agency, we look forward to working with Congress and with this Committee going forward on these issues. I would be happy to answer any questions you may have.