Testimony Concerning Executive Compensation Oversight after the Dodd-Frank Wall Street Reform and Consumer Protection Act

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Introduction

Chairman Frank, Ranking Member Bachus, and Members of the Committee:

My name is Meredith Cross, and I am the Director of the Division of Corporation Finance at the U.S. Securities and Exchange Commission. I am pleased to testify on behalf of the Commission today on the topic of executive compensation oversight.

The Commission's role in this important area has traditionally been to promulgate and administer disclosure requirements concerning executive compensation. This has been the case throughout the Commission's long history, including in the very early days of the agency in the late 1930s.[1] The challenge the Commission has always faced in promulgating and administering its executive compensation disclosure rules is that compensation practices continually evolve. Over the years, the manner and types of

[1] 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. *See* Securities Exchange Act Release No. 1823 (August 11, 1938).

compensation have become increasingly complex. As a consequence, the Commission has revised its disclosure rules as necessary to account for new developments in compensation practices.

The Commission's rules governing executive compensation disclosure are designed to elicit timely, comprehensive, and accurate information about a company's compensation practices and procedures. The Commission's focus has been on requiring companies to provide this information to investors. We believe that information about executive compensation must be straightforward and meaningful to facilitate investor access and use of that information.

As noted, a key component of the Commission's executive compensation disclosure rules is keeping pace with changing trends and developments in executive compensation practices. Accordingly, in 2006, the Commission amended its executive compensation disclosure rules to improve the quality and presentation of executive and director compensation disclosure.[2] Prior to adopting the rules, the Commission and its staff conducted an exhaustive reassessment of the agency's previous disclosure requirements.

Building on the previous disclosure requirement strengths, the 2006 amendments combined a broader-based tabular presentation with improved narrative disclosure designed to give investors information about how and why a company arrived at specific

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[2] SEC Release No. 33-8732A (August 29, 2006).

executive compensation decisions and policies. In the spring of 2007, the staff of the Commission's Division of Corporation Finance conducted a targeted review of 350 public companies in order to assess compliance with the revised rules and provide guidance to companies for future improvements to their disclosures. Executive compensation disclosure review remains a focal point of the Division's review program and the staff continues to comment on ways that companies can enhance their disclosure.

In 2009, the Commission sought to address investor information needs with its Proxy Disclosure Enhancements rulemaking,[3] which further amended its rules to require new disclosure concerning compensation and other corporate governance matters. These amendments were intended to enable investors to better analyze board performance, decision making processes and compensation practices.

An important component of the 2009 disclosure rules is a new requirement concerning the relationship of compensation and risk. In adopting this requirement, the Commission recognized that investors should have access to information about, and understand how, compensation structures and practices affect an executive or other employee's behavior and risk-taking. As noted by the Commission in proposing the new requirement, some had expressed concerns about incentive compensation policies that may have created inadvertent incentives for management or other employees to make decisions that

[3] SEC Release No. 33-9089 (December 16, 2009).

significantly, and inappropriately, increase the company's risk, without adequate recognition of the risks to the company.[4] Companies, and in turn investors, may be negatively impacted where the design or operation of their compensation programs creates incentives that drive behavior inconsistent with the overall goals and strategy of the company.

To address these concerns, the Commission adopted disclosure requirements in its 2009 rules concerning how companies reward and incentivize their employees to the extent these practices create risk to the company. More specifically, to the extent that risks arising from a company's compensation policies and practices are reasonably likely to have a material adverse effect on the company, companies must provide disclosure about those policies and practices. These disclosures apply with respect to compensation policies and practices for all employees – not just executives – if those policies create risks that are reasonably likely to have a material adverse effect on the company. In adopting this new requirement, the Commission used a materiality standard for this

[4] *See, e.g.*, Calvin H. Johnson, *The Disloyalty of Stock and Stock Option Compensation*, 11 CONN. INS. L.J. 133 (2004-2005); Michael C. Jensen, *et al*., *Remuneration: Where we've been, how we got here, what are the problems, and how to fix them (2004)* (unpublished manuscript on file), available at www.ssrn.com/abstract=561305. The relationship between compensation incentives and risk also has been recognized in the legislation authorizing the Troubled Asset Relief Program ("TARP"). Specifically, Section 111(b) of the Emergency Economic Stabilization Act of 2008, as amended by Section 7001 of the American Recovery and Reinvestment Act of 2009, requires the Secretary of the Treasury to require each TARP recipient to meet appropriate standards for executive compensation and corporate governance that shall include "limits on compensation that exclude incentives for senior executive officers of the TARP recipient to take unnecessary and excessive risks that threaten the value of such recipient during the period in which any obligation arising from financial assistance provided under the TARP remains outstanding." *See* Pub. L. 111-5, §7001, 123 Stat. 115, 517 (2009).

disclosure in an effort to guard against disclosure overload. Even where disclosure may not be required, we think the process of determining whether disclosure is required is a useful exercise in and of itself for companies. In comments to companies issued this year, Commission staff asked companies to explain what process they went through in deciding whether their compensation programs posed these risks, which provided us with insight into how companies reached the disclosure decisions they did.

In 2009, the Commission also adopted amendments to the proxy rules to set out the requirements for a say-on-pay vote at companies that received financial assistance under the Troubled Asset Relief Program.[5] Under the Emergency Economic Stabilization Act, these companies are required to permit an annual advisory shareholder vote on executive compensation. Consistent with the EESA, the Commission's rules require public companies that are TARP recipients to provide a separate shareholder vote on executive compensation in proxy solicitations during the period in which any obligation arising from financial assistance provided under the TARP remains outstanding. These rules are intended to clarify what is necessary under the Commission's proxy rules to comply with the EESA vote requirement and help to assure that TARP recipients provide useful information to shareholders about the nature of the required advisory vote on executive compensation.

5 SEC Release No. 34-60218 (July 1, 2009).

Currently, the Commission's and staff's efforts in the area of executive compensation are focused on implementing the provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[6] that address an array of compensation issues. Section 951 of the Act requires a shareholder advisory "say-on-pay" vote on executive compensation at all companies that are subject to the Commission's proxy rules – not only at TARP companies – at least once every 3 years, and a separate advisory vote at least once every 6 years on whether the say-on-pay resolution will be presented every one, two, or three years. In addition, in any proxy statement asking shareholders to approve a merger or similar transaction, the Act requires disclosure about – and a shareholder advisory vote to approve – compensation related to the transaction, unless the arrangements were already subject to the periodic say-on-pay vote. The Dodd-Frank Act also requires that every institutional investment manager subject to Exchange Act Section 13(f) report at least annually how it voted on any of the required votes. Although the Dodd-Frank Act does not specify a deadline for rulemaking, the Commission's goal is to adopt final rules in time to inform the 2011 proxy season. Proposing releases for rules addressing these provisions will be available on the SEC web site when approved by the Commission.

Section 957 of the Dodd-Frank Act also requires the rules of each national securities exchange to be amended to prohibit brokers from voting uninstructed shares on the

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[6] *See* Sections 951 through 957, and 971 through 972 of the Dodd-Frank Act.

election of directors, executive compensation, or any other significant matter, as determined by the Commission by rule. The Commission previously approved changes to New York Stock Exchange ("NYSE") Rule 452 to prohibit broker voting of uninstructed shares in director elections,[7] and on September 9, 2010 approved further changes to the NYSE rules to prohibit broker voting on all executive compensation matters, which include the say-on-pay votes.[8]

Section 952 of the Dodd-Frank Act also requires the Commission to write rules mandating new listing standards relating to the independence of compensation committees and establishing new disclosure requirements and conflict of interest standards that boards must observe when retaining compensation consultants. These rules must be prescribed by the Commission within 360 days from the date of enactment of the Act, and the Commission anticipates proposing such rules soon.

In addition, Section 953 of the Act requires the Commission to amend our executive compensation disclosure requirements to require companies to disclose information showing the relationship between executive compensation actually paid and the financial performance of the company, as well as information about the total annual compensation

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[7] *See* New York Stock Exchange Rule 452.11(19) and Listed Company Manual Section 402.08(B)(19); SEC Release No. 34-60215 (July 1, 2009), 74 FR 33293 (July 10, 2009) (SR-NYSE-2006-92).

[8] SEC Release No. 34-62874 (September 9, 2010). We anticipate that corresponding changes to the rules of other national securities exchanges will be considered by the Commission in the near future.

of the chief executive officer, the median annual total compensation of all other employees, and the ratio between these two amounts. Rule amendments are also mandated by Section 955 of the Dodd-Frank Act that will require companies to disclose in their annual meeting proxy materials whether any employee or director is permitted to purchase financial instruments designed to hedge any decrease in market value of equity securities granted as part of their compensation or held by the employee or director. Section 954 of the Dodd-Frank Act further requires the Commission to adopt rules mandating changes to listing standards requiring companies to implement and disclose "clawback" policies for recovering from current and former executive officers incentive-based compensation paid during any 3-year period preceding an accounting restatement due to material non-compliance with financial reporting requirements. The Dodd-Frank Act does not specify deadlines for rulemaking on these provisions, but the Commission's goal is to publish proposed requirements by July 2011.

Finally, the Commission and its staff are working to implement Section 956 of the Dodd-Frank Act, which requires the Commission and other federal regulators[9] to jointly prescribe regulations or guidelines applicable to "covered financial institutions," including, for the Commission, registered broker dealers and investment advisers with assets of $1 billion or more. The regulations or guidelines will require disclosure to the appropriate federal regulators of the structures of incentive-based compensation and

[9] The other entities specified in Section 956 are the Federal Reserve, Office of the Comptroller of the Currency, the FDIC, the Office of Thrift Supervision, the National Credit Union Administration Board, and the Federal Housing Financing Agency.

prohibit incentive-based payment arrangements that the regulators determine encourage inappropriate risks by covered financial institutions, and must be comparable to the standards applicable to insured depository institutions under the Federal Deposit Insurance Act. The rules or guidelines must be prescribed no later than nine months after the enactment of the Act. Commission staff is working with other federal financial regulators to develop appropriate regulations or guidelines within this timeframe.

To maximize the opportunity for public comment and to provide greater transparency in the rulemaking process, the Commission has made available to the public a series of e-mail boxes to which interested parties can send preliminary comments before the various rules are proposed and the official comment periods begin.[10] These e-mail boxes are on the SEC website, organized by topic. Since July 27th, the public has been providing preliminary comments on 31 topics, including the executive compensation provisions of the Dodd-Frank Act. The comments we have received to date range from those expressing general concern regarding executive compensation practices at public companies to others providing detailed suggestions with regard to the Commission's implementation of specific provisions of the Dodd-Frank Act.

[10] SEC Chairman Schapiro Announces Open Process for Regulatory Reform Rulemaking, Press Release 2010-135 (July 27, 2010), http://www.sec.gov/news/press/2010/2010-135.htm.

Conclusion

As governance and compensation practices continue to evolve, the Commission will remain steadfast in its efforts to assure that our disclosure rules provide investors with the information they need to make informed investment decisions, including in our work to implement the provisions of the Dodd-Frank Act addressing compensation issues. Further, we are committed to working with our fellow regulators to prescribe the regulations or guidelines for covered financial institutions as mandated by the Dodd-Frank Act.

Thank you again for inviting me to appear before you today. I would be happy to answer any questions you may have.