Regulation S-K, Item 402: The New Executive Compensation Disclosure Rules

I. Introduction

Executive compensation has recently become a controversial issue. Critics of executive compensation packages have focused on the "unwarranted disparity" between executive compensation and corporate performance or employee wages, especially in light of the economic effects of our current nationwide recession, including layoffs of thousands of workers.

Largely in response to escalating executive compensation packages and the criticisms which accompanied them, the Securities and Exchange Commission (the "Commission") on October 15, 1992, adopted major revisions to Item 402 of Regulation S-K, the item governing disclosure of issues pertaining to executive compensation.

1. See generally Robert M. Rosenblatt, Firms Must Fully Report Officers' Pay, L.A. TIMES, Oct. 16, 1992, at A1 ("The measures take effect against a backdrop of public revulsion at excessive executive pay and complaints of entrenched corporate management."); Linda Grant, Shareholders Balk at Shift in Executive Incentive Plans, L.A. TIMES, April 12, 1992, at D1 ("Public resentment over ballooning pay packages has spilled over from its peak Now critics are honing in on incentives as the vehicles by which paychecks spiral ever upward."); Linda Grant & Marilyn Yaquinto, Investors May Get More Input on Executive Pay, L.A. TIMES, Feb. 14, 1992, at A1 ("A persistent recession marked by job losses and reduced pay for many employees has turned executive pay into a simmering political issue. Many shareholders question whether the high pay is deserved, particularly for executives at companies that are performing poorly.").


The revisions are designed to increase the total amount of information disclosed and to simplify the method of presentation in order to facilitate shareholder understanding. According to the Commission's Executive Summary, the rules were enacted to "improve shareholders' understanding of all forms of compensation paid to senior executives and directors, the criteria used by the board of directors in reaching compensation decisions, and the degree of relationship between compensation and corporate performance." This is to be accomplished by furnishing shareholder-


The Commission received over 900 comment letters to the proposed rules, including approximately 555 from individual and institutional investors, 245 from issuers and their affiliates, and over 100 from members of the consulting, legal, accounting and academic communities. Id. at 83,416. The Commission reports that the letters generally supported reform of the existing executive compensation disclosure scheme. Id.

6. Id. Throughout this comment, the reader should keep in mind some basic forms of compensation and the means available for shareholders to attack the form or amount of that compensation under basic corporation law.

The primary forms of remuneration may be characterized as follows:

(1) cash salary;
(2) cash bonus (usually connected to corporate earnings);
(3) plans providing for the issue of stock to executives in exchange for their services or for a cash price less than market value;
(4) deferred compensation in which cash payments will be made after the executive's peak earning years, usually with provisions for continued consulting designed to defer income tax until the time of receipt of the monies;
(5) pension plans providing for payment after retirement;
(6) stock option programs under which an executive is given the right to purchase the company's stock at a price less than the anticipated value upon the exercise of that right;
(7) "phantom stock" plans in which the recipient does not have to actually purchase stock but is credited with a specified number of units equivalent to shares of stock and receives cash equivalents to dividends and market value increases; and
(8) various fringe benefits or "perquisites," including use of company vehicles, vacations and hospitalization at corporate expense.


Compensation is generally regarded as the major tool for extracting quality performance from corporate employees. Thus, the compensation package is a central concern of management. From the viewpoint of a disinterested board of directors, an ideal package would: "(1) attract and hold desired employees against competitive offers; (2) reward most highly and obviously those employees whose performance most satisfied management; (3) build morale both competitive and cooperative; (4) avoid taxes as much as possible; and (5) be as cheap for the corporation as possible." Id. at 32. However, since boards are rarely totally disinterested and even "outside" boards cannot function in an atmosphere of "bare-knuckled bargaining," it is no wonder that executive compensation is hugh. Id.
ers with a presentation which is more understandable regarding the nature and extent of executive compensation; this is to be accomplished through the consolidation of the items to be disclosed into a series of tables. In other words, the revisions intend to increase shareholder comprehension by decreasing the amount of narrative information to be disclosed and increasing the amount of detailed numerical information to be presented in tabular form.

As outlined above, the revisions basically replace narrative requirements with quantitative disclosure. They accomplish this by dividing disclosure into four basic components. First, the specific amounts of compensation awarded or paid to "Named Executives" over the past three years must be disclosed in a single table. Second, the rules require more detailed disclosure (also presented in tabular form) of specific types of compensation awarded or paid to the Named Executives in the last year. Third, they require an entirely new report from the Board of Directors' Compensation Committee stating its executive compensation policies generally and specifically delineating the criteria upon which the Chief Executive

Investment professionals suggest the following for shareholders examining the executive compensation disclosure items: 1) compare executive pay with shareholder return, particularly noting "[r]ising executive compensation in the face of sagging stock market performance"; 2) watch how executives are being paid, particularly noting whether compensation is linked to stock performance; 3) check the compensation committee's report to ensure that the company's pay philosophy should coincide with how the executives are compensated; 5) find out how much stock the executives and directors own to see whether they hold a significant stake in the company's performance; 6) beware of a change in auditors in the middle of a controversy; 7) watch for "related transactions"; 8) beware of antitakeover provisions. Earl C. Gottschalk, Jr., Revolutionary Proxies: Read Them & Reap, WALL ST. J., Jan. 29, 1993, at CI, C21.

Although they must keep in mind the factors stated above, which are necessary for acquiring and retaining quality management, shareholders do have remedies to prevent outrageous compensation. For example, shareholders could vote out directors who authorize outrageous compensation. Furthermore, they could initiate suit attacking the quantum of compensation under concepts of basic corporation law, self-dealing and waste. VAGTS, supra, at 336. However, shareholders cannot attack compensation levels if they do not understand them. It is this problem which the Commission attempted to remedy through these rules.

7. Id.
9. "Named Executive" is defined in Item 402(a)(3) of Regulation S-K. See infra notes 21-25 and accompanying text for an explanation of the term Named Executive and whom it includes.
10. Gottlieb & de Brito, supra note 8, at 3. For a complete discussion of the Summary Compensation Table, see infra notes 24-48 and accompanying text.
11. Gottlieb & de Brito, supra note 8 at 3. For a brief discussion of this more detailed tabular disclosure, see infra notes 49-54 and accompanying text.
Officer’s ("CEO’s") compensation was based. Finally, the rules require another totally new item of disclosure: a performance graph representing the return to the issuer's shareholders as compared to a broad market index and an industry index or group of peer issuers for the last five years.

Clearly the revisions make Item 402 of Regulation S-K quite comprehensive. However, as with many comprehensive rules, the Commission has failed to foresee all possible contingencies, thereby creating gaps in regulation for certain issuers. Compliance with the rules is therefore complicated and uncertain: some issuers will be left guessing in the preparation of their proxy materials. First, this comment outlines the new rules and highlights some of those areas which may be of confusion to issuers. Second, it asserts that while the rules should accomplish the articulated goals of the Commission, they may also interact with other recent securities law developments to substantively affect executive compensation decisionmaking. This is not to say the Commission did not foresee such a result. On the contrary, it is likely that the substantive effect of increased shareholder participation was an intentional, albeit not formally articulated, goal of the Commission. Regardless of the Commission's intentions, however, corporations will now be motivated to more closely monitor the processes of decisionmaking and executive compensation decisions themselves due to the increased access of shareholders to information and the increased likelihood of shareholder participation, directly or indirectly, in corporate matters.

12. Gottlieb & de Brito, supra note 8, at 4. For a complete discussion of the Compensation Committee Report, see infra notes 55-86 and accompanying text.
13. Gottlieb & de Brito, supra note 8, at 5. For a complete discussion of the Performance Graph, see infra notes 93-100 and accompanying text.
14. These recent developments include efforts to actually limit certain types of executive compensation arrangements, such as golden parachute agreements, and efforts to allow shareholders to have greater input in the decisionmaking of corporations, both generally and specifically in the area of executive compensation. For a discussion of these developments and how they may relate to the executive compensation disclosure rules in affecting executive compensation decisions, see infra notes 101-127 and accompanying text.
15. See Emanuel D. Strauss, The Compensation Committee Report on Executive Compensation, INSIGHTS, Dec. 1992, at 16 ("Although the SEC does not have the authority to require companies to change the way compensation decisions are made, change is likely to be a by-product of the new focus on compensation disclosure.").
II. ITEM 402: THE NEW EXECUTIVE COMPENSATION DISCLOSURE REQUIREMENTS

The new rules require "clear, concise and understandable disclosure of all plan and non-plan compensation awarded to, earned by, or paid by any person for all services rendered in all capacities to the [issuer] and its subsidiaries."16 Thus, the rules intend comprehensive disclosure of all compensation regardless of form.17

However, in a major change from the previous rules under Item 402 and the new rules as originally proposed, the new rules eliminate the requirement that the issuer disclose the compensation of all executives as a group.18 Rather, the new rules require disclosure of the compensation of the Named Executives. The term Named Executives includes the CEO, regardless of the amount of his or her compensation, and the four most highly paid executive officers serving at the end of the most recent fiscal year whose annual salary and bonus (cash and non-cash), including amounts foregone, exceeded $100,000.19 This means that the compensation of an executive who resigned during the fiscal year need not be disclosed.20 On the other hand, if an individual is included in the definition of Named Executive, then all compensation paid to the executive during the year should be disclosed even if it pertains to the executive's services to the issuer in some other capacity.21 However, as under the old rules, an issuer does not have to disclose an individual's compensation if it is not "appropriate."22

Among the factors to be considered in determining the appropriateness of inclusion of an individual as a Named Executive are: "(a) the distribution or accrual of an unusually large amount of cash compensation that is not part of a recurring arrangement and

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17. However, there are two major exceptions to blanket disclosure. First, issuers need not disclose the value of group life, health, hospitalization, medical reimbursement or relocation plans that do not discriminate in favor of executives and that are generally available to all salaried employees. Id. at Item 402(a)(7).
19. Regulation S-K, Item 402(a)(3). The $100,000 threshold is an increase over the former $60,000 threshold. Adopting Release, supra note 5, at 83,420.
21. Id.
is unlikely to continue; and (b) the payment of cash compensation relating to overseas assignments that may be attributed predominantly to such assignments."

A. The Summary Compensation Table

The Summary Compensation Table (the "Table") is the cornerstone of the new disclosure system. It is designed to show both annual and long-term compensation in a single comprehensive overview. Specifically, the Table requires disclosure of the compensation of the Named Executives for each of the issuer's last three fiscal years in a seven column tabular format. The Table is intended to enable shareholders to understand the extent and form of executive compensation, to identify trends in compensation awards, and to compare the compensation of executives to executive compensation in other companies. Among the items to be included are the dollar values of base salary and bonuses (cash and non-cash) earned by the executive during each of the fiscal years reported. Amounts deferred at the election of the executive, whether pursuant to a 401(k) plan or otherwise, should also be included. However, any amounts foregone at the election of the executive pursuant to a program of the issuer in which stock or other forms of non-cash compensation may be received in lieu of annual compensation need not be included in the salary column but should be included in the appropriate column (i.e. restricted stock awards or options) in the year in which it is received.

This is a one area which may be of confusion to issuers. As stated above, if the executive elects to forego compensation pursu-

23. Id.
25. Regulation S-K, Item 402(b). The columns include annual compensation, broken down into Salary, Bonus and Other Annual Compensation columns, and long-term compensation, broken down into awards, which include Restricted Stock Awards and Option/SARs columns, and payouts, or an LTIP Payout column. Finally, the seventh column is an All Other Compensation column to include anything not captured by the other six columns. Id.

27. Regulation S-K, Item 402(b)(2)(iii)(A), (B).
28. Id. at Item 402(b)(2)(iii), Instruction 1.
29. Id. at Item 402(b)(2), Instruction 3.
ant to a program in which stock or other non-cash compensation may be received in lieu of salary or bonus, the issuer need not include the amount foregone in the salary or bonus columns, but must include that amount in the appropriate column of the Summary Table or the long-term compensation table. However, if the executive receives stock or other non-cash compensation as salary or bonus, rather than in lieu thereof at his election, the fair market value of the compensation must be included in the salary or bonus column. Thus, if the issuer offers the option of receiving non-cash compensation in lieu of salary or bonus, the amount need not be included in the salary or bonus columns; if, on the other hand, the issuer unilaterally pays the executive a portion of his salary or bonus in stock or another form of non-cash compensation, the amount must be reported in the salary or bonus column, as appropriate.

The dollar value of other annual compensation not properly categorized as salary or bonus should also be included in a separate column, aptly entitled “Other Annual Compensation” This includes perquisites and other personal benefits, above-market or preferential earnings on restricted stock, options, stock appreciation rights (“SARs”) or deferred compensation paid or payable at the election of the executive; earnings on long-term incentive plan (“LTIP”) compensation paid or payable at the election of the executive; payments to cover the executive’s taxes, or “gross-

30. For a brief discussion of the long term compensation table, or Long-Term Incentive Plan Awards Table, see infra note 51.
32. Kailer, supra note 20, at 17. Kailer has suggested that the practical solution to this problem may be to report restricted stock or options granted either at the executive’s election or as salary or bonus only under the appropriate column for restricted stock or options and to report unrestricted stock awards received either at the executive’s election or as salary or bonus only in the salary or bonus column, as appropriate. Id.
33. Regulation S-K, Item 402(b)(2)(iii)(C)(1). To be reportable under this item the aggregate value of perquisites and benefits must exceed a specified threshold. That threshold amount is the lesser of $50,000 or 10% of the total salary and bonus reported for the executive for the year. Id. Furthermore, particular perquisites valued at more than 25% of the sum of all perquisites must be described individually in a footnote. Id.
34. Id. at Item 402(b)(2)(iii)(C)(2). Earnings are “above-market” only if the rate of interest paid is in excess of 120% of the applicable federal long-term rate (“AFR”) in effect at the time the rate was set. Id. at Item 402(b)(2)(iii), Instruction 3. AFR data is published monthly by the Internal Revenue Service. Adopting Release, supra note 5, at 83,423 n.45. Moreover, dividends are reportable under this item only to the extent they are preferential, i.e. they are earned at a more favorable rate than dividends on the issuer’s common stock. Regulation S-K, Item 402(b)(2)(iii)(c), Instruction 4.
ups", and preferential discounts on stock purchases. The disclosure of LTIP compensation in the Other Annual Compensation column raises another area of confusion under the Table. In order to disclose LTIP payouts or awards under the appropriate column, one must be able to recognize and identify an LTIP. The confusion in this area relates to the definition of "Long Term Incentive Plan." The term is defined so broadly as to include several possible plans which the Commission did not contemplate should be disclosed as such. Thus, as a practical solution, one commentator has suggested that only those plans under which the compensation to be paid is explicitly based on the issuer's performance should be disclosed.

The fourth, fifth and sixth columns of the Table encompass long-term compensation: restricted stock awards, options and SARs, and LTIP payouts, respectively. In the restricted stock award column, the reported dollar value of any award of restricted stock should be reduced by the amount of consideration paid by the executive. However, awards of restricted stock that are subject to performance-based conditions on vesting, in addition to time limitations and/or continued service with the issuer, may be reported as LTIP awards instead of restricted stock awards; if this approach is adopted, it must also be reported as an LTIP payout upon vesting. If an award of restricted stock provides for vesting of all or part of the shares within three years from the date of the grant, then footnote disclosure is required regarding the terms of vesting.

36. Id. at Item 402(b)(2)(iii)(C)(4).
37. Id. at Item 402(b)(2)(iii)(C)(5). If any amount is reportable under this section, the issuer should disclose the dollar value of the difference between the price paid by an executive for any security of the issuer and the fair market value of such security, unless the discount is generally available to all security holders or to all salaried employees of the issuer. Id.
38. Kailer, supra note 20, at 17. "Long Term Incentive Plan" is defined in Regulation S-K, Item 402(a)(5)(iii) as any plan providing compensation intended to serve as incentive for performance to occur over a period longer than one fiscal year, whether such performance is measured by reference to financial performance of the registrant or affiliate, the registrant's stock price, or any other measure, but excluding restricted stock, stock option and SAR plans.
40. Id.
42. Id. at Item 402(b)(2)(iv), Instruction 1.
43. Id. at Instruction 2.
In the option/SAR grant column, the SARs must include cash-only SARs as well as those payable in stock.\(^4^4\) Furthermore, in the LTIP payout column, the waiver of performance targets or other conditions required for realization of the award if they pertain to a reportable payout must be disclosed in a footnote.\(^4^5\)

The final column is a catch-all column to report any compensation not already reported in the Table.\(^4^6\) All compensation reported in the last fiscal year must be identified and quantified in a footnote.\(^4^7\) Moreover, amounts paid under golden parachute or similar agreements, triggered by a change in control event or an executive’s resignation or termination, are technically subject to disclosure in this column. However, as a practical matter, such amounts will not be disclosed because a severed executive will not be serving at the end of the fiscal year and thus will not be a Named Executive subject to disclosure under the rules.\(^4^8\)

**B. More Detailed Tabular Disclosure**

Five tables round out the tabular disclosure required by the new rules. They are the Option/SAR Grant Table,\(^4^9\) the Aggregated Option/SAR Exercise & Fiscal Year-End Option/SAR Value Table,\(^5^0\) the Long-Term Incentive Plan Awards Table,\(^5^1\) the Pension Plan Table,\(^5^2\) and the Option/SAR Repricing Table.\(^5^3\) These

\(^{44}\) Adopting Release, *supra* note 5, at 83,425.


\(^{46}\) *Id.* at Item 402(b)(2)(v).

\(^{47}\) *Id.*

\(^{48}\) However, such arrangement will probably be described narratively in the issuer’s proxy materials in the years before the amount is paid; this narrative disclosure is required by Item 402(h). See *infra* notes 87-88 and accompanying text.

\(^{49}\) Regulation S-K, Item 402(c). This table includes information concerning individual grants of stock options, with or without tandem SARs, and freestanding SARs made to Named Executives during the last fiscal year. *Id.* at Item 402(c)(1).

\(^{50}\) *Id.* at Item 402(d). This table includes information concerning the exercises of stock options or tandem SARs, freestanding SARs by the Named Executives, information concerning the value of the unexercised options and SARs held by the Named Executives at the end of the fiscal year. *Id.* at Item 402(d)(1).

\(^{51}\) *Id.* at Item 402(e). This table includes information concerning each award made to a Named Executive during the fiscal year under any LTIP. *Id.* at Item 402(e)(1).

\(^{52}\) *Id.* at Item 402(f)(1). For any defined benefit or actuarial plan under which benefits are determined primarily by final compensation and years of service, this table requires information concerning estimated annual benefits payable upon retirement according to a schedule of compensation ranging from $125,000 to $500,000 and years of service ranging from 15 to 35. *Id.* at Item 402(f)(1)(i). In addition, this item requires disclosure of the compensation covered by the plan as it relates to the Summary Compensation Table, the estimated credited years of service for each Named Executive and a statement as to the basis on which benefits are computed and whether they are subject to any off-
tables will not be applicable to most issuers since they encompass more sophisticated types of compensation. If a particular table is inapplicable for an issuer, it may be omitted entirely.

C. The Compensation Committee Report and Other Narrative Disclosures

1. The Compensation Committee Report

The most controversial of the new executive compensation rules is the requirement that the issuer enclose in its proxy materials a report from the Compensation Committee (the "Committee") of the Board of Directors (the "Report"). The Report is intended to "enhance shareholders' ability to assess how well directors are representing their interests." The proposing release stressed this intention by stating that the Report's purpose was "to bring shareholders into the compensation committee or board meeting room and permit them to see and understand the specific decisions made through the eyes of the directors."

The Report accomplishes this by requiring disclosure of the Committee's general compensation policies applicable to all officers, including an explanation of any relationship of these policies to corporate performance. The Committee must also report its basis for the CEO's compensation, including the factors and criteria upon which the CEO's compensation was based. A specific discussion of the relationship of the issuer's performance to the CEO's compensation, describing each qualitative and quantitative

set amounts, including Social Security. Id. at Item 402(f)(1)(ii).

On the other hand, for any defined benefit or actuarial plan under which benefits are not determined primarily by final compensation and years of service, this item requires a narrative description of the formula by which benefits are determined and the estimated annual benefits payable to the Named Executives upon retirement. Id. at Item 402(f)(2).

52. Id. at Item 402(i). The information in this table is reportable only if, during the last fiscal year, the issuer, while a reporting company under § 13(a), 15 U.S.C. § 78m(a), or § 15(d), 15 U.S.C. § 78o(d), of the Exchange Act, adjusted or amended the exercise price of stock options or SARs previously awarded to a Named Executive. Id. at Item 402(i)(1). Thus, inclusion of this table should be extremely rare.

53. Id. at Item 402(a)(6).

54. See generally id. at Item 402(k). If no committee performs the function of determining compensation, the Board itself should issue the Report. Id. at Item 402(k)(3).

55. Adopting Release, supra note 5, at 83,432.


57. Regulation S-K, Item 402(k)(1).

58. Id. at Item 402(k)(2).
measure of issuer performance upon which his or her compensation was based, is also required. In meeting these criteria, boilerplate language should be avoided, but target levels or information which would have an adverse effect on the issuer need not be disclosed.

The Report's requirements provoked the strongest reaction from commentators on both sides of the issue. The objections of the corporate community may be summarized as follows: (1) the Commission lacked authority, was interfering with the business judgment rule, and was attempting to change the methods used in making compensation decisions; (2) the provision requiring the Report did not adequately recognize the oversight role of boards of directors over compensation committees; (3) the specificity of disclosure was inappropriate, based, inter alia, on privacy and competitive harm; (4) the disclosure requirement would have a "chilling effect" on compensation committee members and would make it difficult to get qualified persons to serve; (5) the Report would create new grounds for legal liability, especially because of the requirement that the Report be signed; and (6) issuers would be forced to incur the added expenses of outside consultants and increased legal fees.

In response to comments the Commission received, it attempted to reach a compromise between the corporate community's concerns and maintenance of meaningful disclosure rules which would elicit more than mere boilerplate responses. However, in defense

60. Id.
61. Id. at Item 402(k), Instruction 1.
62. Id. at Instruction 2.
63. Adopting Release, supra note 5, at 83,431. See also Strauss, supra note 14, at 16.
64. The business judgment rule springs from the fundamental principle that the business and affairs of the corporation are managed by its Board of Directors. The rule itself presumes that in making a business decision, the directors acted on an informed basis, in good faith and with an honest belief that the action taken was in the best interests of the corporation. See AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE § 4.01 (Proposed Final Draft, Mar. 31, 1992); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985). Thus, an individual challenging a board decision must rebut the aforementioned presumptions. Van Gorkom, 488 A.2d at 872. Critics of the Report obviously felt that, contrary to the business judgment rule, the Report would create liability and accountability for those matters which are in the Board's sole discretion.
65. It is the thesis of this comment that, despite the concessions the Commission made in response to comments from the corporate community, this was precisely what it was attempting to do. See infra notes 127-144 and accompanying text.
of the new rules it promulgated, the Commission stated that the Report would neither impose new fiduciary duties on directors nor require any specific actions. Furthermore, the Commission asserted that the Report was not inconsistent with business judgment standards, which, in essence, ensure reasonable and good faith action by the directors. Moreover, the Report does not require an outline of the Committee's discussions or each Committee member's reasons or motivations for supporting the Committee's recommendations; a description of the Committee's rationale and its relationship to performance are all that is required.

First, in response to specificity concerns, Item 402(k) now only requires specific information about the CEO rather than all Named Executives. Only a discussion of the Committee's general policies with respect to the other Named Executives is required. This avoids potentially repetitive descriptions. Furthermore, factors or criteria involving confidential information, including specific target levels for quantitative and qualitative performance factors, need not be disclosed if doing so would have an adverse effect on the issuer. Finally, subjective personal performance factors relating to an executive's performance, such as personality and judgment, do not need to be disclosed. In other words, the mandated disclosure is solely based on corporate performance criteria, such as profitability, sales growth, return on equity, and market share, upon which the Committee relied when setting the CEO's compensation.

Second, in response to concerns regarding potential liability to Committee members which could arise from the Report, the Commission explicitly stated that the Report will not be subject to

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68. Adopting Release, supra note 5, at 83,432.
69. Id.
70. Id.
71. Regulation S-K, Item 402(k)(2). See also Adopting Release, supra note 5, at 83,432.
73. Adopting Release, supra note 5, at 83,417.
74. Regulation S-K, Item 402(k), Instruction 2. See supra note 62 and accompanying text.
75. Adopting Release, supra note 5, at 83,417.
76. Id. On the other hand, several practicing attorneys have expressed concern that smaller businesses subject to the proxy rules may not rely on factors such as these. If a Committee did not rely on such factors, it should certainly disclose the true basis for its decision, regardless of its nature, in order to avoid future inconsistencies, whether in the disclosure or litigative context.
liability under Section 18 of the Securities Exchange Act of 1934\(^7\) (the “Exchange Act”).\(^8\) It averts liability by deeming the Report not “filed” with the Commission and not “soliciting material” within the context of that section.\(^7\) Furthermore, the Report will not be subject to Regulations 14A or 14C.\(^8\) The Commission stated that the appropriate remedy for a shareholder who is dissatisfied with the Report is to remove the director from office — not to initiate a lawsuit.\(^8\) In addition, the Report must be included in an issuer’s proxy materials only as they pertain to a meeting at which directors will be elected.\(^8\) As noted above, the Report is not filed with the Commission in any other filings under either the Exchange Act or the Securities Act of 1933 (the “Securities Act”). Finally, in response to the practical problems of obtaining the directors’ signatures as well as the concerns about personal liability, the Report need not be signed by the members of the Committee, as originally proposed.\(^8\)

In addition, Item 402(k) now recognizes the oversight role of the board of directors.\(^8\) If the board modified or rejected any action or recommendation of the Committee, the Report must be issued “over” the names of the entire board of directors.\(^8\) The relevant modification or rejection with the reasons therefor must also be disclosed.\(^8\)

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\(^7\) 15 U.S.C. § 78r (1988). Section 18 explicitly grants a private right of action for deceptive statements. Id.

\(^8\) Regulation S-K, Item 402(a)(9). Along with the exemption from Regulations 14A and 14C, discussed infra at note 79, this is the same treatment accorded to annual reports under Rule 14a-3(c), 17 C.F.R. § 240.14a-3(c) (1992).

\(^7\) Id.

\(^8\) Id. Regulation 14A, 17 C.F.R. § 240.14a (1992), governs the solicitation of proxies, including the information required to be contained in the proxy statement. Regulation 14C, 17 C.F.R. § 240.14c (1992), governs the distribution of information statements to shareholders when proxies are not solicited.

\(^81\) Adopting Release, supra note 5, at 83,417.

\(^82\) Regulation S-K, Item 402(a)(8).

\(^83\) The Report will, however, be issued “over” the names of each individual who contributed to the compensation decisionmaking. Id. at Item 402(k)(3). In other words, the name of each Committee member, including any past member who participated in determining executive compensation, should appear at the end of the Report.

\(^84\) Strauss, supra note 14, at 12.

\(^85\) Regulation S-K, Item 402(k)(3).

\(^86\) Id.
2. Employment Contracts, Termination of Employment and Change-in-Control Arrangements

Furthermore, issuers must describe in narrative form the terms and conditions of any employment contract with a Named Executive and any compensatory plan for amounts in excess of $100,000 resulting from the resignation, retirement, or termination of an executive officer, any change in control of the issuer, or any change in the executive’s responsibilities. The purpose of retaining the narrative disclosure is the “clear interest” of the shareholders “in knowing what contractual commitments the board has made on behalf of the [issuer], both with respect to present inducements and future promises.”

3. Director Compensation

Finally, in addition to the voluminous information which must be provided about the Named Executives, the issuer must include a narrative description of directors’ compensation. This basically consists of a statement regarding the standard arrangements by which directors are compensated for their services qua directors, including specific amounts and disclosure of any additional amounts payable for committee participation or special assignments. Furthermore, it requires narrative disclosure of any other non-standard arrangements, such as consulting agreements, by which any directors were compensated for their services. This is not a change from the former rules under Item 402.

D. The Performance Graph

The new disclosure rules require a line graph comparing cumulative total issuer shareholder return with general indicators of shareholder return in the issuer’s market and industry for at least five years (the “Graph”). The implication of this requirement is

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87. Id. at Item 402(h).
88. Adopting Release, supra note 5, at 83,431. Another likely reason for retaining this narrative disclosure is that otherwise, such severance payments might never be reported to the shareholders. After an executive’s termination, he or she is no longer a Named Executive and, therefore, his compensation is no longer subject to tabular disclosure. See supra note 48 and accompanying text.
89. Regulation S-K, Item 402(g).
90. Id. at Item 402(g)(1).
91. Id. at 402(g)(2).
92. Adopting Release, supra note 5, at 83,431.
93. Regulation S-K, Item 402(1)(1)(i), (1)(ii) and (2).
that executive compensation should be justified by the comparative market performance of an issuer’s securities.\footnote{94} As the market index, the issuer should use the Standard & Poor’s 500 Composite Stock Price Index, if it is included in that index; otherwise it may use Standard & Poor’s or any broad equity market index which includes companies traded in the same market or are of similar market capitalization.\footnote{95} An issuer may use a published industry index, peer issuers, or issuers with similar market capitalization as an industry indicator.\footnote{96} In a correcting release issued on November 9, 1992, the Commission added the requirement that an issuer that constructs its own peer issuer comparison must disclose the identity of each issuer in its comparison group and weigh the returns of each issuer for market capitalization.\footnote{97}

Since the purpose of the Graph is to aid shareholders in evaluating the decisions of directors in the context of re-election,\footnote{98} the Commission provided exemptions from liability for selection of the industry or peer index by exempting liability under Section 18 and Regulations 14A and 14C of the Exchange Act.\footnote{99} These exemptions are also intended to ensure that the issuer will not be subjected to liability concerning its selection of the indices for inclusion in the Graph since no industry or peer index will be perfectly comparable to a specific issuer.\footnote{100}

One serious issue concerning the Graph which the Commission has left unaddressed is how an issuer which has no public market for its shares should design an appropriate index, especially when fourth quarter information for its peer group is not publicly available until after the issuer sends its proxy materials to the shareholders. This question remains unresolved. However, at this point, the sensible approach would be to provide as close an index

as possible with a footnote disclaiming it. Issuers in this predicament should also be aware that a peer index may be comprised of a single issuer and that financial consulting firms are starting to address this problem for their clients and will soon begin compiling their own indices.

III. OTHER RECENT SEC INITIATIVES AFFECTING EXECUTIVE COMPENSATION: EFFORTS TO INCREASE SHAREHOLDER PARTICIPATION IN THE CORPORATE CONTEXT

Basically, the proposals affecting executive compensation have taken two forms — those which have attempted to limit executive compensation directly and those which have attempted to increase shareholder participation in the corporate context. The

101. Section 18(k) of the Federal Deposit Insurance Corp. Act, 12 U.S.C.A. § 1828(k) (West Supp. 1993), gives the Federal Deposit Insurance Corporation ("FDIC") authority to promulgate regulations prohibiting or limiting golden parachute or indemnification payments. Id. § 1828(k)(1). The section defines a golden parachute as any payment or agreement to make a compensatory payment for the benefit of an affiliate pursuant to an obligation that is contingent on the recipient's affiliation, or is received upon the institution's insolvency, conservatorship or troubled condition. Id. § 1828(k)(4). As yet, the FDIC has not issued its regulations.

102. For example, the Corporate Pay Responsibility Act, 1991 H.R. 2522, 1991 S. 1198, (the "Act") was introduced in Congress to achieve more thorough disclosure of executive compensation and give shareholders greater rights to challenge it. BLOOMENTHAL & WOLFF, supra note 2, § 10.04[4] at 10-64. The Act first provided that compensation was an appropriate subject for action by a corporation's security holders. This would have been achieved by a requirement that if a shareholder proposal met specified standards, it would not be permitted to be excluded from an issuer's proxy materials. S. 1198 § 2 ("recommendations, proposals, or statements on the policies, criteria or methods to be used in determining or providing the compensation to be paid to the directors or chief executive officer of an issuer shall be considered proper subjects for action by its security holders"). The need for this provision has been mitigated by the Commission's no-action position detailed infra at notes 123-27 and accompanying text. In addition, the Act required that proxy statements contain clear and comprehensive information regarding the pay of directors and senior executives, including a single dollar figure representing total compensation for the preceding year, a graphic representation of the total compensation received for the three preceding fiscal years, and the estimated present value, as defined by the Commission, of any future, deferred or contingent compensation. Id. Clearly, the need for this provision was also eliminated, given the new Item 402 disclosure rules.

Secondly, the Act provided for increased ability to nominate directors and inclusion of information concerning those nominations in the issuer's proxy materials. Id. Finally, the Act provided for access to record ownership lists and the promulgation of regulations protecting the confidentiality of the voting process. Id. § 3. These issues were addressed by the Commission in the new proxy rules discussed infra at notes 103-22 and accompanying text. Given the similarity of these provisions to the regulations promulgated by the Commission under the Exchange Act and the no-action position taken by the Commission in February, 1992, the proposed Act was put on hold and presumably will be tabled en-
latter efforts obviously assume that increasing a shareholder's awareness and participation in the corporate process will have the secondary effect of limiting executive compensation, or at least effectively monitoring it, making outright compensation controls unnecessary.

A. Generally

Major changes in the area of proxy solicitations were proposed and enacted together with the executive compensation rules, signaling their importance to the general scheme of empowering shareholders to affect directors' decisions pertaining to executive compensation, as well as other areas. In fact, the Commission explicitly stated that Congress intended the role of the proxy rules in the overall scheme of corporate governance to be assurance of "fair, and effective shareholder suffrage."¹⁰³

In a nutshell, the new proxy rules eliminate unnecessary regulatory obstacles to the exchange of views and opinions by shareholders and others concerning management performance and initiatives presented for a vote of shareholders. The [new rules] also lower the regulatory costs of conducting a regulated solicitation by management, shareholders and others by minimizing regulatory costs related to the dissemination of soliciting materials. The rules also remove unnecessary limitations on shareholders' use of their voting rights, and improve disclosure to shareholders in the context of a solicitation as well as in the reporting of voting results.¹⁰⁴

Specifically, the new rules amend the proxy rules promulgated under Section 14(a)¹⁰⁵ of the Exchange Act. In particular, Rule 14a-2(b)¹⁰⁶ was amended to create an exemption from the proxy statement delivery and disclosure requirements for communications with shareholders under circumstances where the communicator is not seeking proxy authorization and does not have a substantial interest in the subject matter of the vote or is otherwise eligible for

¹⁰⁴ Id. at 83,353.
an exemption.\textsuperscript{107} In addition, the definition of "solicitation" in Rule 14a-1\textsuperscript{108} was amended to specify that a shareholder can publicly announce how he intends to vote and provide reasons for that decision without requiring complicated compliance with the proxy rules.\textsuperscript{109} Moreover, Rule 14a-3\textsuperscript{110} was amended to add a new paragraph (f), exempting solicitations conveyed by public broadcast, speech, or publication from the proxy requirements, provided a definitive proxy statement is on file with the Commission.\textsuperscript{111} Rules 14a-3(a) and 14a-4\textsuperscript{112} were amended to allow issuers and other solicitors to commence a solicitation on the basis of a preliminary proxy statement filed with the Commission so long as no actual proxy card is distributed to shareholders until the dissemination of a definitive proxy.\textsuperscript{113} Furthermore, Rule 14a-7\textsuperscript{114} was amended to require issuers to furnish requesting shareholders copies of lists of shareholder names and position listings under certain conditions and, in all other circumstances, to make an election to either provide a list to the requesting shareholders or mail the materials for them.\textsuperscript{115} Rule 14a-7, in conjunction with Rule 14a-4, also now requires that the actual proxy set forth each matter to be voted on separately to allow shareholders to vote individually for each matter, rather than voting for a package of resolutions or a slate of candidates.\textsuperscript{116} Finally, Items 4(c) of Forms 10-K,\textsuperscript{117} 10-Q,\textsuperscript{118} 10-KSB\textsuperscript{119} and 10-QSB\textsuperscript{120} and Item 21 of Schedule 14A\textsuperscript{121} were revised to improve disclosure of vot-

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\bibitem{107} Shareholder Communications Release, \textit{supra} note 103, at 83,353.
\bibitem{108} 17 C.F.R. \textsection 240.14a-1(f) (1992).
\bibitem{109} Shareholder Communications Release, \textit{supra} note 103, at 83,353.
\bibitem{110} 17 C.F.R. \textsection 240.14a-3(f) (1992).
\bibitem{111} Shareholder Communications Release, \textit{supra} note 103, at 83,353-54.
\bibitem{112} 17 C.F.R. \textsection 240.14a-4 (1992).
\bibitem{113} Shareholder Communications Release, \textit{supra} note 103, at 83,354.
\bibitem{114} 17 C.F.R. \textsection 240.14a-7 (1992).
\bibitem{115} Shareholder Communications Release, \textit{supra} note 103, at 83,354.
\bibitem{116} \textit{Id}.
\bibitem{117} 17 C.F.R. \textsection 249.310 (1992). The Form 10-K is the form on which the annual report is required to be filed pursuant to \textsection 13, 15 U.S.C. \textsection 78m, or \textsection 15(d), 15 U.S.C. \textsection 78o(d), of the Exchange Act.
\bibitem{118} 17 C.F.R. \textsection 249.308a (1992). The Form 10-Q is the form on which quarterly reports are required to be filed pursuant to \textsection section 13 or 15(d) of the Exchange Act.
\bibitem{119} 17 C.F.R. \textsection 240.310b (1992). The Form 10-KSB is the form on which "small business issuers" should file their annual reports pursuant to \textsection section 13 or 15(d) of the Exchange Act.
\bibitem{120} 17 C.F.R. \textsection 240.308b (1992). The Form 10-QSB is the form on which "small business issuers" should file their quarterly reports pursuant to \textsection section 13 or 15(d) of the Exchange Act.
\bibitem{121} 17 C.F.R. \textsection 240.14a-101 (1992). Schedule 14A contains the information required to
ing results and of the vote needed for approval of matters presented to shareholders.122

B. Specifically in Relation to Executive Compensation

Specifically in the arena of executive compensation decisionmaking, the Commission has facilitated shareholder participation through a series of no-action letters issued February 13, 1992.123 In a radical departure from its traditional position, the Commission announced that proposals which suggest changes regarding executive compensation would henceforth be required to be included in a corporation’s proxy materials.124 Historically, such proposals had been excluded from the proxy statement based on

be contained in the proxy statement.

122. Shareholder Communications Release, supra note 103, at 83,354.

All of the foregoing were deemed by the Commission to be non-excludible from the corporations’ proxy statements with two caveats: some of the proposals required revision to be phrased as a recommendation or request, and some required clarification that they related only to senior executive officers’ compensation.


124. See supra note 123.
Rule 14a-8(c)(7), promulgated under the Exchange Act, which states that proposals relating to the conduct of the ordinary business of the corporation are excludible from the proxy statement based on the directors' plenary power over the ordinary business and affairs of the corporation. The Commission explained the change by noting that increasing public and shareholder concern over executive compensation signified the importance of the issue.

C. The Total Impact on Executive Compensation Decisionmaking

In addition to the articulated goals of the Commission in enacting the new rules, the Commission may have had other intended objectives. It is likely the Commission was acting to motivate shareholders to take a more active role in compensation decisionmaking regarding the nature of compensation itself.

For example, in introducing the new executive compensation disclosure rules, then Chairman Richard Breeden cited the "increasing and quite disturbing trend" of corporations awarding "mega grants" to executives. He noted that "aside from their absolute size, some mega-options make mini-sense for shareholders." These comments would be irrelevant if the disclosure rules were not meant to affect the underlying trends in executive compensation itself. Chairman Breeden is also reported as stating that the rules will "inform and empower" shareholders. He reportedly stated, "The best protection against abuses in executive compensation is a simple weapon - the cleansing power of sunlight and the power of an informed shareholder base. The new compensation disclosure rules will do away with impenetrable legalistic narratives that often obscure the bottom line." Once

126. Rule 14a-8(c)(7) ("The [issuer] may omit a proposal and any statement in support thereof from its proxy statement if the proposal deals with a matter relating to the conduct of the ordinary business operations of the [issuer].").
127. Reebok Int'l, SEC No-Action Letter, at 76,131 ("In view of the widespread public debate concerning executive and director compensation policies and practices, and the increasing recognition that these issues raise significant policy issues, it is the [Commission's] view that proposals relating to senior executive compensation no longer can be considered matters relating to ordinary business.").
128. Gottlieb & de Brito, supra note 8, at 5 (citing Opening Statement of Chairman Richard C. Breeden at the Open Meeting of the Commission, October 15, 1992, at 5 [hereinafter Opening Statement]).
129. Id. (citing Opening Statement, at 6).
130. Id.
again, this signifies the Commission's belief that the disclosure rules will sufficiently inform shareholders about executive compensation abuses and that once they are fully informed, shareholders will have the power to curb those abuses and actually affect the substance of compensation packages.

Specifically, one commentator, relying on statements by the Commission, has stated that the Performance Graph is intended not simply as a disclosure tool but as a means to foster accountability by directors to shareholders "to be used by shareholders in evaluating the quality of decisions made by directors standing for re-election." The Performance Graph is intended to "complement the discussion by the compensation committee of the relationship of executive compensation to corporate performance in a given year." The effect of disclosure of the graph may be to prompt shareholders to demand a closer relationship between executive compensation and a company's performance.\(^1\)

The same can be said for the Compensation Committee Report as well. In addition, the new proxy rules,\(^1\) adopted the same day as the executive compensation disclosure rules, also act to empower shareholders. In explaining the rationale behind the new proxy rules, Chairman Breeden is reported as stating that it had become "overwhelmingly clear" to the Commission that the proxy system had acted to "insulate" management from accountability to shareholders.\(^1\)

Thus, all these signals mandate the conclusion that the Commission clearly intended that together, the executive compensation and proxy rules would have the secondary effect of limiting executive compensation. Nonetheless, the Commission rejected suggestions that it regulate executive compensation directly\(^1\) Chairman Breeden stated that it is the province of shareholders — not the government — to monitor the decisions of the directors with re-

\(^1\) See supra note 8, at 5-6 (citing Proposing Release).
\(^1\) See supra notes 103-122 and accompanying text.
\(^1\) Id. (citing Testimony of Richard C. Breeden, Chairman, U.S. Securities and Exchange Commission, before the Subcommittee on Taxation of the Senate Committee on Finance, June 4, 1992).
The power shareholders will potentially receive as the result of the new rules has understandably pleased representatives of shareholder groups; likewise, several corporate representatives are upset about the new rules because they believe the rules are costly, complicated and open the door to corporate raiders, leaving corporations virtually defenseless. Yet, at least one commentator believes the new rules make sense from a business perspective. John Balkcom, a principal of a Chicago management consulting firm, has stated that the new rules give boards of directors and compensation committees the opportunity to clearly state executive compensation packages. This is beneficial because compensation committees have historically been "hobbled by platitudes that pass for compensation philosophies [and] slowed or confused by ambiguous responsibilities for top management pay decisions and conflicted by turf wars among the chief executives, the compensation committee and the full board of directors." Thus, now many companies will have the opportunity to, indeed will be required to, "do some fundamental rethinking about how and why they make pay decisions."

Furthermore, the Compensation Committee Report should serve to define the roles of the Committee, the Board of Directors as a whole, and the CEO. Balkcom notes that few compensation committees clearly understand their roles in decisionmaking versus the roles of the board and the CEO. He states that "[w]ithout clearly delineated powers regarding initiation, ratification, implementation and monitoring of compensation programs, companies risk awkward, adversarial proceedings" among the key players over decisionmaking powers; thus, "clarifying these roles is one important aspect of the disclosure of 'the company's compensation poli-

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136. Id. (citing Opening Statement, at 6).
138. Id. (describing the Business Roundtable's reaction to the shareholder communication rules).
140. Id.
141. Id.
142. Id.
143. Id.
144. Id.
Despite Balkcom's positive exhortations regarding the new rules, the rules simply do not inure to the benefit of corporate issuers — nor were they intended to. The rules benefit shareholders who would like to have a more active role in the governance of the corporations in which they have invested. Until now, those shareholders were disenfranchised and disempowered by a relative lack of knowledge, whether it resulted from nondisclosure altogether or from the complexity of that disclosure. The new streamlined disclosure system will remedy that problem. And this, in conjunction with the new proxy rules and the reinterpretation of ordinary business matters under Rule 14a-8, will give shareholders the power to have input in the management of the corporations which they own. To that extent, the rules are not unbeneficial to corporations themselves. The corporations will have the benefit of interested input and may be forced to operate more efficiently. Thus, the real losers under the new system of disclosure are the executives who may be forced to take pay cuts and will have to pay closer attention to the needs and expectations of the shareholders whom they represent.