2011

Regulation S-K Item 402(S): Regulating Compensation Incentive-Based Risk through Mandatory Disclosure

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REGULATION S-K ITEM 402(S):  
REGULATING COMPENSATION  
INCENTIVE-BASED RISK THROUGH  
MANDATORY DISCLOSURE

"Sunlight is said to be the best of disinfectants; electric light the most efficient policeman." 

It is axiomatic that transparency underlies the United States capital markets and the entire public company mandatory disclosure scheme. Periodic reports and public offering registration documents are intended to provide potential investors and current shareholders with the information necessary to make informed decisions whether to buy, sell, or hold securities. Disclosure of such extensive information comes at a price—periodic disclosure documents can reach several hundred pages, costing companies and their management and directors, significant expense and time. The federal securities laws’ focus on disclosure, transparency, and informed investor choice are not only important tools against investment fraud but are also thought to be important deterrents to other undesirable corporate conduct and decision making. Yet, it seems that no matter

1 LOUIS D. BRANDEIS, OTHER PEOPLE’S MONEY AND HOW THE BANKERS USE IT 92 (1914).
3 See Joel Seligman, No One Can Serve Two Masters: Corporate and Securities Law After Enron, 80 WASH. U. L. Q. 449, 450 (2002) (“At its core, the primary policy of the federal securities laws involves the remediation of information asymmetries, that is, equalization of the information available to outside investors and insiders.”).
5 See Seligman, supra note 3, at 449–50 (discussing the harm done to investors when corporations act without making proper disclosures to shareholders, which was the
how much information is currently disclosed, with each new financial or corporate scandal, even more disclosure is compelled in response.\(^6\) It is no surprise, then, that disclosure requirements have grown as a result of the 2008 collapse of Bear Stearns and Lehman Brothers.

The unprecedented collapse of two of Wall Street’s most longstanding and prominent investment banks sparked the worst phase of the most recent “scandal,” or more aptly, “Financial Crisis.”\(^7\) The sophisticated and risky financial products that generated billions of dollars in profit for the financial services industry during the preceding years, culminated with dramatic and devastating effects.\(^8\) To prevent a global economic collapse, the federal government injected nearly $250 billion into the financial sector by purchasing assets and equity from troubled financial institutions via the Troubled Asset Relief Program (“TARP”).\(^9\) From its inception, TARP


\(^8\) The casualties included two of Wall Street’s oldest and most preeminent investment banks—Bear Stearns and Lehman Brothers—while many other financial firms hung on by a thread. See Robin Sidel et al., The Week That Shook Wall Street: Inside the Demise of Bear Stearns, WALL ST. J., Mar. 18, 2008, at A1 (detailing the fall of Bear Stearns).

generated significant controversy and numerous critics. However, when insurance behemoth American International Group (AIG) released compensation data for its failed derivatives trading group—including substantial bonuses funded by federal TARP assistance—public outrage over executive compensation practices came to a derisive head.

Policymakers, commentators, and business executives have all offered various, and in many cases, competing theories outlining the “causes” of the Financial Crisis. Conventional wisdom claims that “perverse” compensation bonus incentives paid to individual bankers are to blame in large part. Others believe the banks themselves disregarded risk because they were engaged in a figurative “arms race” amongst each other, competing to amass the largest profits for their respective organizations and, consequently, paying their employees the largest bonuses. But others contend that the empirical evidence linking incentive-based compensation and excessive risk taking is lacking, and maintain that the bankers simply lacked foresight and were ignorant of the substantial risks inherent in the various transactions in which they were engaged.

10 See Michael R. Crittenden, Panel Steps Up Criticism of Treasury Over TARP, WALL ST. J., Jan. 9, 2009, at A3 (discussing “scathing criticism” of TARP by five-member congressional oversight panel).


12 For a detailed analysis of the financial crisis, its causes, and the subsequent bailouts, see Steven L. Schwarz, Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown, 93 MINN. L. REV. 373, 376 (2008) (“Most of the causes . . . can be attributed to conflicts of interest, investor complacency, and overall complexity, all exacerbated by cupidite.”).


15 Rüdiger Fahlenbrach & René M. Stulz, Bank CEO Incentives and the Credit Crisis 18 (Charles A. Dice Ctr. For Research in Fin. Econ., Working Paper No. 2009-13, 2010), available
Nevertheless, the notion of “excessive” or “imprudent” risk taking emerges as a common thread in the various articulations. Interestingly, and perhaps intuitively, most commentators and legislators have almost myopically associated excessive or imprudent risk taking with “excessive” or “perverse” executive compensation arrangements. Indeed the public is led to believe that short-term incentive-based bonus compensation constitutes a significant, and arguably obscene, portion of the total compensation awarded to many business executives and employees because huge bonus payouts make the news.

Indeed, Congress viewed risk management and mitigation as focal points in the recent Dodd-Frank legislation. Further, the Securities Exchange Commission (“SEC”) recently released new Regulation S-K disclosure enhancements aimed at increasing internal risk management, and requiring disclosure where incentive-based compensation is likely to result in imprudent risk taking that is damaging to the corporation. The new requirements largely focus on

at http://ssrn.com/abstract=1439859 (“[O]ur results cannot be explained by the large share ownership of some CEOs of investment banks that performed poorly.”); Floyd Norris, It May be Outrageous, but Wall Street Pay Didn’t Cause This Crisis, N.Y. TIMES, July 31, 2009, at B1 (“[T]here is little evidence that big pay – or the incentives connected to it – caused the financial train wreck that sent the world into recession . . . . To the contrary, there is plenty of evidence that no one who counted – traders, chief executives or regulators – understood the risks that were being taken.”).
disclosure, but fail to provide meaningful guidance on how reporting companies are to gauge risk or can delineate productive prudent risk taking from excessive risk taking. Nevertheless, companies are required to evaluate and disclose how their compensation schemes may encourage imprudent risk-taking behavior. In light of these considerations, this Comment first attempts to succinctly explore the SEC’s intent in implementing the disclosure enhancements and delineate the likely intended scope of disclosure. Second, this Comment suggests that firms consider adopting various mitigation and deferment mechanisms to limit their exposure to potential liability stemming from disclosure requirements, and to encourage prudent risk taking in compliance with internal risk-management policies. These recommendations will be analyzed in light of traditional theories of executive-compensation and corporate-reform requirements.

This Comment proceeds in two Parts. The first Part describes how compensation practices may theoretically incentivize employees to take imprudent risks or create adverse risk in general, focusing on potential agency issues inherent in the shareholder-manager relationship. The second Part explores the scope of Regulation S-K Item 402(s), which requires public companies to disclose compensation risk that is reasonably likely to have a materially adverse effect, from the perspectives of both the SEC and subject companies.

I. BRIEF OVERVIEW OF EXECUTIVE COMPENSATION IN THE UNITED STATES

Executive compensation in the United States has long been considered a problematic corporate governance issue. It has generated even further attention and condemnation over the past few decades given the seemingly exponential growth of executive

regulators to issue guidelines mandating the disclosure of incentive-based compensation that encourages inappropriate risks at banking holding companies, registered broker-deals, and other investment firms); id. § 952, 124 Stat. at 1900 (requiring compensation committee independence).


compensation packages in relation to the “average” employee wage. Whether the dollar figure awarded to executives is patently reasonable or excessive is beyond the scope of this Comment. Rather, this Comment is concerned with the extent to which compensation practices may be tied to imprudent risk taking, and how companies should handle this situation in light of Item 402(s) disclosure requirements.

A for-profit corporation’s primary objective is to “conduct . . . business activities with a view to enhancing corporate profit and shareholder gain.” Specifically, maximization of long-term, as opposed to short-term, shareholder gain is fundamental. In all business dealings, however, elements of uncertainty and risk exist as potential impediments to the realization of profit. Prudent corporations must therefore evaluate the risk/reward attributes of corporate actions to determine those most likely to achieve optimal results. The question then becomes: who makes this assessment?

A corporation’s stakeholders typically exercise very little direct control over the direction and management of the corporation, particularly in the case of large, publicly traded corporations. That task is left to corporate boards of directors, who in turn delegate

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24 Although specific dollar figures are not the focus of this paper, it should be noted that incentive-based compensation typically constitutes a substantial portion of executive compensation packages, particularly within the financial services industry where these particular issues are most likely to arise. See e.g., Louise Story, Executive Pay, N.Y. TIMES, Dec. 20, 2010, available at http://topics.nytimes.com/top/reference/timestopics/subjects/e/executive_pay/index.html?scp=1&sq=executive%20compensation%20&st=cse (noting that executive compensation funds began to soar in the 1980s and 1990s).


26 See THE AMERICAN LAW INSTITUTE, supra note 25, at cmt. f (“[T]hat the objective of the corporation is to conduct business activities with a view to enhancing corporate profit and shareholder gain [ ] does not mean that the objective of the corporation must be to realize corporate profit and shareholder gain in the short run. Indeed, the contrary is true: long-run profitability and shareholder gain are at the core of the economic objective.”).

27 FRANK H. KNIGHT, RISK, UNCERTAINTY AND PROFIT (8th ed. 1957) (explaining why risk and uncertainty does not give rise to profits).

responsibility to executive officers, who run the day-to-day operations of the corporation.\textsuperscript{29} But achievement of the long-term profit objective may be compromised where corporate executives and their employees make business decisions while receiving a fixed salary and bearing little “risk.” In the meantime, “those who take the risk and receive profits—the stockholders—make no decisions, exercise no control.”\textsuperscript{30} In response to this conundrum, boards often structure compensation packages to award executives with incentive-based bonuses or equity awards, based on the achievement of a particular target or benchmark.\textsuperscript{31}

Scholars are sharply divided on the question of whether incentive-based compensation provides executives with perverse incentives to take imprudent risks at their company’s expense. Professors Lucian Bebchuk and Jesse Fried have extensively studied the various forms of CEO compensation and ultimately conclude that the so-called “pay-for-performance” incentive-based payments have failed to deliver on their promise.\textsuperscript{32} They articulate two primary critiques of traditional corporate governance of executive compensation arrangements. First, in the executive compensation context, an inherent conflict of interest in the agency relationship exists, at least in theory, between shareholders and management.\textsuperscript{33} Second, the

\textsuperscript{29} Id.

\textsuperscript{30} KNIGHT, supra note 27, at 203 (“There is an apparent separation of the functions of making decisions and taking the ‘risk’ of error in decisions.”).


\textsuperscript{32} See, e.g., id. (describing significant flaws in corporate governance and executive compensation packages and suggesting that they must fundamentally change if companies are to be managed in a manner that promotes shareholders’ interests); Lucian Arye Bebchuck & Jesse M. Fried, Executive Compensation as an Agency Problem, 17 J. ECON. PERSP. 71, 72 (2003) (explaining that substantial costs are imposed on shareholders when managers have influence over their own pay); Lucian A. Bebchuk et al., Managerial Power and Rent Extraction in the Design of Executive Compensation, 69 U. CHI. L. REV. 751, 751 (2002) (describing executive compensation as rent extraction, which produce “suboptimal incentives” and ultimately hurts shareholder value in a company); Lucian A. Bebchuk & Jesse M. Fried, Pay Without Performance: Overview of the Issues, 17 J. APPLIED CORP. FIN. 8 (2005) (discussing how executive compensation in the United States has strayed from the model upon which it was built, arm’s-length negotiation). But see Patrick Bolton et al., Executive Compensation and Short-Termist Behaviour in Speculative Markets, 73 REV. OF ECON. STUDIES 577, 577 (2006) (arguing that, in a speculative market where stock prices may deviate from fundamentals, an emphasis on short-term stock performance may be the outcome of an optimal contracting problem rather than rent extraction by managers).

\textsuperscript{33} See BEBCHUK & FRIED, supra note 31, at 15–16. To mitigate the inherent tension between agents and principals, corporate law requires firms to elect boards of directors, who in turn, are required to act in the best interest of the shareholders. State law governs the relationship between directors and shareholders by imposing a fiduciary duty of good faith and loyalty on directors to act in the best interest of the corporation’s shareholders. See, e.g., Smith v. Van Gorkom, 488 A.2d 858, 881 (Del. 1985) (holding that the board of directors of Trans
notion that boards represent shareholders’ interests by negotiating compensation arrangements at arm’s length with management may be flawed if boards are not truly independent.\textsuperscript{34}

Bebchuk and Fried argue that current compensation packages are often overly favorable to management because directors are reluctant to seriously negotiate and hold executives accountable for their performance.\textsuperscript{35} Additionally, they suggest that incentive-based schemes may provide perverse incentives for executives to maximize current compensation by taking short-term hyper-risks while ignoring serious long-term systemic risks.\textsuperscript{36} This argument is easy to understand when compensation packages are overly weighted toward short-term, rather than long-term, payouts, especially in industries where frequent lateral employment moves are common. It seems obvious that an employee who does not plan to stay at the current

Union Corp. breached their fiduciary duty to Trans Union shareholders and were grossly negligent by failing to make an informed business decision regarding a cash-out merger and failing to disclose material facts regarding the merger to shareholders), \textit{superseded by statute}, Del. Code Ann. tit. 8, § 102 (2001), as recognized in Emerald Partners v. Berlin, 787 A.2d 85, 90 (Del. 2001); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 179 (Del. 1986) (stating that duty of directors when company is being sold is to maximize company’s value for shareholders). Notably, the business judgment rule limits the extent of directors’ fiduciary duty to shareholders in disinterested transactions. See, e.g., Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) (holding that board will enjoy protection of business judgment rule, in suits challenging propriety of its takeover defenses, where directors demonstrate their good faith, reasonable investigation and proportionality of defenses against perceived harm to corporation).

\textsuperscript{34} \textsc{Bebchuk \& Fried}, supra note 31, at 23–44 (describing the design of executive compensation structures). Generally, the director-primacy model underlies traditional corporate law’s approach to executive compensation. See Stephen M. Bainbridge, \textit{Director Primacy: The Means and Ends of Corporate Governance}, 97 NW. U. L. REV. 547 (2003) (exploring the benefits and implications of the director-primacy model across the spectrum of corporate law).

At its core, the director-primacy model assumes that boards, bargaining at arm’s length with corporate executives, negotiate pay arrangements designed to serve shareholders’ interest. See \textsc{id.} at 562 (noting the recent trend of paying directors in stock, which serves to align director and shareholder interests). Additionally, national stock exchange listing requirements mandate that “independent” directors must constitute a majority on the boards of listed companies. \textsc{NASDAQ, Listing Standards \& Fees 22} (2010), available at http://www.nasdaq.com/about/nasdaq_listing_req_fees.pdf. Accordingly, it can be assumed that when Bebchuk discusses a lack of director independence, he does so figuratively (i.e., social relationships between independent directors and management as influencing director objectivity) rather than literally (i.e., directors are all insiders or affiliates).

\textsuperscript{35} Theoretically, the widely accepted director-primacy model serves to mitigate the agency problem because independent directors constitute a majority of boards, and it is assumed that independent directors negotiate executive compensation at arm’s length with management. See \textsc{Bebchuk \& Fried}, supra note 31, at 17 (describing the corporate theory of arm’s-length negotiating between directors and executives for executive compensation). Bebchuk and Fried’s “managerial power” critique contends that a structural bias among those who comprise boards of directors and managements of corporations prohibits arm’s-length bargaining. \textsc{id.} at 61–79.

\textsuperscript{36} See Lucian A. Bebchuk, \textit{How to Fix Bankers’ Pay}, 139 DAEDALUS 52, 53 (2010) (suggesting that executives’ ability to garner large amounts of compensation based on short-term results induces them to take excessive risk).
employer for the long term will be motivated to maximize her short-term reward, without regard for the long-term consequences. By the time the unfortunate results occur, the employee will have cashed out and moved on, often to an even more lucrative position.

The critical debate over whether short-term compensation bonus incentives actually incentivized banking executives to engage in hyper-risky transactions, or whether ignorance or underestimation of the risk alone is to blame, however, is more contentious than Bebchuk and Fried’s general conclusions. Proponents of the latter theory suggest that compensation incentives were irrelevant to the discussion, as executives at Lehman Brothers and Bear Stearns maintained outstanding stock and options that were not cashed in before the Financial Crisis. Even assuming that executives did not knowingly engage in short-term risk-taking compensation arrangements that award executives handsomely for short-term profit, their compensation arrangements may nonetheless have discouraged them from appropriately gauging long-term risk. At the systemic level, however, it is arguably less likely that compensation bonus

37 Compare William D. Cohan, Make Wall Street Risk It All, N.Y. TIMES ONLINE (Oct. 7, 2010, 8:40 PM), http://opinionator.blogs.nytimes.com/2010/10/07/make-wall-street-risk-it-all/?scp=4&sq=excessive%20risk-taking%20financial%20crisis&st=cse (“We already have definitive proof that Wall Street’s compensation practices lead to excessive risk-taking: witness the way Wall Street’s armies kept selling mortgage-based securities filled with defaulting home mortgages long after the securities made any sense as an investment. Wall Street did the same thing in the 1980s with junk bonds, the same thing in the 1990s with Internet initial public offerings in the in the early 2000s with the debt of emerging telecommunications companies.”), with Ira T. Kay, CEO Pay for Performance: The Solution to “Managerial Power,” 30 J. CORP. L. 785 (2005) (arguing that the current pay model is not broken, but agrees that more long-term vesting equity awards are preferable).

38 See Floyd Norris, It May Be Outrageous, But Wall Street Pay Didn’t Cause this Crisis, N.Y. TIMES, July 31, 2009, at B1 (noting that most bank CEOs lost millions of dollars in share value in the 2008 financial crisis and did not sell their shares to avoid losses); Jeffrey Friedman, Op-Ed., Bank Pay and the Financial Crisis, WALL ST. J. ONLINE (September 28, 2009, 10:27 AM), http://online.wsj.com/article/SB1000142405297020488304574429293838639418.html "?KEYWORDS=%22jeffrey+friedman%22 (relying on the Lehman CEOs’ large paper losses as a basis for his view that financial firm compensation structure was not at fault for bank’s risk-taking). Empirical evidence demonstrates, however, that in the years prior to the Wall Street crash, executives of these firms earned substantially more through short-term bonus incentives and cashed-in options and stock than they lost during the crash. See Lucian A. Bebchuk et. al, The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008, 27 YALE J. ON REG. 257, 257 (“[T]he top executive teams of Bear Stearns and Lehman Brothers derived cash flows of about $1.4 billion and $1 billion, respectively, from cash bonuses and equity sales during 2000-2008.”).

39 See Miriam A. Cherry & Jarrod Wong, Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes, 94 MINN. L. REV. 368, 392 (2009) (“One of the major problems with executive compensation has been a focus only upon short-term performance. Such short-term thinking often leads to opportunistic behavior, at the expense of the long-term health of the company. By in a sense operating as a ‘lead parachute,’ prospective clawback provisions begin to align incentives over a longer time frame.”).
incentives were the sole motivating factor behind the Financial Crisis.\footnote{See Schwarcz, supra note 12, at 373–74 (suggesting that the financial crisis of 2008 was due to weaknesses in the financial markets rather than banks specifically). Nevertheless, during 2000–2008, the top five executives at Bear Stearns and Lehman pocketed roughly $1.4 billion and $1 billion, respectively, averaging out to approximately $250 million per executive. See Bebchuk supra note 38, at 267–73 (noting that top executives unloaded shares and options and therefore were able to cash out much of their equity before the stock price of their firms plummeted).}

A recent study, for example, found that the financial services industry had “some of the longest vesting schedules in their executive pay contracts” of any industry reviewed.\footnote{Radhakrishnan Gopalan et al., The Optimal Duration of Executive Compensation: Theory and Evidence 2–3 (August 10, 2010) (The Harvard Law School Forum on Corporate Governance and Financial Regulation) (unpublished manuscript), available at http://ssrn.com/abstract=1656603 (“This [finding] is somewhat surprising, given the recent criticism that short-termism in executive compensation at banks may have contributed to the 2007-09 financial crisis.”).} Thus, while conventional wisdom believes that short-term incentives are to blame for the Financial Crisis, notably little empirical evidence in support of that notion exists, while evidence to the contrary continues to mount.\footnote{See supra notes 16–17 and accompanying text.}

Interestingly, an emerging minority of scholars and critics are offering empirical evidence debunking the mainstream notion that incentive-based compensation encourages imprudent risk taking.\footnote{Id.}\footnote{See supra notes 15-17 and accompanying text.}

If these scholars are correct, the exhaustive focus on risk and compensation may be misplaced and the practical effect of Item 402(s) may be slight.

Currently, however, the majority’s view pervades the media and has garnered the support of the public and policymakers.\footnote{See supra notes 15–17 and accompanying text.} Within the last decade alone, egregious examples of executives acting opportunistically to maximize personal gain at the expense of their corporations produced significant media attention and have served as the basis for significant corporate financial reform.\footnote{See Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745 (codified at 15 U.S.C. §§ 7201-66 (2006)) (mandating widespread corporate governance reform in the areas of accounting, executive compensation, and mandatory disclosure for public companies).}

The Enron and WorldCom accounting scandals both serve as extreme examples of self-serving, opportunistic, and fraudulent behavior by executives to maximize their personal gains at the expense of the corporation and shareholders.\footnote{See, e.g., Richard W. Stevenson & Richard A. Oppel Jr., Fed Chief Blames Corporate Greed; House Revises Bill, N.Y. TIMES, July 17, 2002, at A1 (discussing remarks on “a culture a corporate culture blighted by ‘infectious greed’” made by then Federal Reserve Board Chairman Alan Greenspan following the collapse of Enron); Louis Lavelle, The Best & Worst Boards: How the Corporate Scandals Are Sparking a Revolution in Governance, BUSINESS
Even if compensation incentives may have only been one relevant factor among many contributing to the Financial Crisis, executives and compensation committees are nevertheless more likely to thoroughly vet the risks and consequences of their compensation policies and practices if the SEC requires disclosure of compensation risk, as the executives and directors bear potential liability for nondisclosure or false disclosures. Accordingly, Part Two considers how recent regulatory reform encourages public companies to seriously review and consider the scope of their risk-management policies and compensation packages, by requiring such companies to disclose information about risk-management and compensation-induced risk taking.

II. ITEM 402(s): SEC DISCLOSURE OF INCENTIVE-BASED COMPENSATION RISK MANAGEMENT

Undoubtedly, the Financial Crisis and subsequent bailout have cast a shadow of uncertainty over current incentive-based compensation arrangements in investment banking, mortgage, insurance, and other industries. Indeed, members of the SEC have bought into the notion that executive compensation arrangements influence risk-taking behavior; for example, here are the comments of one sitting Commissioner:

How executives are paid influences how they behave. Executive behavior reveals itself in how the company evaluates risk; in whether the management team is too tepid or, by contrast, overconfident in pursuing new growth opportunities; in the extent to which innovation is rewarded; in the extent to which the corporate culture emphasizes ethics and personal responsibility; and in whether the company’s controls demand accountability.

To that end, over the past decade, the SEC has significantly expanded the scope of executive-compensation-practice disclosure.
For example, SEC rules require most public companies to disclose extensive information regarding all aspects of the compensation packages awarded to the corporation’s five highest paid executives in the annual proxy statement, including, since 2006, a comprehensive compensation, disclosure, and analysis (“CD&A”) section.\(^{50}\) Predictably, the trend towards increased disclosure of compensation-related and risk-based corporate decisions continued with the recent disclosure-enhancement rules.

\[\text{A. Rule Making Process for Item 402(s) and Final Release}\]

To encourage disclosure and candid discussion of these sensitive issues, the SEC recently promulgated a set of new disclosure rules intended to compel greater disclosure of executive compensation arrangements, as they pertain to risk taking and risk management.\(^{51}\) In December 2009, the SEC issued final rules on new CD&A guidelines. These rules are intended to enhance the laws that govern: (1) compensation disclosure; (2) director and nominee disclosure; (3) board-leadership and risk-oversight disclosure; (4) compensation consultant disclosure; and (5) reporting of voting results on Form 8-K.\(^{52}\) While “each ‘enhancement’ is important, the first—enhanced compensation disclosures—is an explicit recognition of the supposed need to address risk-related compensation practices across firms.”\(^{53}\)

This Comment focuses on the amendment requiring reporting companies to disclose any compensation policies and practices that specifically relate to risk management.\(^{54}\) Specifically, companies are instructed as follows:

and analysis disclosures in annual proxy statements).

\(^{50}\) See id. (“[R]evis[ing] Summary Compensation Table and Director Compensation Table disclosure with respect to stock awards and option awards to provide disclosure of the compensation cost of awards over the requisite service period.”).


\(^{53}\) Okatomo & Edwards, supra note 21, at 178 (arguing that current regulatory attempts to curb excessive risk taking fail to provide an account of “optimal risk taking”); see also S.E.C. Approves Tougher Rules on Executive Pay, N.Y. TIMES, Dec. 16, 2009, available at http://nytimes.com/2009/12/17/business/17pay.html (discussing how new rules were partly intended to remedy “[c]ompany policies that encouraged excessive risk-taking and rewarded executives for delivering short-term profits”).

\(^{54}\) See Regulation S-K Item 402(s), 17 C.F.R. § 229.402(s) (2010).
To the extent that risks arising from the registrant’s compensation policies and practices for its employees are *reasonably likely* to have a material adverse effect on the registrant, discuss the registrant’s policies and practices of compensating its employees, including non-executive officers, as they relate to risk management practices and risk-taking incentives.\(^{55}\)

Although this provision has the potential to significantly impact incentive-based compensation practices, its practical effect will be largely based on how the SEC interprets and enforces the rule. First, a review of the rule-making process is necessary to grasp what the SEC intended to accomplish by implementing the rule, and in turn, what type of information should be disclosed to meet the intended objective.

### 1. Rule Making History and Intent

These rules had been anticipated for some time.\(^{56}\) At the onset of the Financial Crisis, the SEC acknowledged a need for greater transparency in executive compensation practices, “especially with regard to activities that materially contribute to a company’s risk profile.”\(^{57}\) Concurrently, the SEC perceived a corporate governance failure stemming from “compensation policies [that] ha[d] become disconnected from long-term company performance because the interests of management and some employees, in the form of incentive compensation arrangements, and the long-term well-being of the company [were] not sufficiently aligned.”\(^{58}\)

The rule, as originally proposed, required disclosure of risks arising from compensation policies that *may* have an adverse effect on the company. Notably, the final rule replaces “may” with “reasonably likely to,” a higher standard of certainty.\(^{59}\) By making

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\(^{55}\) *Id.* (emphasis added).


\(^{57}\) *Id.*

\(^{58}\) *Id.* at 35077 (citing FINANCIAL STABILITY FORUM, FSF PRINCIPLES FOR SOUND COMPENSATION PRACTICES 1 (2009), http://www.financialstabilityboard.org/publications/r_0904b.pdf).

\(^{59}\) In response to a number of comments submitted following publication of the proposing release, the SEC determined that raising the threshold standard of certainty to reasonably likely would lessen the potential for overreaching, and would provide shareholders with disclosure of the most meaningful information, rather than an overwhelming and undecipherable information dump. See Proxy Disclosure Statements, 74 Fed. Reg. 68,334, 68,336-37 (Dec. 23, 2009) (codified at 17 C.F.R. § 229.402(s)) (discussing that broad disclosure requirements could have a materially adverse effect on companies).
this alteration, the SEC significantly reduced the risk of overdisclosure, as “may” is perhaps the broadest possible form of probability. This change parallels the SEC’s prior approach to risk-based disclosure in Management’s Discussion and Analysis (“MD&A”) under Item 303 of Regulation S-K.  

2. Final Rule Release

As discussed above, the new disclosure requirements are intended to help shareholders better understand and evaluate the leadership of public companies. Item 402(s) requires a narrative discussion of how a company’s overall employee compensation policies create incentives that can affect the company’s risk profile and how the company manages that risk. Additionally, in contrast to the traditional disclosure about executive compensation, which focused exclusively on senior management, Item 402(s) requires a company to address its compensation policies and practices for all employees to the extent they create risks that are reasonably likely to have a material adverse effect on the company. This means, for example, that a bank must consider the compensation schemes that, for example, might entice a low- or middle-ranking trader to engage in the high risk trading epitomized by “rogue traders,” such as Jerome Kerviel at Société Générale.

To assist companies in executing the arguably onerous task of evaluating compensation risk for all employees, the final rule includes a non-exclusive list of situations in which compensation policies and practices may raise material risks to companies and the concomitant requirement to discuss them, as follows:

- At a business unit of the company that carries a significant portion of the company’s risk profile;
- At a business unit with compensation structured significantly differently than other units within the company;

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62 See SEC Regulation S-K Item 402(s), 17 C.F.R. § 229.402(s) (2010).

63 Id.

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- At a business unit that is significantly more profitable than others within the company;
- At a business unit where compensation expense is a significant percentage of the unit’s revenues; and
- That very significantly from the overall risk and reward structure of the company, such as when bonuses are awarded upon accomplishment of a task, while the income and risk to the company from the task extend over a significantly longer period of time.  

Item 402(s) specifies that the above list is not exhaustive, however, it is a good starting point. During its evaluation of compensation risk, a company should consider whether any of the company’s business units fall within the descriptions in the above list. In any such unit or division, the company’s evaluation should analyze the key employees or groups of employees. If the company considers these employees in addition to the compensation practices relating to executives, the company can be confident that its evaluation satisfies Item 402(s) requirements.

B. Scope of Item 402(s)

1. Determination of Materiality

As a threshold issue, companies must first determine whether their compensation arrangements create risks, and second, whether such risks are reasonably likely to have a materially adverse effect on the company. The general standard of materiality, set forth in *TSC Industries, Inc. v. Northway, Inc.*, [426 U.S. 438 (1976)](https://www.law.cornell.edu/supct/html/426 U.S. 438.html) is whether there is a “substantial likelihood that the disclosure of [an] omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” Further, in *Basic Inc. v. Levinson*, the Supreme Court adopted the *TSC Industries* standard of

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65 Proxy Disclosure Enhancements, 74 Fed. Reg. at 68,337. The SEC indicated that this is intended to be a non-exhaustive list, as other situations may arise that warrant disclosure and discussion. Id. Further, even in the above-listed scenarios, the SEC believes that a company could reasonably conclude that the requisite risk is not present. Id.

66 Id.

67 Id.


69 Id. at 449 (holding that “[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote”); see also SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45150 (Aug. 19, 1999) (stating that misstatements that have the effect of increasing management’s compensation may well render material a relatively small misstatement of a financial item).

materiality for the anti-fraud context,\textsuperscript{71} and applied a “probability/magnitude” balancing approach to determine materiality in the case of contingent or speculative information or events.\textsuperscript{72}

The SEC provided additional guidance on the extent to which companies must disclose risk-taking compensation incentives through recently released comments.\textsuperscript{73} Specifically, the SEC explained that the “reasonably likely” standard parallels the Management’s Discussion and Analysis (“MD&A”) disclosure requirements\textsuperscript{74} Interestingly, the SEC specifically rejected the Basic “probability/magnitude” test general materiality standard when interpreting the “reasonably likely” standard in the MD&A context,\textsuperscript{75} and instead, applied a two-prong approach to interpretation of the “reasonably likely” standard:

[T]wo assessments management must make where a trend, demand, commitment, event or uncertainty is known:

1. Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required.

2. If management cannot make that determination, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect

\textsuperscript{71} Id. at 232.
\textsuperscript{72} Id. at 238–39 (quoting SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2nd Cir. 1968)) (holding that where information or events are speculative, such as in the merger negotiation context, materiality “will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity”).
\textsuperscript{73} See Proxy Disclosure Enhancements, 74 Fed. Reg. 68,334, 68,337 (Dec. 23, 2009) (codified at 17 C.F.R. § 229.402(s)).
\textsuperscript{74} Id. at 68,336. For example, the MD&A imposes a forward-looking duty to “[i]dentify any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant’s liquidity increasing or decreasing in any material way.” 17 C.F.R. § 229.303(a)(1) (2010) (emphasis added).
on the registrant’s financial condition or results of operations is not reasonably likely to occur.76

Accordingly, Item 402(s) requires disclosure of compensation risk unless the risk is not reasonably likely to occur and/or the risk is not reasonably likely to cause a materially adverse effect.

Such an approach may seem puzzling to an investor at first glance. Intuitively, one would assume that should an incentive-based compensation practice tied to risk taking materialize and result in a materially adverse effect on the corporation, a shareholder would likely assert that had the short-term risk-rewarding compensation practice been disclosed, the shareholder would not have invested in the corporation, or perhaps would have voted against the compensation policy. But in MD&A, and now in Item 402(s), the SEC chose the pragmatic approach of “reducing the possibility that investors will be overwhelmed by voluminous disclosure of insignificant and possibly unnecessarily speculative information.”77

This formulation follows the approach adopted by the Supreme Court in its definitions of materiality, taking into account Judge Friendly’s concern with the term “might,” as explained by Justice Marshall in the seminal materiality case TSC Industries v. Northway, Inc.:

We are aware, however, that the disclosure policy embodied in the proxy regulations is not without limit. Some information is of such dubious significance that insistence on its disclosure may accomplish more harm than good. The potential liability for a Rule 14a-9 violation can be great indeed, and if the standard of materiality is unnecessarily low, not only may the corporation and its management be subjected to liability for insignificant omissions or misstatements, but also management’s fear of exposing itself to substantial liability may cause it simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decisionmaking.

Precisely these dangers are presented, we think, by the definition of a material fact adopted by the Court of Appeals

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in this case—a fact which a reasonable shareholder *might* consider important. We agree with Judge Friendly, speaking for the Court of Appeals in *Gerstle*, that the “might” formulation is “too suggestive of mere possibility, however unlikely.”

Presumably, the “reasonably likely” standard requires a determination by the company involving a higher level of certainty that a particular compensation incentive actually creates a risk, which is “reasonably likely” to occur, and will have a materially adverse effect on the company if it does occur.

Further, the MD&A section sets forth a “knowledge” requirement, mandating that the corporation have knowledge of the events and/or conditions that are reasonably likely to materially affect some aspect of the corporation. Thus, the MD&A requires management to assess what it has already contemplated as a risk or at least is aware of as a trend, event, or uncertainty. Such a knowledge requirement is noticeably lacking in Item 402(s); in effect, the SEC is treating all compensation as inherently risky, and therefore something that must be assessed for possible adverse effect. Accordingly, we can infer that corporations have both a duty to first investigate potential risks relating to compensation and then to determine whether those identified risks rise to “reasonably likely” level. Importantly, compensation committees must evaluate compensation risk by expanding the focus beyond the executive officers to all employees.

Although there is some risk involved in all corporate activity, the financial services industry inherently involves high levels of risk. Arguably, when incentive-based compensation is tied to short-term profits, which is in turn dependent on short-term risk taking, there is a potential for opportunistic abuse by executives and employees. Whether an accurate portrayal or not, conventional wisdom maintains that executives are more likely to focus on short-term profits at the expense of potential long-term disaster. Accordingly, under many circumstances, short-term incentives may well be considered

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79 17 C.F.R. § 229.303(a)(1).
80 See, e.g., J & R Mktg., SEP v. Gen. Motors Corp., 549 F.3d 384, 392 (6th Cir. 2008) (holding that the company must have actual knowledge about the information at issue). Requiring disclosure of information that is “knowable” would “extend[] the duty to disclose information to include a duty to first investigate and then disclose . . . [which] directly contradicts the text of Item 303.” *Id.*
81 See supra note 8 and accompanying text.
82 See supra Part I.
83 See supra note 13 and accompanying text.
“reasonably likely” to have a materially adverse effect on the corporation, and failure to disclose such material information may result in liability.\textsuperscript{84} It is clear that both the SEC and Congress intended to capture incentive-based short-term risk taking in the recent reform:

First, incentive comp arrangements should provide employees with incentives that are appropriately balanced so they do not encourage employees to expose their organizations to imprudent risk.

Second, these arrangements should be compatible with effective controls and risk management.

And third, these arrangements should be supported by strong corporate governance, including active oversight by the organization’s board of directors.\textsuperscript{85}

When viewed in conjunction with disclosure enhancements requiring discussion of internal risk management policies and procedures,\textsuperscript{86} disclosure of executive hedging activity,\textsuperscript{87} and shareholder “say-on-pay” provisions,\textsuperscript{88} it is apparent that transparency was a chief concern of Congress and the SEC.

To illustrate how a company might approach evaluation of compensation risk and Item 402(s) disclosure, consider the following hypothetical. BigPharma is large public company subject to Regulation S-K and, therefore, Form 10-K and annual proxy disclosure requirements. Research and development (“R&D”) is often a large and crucial component of a pharmaceutical company’s future profitability, but can also be very expensive and risky.\textsuperscript{89} Rather than

\textsuperscript{84} SEC Regulation S-K Item 402(s), 17 C.F.R. § 229.402(s) (2010).


\textsuperscript{87} The Dodd-Frank Wall Street Reform and Consumer Protection Act requires companies to disclose to shareholders whether they permit any employee or board member to purchase financial instruments that are designed to offset or hedge any decrease in market value of their equity-related compensation. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, § 955, 124 Stat. 1376, 1904–05 (2010).

\textsuperscript{88} Id. § 971, 124 Stat. at 1915 (requiring a separate resolution at proxy meetings on which shareholders will vote to improve the compensation of executives).

\textsuperscript{89} See OFFICE OF TECHNOLOGY ASSESSMENT, UNITED STATES CONGRESS, PHARMACEUTICAL R&D: COSTS, RISKS AND REWARDS (1993) (focusing on the potential impacts that changes in federal policy could have on the economic side of pharmaceutical
developing new drug therapies internally, BigPharma focuses much of its strategic R&D efforts on acquisition of experimental patents and small start-up biotech companies with seemingly promising drug pipelines.

Suppose that BigPharma hires an acquisition team of prominent scientists and physicians to seek out the most promising new startups and patents before they come to market (i.e. before FDA trials have begun or during early-stage trials). Suppose further that when BigPharma acquires a target company or patent, it pays its R&D acquisition team an immediate bonus equal to a percentage of the estimated market value that the drug is anticipated to generate over the course of its lifecycle (as opposed to, for example, a continuing percentage of the value stream payable over time). Given that a successful drug therapy in a large market (such as diabetes or blood pressure treatments) can generate several billion dollars during its product lifecycle, the acquisition team bonuses are substantial and material to the company in the aggregate.

In light of Item 402(s), BigPharma’s compensation committee must evaluate the R&D acquisition team’s compensation arrangement. The R&D team is compensated based on forecasts made upon completion of an acquisition, while the income and risk to BigPharma that the drug will be approved by the FDA and prove successful in the market extend over a significantly longer period of time. This is the precise situation found on the SEC’s laundry list of enumerated “situations that potentially could trigger discussion.” Accordingly, the R&D acquisition team’s compensation structure certainly has the potential to have a materially adverse effect on the company. Next, BigPharma must evaluate whether the risk is reasonably likely to come to fruition. If so, or if the likelihood of the risk materializing is too uncertain to determine, BigPharma must analyze whether the arrangement is reasonably likely to create a materially adverse effect. Overall, the test of what constitutes a “materially adverse effect” is not a new concept, and will follow the same MD&A test that is familiar to reporting companies.

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92 See supra notes 68–76 and accompanying text.
The question of whether something is “reasonably likely” to occur is highly subjective, however, and requires some knowledge about the players, industry, human psychology, and the extent of other controlling factors, such as the company’s corporate culture and internal risk management policies. Some questions a reporting company might need to ask include: Are the players risk adverse? How do they value their long-term reputation versus near-term wealth? What is the likely duration of the employee’s continuing work for the company? Does the employee favor short-term gain over long-term loyalty to the company? One can imagine that two companies could reasonably reach opposite conclusions about the “reasonable likelihood” of a material adverse effect stemming from similar policies simply based on the risk-taking propensities of the individuals involved.

2. Drafting Item 402(s) Disclosures

After a company completes the material risk evaluation, its focus must shift to drafting the Item 402(s) disclosure. Where no material risks exist, a reporting company is technically not required to affirmatively state that it has determined that any risks arising from its compensation practices are not reasonably likely to have a materially adverse effect on the company. Yet, during the 2010 proxy season, the majority of companies evaluated made an affirmative statement that no risks creating a materially adverse effect existed. Further, the SEC seemed more likely to issue comments to companies that did not provide such a voluntary “negating” risk assessment disclosure. This follows what appears to be a fairly normal pattern: negative statements are often found in periodic reports apparently either as a reminder to the preparer to re-consider the issue in later filings or as evidence that they have done so currently.

If, however, a company determines that disclosure is required, the SEC set forth numerous considerations and issues the company may need to address:

- The general design philosophy of the company’s compensation policies and practices for employees whose behavior would be most affected by the incentives established by the policies and practices, as such policies and practices

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94 See infra notes 99–103 and accompanying text.
95 See infra notes 107–08 and accompanying text.
relate to or affect risk taking by those employees on behalf of the company, and the manner of their implementation;

- The company’s risk assessment or incentive considerations, if any, in structuring its compensation policies and practices or in awarding and paying compensation;

- How the company’s compensation policies and practices relate to the realization of risks resulting from the actions of employees in both the short term and the long term, such as through policies requiring claw backs or imposing holding periods;

- The company’s policies regarding adjustments to its compensation policies and practices to address changes in its risk profile;

- Material adjustments the company has made to its compensation policies and practices as a result of changes in its risk profile; and

- The extent to which the company monitors its compensation policies and practices to determine whether its risk management objectives are being met with respect to incentivizing its employees.\(^{96}\)

At first glance, the list appears detailed and onerous. Importantly, discussion of these factors is *only required* if the compensation policies and practices create risks that are reasonably likely to have a materially adverse effect on the company.\(^{97}\) Additionally, the rule requires analysis and discussion about specific facts and circumstances—generic boilerplate language is insufficient.\(^{98}\) A review of 2010 proxy disclosures reveals how companies initially interpreted the scope of the Item 402(s) disclosure requirements.

*a. 2010 Proxy Season Disclosures*

Following the 2010 proxy season—the first year in which most companies were required to address the new rule—several compensation consulting companies conducted reviews of Item 402(s) disclosures made during the 2010 proxy season.\(^{99}\) The reviews revealed three broad trends: silence, affirmative disclosure, and mitigation disclosure. Interestingly, albeit not surprisingly, none of

\(^{96}\) Proxy Disclosure Enhancements, 74 Fed. Reg. at 68,337.

\(^{97}\) Id.

\(^{98}\) Id. For example, a company cannot merely state that compensation risk is necessary to attract or retain the most talented employees. Id.

\(^{99}\) See *infra* notes 99–105 and accompanying text.
the reviewed proxy statements articulated a specific unmitigated risk.100

A report reviewing 215 of the 301 nonfinancial S&P 400 companies analyzed a number of variables, including: whether companies provided risk-assessment disclosure in their proxy filings, where the disclosures were located, the employee population covered, whether actual results of risk assessment were disclosed, how companies viewed risk mitigation, and any changes made by companies to address compensation risk.101 The study found that although most companies reported a risk assessment (67%), no materially adverse risks were disclosed.102 Of those companies that did perform a risk assessment, very few described the process used to determine that there were no materially adverse risks; rather, “the disclosures emphasized how plan design elements have served to mitigate risk.”103 Generally, the study reported an overall lack of consistency and substance.104

Another report, which reviewed 223 S&P 500 companies, evaluated the disclosures along three measures of compliance: process, mitigators, and affirmative statements.105 Again, not surprisingly, no materially adverse risks were identified in any of the disclosures.106 The study found that 80% of companies discussed the process for evaluating risk in their compensation practices; 56% described risk-mitigating elements of their compensation practices; and 64% of companies included either an implicit or explicit affirmative statement about the riskiness of their compensation practices.107

Comparison of these disclosures to the SEC final release and stated intent reveal potentially striking disparities. Either companies are underreporting the extent to which their compensation policies incentivize imprudent risk taking, as conventional wisdom would lead one to believe, or as the reality of the case may be, the compensation

100 For example, Fortune Brands, Inc. stated that they believe that there are no risks arising from their compensation policies that are reasonably likely to have a material adverse effect on the company. Further, they provide a “mitigation” disclosure outlining how the compensation committee, with the assistance of independent compensation consultant, reached its decision. FORTUNE BRANDS INC., Definitive Proxy Statement (SCHEDULE 14A) (Mar. 8, 2010).


102 Id. at 5.

103 Id.

104 Id.


106 Id. at 1.

107 Id. at 2–3.
arrangements at the vast majority of public companies simply do not encourage imprudent risk-taking behavior to the extent many believe. Alternatively, mitigation mechanisms are already in place.

Further, a challenge to the fundamental notions of transparency and information asymmetry emerges in light of these findings. If companies do not apply a consistent approach towards risk assessment and disclosure, how can investors truly benefit from the SEC’s requirement to provide narrative disclosures of risk? Currently, the lack of overall consistency within proxy disclosures seems to create a confusing web of information. More information is meaningless unless it is useful information that can be understood in context and compared to other similar information. Given the lack of uniformity in current disclosure, it is difficult for an investor to rationally compare the compensation risks among companies.

b. Utilizing Remedial Mechanisms and Deferments to Avoid Disclosure of Specific Risks.

Drafting the disclosure obviously becomes more precarious if material risks exist. In that instance, the company would have several conceivable options. First, a company could simply disclose the risk. While it may be the most straightforward approach, the 2010 proxy season illustrates a clear preference to avoid affirmative disclosures of material risks. In the BigPharma hypothetical scenario, suppose BigPharma chose to proceed as planned with the R&D Acquisition bonus plan. BigPharma would be required to disclose the facts and circumstances of the compensation agreement. Its Item 402(s) disclosure might read something along these lines: Our compensation committee regularly conducts a risk assessment of our compensation policies and practices for our executive officers and other employees. The committee’s assessment for the current year evaluated the company’s R&D acquisition team compensation agreement, which guarantees the team a current cash payment equal to 5% of the projected lifetime market value of any newly acquired biotech company or drug patent attributable to the team’s efforts. The committee determined that the team’s compensation arrangement involves an inherent level of risk of a materially adverse effect on our long-term results by potentially overpaying the team members in the event that actual results of the acquisition are materially worse than

108 See supra notes 99–107 and accompanying text.
109 See Proxy Disclosure Enhancements, 74 Fed. Reg. 68,334, 68,336–37 (Dec. 23, 2009) (codified at 17 C.F.R. § 229.402(s)) (requiring discussion of compensation policies if the risks arising from those policies are reasonably likely to have a material effect on a company).
those projected. The committee believes that the risk is reasonable, however, because all targets are thoroughly vetted, and due diligence was conducted and reviewed by our corporate executives, directors, and independent consultants prior to acquisition.

Obviously, while the above disclosure meets the technical requirements of Item 402(s), it may not meet the approval of shareholders and potential investors.110 Companies in 2010 unanimously sought to avoid disclosure of specific compensation risks that were reasonably likely to create a material risk.111 To avoid making a negative disclosure, BigPharma must choose between restructuring the compensation agreement and utilizing a remedial mechanism to mitigate the risk. BigPharma may wish to avoid making a negative disclosure but maintain the underlying “incentive” bonus paid to the R&D team. Several remedial mechanisms are available. Prospective clawback mechanisms probably provide the most liberal check against incentive-based compensation risk.112 In a clawback, the employee receives the compensation upfront, but assumes the risk of having to repay the amount should later events demonstrate he was overpaid.113 The problem with the clawback, of course, is that the employee may leave the company, spend the money, and refuse to cooperate in repaying. For this reason, the more widely utilized mechanisms are forms of deferred compensation, as well as forfeiture and recoupment policies, which are more restrictive for the individual employee but provide a better check against risk, as they align the employee’s compensation with the long-term profitability of the company.114

Of course, any combination of the above mechanisms can be utilized to mitigate the particular compensation risk to a point in

110 See infra Part II(C) for a detailed discussion of how the recent Dodd-Frank legislation expands shareholder control and influence over compensation practices.
111 See supra notes 102, 106 and accompanying text.
112 For a detailed discussion of prospective clawback agreements, see Cherry & Wong, supra note 39, at 388–92 (describing how prospective clawback agreements are becoming more commonplace). A review of voluntarily adopted claw-back agreements adopted by various publicly traded companies provides a foundation for the drafting of such agreements. See, e.g., GENERAL ELECTRIC CO., Definitive Proxy Statement (SCHEDULE 14A) 19 (Mar. 5, 2010) (restructuring its clawback provisions and policy to allow the board “discretion to recapture compensation for any conduct that is detrimental to the company, rather than just fraudulent or intentional misconduct, and that, in all cases, it will seek reimbursement if an executive has engaged in fraudulent conduct”); VERIZON COMM’NS INC., Definitive Proxy Statement (SCHEDULE 14A) 44 (Mar. 8, 2010) (stating that the compensation committee adopted a “policy that enables the Company to recapture and cancel certain incentive payments received by an executive who has engaged in financial misconduct”).
113 See Cherry & Wong, supra note 39, at 410–11(defining the scope and identifying features of clawbacks).
114 See, e.g., Tung, supra note 13, at 13–35.
which the compensation committee feels comfortable concluding that the risk is not reasonably likely to have a materially adverse effect. Suppose, for instance, that BigPharma’s compensation committee chose to revise the R&D acquisition team’s compensation agreement. Instead of offering a guaranteed lump-sum bonus upon acquisition of a target, BigPharma will offer the employees 25% of the total bonus award in cash at the time of acquisition. The bulk of the acquisition bonus will then be deferred over a period of time until certain benchmarks are met, subject to a forfeiture provision (i.e. the employees will receive 25% of the outstanding bonus when the drug receives FDA approval, 25% when the drug meets certain sales projections, and 25% at retirement). Payment of each deferred payment is contingent upon the achievement of the particular goal. For instance, if the drug does not receive FDA approval, the employees will forfeit the remaining 75% of bonus.

Aligning the employees’ bonus compensation with the long-term success of the underlying drug is likely sufficient to mitigate any potential risks.\(^{115}\) Accordingly, BigPharma would not be required to disclose details of the team’s compensation agreement. If BigPharma chose to disclose, the statement may read as follows: Our compensation committee regularly conducts a risk assessment of our compensation policies and practices for our executive officers and other employees. The committee’s assessment for the current year evaluated the company’s R&D acquisition team agreement. Although the team is compensated for targeted acquisitions, only a small portion of the team’s total bonus compensation is guaranteed and short-term in nature. Since the majority of the team’s incentive-based bonus compensation is long-term, contingent upon the achievement of various benchmarks, and subject to forfeiture, the team’s compensation is closely aligned with the company’s risk and income, thereby mitigating the extent to which the compensation arrangement could produce an adverse effect.

3. What to Expect in the Future

The SEC was notably quiet on Item 402(s) disclosures following the 2010 proxy season, particularly in light of the relatively sparse substantive disclosures provided by most companies. It did, however, issue comment letters to a number of companies, which generally fell

\(^{115}\)See Proxy Disclosure Enhancements, 74 Fed. Reg. at 68,337 (to be codified at 17 C.F.R. pts. 229, 239, 240, 249, 274) (noting that disclosure will serve to mitigate risks caused when companies award task-based bonuses to employees but the company continues to face risk from that task for a longer period of time).
under one of two categories. Some letters were issued to companies that omitted Item 402(s) discussion entirely,\(^\text{116}\) which seems peculiar given that companies are not required to make any disclosure if there are no compensation risks.\(^\text{117}\) Other comment letters were issued to companies that made disclosures, but failed to mention the process they used to arrive at their conclusions regarding risk.\(^\text{118}\)

Nevertheless, such results are not surprising. First and foremost, the SEC consistently emphasizes the “why” and “how” of a company’s decision-making process. If the company determines that there are no material risks reasonably likely to have an adverse effect on the company, a simple statement that such risks do not exist will likely be insufficient. Rather, the SEC is seeking substantive discussion exploring why such risks do not exist (for example, did the company implement remedial risk-reduction measures in its compensation arrangements such as clawbacks, deferrals, etc.), and how the company came to its conclusion (for example, does the company employ an independent compensation consultant, did the board of directors thoroughly vet the various compensation factors involved). Likewise, if a company concludes that such risks may or do exist but are not material or not reasonably likely to have an adverse effect, the deductive process that led to such a conclusion should be articulated.

It should be noted, however, that simply because the SEC has not yet provided further clarification regarding the scope of the disclosure requirements, does not necessarily mean that it will not in the future. In terms of additional guidance and enforcement, the SEC’s handling of the MD&A disclosure may serve as an illustration as to how the SEC intends to construe and enforce the recent disclosure enhancements.

The current MD&A framework was adopted in 1980, and requires a discussion of “liquidity,” “capital resources,” “results of operations,” and “other information that the registrant believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations.”\(^\text{119}\) The 1980 requirements were far more comprehensive than prior iterations, but were intentionally broad to encourage meaningful disclosure rather than boilerplate discussions.\(^\text{120}\) Despite the 1980 version’s broad

\(^{116}\) See BUCK CONSULTING, supra note 101, at 10.

\(^{117}\) See SEC Regulation S-K Item 402(s), 17 C.F.R. § 229.402(s) (2010) (requiring narrative disclosure only if there are compensation risks).

\(^{118}\) See BUCK CONSULTING, supra note 101, at 10.

\(^{119}\) Regulation S-K Item 303, 17 C.F.R. 229.303(a) (2010).

\(^{120}\) Management’s Discussion and Analysis of Financial Condition and Results of
scope, the SEC found that the original general language led to underreporting, non-compliance, and minimal enforcement.\textsuperscript{121} Eight years later, the SEC embarked on a sweeping review of MD&A disclosures, which resulted in hundreds of comment letters, amendments, and requests for future compliance.\textsuperscript{122} In addition, in 1989 the SEC issued an interpretive guidance release that provided significantly more detailed and specific disclosure requirements, arguably expanding the scope of MD&A far beyond what was originally contemplated by most registrants and commentators.\textsuperscript{123} Indeed, the clarity with which MD&A is written today is likely largely dependent on this and subsequent formal and informal SEC interpretations and staff discussions, rather than the rule as written. So too may be true for Item 402(s).

It is conceivable for the SEC to proceed in a similar fashion with respect to Item 402(s). Such a situation is more likely to occur if the SEC believes that the rule, as written without more guidance, is not compelling the type and depth of disclosure intended. While not providing much substantive guidance beyond the final release, the SEC has spoken numerous times on their intent in implementing Item 402(s)—to combat compensation based incentives to engage in excessive risk taking.\textsuperscript{124} Accordingly, companies should be encouraged to err on the side of caution in considering whether to disclose various risk-taking incentives. Preferably, companies should seek to establish risk-management policies and execute agreements with executives to prospectively limit the extent to which various incentive-based compensation practices may encourage employees to take imprudent risks. To avoid the ambiguity and liability issues associated with Item 402(s), companies should consider utilizing mitigation mechanisms as a means to properly comply with the requirements of Item 402(s),

\textsuperscript{121} Id. at 22,427–28.

\textsuperscript{122} Id.

\textsuperscript{123} Id.

while avoiding specific and explicit disclosure of incentive-based compensation risks.

Above all, corporate boards and officers should be diligent in their effort to fully and fairly evaluate and disclose risk situations before they create actual exposure to the company. No company wants to be the “poster child” for noncompliance, as Caterpillar was for MD&A non-disclosure.125

C. Shareholder Empowerment

Finally, and perhaps most importantly from a practical perspective, the ultimate impact of Item 402(s) may stretch beyond a mere disclosure provision, particularly given the potential interplay among the new Dodd-Frank provisions. For example, one could easily imagine shareholder disapproval in the event a company discloses that its compensation practices are reasonably likely to have an adverse effect on the company. Suppose, hypothetically, that the California Public Employees’ Retirement System (“CalPERS”) owns 5% of BigPharma’s common stock and relies on RiskMetrics for a determination of how to vote its “say-on-pay” vote. Undoubtedly, a negative disclosure under Item 402(s) will raise a red flag for RiskMetrics, which will likely result in a recommendation for CalPERS to reject BigPharma’s proposed compensation packages.126 The consequences are twofold. First, the votes of other shareholders will be affected if they are aware of BigPharma’s “no” vote or have access to RiskMetrics’ advice themselves.127 Second, suppose BigPharma’s board of directors decides to ignore the negative votes, CalPERS among them, and approves Company X’s compensation arrangements going into the next year. The board members should be willing to forego their Board seats following next year’s proxy vote,

125 See In re Caterpillar, Inc., Exchange Act Release No. 34-30,532, 51 SEC Docket (CCH) 147 (March 31, 1992) (issuing a cease-and-desist order for Caterpillar’s failure to disclose financial results about its Brazilian subsidiary because there was known future uncertainty regarding the subsidiary’s operations and the subsidiary’s current earnings materially affected Caterpillar’s reported income).

126 In its 2011 corporate governance policy update, ISS explicitly states that although executive pay and practices are evaluated on a case-by-case basis, its current recommendation if a company maintains problematic pay practices is to generally vote against management “say on pay” proposals. INSTITUTIONAL S’HOLDER SRS., U.S. CORPORATE GOVERNANCE POLICY: 2011 UPDATES 16 (2010), available at http://www.issgovernance.com/files/ISS2011USPolicyUpdates20101119.pdf. Although “say-on-pay” votes are not votes regarding compensation risk, shareholders are nevertheless likely to view compensation practices that create a risk of adverse effects on the company as problematic.

as BigPharma has likely adopted a majority-vote requirement for the election of directors. In addition, SEC rule provisions now being contested in the courts, will, if upheld, provide CalPERS with the unqualified right to nominate a new board member to be included on the proxy voting cards. In short, disgruntled shareholders now have more power to directly influence Board behavior—at least in theory. Depending on how the SEC construes the scope of disclosure, these issues are more likely to arise as companies will be forced to disclose more substantive information. The SEC’s precedential approach in other areas of disclosure indicates that the scope of Item 402(s) disclosure may ultimately be broader than companies now hope.

Accordingly, the incentive for compensation committees to mitigate or eliminate compensation risk and avoid disclosure extends beyond public perception and forced disclosure. Fundamentally, it is assumed that the more information is disclosed, the more information shareholders can evaluate in making proxy-and-trading decisions and potential investors can consider in determining whether to invest. Interestingly, Congress now seems to be shifting its focus beyond mere disclosure and transparency to shareholder empowerment and policing. Instead of “voting with their feet,” shareholders now harness greater influence and control over public companies and their Boards—at least in theory. Whether any practical effects will result, and whether compensation risk disclosure will expand beyond a mere nuisance for compensation committees remains to be seen. One thing is for certain—compensation risk has been thrust into the spotlight. The potential interaction among the various new rules and regulations are complex and substantial, and will undoubtedly be developed over the coming years.

128 Id. § 971, 124 Stat. at 1915 (providing shareholders holding greater than 5% of a company’s stock with an unqualified board seat nomination to be included on the company’s proxy voting cards distributed to shareholders providing that the shareholder has held the stock for at least three years and will continue to hold the stock through the next election); see also Order Granting Stay In the Matter of the Motion of Business Roundtable and the Chamber of Commerce of the United States of America, Securities Act Release No. 9149, Exchange Act Release No. 63,051, Investment Company Act Release No. 29, 456, 75 Fed. Reg. 64,641 (Oct. 4, 2010) (ordering stay of SEC rules implementing § 971 mandates and summarizing pending litigation).

129 See supra notes 119–122 and accompanying text.

130 See supra notes 2–3, 7 and accompanying text.

131 See Dodd-Frank Wall Street Reform and Consumer Protection Act § 951, 124 Stat. at 1899–900 (setting forth shareholder “say-on-pay” provisions); see also id. § 971, 124 Stat. at 1915 (providing shareholders holding greater than 5% of a company’s stock with an unqualified board seat nomination to be included on the company’s proxy voting cards distributed to shareholders).
III. CONCLUSION

The precise scope of disclosure required under Item 402(s) will likely be shaped in the years to come. Undoubtedly, the evidence is conflicting as to whether executives and their employees knowingly engaged in excessive risky behavior for short-term economic gain.\(^{132}\) Yet, pursuant to Item 402(s), companies should prudently evaluate and monitor their compensation practices, particularly incentive-based compensation, to the extent it may encourage or allow for employees to engage in adverse risk taking.

Most importantly, as with any disclosure, companies should be honest and forthright in drafting their Item 402(s) disclosures. If any compensation risks surface during the compensation committee evaluation process, companies should consider use of mitigation mechanisms such as deferments or clawbacks as components of a well-designed risk management and compensation practice plan, if they have not already done so.\(^{133}\) Diligence and full disclosure are certainly advisable as these new regulations take effect and their ultimate reach is still uncertain.

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\(^{132}\) See supra notes 14–15, 38 and accompanying text.

\(^{133}\) See supra Part II.B.2.

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