Executive Compensation Disclosure: The SEC's Attempt to Facilitate Market Forces

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Executive Compensation Disclosure: The SEC's Attempt To Facilitate Market Forces

TABLE OF CONTENTS

I. Introduction ............................................. 804
   A. Overview of the Rules ................................ 804
   B. Basic Intent/Goals of Rules ........................... 804
   C. Conditions Which Led to the Change ................. 806
      1. Increasing Use of Long-Term Compensation
         Arrangements ....................................... 806
      2. Institutional Investors and Shareholder Activism . 807
      3. Negative Publicity ................................ 808
   D. Other Government Action in the Executive Pay
      Arena .................................................. 809
      1. Congressional Action .............................. 809
      2. Other SEC Action ................................ 810

II. Tabular and Graphic Presentation of Compensation-Related Information .................................... 810
   A. Overview of New Presentation ........................ 810
   B. Tabular Disclosure Versus Narrative Description .... 816

III. Summary Compensation Table ............................ 816
   A. Generally ............................................ 816
   B. Specific Elements .................................... 817
      1. Salary and Bonus .................................. 817
      2. Other Annual Compensation ....................... 818
      3. Restricted Stock Awards ........................... 820
      4. Option/SAR Grants ................................ 821
      5. LTIP Payouts ...................................... 822
      6. All Other Compensation ........................... 822
   C. Other Criticisms/Potential Improvements ............ 822
      1. Bottom-Line Figure ................................ 822

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I. INTRODUCTION

A. Overview of the Rules

In June 1992 the Securities and Exchange Commission (SEC) announced proposed amendments to rules regarding disclosure of compensation paid or awarded to senior executives.1 With several significant modifications, the proposals were approved in October 1992.2 The new rules apply to proxy statements, periodic reports and other filings under the Securities Exchange Act of 1934, and to registration statements under the Securities Act of 1933.3

In essence, the new rules consolidate the required compensation disclosure in a series of tables setting forth the compensatory elements for a particular year.4 The general descriptions of compensation plans prescribed under the old rules are no longer required.5 The SEC also enacted several other provisions in an effort to further inform shareholders about executive compensation. These provisions include a report by the board compensation committee (or the board of directors) on the bases for its compensation decisions with respect to certain executives and the relationship of such compensation to corporate performance.6 In addition, the new rules require a line graph comparing the cumulative return on the company’s common stock with the return on both a broad market index such as the Standard and Poor’s 500 (S&P 500), and an industry or a peer group index.7

B. Basic Intent/Goals of Rules

According to SEC Chairman Richard Breeden, the changes to the disclosure rules were necessary because current disclosure in the executive compensation area was an “impenetrable, legalistic narra-

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3. Id.
4. Id.
5. Proposed Rules, supra note 1, at 82,853.
Because many shareholders did not understand this narrative, the old proxy system insulated management from accountability to shareholders.\textsuperscript{9} The stated purpose of the new rules is to "provide shareholders with a clear and concise presentation of compensation paid or awarded to executive officers, and the directors' bases for making such compensation decisions."\textsuperscript{10} Similarly, the SEC maintains that the goals of the rules are to "assure that shareholders are well informed and that all the facts regarding the compensation that the shareholders are paying are out in the open, and to foster better accountability of the board of directors to the shareholders."\textsuperscript{11} Whether the new rules will achieve their stated objectives is considered throughout this Article.

The new rules do not dictate the amount or the structure of executive compensation. Rather, they concentrate on improving disclosure of compensation information to shareholders, regardless of what that information is. The SEC recognizes that the appropriate amount and structure of compensation for corporate employees is a question that should be resolved in the private marketplace, not by government regulation.\textsuperscript{12} If market participants are to make appropriate decisions, however, they must have access to all pertinent information. It is the goal of the rules not only to help provide shareholders with that access, but also to make that information easier to understand and more relevant to proxy voting and investment decisions.\textsuperscript{13} Thus, the changes to the rules are designed to enhance the workings of market forces with respect to executive pay.\textsuperscript{14}

It is interesting to consider whether the SEC has in fact molded the rules to allow the market to dictate the level and structure of executive compensation. Has the SEC inadvertently (or advertently) created a bias in favor of or against certain forms of compensation? This

\begin{itemize}
  \item \textsuperscript{8} SEC Adopts Proxy Reform Package After Long Study and Intense Debate, Sec. L. Daily (BNA)(Oct. 16, 1992).
  \item \textsuperscript{9} Id.
  \item \textsuperscript{10} Proposed Rules, supra note 1, at 82,852-53.
  \item \textsuperscript{11} Id. at 82,853.
  \item \textsuperscript{12} Richard C. Breeden, Chairman of the SEC, press release (Feb. 13, 1992). \textit{See also} Richard C. Breeden, Chairman of the SEC, \textit{Proxy Rules and Executive Compensation} 4 (June 23, 1992)(opening remarks)(transcript available at the Commission)("Ultimately, compensation decisions must be made in the private marketplace.").
  \item \textsuperscript{13} Proposed Rules, supra note 1, at 82,853.
  \item \textsuperscript{14} Id. \textit{See infra} subsection I.D.2. for a discussion of other SEC action in this area.
\end{itemize}
issue will be revisited below as the various components of the new disclosure scheme are analyzed.

C. Conditions Which Led to the Change

1. Increasing Use of Long-Term Compensation Arrangements

The compensation disclosure requirements which the new rules replaced were adopted approximately ten years ago. Three relevant factors have changed since then. First, the structure of executive compensation packages has changed significantly over the last decade.15 Second, shareholder activism has increased.16 Finally, public sentiment regarding executive pay has become increasingly negative.17 These three changes provided the impetus for changing the executive compensation disclosure rules.

The structure of executive pay packages has evolved over the last decade to include more long-term compensation provisions.18 The increase in the use of long-term compensation can be accredited to the belief that such compensation arrangements provide management with incentives to create shareholder value.19 Arguably, real ownership by executives "builds commitment and risk on the part of executives and positively influences long-term decisionmaking."20 The increasing emphasis placed on long-term incentive compensation indicated the need for change to the old disclosure rules. According to one survey, base salary constituted 35% of compensation packages and long-term incentive compensation constituted 31% of total compensation reported for executives among surveyed companies in 1991.21 In 1985, base salary constituted 52% of compensation packages and long-term compensation constituted only 8% of such compensation.22 Stock options are the principal form of long-term incentive...
compensation being used. One study reported that more than 90% of the companies it analyzed offered stock options as the main form of long-term incentive compensation.\textsuperscript{23}

Executive pay packages have grown increasingly complex as the use of long-term incentive compensation has increased. According to the SEC, many shareholders now find the reporting of compensation "incomprehensible."\textsuperscript{24} Current compensation schemes are buried in pages of opaque proxy-speak.\textsuperscript{25} Even sophisticated financial newspapers sometimes have difficulty determining exactly what executives are paid. For example, in 1991, the \textit{Wall Street Journal} reported that the salary of ITT CEO Rand Araskog had increased to $7.3 million.\textsuperscript{26} One month later, the \textit{Journal} explained that Araskog's salary had actually risen to $11.4 million.\textsuperscript{27} To determine Araskog's pay, the \textit{Journal} had to examine 19 dense pages of the company's proxy statement.\textsuperscript{28} In short, company descriptions of compensation packages through the narratives required under the prior disclosure rules have become unwieldy.

2. \textit{Institutional Investors and Shareholder Activism}

Also affecting executive compensation are the increases in institutional investors and shareholder activism. Stockholders are becoming more active in corporate governance matters (perhaps out of necessity because information is in fact "incomprehensible") and are increasingly demanding reforms regarding communication and disclosure.\textsuperscript{29} A major reason shareholders are becoming more active is because institutional investors\textsuperscript{30} are holding an increasing amount of equity. 

\begin{itemize}
\item \textsuperscript{23} \textit{Compensation Mix}, J. OF ACCT., May 1992, at 18. Compensation in 1987 consisted of base salary, 39%; long-term incentives, 27%; bonus, 18%; benefits, 13%; and perquisites, 3%. \textit{Id.}
\item \textsuperscript{24} \textit{FREDERIC W. COOK & CO., INC., LONG-TERM INCENTIVE COMPENSATION GRANTS AMONG THE SERVICE 200 2 (1991); FREDERIC W. COOK & CO., INC., supra note 20, at 2.}
\item \textsuperscript{25} Proposed Rules, supra note 1, at 82,854.
\item \textsuperscript{26} "A good deal of the skepticism over pay results from the public's inability to understand it. Many companies have contributed to the problem by making the proxy statement an exercise in obfuscation." \textit{Executive Pay}, BUS. WK., Mar. 30, 1992, at 55. According to Jerry K. Pearlman, Chairman of Zenith Electronics Corp., "[t]he growth in long-term compensation was largely because it was far less disclosed and certainly far less understandable." \textit{Id.} at 55-56.
\item \textsuperscript{27} Nell Minow & Kit Bingham, \textit{Executive Pay: Investors Care}, LEGAL TIMES, Sept. 28, 1992, at 22, 25.
\item \textsuperscript{28} \textit{Id.}
\item \textsuperscript{29} \textit{See infra} notes 34-35 and accompanying text.
\item \textsuperscript{30} The term institutional investor generally includes pension funds, mutual funds, insurance companies, bank managed trusts, and foundation and endowment funds.
\end{itemize}
institutional investors controlled 23% of the equity capital of U.S. corporations in 1955.\(^1\) That percentage grew to 38% by 1981.\(^2\) In 1990, institutional investors controlled more than 53% of such capital.\(^3\) As institutional investors increase their control over the equity of corporations, they are becoming more active in corporate governance. The number of corporate governance shareholder resolutions has risen sharply. In 1990, there were 294 such resolutions, while there were just 55 resolutions in 1986.\(^4\) During the same period, the number of shareholder resolutions on executive compensation and benefits issues rose from 35 to 110.\(^5\) Shareholder resolutions on executive compensation were supported by an average of 20.7% of the shares voted at 1992 annual meetings (shareholders have also submitted such resolutions to several other companies whose 1992 annual meetings were to be held later in the year).\(^6\)

Without the increase in shareholder activism, primarily through institutional investors, the impetus for change in the disclosure rules might not have occurred.\(^7\) Large investor motivation was necessary because individual investors lack the incentive to push for change regarding executive compensation. Additionally, the costs to small shareholders of taking action in this area outweigh any benefits which they might obtain.\(^8\)

3. **Negative Publicity**

The third factor underlying the new rules is the growing public


\(^{3}\) *Id.*


\(^{6}\) *Pay Proposals Debut, Receive Mixed Reviews, IRRC CORP. GOVERNANCE BULL., May/June 1992, at 7.* More pay related proposals are expected in 1993, which will be the first full proxy season for the SEC's new policy regarding shareholder proposals on executive compensation. *IRRC CORP. GOVERNANCE BULL. 40 Sept. 11, 1992, at 1.*

*See infra subsection I.D.2. for a discussion of the SEC's decision to allow shareholder proposals on executive pay.*

\(^{7}\) *See generally Stephen M. Bainbridge, Executive-Pay Disclosure: Who Listens?, LEGAL TIMES, Aug. 10, 1992, at 22. (SEC developed new disclosure rules after being pressured by Congress, institutional investors, and self-appointed shareholder spokespersons.)*

\(^{8}\) See, *e.g.,* ROBERT CLARK, CORPORATE LAW 390-394 (1986).*
concern over the amount of executive pay. For example, presidential candidates, shareholder groups, and the media have criticized executive pay.39 Fortune, Business Week, and The Wall Street Journal have devoted considerable negative attention to the subject.40 Critics point to examples such as comparisons of CEO pay with nonexecutive worker pay or with non-U.S. executive pay to argue their point that executives are overpaid.41 Critics also complain that executive pay increases regardless of company performance.42

D. Other Government Action in the Executive Pay Arena

1. Congressional Action

Several bills have been introduced in Congress that could affect the levels and structure of executive pay. The Income Disparities Act of 199143 proposed limiting corporate tax deductions for executive pay to 25 times that paid to the company’s lowest paid, full-time employee. The Corporate Pay Responsibility Act44 would have permitted stockholders to include proposals in proxy statements soliciting advisory votes on compensation matters. The bill also would have required additional disclosure of executive pay in annual proxy statements, including a single dollar figure representing total compensation, an estimate of the present value of future compensation and a graphic comparison of past and anticipated future compensation. Neither bill has passed. The Corporate Pay Responsibility Act is unlikely to ad-

41. The average total compensation of U.S. CEOs was $1.95 million in 1990, compared with $190,000 in 1960. Shareholder Rights: The Role of the Federal Proxy Regulatory System, 1991, supra note 31, at 16. In contrast, the average factory worker earned $23,000 in 1990, and approximately $18,000 in 1960. Id.

The CEO of an American manufacturing company typically earns twice the total pay of a foreign CEO, and the gap may be larger in companies with annual sales in excess of $250 million. TOWERS PERRIN, 1990 EXECUTIVE PAY UPDATE: WORLDWIDE TOTAL REMUNERATION (1990).

One critic of executive compensation maintains that “where [a] typical CEO earned total compensation (excluding perquisites and fringe benefits) that was around 35 times the pay of an average manufacturing worker in 1974, a typical CEO today earns pay that is around 120 times that of an average manufacturing worker and about 150 times that of the average worker in both manufacturing and service industries.” GRAEF S. CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES 27 (1991).
vance since its provisions have been essentially duplicated by the SEC in its recent activities.

2. Other SEC Action

In addition to the new executive pay disclosure rules, the SEC has taken action in several other areas which affect executive pay. Recently, the SEC has begun to require companies to include shareholder proposals on executive compensation submitted pursuant to Rule 14a-8 in their proxy statements. Historically, shareholder proposals on executive pay were prohibited by the SEC on the basis that such proposals constituted unjustified shareholder interference with the ordinary business of corporations under state law. Although the resolutions are only advisory in nature, they do allow shareholders to provide direct input to the board on its compensation decisions.

When the SEC approved the rule changes regarding executive compensation disclosure, it also approved rule changes designed to allow shareholders to communicate with each other more easily about corporate voting matters. Generally, the reformed shareholder communication rules provide an exemption from proxy solicitation requirements for communications to shareholders from any person who is not seeking proxy authority or does not have a special interest in the issue being put to shareholders for a vote.

Without the SEC’s change of position on these issues, shareholders would have been limited regarding actions they could take to change the level and structure of compensation plans. Once shareholders get a clearer picture of a company’s pay scheme, which the new disclosure rules are designed to provide, a means of voicing their concern and having input into the compensation decisions is necessary. Allowing shareholders to propose executive compensation resolutions and facilitating shareholder communication help to provide such a means.

II. TABULAR AND GRAPHIC PRESENTATION OF COMPENSATION-RELATED INFORMATION

A. Overview of New Presentation

The proposed rules took the idea of tabular disclosure to an extreme. Approximately a dozen tables and a line graph were required under the proposed rules. The SEC’s goal of providing clear and con-

45. Proposed Rules, supra note 1, at 82,853. See also SEC Allows Shareholder Votes on Executive Compensation, IRRC CORP. GOVERNANCE BULL., Jan./Feb. 1992, at 1.
46. Id. at 3.
47. Proposed Rules, supra note 1, at 82,853.
48. SEC Adopts Proxy Reform Package After Long Study and Intense Debate, supra note 8.
49. Id.
cise disclosure\(^5\) could not have been achieved under such a framework.

The rules as finally enacted reduced the maximum number of required tables to seven. The four main tables required by the final rules are:

- A summary compensation table disclosing compensation of the company’s chief executive officer and its four other most highly compensated executives for the last three years (Table A);

- Two tables detailing options and stock appreciation rights (SARs) for the above named executives (Tables B and C); and

- A long-term incentive plan award (LTIP) table (Table D).

The summary compensation table shows both annual and long-term compensation in a single comprehensive table. It is essentially the linchpin of the new disclosure scheme.\(^5\) Other required tables include a pension plan table and an option/SAR repricing report. For companies that solicit shareholder action with respect to a compensation plan, tabular disclosure of the benefits that will be received by or allocated to certain executives under the plan must be made. The corporation is not required to disclose information on plans not subject to a vote.\(^5\)

**TABLE A**

**SUMMARY COMPENSATION TABLE**

<table>
<thead>
<tr>
<th>Name and principal position</th>
<th>Annual Compensation</th>
<th>Long Term Compensation</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Salary ($)</td>
<td>Bonus ($)</td>
<td>Other/annual compensation ($)</td>
<td>Restricted stock award($)</td>
</tr>
<tr>
<td>(a)</td>
<td>(b)</td>
<td>(c)</td>
<td>(d)</td>
<td>(e)</td>
</tr>
<tr>
<td>CEO</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>B</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>C</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>D</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\(^5\) See *supra* note 10 and accompanying text.

\(^5\) Final Rules, *supra* note 2, at 48,129.

\(^5\) Id. at 48,143.
TABLE B

OPTION/SAR GRANTS IN LAST FISCAL YEAR

(Individual Grants)

<table>
<thead>
<tr>
<th>Name</th>
<th>Options/SARs granted (#)</th>
<th>Percent of total options/SARs granted to employees in fiscal year</th>
<th>Exercise or base price ($/S)</th>
</tr>
</thead>
<tbody>
<tr>
<td>CEO</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>B</td>
<td></td>
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<td>C</td>
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<td></td>
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<tr>
<td>D</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

TABLE C

AGGREGATED OPTION/SAR EXERCISES IN LAST FISCAL YEAR AND FY-END OPTION/SAR VALUES

<table>
<thead>
<tr>
<th>Name</th>
<th>Shares acquired on exercise (#)</th>
<th>Value realized ($)</th>
<th>Number of unexercised options/SARs at FY-end (#)</th>
<th>Value of unexercised in-the-money options/SARs at FY-end ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>CEO</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A</td>
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<td>D</td>
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</tr>
</tbody>
</table>

TABLE D

LONG-TERM INCENTIVE PLANS—AWARDS IN LAST FISCAL YEAR

<table>
<thead>
<tr>
<th>(a) Name</th>
<th>(b) Number of shares, units or other rights (#)</th>
<th>(c) Performance period until maturation or payout</th>
<th>Estimated Future Payouts under Non-Stock Price-Based Plans</th>
</tr>
</thead>
<tbody>
<tr>
<td>CEO</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>C</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>D</td>
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</tr>
</tbody>
</table>

The reduction in the number of required tables is attributable to several factors. First, information in several tables was often duplicative and because of the duplication, was potentially misleading. For example, in the proposed rules, nine tables required some disclosure concerning stock options and SARs. Some shareholders might consider such compensation suspect when it receives disproportionate dis-

53. Id. at 48,127.
closure treatment. With such extensive coverage and emphasis on options and SARs, shareholders might have inferred that options and SARs are not in their best interests. However, as discussed earlier, many people argue that long-term incentive compensation devices such as options and SARs are beneficial to shareholders because they align the interests of management with those of shareholders.

Redundant disclosure also could have resulted in unsophisticated shareholders misinterpreting information and mistakenly believing that executives are receiving more pay than they actually are. For instance, if an item of compensation is disclosed in more than one table, a shareholder might "double-count" the item. The rules as finally enacted appear to remedy these problems through reduction of the amount of duplicative information and the number of required tables.

Another reason the number of tables was reduced is that portions of several tables were of little utility to shareholders. For example, the proposed disclosure of compensation of all executive officers as a group was deleted. In several cases, the pertinent information in these tables was streamlined and combined with the information in other tables to form a more concise disclosure scheme. For example, the proposed option/SAR summary report that detailed the nature and extent of the company's use of options was deleted, and a new column was added to the option/SAR grant table (Table B) to reflect the percent of total options and SARs which were granted to the named executives.

The issue of which executives' pay information must be disclosed is of paramount importance. If the information disclosed is not representative of the company's pay practices, the rules fail to achieve their purpose from the outset. The final rules provide that the persons subject to individualized disclosure in each of the required tables include the CEO, regardless of the amount of pay, and the company's four other most highly compensated executive officers. However, if the "other" officers earned salary and bonuses not exceeding $100,000 for the last completed fiscal year, disclosure is not required. Further

55. See supra notes 19-20 and accompanying text.
56. Final Rules, supra note 2, at 48,127.
57. Id. at 48,134.
58. The term CEO includes any individual acting in a capacity similar to that of Chief Executive Officer. Item 402(a)(2)(i) of Regulation S-K, supra note 2, at 48,145.
59. Id.
60. As defined in Item 402(b)(2)(iii)(A) and (B) of Regulation S-K, supra note 2 at 48,146.
61. Instruction 1 to Item 402(a)(2) of Regulation S-K, supra note 2, at 48,145.
ther, the determination of the most highly compensated executive officers is made by reference to total annual salary and bonus for the last fiscal year.62

The SEC decision to focus solely on the previous year's salary and bonus to determine the four other most highly compensated executives appears to be inconsistent with the SEC's statements concerning the goals of the rules and the need for these rules. As mentioned earlier, one of the Commission's goals was to assure "that shareholders are well informed and that all the facts regarding the compensation that the shareholders are paying are out in the open."63 However, because the determination of the executives to be included is based solely on salary and bonus, there is a risk that shareholders will not be well informed. If an executive receives a small salary and bonus, but a large amount of long-term compensation, he might not meet the SEC's narrow definition of the company's four other most highly compensated executives because long-term compensation is totally ignored in making the determination. Yet this executive's total compensation package could be one of the four highest in the company.

The SEC's decision appears even more dubious when one considers its stated justification for the new rules. The SEC enacted the new rules because the old rules did not report long-term compensation arrangements clearly and concisely.64 To explain the importance of clearly reporting these long-term arrangements, the SEC stated that long-term incentive compensation has overtaken the more traditional fixed salary and bonus to become the largest single component of the typical executive's pay.65 Thus, the foundation of the new rules is based on the form of compensation (salary and bonus) which currently makes up a minority portion of the typical executive's pay, completely ignoring the form of compensation (long-term compensation) which led to the new rules!

It will not matter that long-term compensation is not included in determining the four other most highly compensated executives if the executives who receive the largest salary and bonus likewise receive the largest total compensation package. However, a company might arrange its pay packages so that its "highest" executives receive a large long-term component but a salary and bonus component lower than that of other executives.66 Similarly, a company could limit an executive's salary and bonus to $100,000 or less, but pay him considera-

62. Id.
63. Proposed Rules, supra note 1, at 82,853. See supra note 11 and accompanying text.
64. See supra notes 18 and 24 and accompanying text.
65. Proposed Rules, supra note 1, at 82,854 (citing W. James, Reality and Perception of Executive Compensation, in PERFORMANCE AND COMPENSATION: AN ISSUE OF CORPORATE GOVERNANCE 82-83, J.L. Kellogg Graduate School of Management, Northwestern University, Jan. 13, 1992).
66. An issue raised by this approach is whether the failure to disclose such a strategy
bly more in long-term compensation and avoid disclosure of his pay package. The SEC did reduce a company's opportunity to manipulate the rules by providing that if an executive receives non-cash compensation in lieu of earned salary and bonus, such amounts must be included when calculating whether the executive is among the most highly compensated and when calculating whether an executive's annual salary and bonus exceed the $100,000 threshold for disclosure.67

Although the SEC's approach to determining the other four most highly compensated executives has the benefit of simplicity, several alternative approaches were available. One obvious alternative would have been simply to require registrants to make their determinations based on a summation of the monetary elements of the summary compensation table.68 The cost added by such an approach should be minimal, while the benefits from the elimination of the risk of misleading information would be substantial. This approach avoids the situation where an executive with a high total compensation package is not included simply because the salary and bonus components of the package are lower than four of the company's other executives.

Another possible approach in determining which executives to include is to consider all the monetary elements of the summary table plus a valuation of option and SAR grants in the last fiscal year in the calculations.69 This approach would most accurately reflect a company's total pay practices. Admittedly, this approach would be more costly to the disclosing company because it would have to value option and SAR grants for numerous executives to determine who to include in the report. However, these costs should not be burdensome because the company should already have some idea of the value of option and SAR awards from its initial determination of the appropriate number of such shares to award.70

67. Instruction 3 to Item 402(b)(2)(iii)(A) and (B) of Regulation S-K, supra note 2, at 48,146; Instruction 1 to Item 402(a)(2) of Regulation S-K, supra note 2, at 48,145.

68. Such an approach would require the following elements of the summary compensation table to be included: salary; bonus; "other annual compensation"; restricted stock awards; LTIP payouts; and "all other compensation." Note that the only element of the table not included would be the number of options and SARs awards. See infra Part III. for a discussion of the summary compensation table.

69. In the option/SAR grant table, a company has the choice of reporting either the grant-date option/SAR value or the potential realizable value of the option/SAR. See infra note 137 and accompanying text. The value determined under the method selected by the company would be added to the other elements of the summary table to determine which executives to include.

70. Although companies might not value option and SAR grants in the manner the SEC requires, their valuations would serve to reduce the number of individuals whose grants must be valued for comparison purposes.
B. Tabular Disclosure Versus Narrative Description

Under the previous compensation disclosure rules, compensation packages were presented mainly through narrative descriptions. Arguably, these descriptions became too confusing and complicated as the forms of compensation expanded in number and complexity. Disclosure under the new rules, in contrast, is designed to be more clear and concise. Although the tabular presentation facilitates shareholder understanding of compensation, narrative disclosure is still necessary and required where information is not amenable to tabular presentation. For example, a narrative form is needed to effectively explain employment agreements which include “golden parachute” payments contingent on the executive’s termination. Footnote narrative disclosure is required regarding the vesting terms for restricted stock awards that provide for vesting of all or part of the shares awarded in less than three years from the date of grant.

Company-specific intricacies in compensation arrangements and practices threaten the SEC’s goal of clear and concise disclosure. These factors require detailed disclosure which would be relegated to footnote or other narrative disclosure, and companies may find it difficult to provide such disclosure in a clear, concise manner.

Although the proliferation of footnotes has been criticized as too confusing, the information they disclose is essential to a complete understanding of the compensation picture. Certainly, tables which clearly and concisely set out basic compensation, coupled with footnote disclosure of other more specific, pertinent information, are more valuable to shareholders than total narration.

III. SUMMARY COMPENSATION TABLE

A. Generally

Probably the single most important component of the new com-

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71. A cash compensation table was also required. Former Item 402(a) of Regulation S-K, 17 C.F.R. § 229.402(a)(1)(1992). See Also Proposed Rules, supra note 1, at 82,855.

72. See supra notes 24-28 and accompanying text.


74. Final Rules, supra note 2, at 48,132. Footnote disclosure is required in this situation because restrictions on full ownership of restricted shares typically lapse over a period of at least three to five years. Id.

75. See, e.g., supra notes 73-74 and accompanying text.

pensation disclosure scheme is the summary compensation table (Table A). The summary compensation table is a concise overview of compensation awarded, earned or paid to a company's CEO and its four other most highly compensated executives for each of the preceding three years. The table requires disclosure of all forms of executive compensation paid by the registrant, whether pursuant to a plan or otherwise or through a third party.

The summary compensation table is intended to give shareholders a clear understanding of compensation for the last completed fiscal year and to help shareholders identify trends in the company's pay of management. These trends can then be compared to those of other companies in an effort to determine whether current compensation diverges from market norms. Many shareholders are likely to focus on the summary compensation table because, as the name implies, it is a "summary" of all compensation. Therefore, it is important that the table portray executive compensation as accurately as possible.

B. Specific Elements

1. Salary and Bonus

The dollar values of base salary and annual bonus, whether denominated as cash or noncash, are to be set out in separate columns of the summary compensation table. Salary or bonus earned for services performed, but deferred at the election of the executive, are reported as annual compensation. Awards of noncash compensation made to an executive in lieu of salary or bonus must be disclosed where these awards are otherwise required to be reported in the summary compensation table.

Various types of bonuses exist. Some bonuses are performance sensitive, while other bonuses simply represent a percentage of salary. Bonus criteria can be disclosed in the board compensation committee.

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77. Proposed Rules, supra note 1, at 82,855. The table replaces the cash compensation table previously required. Id.
78. The year in which compensation is reported in the table is subject to rules which vary for each form of compensation.
79. Proposed Rules, supra note 1, at 82,854; Final Rules, supra note 2, at 48,129.
80. Proposed Rules, supra note 1, at 82,855.
81. Final Rules, supra note 2, at 48,129.
82. Id.
83. Id.
84. For stock or any other form of noncash compensation, the fair market value at the time the compensation is awarded, earned, or paid must be disclosed. Instruction 2 to Item 402(b)(2)(iii)(A) and (B), supra note 1, at 48,146.
85. Final Rules, supra note 2, at 48,130.
86. Id. at 48,130.
87. Id.
The SEC decided to group all bonuses together; however, shareholder understanding of bonuses would have been facilitated by separately stating performance-based bonuses and non-performance-based bonuses. Many shareholders prefer performance-based bonuses over non-performance-based bonuses because performance sensitive bonuses, similar to stock options, tie management's pay to their performance aligning the interests of shareholders and management. However, for the summary compensation table to be effective, it must be concise. Shareholder understanding of the overall compensation scheme is paramount to the understanding of one component of compensation. Thus, the SEC made the correct choice. However, rather than only disclosing specific information about the bonuses in the compensation committee report, footnote disclosure of this information to the summary table also should have been required in order to further promote shareholder awareness.

2. Other Annual Compensation

As initially proposed, the rules required all additional forms of annual cash and noncash compensation paid, awarded or earned from company contributions to retirement plans to be reported in the “other annual compensation” column. Under the final rules, this provision covers only specified compensation items which are not properly categorized as salary or bonus. The specific items the new rule requires are: perquisites; payments to cover an executive's taxes; above-market or preferential earnings on restricted stock, options, SARs, or deferred compensation paid during the year or payable during the year but deferred at the election of the executive; all earnings paid, or payable but deferred at the election of the executive, on long-term incentive plan compensation; and the difference between the fair market value of a company's stock and the price paid by an executive for that stock (preferential discounts on stock purchases).

Perquisites must be disclosed in the table only when their aggregate value exceeds the lesser of either $50,000 or 10% of the executive's total salary and bonus. Narrative disclosure of the nature and value of the perquisite is required for any particular perquisites valued at more than 25% of the sum of all perquisites reported for that executive.

88. Id. See infra Part V. for a discussion of the board compensation committee report.
89. Id. at 48,130-31.
90. Proposed Rules, supra note 1, at 82,856.
91. Item 402(b)(3)(iii)(C) of Regulation S-K, supra note 2, at 48,146.
92. Id.; Instructions to Item 402(b)(2)(iii)(C) of Regulation S-K, supra note 2, at 48,146.
93. Item 402(b)(2)(iii)(C) of Regulation S-K, supra note 2, at 48,146.
94. Instruction 1 to Item 402(b)(2)(iii)(C) of Regulation S-K, supra note 2, at 48,146.
As indicated above, earnings on deferred compensation, restricted stock, options, and SARs are potentially subject to disclosure in the “other annual compensation” column. The proposed rules would have required disclosure of all interest on deferred compensation and all dividends on restricted stock.95 Such an approach is flawed for several reasons. First, if all interest on deferred compensation (or all dividends on restricted stock) is reported, compensation will be overstated. Where an executive has voluntarily deferred a portion of annual bonus or salary, the executive is effectively making a loan to the company.96 This loan is financially equivalent to any other investment the executive could have made outside the company if he had not deferred his bonus or salary. If the executive had made the “other investment,” interest earned on the investment would not be reported as compensation by the company. Earnings on the deferred compensation are no different than the earnings on the “other investment.” Thus, interest paid or credited to the executive on the deferred amount should not be viewed as compensation. If it is included, compensation will be overstated. Including all interest earned on deferred compensation leads to the additional problem of misleading intercompany and intracompany comparisons.97 If an executive has been deferring compensation for a number of years, the amount of earnings disclosed will not be fairly comparable with the disclosure of earnings of an executive who does not defer pay or has only recently begun to do so.98

Another problem with the proposed rules requiring reporting of all interest on deferred pay is that the Commission would, in effect, be discouraging executives from deferring compensation.99 Companies and their executives, seeking to prevent compensation from appearing larger than it actually is, would try to minimize deferred compensation. This might prove to be detrimental to executives in the long-term since compensation is often deferred for tax or retirement planning purposes.100 Thus, the rules as initially proposed would have in-

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95. Proposed Rules, supra note 1, at 82,857-58.
97. Id.
99. Id.
100. Id.
jected a bias against executives who defer compensation.

The final rules require above-market or preferential earnings on restricted stock, options, SARs, or deferred compensation paid during the year or payable during the year but deferred at the election of the executive to be included as “other annual compensation.” This change eliminates the potential problems discussed above. Disclosure of the portion of interest which is above the market rate and the portion of dividends which is preferential is necessary to prevent companies from disguising compensation as noncompensatory interest or dividends. Interest is deemed to be above-market if the rate of interest is in excess of 120% of the applicable federal long-term rate in effect at the time the interest rate was set. Dividends are preferential only if they are earned at a more favorable rate than dividends on the company’s common stock.

Another item included in the “other annual compensation” column is earnings on long-term incentive plan (LTIP) compensation. The full amount of such earnings must be reported as compensation. The full amount is included because, in contrast to earnings on deferred compensation and restricted stock, earnings on long-term incentive plan compensation do not represent payments for the company’s use of the executive’s deferred funds.

3. Restricted Stock Awards

A restricted stock award is a compensation device whereby a corporation issues shares of its stock to executives, generally at no cost, at par value, or at some nominal cost, in connection with the performance of future services by the executive. The full market value of restricted shares awarded to an executive in a given fiscal year under restricted stock award must be reported in the appropriate column of the summary compensation table. Typically, these shares are sub-

101. Item 402(b)(2)(iii)(C) of Regulation S-K, supra note 2, at 48,146.

102. Instruction 3 to Item 402(b)(2)(iii)(C) of Regulation S-K, supra note 2, at 48,146. Applicable federal long-term rate data are published monthly by the Internal Revenue Service. Final Rules, supra note 2, at 48,132 n.45.

103. Instruction 4 to Item 402(b)(2)(iii)(C) of Regulation S-K, supra note 2, at 48,146-47.

104. Item 402(b)(2)(iii)(C) of Regulation S-K, supra note 2, at 48,146.

105. Item 402(b)(2)(iv) of Regulation S-K, supra note 2, at 48,147.
ject to forfeiture and are nontransferable until a specified period of time has elapsed. However, during the restricted period, executives are treated as the owners of the stock and thus possess all dividend and voting rights connected with ownership.

The SEC elected to require the full market value of the restricted stock awards to be reported because of the stock's "minimal risk of forfeiture and the concomitant likelihood of appreciation above the grant-date market value." In other words, the SEC is requiring the full market value of restricted stock awards to be included because the recipient has close to full ownership of the stock. This approach may mislead shareholders because such stock rarely has the same value as freely transferable shares. An alternative to this approach would be to require the company to discount the value of the shares to market value to reflect the constraints on transferability. However, restricted stock is difficult to value in such a manner. The concern really should be which approach would be less misleading to shareholders. Given the difficulty in discounting the value of restricted stock, the minimal risk of forfeiture of such stock, and the relative ease of calculating the full market value of the stock, the SEC's methodology appears to be the more appropriate solution.

4. Option/SAR Grants

Generally speaking, an option is a right granted by the issuing corporation to the executive allowing him to purchase a specified amount of shares of the corporation's stock for a specified price. An SAR is a contractual right to be paid an amount equal to the difference (or appreciation) between the value of a share of a company's stock on the date the SAR is granted and the value of the stock on the date the SAR is exercised. Companies must disclose in the summary compensation table the number of shares of options and/or stock appreciation rights (SARs) awarded. Only the number of shares of options and/or SARs must be reported in the summary table. Options and SARs are not valued in the summary table but are instead subject to

109. Id.
110. Final Rules, supra note 2, at 48,132. Where a restricted stock plan includes performance-based conditions on vesting, the company may choose to treat these as long-term incentive plan compensation. Id.
111. Restricted stock recipients enjoy the stock ownership benefits of voting and dividend rights. Hawksley & Melbinger, supra note 107, at 38.
112. Final Rules, supra note 2, at 48,132.
113. Blackiston, supra note 106, at 256.
114. Id. at 310.
115. Item 402(b)(2)(iv)(B) of Regulation S-K, supra note 2, at 48,147.
disclosure in a separate table.\textsuperscript{116}

5. \textit{LTIP Payouts}

The SEC defines a long-term incentive plan ("LTIP") as any plan providing compensation intended to serve as incentive for performance to occur over a period longer than one fiscal year, whether by reference to the company's financial performance, stock price or other measures, other than restricted stock, options, and SARs.\textsuperscript{117} Companies must disclose, in the summary table, the dollar value of cash or stock-denominated awards actually realized or matured but deferred at the election of the executive in each appropriate year.\textsuperscript{118}

6. \textit{All Other Compensation}

The "all other compensation" column is a catch-all category. Included in this category is any compensation not reported in the other columns of the summary table (other than option and SAR exercises and LTIP awards which are covered in other tables).\textsuperscript{119} An example of an item included in this category is amounts paid, payable or accrued under termination, severance and change-of-control arrangements (e.g. golden parachutes).\textsuperscript{120}

\section*{C. Other Criticisms/Potential Improvements}

1. \textit{Bottom-Line Figure}

It has been suggested that the summary table should include a "bottom-line" figure representing the total value of all cash and non-cash compensation received by each executive.\textsuperscript{121} Because the summary compensation table is probably the single most important part of the disclosure scheme, and many shareholders are likely to focus solely on this table, a bottom-line figure is potentially a serious omission. Is the Commission satisfying its goal of facilitating clear understanding? It is not if shareholders cannot answer the most basic question of all—how much was an executive paid during the last year?\textsuperscript{122}

One reason why the Commission may have chosen not to require a bottom-line figure is that reaching a truly accurate bottom-line figure

\textsuperscript{116} See \textit{infra} subsection III.C.1. for a discussion of the advantages and disadvantages of such an approach.

\textsuperscript{117} Item 402(a)(6)(iii) of Regulation S-K, \textit{supra} note 2, at 48,145.

\textsuperscript{118} Item 402(b)(2)(iv)(C) of Regulation S-K, \textit{supra} note 2, at 48,147.

\textsuperscript{119} Item 402(b)(2)(v) of Regulation S-K, \textit{supra} note 2, at 48,147; Instruction 1 to Item 402(b)(2)(v) of Regulation S-K, \textit{supra} note 2, at 48,147.

\textsuperscript{120} \textit{Final Rules}, \textit{supra} note 2, at 48,133.

\textsuperscript{121} \textit{USA Letter}, \textit{supra} note 73, at 3.

\textsuperscript{122} \textit{Id.} However, important information would be missed if a shareholder focused exclusively on a bottom-line figure. \textit{Cf. supra} notes 73-75 and accompanying text.
is arguably not possible because the present value of stock options cannot be precisely determined. The SEC has chosen to require companies simply to disclose in the summary table the number of options or SARs awarded. Any monetary valuation of the grants is deferred to the tables dealing specifically with them. Should the SEC nevertheless require companies to use option valuation models to provide present values for option grants in the summary compensation table? If the present value of options could be reliably ascertained, they should be included in the table. That would make a bottom-line figure possible. However, in light of the potential problems with such models, the SEC should not be criticized for its choice.

2. Exclusion of Option/SAR Information

Some commentators have argued that information regarding stock options should not appear in the summary table at all. They argue that the information regarding the options is not readily comparable to other data in the table because it is impossible to understand the value of a grant without knowing such details as exercise price and vesting date. Considering the SEC's goal of understandable disclosure, this appears to be a valid argument. However, one must consider the alternatives.

Would disclosure be more understandable if the number of options and SARs were totally excluded from the summary table? Probably not. If some shareholders focus exclusively on the summary table, it will appear that executives are receiving less than in fact they are. Shareholders must be made aware that option grants also exist. The column disclosing the number of shares of options and SARs awarded does that. Narrative disclosure is not adequate because of the risk that the information will not be read, and the new rules seek to avoid such confusing narratives. Also, it cannot be assumed that unsophisticated shareholders will look beyond the summary table to the option/SAR tables to discover this information.

123. See supra note 113 and accompanying text.
124. See infra Part IV for a discussion of the potential problems with option valuation models.
125. ACCA Letter, supra note 98, at 1.
126. Id.
127. "A rational shareholder will expend the effort to make an informed decision only if the expected benefits of doing so outweigh its costs. Given the length and complexity of SEC disclosure documents, the opportunity costs are quite high and very apparent. In contrast, the benefits aren't at all clear since most shareholders' holdings are too small to have any significant effect on the vote's outcome." Bainbridge, supra note 37, at 22. Professor Bainbridge goes so far as to say that most institutional investors choose to be passive investors due to high information cost. Id.
3. Disclosure Period

The final rules call for a three-year look-back period. This is intended to show trends in the company’s pay practices and to allow shareholders to compare the company’s trends to those of other companies. A longer disclosure period would facilitate these goals by making trends more apparent, making perhaps a five-year period preferable. The added cost of such an approach could be alleviated by providing for a phase-in of such a requirement. Companies could be required to provide the three-year disclosure for the first applicable year, as is required under the rules as enacted. A four-year disclosure period would be required in the second year and a five-year disclosure period in the third year and beyond. Under this approach, companies would simply retain information from the initial table until a full five years are disclosed, but would not incur any additional costs to gather the information. Although historical information is available in prior public filings, the relatively low cost of providing this additional information would be more than offset by the benefits provided to shareholders who might not have ready access to the prior public filing.

IV. OPTION/SAR TABLES

The new rules require three tables dealing with options and SARs. First, the rules prescribe a table including individual option and SAR grants and related valuation information (Table B). Also required is a table including aggregated exercise and year-end holdings value information (Table C). Finally, a table disclosing option and SAR repricings is required. Certain provisions of the individual grant and related value table are discussed below.

The individual grant and related valuation table requires, with respect to each grant, the name of the executive receiving the grant, the number of options and SARs granted, the percent of the total options and SARs granted to employees during the year that the grant to the executive represents, the per-share exercise or base price of the options or SARs, and the expiration date of the options or SARs. If the exercise or base price is less than the market price of the underlying security on the date of grant, a separate, adjoining column must be added showing the market price on the date of grant.
Repriced options or SARs must be reported as new grants. An option or SAR is "repriced" when the exercise price of the option or SAR is lowered by the issuing company. Disclosure of performance criteria and other material terms of the option or SAR is also mandated. A performance-based option or SAR is an option whose vesting, exercisability or actual grant is keyed to the executive achieving predetermined objectives.

In addition to the individualized grant information listed above, the rules require disclosure of either the potential realizable value of each option/SAR grant or the present value of each such grant. The company may choose the approach it prefers. In the proposed rules, the SEC mandated disclosure of data reflecting a range of potential realizable values calculated on the basis of various assumed stock price appreciation rates over a period of ten years. The Commission's proposal envisioned calculations based on arbitrarily determined appreciation rates of 50%, 100%, and 200% for the ten-year period. No provision was made for present value calculations.

The proposed rules were criticized for a number of reasons. For example, it was argued that the percentages adopted could mislead shareholders as to the range of probable stock price growth for most companies. Stock price appreciation varies significantly depending on a company's performance, the performance of the stock market in general, and on industry-specific factors. Nevertheless, the proposed rules dictated that all companies were to use the same percentages. Interestingly, the Commission noted that, between 1925 and 1991, the average ten-year capital appreciation rate for the S&P 500 Stock Index was 70%. Yet, it proposed appreciation rates as high as 200%, an overly optimistic estimate for many companies.

The rules as proposed were also criticized for their assumption of a ten-year option/SAR term. While many options/SARs have a ten year life, other terms are used. Further, many option plans reduce the term to a shorter period after an executive retires. When the overstatement of both appreciation rates and exercise period are com-

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134. Instruction 2 to Item 402(c) of Regulation S-K, supra note 2, at 48,148.
135. Instruction 3 to Item 402(c) of Regulation S-K, supra note 2, at 48,148.
136. See Blackston, supra note 106, at 279. An example of a performance-based option is an option which vests only when the corporation achieves a specified cumulative earnings per share. Id.
137. Item 402(c)(2)(iv) of Regulation S-K, supra note 2, at 48,148.
139. Id.
140. NYSBA Letter, supra note 54, at 9; ABA Letter, supra note 76, at 30.
141. ABA Letter, supra note 76, at 30.
142. Proposed Rules, supra note 1, at 82,859 n.28 (citing R. Ibbotson, Stock, Bonds, Bills and Inflation Yearbook (1991)).
143. NYSBA Letter, supra note 54, at 9.
bined, the proposed table would have been misleading to shareholders.\textsuperscript{144}

Some commentators suggested that the SEC require present valuation of options and SARs, either in all cases or as an alternative to the potential realizable value information.\textsuperscript{145} They argued that present value calculations are recognized as valid and are generally relied on in the market.\textsuperscript{146} The SEC partially acceded to these suggestions in the final rules by allowing companies to select which of the two forms of disclosure they prefer.\textsuperscript{147}

The SEC also revised its rules governing the potential realizable value disclosure in response to the above mentioned criticism.\textsuperscript{148} If a company chooses to utilize the potential realizable value approach, it must report potential option/SAR gain values based on assumed annual appreciation rates of 5\% and 10\% over the actual term of the option or SAR granted.\textsuperscript{149} Assuming a ten-year term and annual compounding, a 5\% assumed annual rate of appreciation would result in total potential appreciation of 63\%.\textsuperscript{150} Under the same assumptions, a 10\% assumed annual rate of appreciation would result in total potential appreciation of 159\%.\textsuperscript{151} Merely providing for 63\% and 159\% assumed appreciation may not adequately inform shareholders. A preferable approach would be to provide a broader range of realistic hypothetical rates.\textsuperscript{152} Increasing disclosure of the range of potential results by adding columns for 3\% and 7\% assumed annual rates would be less misleading to shareholders. Assuming a ten-year term and annual compounding, 3\% and 7\% assumed rates of appreciation would result in total potential appreciation of 34\% and 97\%, respectively. If a broader range of rates is provided, shareholders would be less apt to mistakenly believe the percentage growth figures are equivalent to the company's internal projections for stock price growth. Further, to the extent the SEC requires hypothetical appreciation based on percentages above what is reasonably expected, without a concomitant requirement of disclosure based on rates lower than expected, the SEC will be creating a bias against the use of options and SARs. Companies

\textsuperscript{144} Id.
\textsuperscript{145} \textit{Final Rules}, supra note 2, at 48,135.
\textsuperscript{146} Id.
\textsuperscript{147} Id.
\textsuperscript{148} Id.
\textsuperscript{149} Item 402(c)(2)(vi)(A) of Regulation S-K, supra note 2, at 48,135.
\textsuperscript{150} Final Rules, supra note 2, at 48,135.
\textsuperscript{151} Id.
\textsuperscript{152} Id.

As an example of what the table would disclose, the SEC provided the following: "the potential realizable values of an option for 1000 shares with an exercise price of $10, and a five-year term would be reported as $2,763 (5\%) and $6,105 (10\%)." \textit{Final Rules}, supra note 2, at 48,135 n.80.

\textsuperscript{150} Final Rules, supra note 2, at 48,135.
\textsuperscript{151} Id.

The number of hypothetical rates disclosed must not be too large or the interests of concise, understandable disclosure will suffer.
may believe that shareholders will perceive such disclosure negatively and as a result, use other compensation devices.

As mentioned above, the SEC decided to allow companies to report grant-date option/SAR value information rather than potential value information.\textsuperscript{153} Such present value information can be procured through uniform option pricing methodologies. Option pricing models determine present value based on company-specific parameters, and thus, would arguably provide shareholders with more meaningful information about an option’s incentive qualities than would the potential appreciation approach.\textsuperscript{154} The modified Black-Scholes model is an example of an option pricing model.\textsuperscript{155} If a company chooses to use the grant-date valuation alternative, the disclosure must be footnoted to describe the valuation method utilized.\textsuperscript{156}

Many commentators argue that option valuation models do not adequately value long-term options.\textsuperscript{157} Valuation of nontransferable long-term options is even more questionable.\textsuperscript{158} The Black-Scholes model is primarily designed to be used with short-term tradable options, not nontransferable long-term options.\textsuperscript{159} Further, using such a model might lead a reader to believe that the amounts presented are totally accurate when in fact they are not. In fact, commentators argue that the Black-Scholes formula is dependent on the user’s views on such matters as the company’s future dividends and market inter-

\textsuperscript{153} See supra note 147 and accompanying text. The grant-date option/SAR value is a present value figure while a potential value figure reflects the potential gain value of the option/SAR based on hypothetical appreciation rates.

\textsuperscript{154} Id.

\textsuperscript{155} USA Letter, supra note 73, at 4.

\textsuperscript{156} Instruction 9 to Item 402(c) of Regulation S-K, supra note 2, at 48,154. If the company uses a variation of the Black-Scholes option pricing model, the description may be limited to a simple indication of the use of such pricing model. Id. If another valuation method is used, the methodology as well as any material assumptions must be described. Id.


\textsuperscript{158} Business Roundtable Letter, supra note 96, at 10.

\textsuperscript{159} Id.

The Black-Scholes option valuation model is not designed to accurately value long-term, nontransferable executive options. CSM Letter, supra note 157, at 23-24. The model values options based on a trader’s ability to effect a dynamic arbitrage between the option and the underlying security on an ongoing basis. Id. The value of an option is equal to its expected terminal value on the option expiration date discounted at the risk-free rate. Id. (citation omitted). The low discount rate is only appropriate if the option trader can execute countervailing transactions to the purchase or sale of the option. Id. An executive holding a long-term, nontransferable stock option is not able to participate in such arbitrage activities because the option is not transferable and because the holder cannot engage in countervailing transactions due to certain trading prohibitions. Id.
est rates over the life of the option. The model's result might actually mislead shareholders since the disclosing company has discretion over the variables and many shareholders are inexperienced with the model.

Neither reporting the grant-date option/SAR value nor reporting potential option/SAR values is totally accurate. Further, each method has advantages and disadvantages. Because both alternatives have drawbacks, it is difficult to suggest that one alternative be mandated. However, allowing a company to choose the method it prefers does nothing to enhance inter-company comparability of executive option/SAR grants. Shareholders unfamiliar with the new disclosure regime are likely to be misled by the two divergent approaches to option/SAR valuation when making comparisons among companies.

Companies are likely to report grant-date option/SAR value rather than use the hypothetical appreciation rates. Using the grant-date valuation alternative will result in a lower dollar figure being disclosed to shareholders. Grant-date valuation employs a present value determination while the hypothetical appreciation approach discloses potential future values. Because potential gain values based on assumed rates of appreciation are not discounted to present value under the SEC's approach, the future values will always exceed the present values. However, sophisticated shareholders, especially institutional investors, will understand that companies are taking such an approach and weigh the disclosure accordingly.

Arguably, in the near future, some corporations may be hesitant to use the grant-date alternative in light of the Financial Accounting Standards Board's (FASB) current consideration of appropriate accounting for stock options and similar awards. Such corporations may be concerned that if they begin to consistently provide present value information to shareholders, FASB may require that the present value of options be charged to earnings. This fear is countered by the fear that other companies will make disclosure based on present value, giving the appearance of a lower compensation scheme.

V. BOARD COMPENSATION COMMITTEE REPORT

The new rules require a report by the board compensation committee disclosing the company's compensation policies concerning its executive officers, including the specific relationship of corporate performance to executive compensation. Specific discussion is not

161. *Id.*
162. *See Proposed Rules, supra* note 1, at 82,858 & n.27.
163. *USA Letter, supra* note 73, at 3.

"Boilerplate language" is to be avoided in describing the factors or criteria
required with respect to each executive. Instead, a discussion is required with respect to the executive officers as a group. However, the rules do require specific discussion of the CEO's compensation. The committee's bases for the CEO's pay reported for the last completed year, including the factors and criteria upon which the CEO's compensation was based, must be addressed. A specific discussion of the relationship of the company's performance to the CEO's compensation for the last completed year is also mandated. Both the discussion concerning the CEO and the discussion regarding the other named executives must include a description of each measure of the company's performance, whether qualitative or quantitative, on which compensation was based. Such performance measures might include sales, earnings, quality rate, return on assets or market share.

The final rules provide that the disclosure is to be made "over the name of each member of the [company's] compensation committee." However, the members do not have to sign the report. If the board of directors modified or rejected in any material way any action or recommendation by the compensation committee, such information, along with an explanation of the rationale for the action, must be disclosed. This disclosure must be made over the names of all members of the board, but the members do not have to sign the report. The SEC has stated that the "disclosure of the Compensation Committee's policies will enhance shareholders' ability to assess how well directors are representing their interests." Thus, theoretically, the

underlying compensation packages. Instruction 1 to Item 402(k), supra note 2, at 48,157.
165. Item 402(k)(1) of Regulation S-K, supra note 2, at 48,157. See also Final Rules, supra note 2, at 48,138.
166. Item 402(k)(2) of Regulation S-K, supra note 2, at 48,157.
167. Id.
168. Id.; Final Rules, supra note 2, at 48,138.
169. Proposed Rules, supra note 1, at 82,868; Final Rules, supra note 2, at 48,138.
170. Item 402(k)(3) of Regulation S-K, supra note 2, at 48,157. If a company does not have a compensation committee, the names of the members of any committee performing equivalent functions is to be included. If no such committee exists, the names of each member of the board of directors is to be included. Id.
171. See infra notes 186-193 and accompanying text.
173. Id.
174. Final Rules, supra note 2, at 48,138. See also Proposed Rules, supra note 1, at 82,867; supra note 164 and accompanying text.

The report is "intended 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." Proposed Rules, supra note 1, at 82,868.

At least one commentator has argued that this goal conflicts with state corporate law which provides for the division of authority between shareholders and directors. Bainbridge, supra note 37, at 22. Professor Bainbridge predicts that
report will help improve the accountability of directors to shareholders.\textsuperscript{175} The Commission believes that shareholders are entitled to know the bases for directors' compensation decisions since it is the shareholders who ultimately fund executive pay.\textsuperscript{176} With an enhanced understanding of the rationale for compensation practices, the Commission expects that shareholders will be able to make an informed decision when voting on directors or on executive and director compensation plans.\textsuperscript{177}

Several issues are raised regarding the compensation committee report. An initial question is whether it is even possible to delineate the specific factors upon which a compensation decision is based.\textsuperscript{178} In this situation, the compensation committee is treated as a distinct entity with an independent rationale for its decisions. The rules seem to assume that each and every member of the committee used the same factors or criteria in making compensation decisions. In contrast to this assumption, the views of individual committee members are likely to vary considerably.\textsuperscript{179} Any specific factor may be significant to one member of the committee, but of little or no importance to other members.\textsuperscript{180} Thus, the report may mislead shareholders as to exactly on what the various committee members based their support for the committee's decision.

From the foregoing discussion, one might argue that the SEC should have required disclosure of each individual committee member's reasons or motivations for supporting the committee's recommendations. However, such an approach would have several drawbacks. If discussions among committee members were to be summarized in the report, open communication during committee meetings might be hindered.\textsuperscript{181} This might lead to compensation awards based on formulas alone without taking into consideration individual performance.\textsuperscript{182}

The final rules allow a company to withhold target levels with respect to specific performance-related factors or any factors involving confidential information, if such disclosure would adversely affect the company.\textsuperscript{183} While this exception is necessary from a business standpoint, the omission of this information could be misleading to readers

\textsuperscript{175} See supra note 11 and accompanying text.
\textsuperscript{176} Proposed Rules, supra note 1, at 82,867.
\textsuperscript{177} See Proposed Rules, supra note 1, at 82,867.
\textsuperscript{178} CSM Letter, supra note 157, at 4.
\textsuperscript{179} Id.
\textsuperscript{180} Id.
\textsuperscript{181} See Final Rules, supra note 2, at 48,138; ACCA Letter, supra note 98, at 8.
\textsuperscript{182} Id.
\textsuperscript{183} Instruction 2 to Item 402(k) of Regulation S-K, supra note 2, at 48,157.
because some of the factors which may have been used in compensation determinations will not be disclosed.\textsuperscript{184} Compensation decisions may appear to be unjustified and thus would be misleading.\textsuperscript{185}

The proposed rules required the individual committee members to sign the committee report.\textsuperscript{186} According to the Commission, the signature requirement was intended to increase the committee members' focus on the specific disclosure obligation.\textsuperscript{187} Under the final rules, the SEC changed its position and simply required the committee members' names to be printed at the end of the report.\textsuperscript{188} The Commission stated that the signature requirement was deleted because the same purpose could be accomplished, and the practical difficulties associated with obtaining manual signatures avoided, if the report were simply made over the names of the committee members.\textsuperscript{189} However, it is more plausible that the Commission removed the requirement in response to heavy criticism by commentators. Commentators criticized the signature requirement for potentially creating a risk of increased individual director liability.\textsuperscript{190} They questioned whether committee members would have a special responsibility and, therefore, liability for having signed the report.\textsuperscript{191} If there is a risk of increased liability, either real or perceived, communication among directors will not be as complete and open as possible. Further, individuals might have become hesitant to serve as directors, to serve on compensation committees or to take an activist role in compensation matters.\textsuperscript{192} Committee members may have increasingly consulted outside compensation experts in an effort to avoid personal liability from deficient disclosure.\textsuperscript{193}

In an effort to dissipate concerns over director liability, the SEC further explained its position regarding the committee report. The SEC stated that "[i]f shareholders are not satisfied with the decisions reflected in the report, the proper response is the ballot, not resort to the courts to challenge the disclosure."\textsuperscript{194} Additionally, the provisions

\textsuperscript{184.} CSM Letter, supra note 157, at 34.
\textsuperscript{185.} Id.
\textsuperscript{186.} Proposed Rules, supra note 1, at 82,867.
\textsuperscript{187.} Final Rules, supra note 2, at 48,139.
\textsuperscript{188.} See supra notes 170-71 and accompanying text.
\textsuperscript{189.} Final Rules, supra note 2, at 48,139.
\textsuperscript{190.} See e.g., CSM Letter, supra note 157, at 5; NYSBA Letter, supra note 54, at 4.
\textsuperscript{191.} See e.g., CSM Letter, supra note 157, at 5; NYSBA Letter, supra note 54, at 4.
\textsuperscript{192.} CSM Letter, supra note 157, at 65.
\textsuperscript{193.} Id. Use of outside compensation consultants may result in negative consequences to shareholders. For example, because such experts are largely performing a function which the compensation committee would have performed, costs to shareholders are increased. It should be noted, however, that many large companies already employ such consultants. To the extent the consultants remain objective, shareholders should benefit from the consultant's analysis.
\textsuperscript{194.} Final Rules, supra note 2, at 48,138.
requiring the report were revised to provide that the disclosure will not be deemed soliciting material, or to be filed under section 18 of the Exchange Act. The compensation committee report is not exempted from all shareholder litigation, however. Section 10(b) and Rule 10b-5 under the 1934 Act are still applicable because the SEC cannot exempt parties from these provisions.

Some commentators questioned the Commission's authority to require a report signed by each member of a compensation committee. These parties believed that the Commission's requirement constituted, or could evolve into, substantive regulation of corporate conduct. The commentators maintained that compensation decisions are corporate actions and that the corporation should disclose such decisions rather than board committees. The Commission was attempting to require a report not of the company, but of a committee of the board normally comprised of outside directors. Such information disclosure is a matter of state law, it was argued, and is beyond the scope of the Commission. The SEC responded by stating that because disclosure of the committee's policies will enhance shareholder's ability to assess how well directors are representing their interests, the report is appropriate and necessary and within the Commission's authority. Further, the SEC declared that the disclosure would not impose new fiduciary standards on directors.

VI. PERFORMANCE GRAPH

The new rules require companies to provide a line graph (Table E) comparing the company's cumulative total shareholder return with a performance indicator of the overall stock market. The company's

195. Id.; Item 402(a)(9) of Regulation S-K, supra note 2. The performance graph, discussed infra in Part VI., is treated similarly to the compensation committee report. The rules specify that the compensation committee report and the performance graph are required only in a proxy or information statement relating to an annual meeting of security holders at which directors are to be elected. Item 402(a)(8) of Regulation S-K, supra note 2. Thus, this information is not deemed to be incorporated by reference into any Securities Act or Exchange Act filing, except to the extent that a company specifically incorporates it by reference. Final Rules, supra note 2, at 48,138.

196. ABA Letter, supra note 76, at 9; NYSBA Letter, supra note 54, at 16.
197. ABA Letter, supra note 76, at 9; NYSBA Letter, supra note 54, at 16.
198. ABA Letter, supra note 76, at 9.
199. Id.
201. Final Rules, supra note 2, at 48,138.
202. Id.
203. Id. at 48,139. To facilitate inter-company comparisons, total return must be presented on a dividend-reinvested basis. Item 402(l)(1) of Regulation S-K, supra note 2, at 48,157. Companies must assume that dividends are reinvested into additional shares of the same class of stock. Instruction 1 to Item 402(l) of Regulation S-K, supra note 2, at 48,158. Without such a requirement, companies that have
total return must also be compared with the cumulative total return of either a published industry or line-of-business index or a company-determined peer group selected in good faith. Alternatively, the comparison may be made to issuers with similar market capitalizations, but only if the company does not use a published industry or line-of-business index and does not believe it can reasonably identify a peer group.

The performance presentation is designed to complement the compensation committee's discussion of the relationship of executive pay to corporate performance. Therefore, the graph is expected to aid shareholders in analyzing corporate performance and its relationship to the company's compensation policies.

An example of a performance indicator of the overall stock market is the S&P 500, although other broad market indices exist. Companies that are not included in the S&P 500 are allowed to use a different broad equity market index that includes companies that trade on the same exchange or NASDAQ market or are of comparable market capitalization. If the company is included in the S&P 500, the company must use that index. A published index is any index which was prepared by a party other than the company or an affiliate and is accessible to the company's shareholders. If a peer group is used, the company has broad discretion in determining its peer comparison.

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204. Item 402(l)(1)(ii)(A) and (B) of Regulation S-K, supra note 2, at 48,157. If the company does not select its peer group on an industry or line-of-business basis, the company must disclose the basis for its selection. Id.

205. Item 402(l)(1)(ii)(C) of Regulation S-K, supra note 2, at 48,157. See infra note 214 and accompanying text for a discussion of the rationale for this provision.


207. The S&P 500 is an unmanaged index of the common stock prices of 500 well-known multinational corporations covering more than 30 different industries. S&P 500 returns include reinvestment of dividends.

208. Item 402(l)(1)(i) of Regulation S-K, supra note 2, at 48,157. Other indices include the S&P 500 Composite Index, the Dow Jones Equity Market Index, the American Stock Exchange Market Value Index, the Wilshire 5000 Equity Index, and the Russell 1000, 2000, or 3000. Final Rules, supra note 2, at 48,139 n.112.

209. Item 402(l)(1)(i) of Regulation S-K, supra note 2, at 48,157. Intercompany comparisons will be enhanced by this requirement. Final Rules, supra note 2, at 48,139 n.112.

210. Item 402(l)(3) of Regulation S-K, supra note 2, at 48,157. A company may, however, use an index prepared by the company or affiliate if such index is widely recognized and used. Id.

211. Final Rules, supra note 2, at 48,139.

This broad discretion in determining peer groups could translate into compa-
The comparison may be made to one or a number of other companies.212 Further, bases other than industry or line-of-business may be used for determining peer comparisons as long as the bases are disclosed.213 The provision allowing companies that do not believe it is possible to provide a peer comparison to disclose this belief and compare their shareholder return to one or more companies selected on the basis of similar market capitalization was included in the final rules for the benefit of companies whose peers are privately-held companies or subsidiaries or divisions of larger publicly-held companies.214 This provision is also applicable to diversified companies that do not readily fit into a standard industry category and do not have a peer group.

One general criticism of the performance graph is the possible implication that company performance should be the only factor considered in determining executive compensation.215 Arguably, such a determination should be left to a company's compensation committee and ultimately, to its shareholders.216 On the other hand, if a company does use some measure of financial performance to determine the compensation of its executives, the performance graph would be appropriate.217 Regardless of the factors weighed in determining compensation, the new rules require a board compensation committee report disclosing the directors' discussion and analysis of the relationship, if any, between corporate performance and executive compensation.218 The committee report specifically describes the actual link between company performance and executive compensation. The performance graph, in contrast, simply compares the company's shareholder return with various performance indicators external to the company. If shareholders believe executives are being overpaid in light of company performance, they should focus their attention on the committee report. Thus, while the SEC required the performance graph to complement the discussion by the compensation committee of the relationship of executive compensation to corporate perform-

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212. Final Rules, supra note 2, at 48,139.
213. Id.
214. Final Rules, supra note 2, at 48,139-40.
215. See ACCA Letter, supra note 98, at 3.
216. Id.
217. See Id. at 4.
218. See supra note 168 and accompanying text.
ance, the graph may actually mislead shareholders and detract from the committee report. The SEC's decision to include the performance graph in its new disclosure scheme was probably ill-advised.

The performance graph can also be criticized for implying that companies evaluate performance by "total return." Many other indices of performance are available and used. However, the SEC's decision to focus on a single standard for evaluating performance furthers the goal of providing concise and understandable disclosure. Another criticism of the graph is that it encourages management to focus on short-term objectives such as bolstering the year-end stock price. Such an approach may prove detrimental to shareholders interested in long-term growth and value. Further, short-term fluctuations in a company's stock price caused by factors not directly related to the company, such as macro-economic or industry conditions, may mislead shareholders.

VII. CONCLUSION

Small, unsophisticated investors (and some sophisticated investors) were unable to understand the disjointed, legalistic narratives produced under the former disclosure rules. The new rules will make disclosure more understandable and more concise, thus achieving the SEC's stated purpose.

The new disclosure scheme will reduce shareholders' costs of making informed decisions regarding executive compensation because compensation information will be easier to understand and relatively concisely displayed. Whether the benefits of making an informed decision will outweigh the remaining costs is yet to be seen. Shareholders with a small ownership interest are still not likely to profit from an increased role in compensation decisions. Such shareholders are rationally apathetic. The cost of becoming informed is greater than any benefit received. Many of these investors will "free-ride" on the efforts of other investors who are willing to expend the resources to analyze the compensation information.

Institutional investors already had access to much of the information provided under the new rules through the narrative disclosure

220. Id. Examples of other indices include Return on Equity, Return on Assets, and Growth in Earnings Per Share.
221. Id. at 3. This argument assumes an inefficient market.
222. See ABA Letter, supra note 76, at 43. However, presumably all companies would be affected by such changes.
223. See supra note 10 and accompanying text.
provided under the old rules, other public filings, and various financial statements. However, rather than engaging in the costly and time consuming task of assessing and evaluating various compensation schemes themselves, institutional investors may now rely on the company to do much of the work for them. Further, many institutional investors hold large enough interests in company equity to profit from increased participation in compensation decisions.

If enough shareholders will benefit from taking an active role in compensation decisionmaking, the SEC is well on its way toward achieving its initiative of enhancing the workings of market forces with respect to executive pay.