Written Testimony

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September 24, 2010

Committee on Financial Services
United States House of Representatives

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

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Introduction

My name is Darla C. Stuckey and I am currently Senior Vice President – Policy & Advocacy, for the Society of Corporate Secretaries and Governance Professionals (the "Society"). The Society is a professional association, founded in 1946, with over 3,100 members who serve more than 2,000 companies. Our members are responsible for supporting the work of corporate boards of directors and their committees and the executive management of their companies regarding corporate governance and disclosure. At our companies we seek to develop corporate governance policies and practices that support our boards in the important work and that serve the interests of long term stockholders. Our members generally are responsible for their companies' compliance with the securities laws and regulations, corporate law, and stock exchange listing requirements. The majority of Society members are attorneys, although our members also include other non-attorney governance professionals. More than half of our members are from small and mid-cap companies.

I have previously served as Corporate Secretary at the NYSE and as Senior Assistant Corporate Secretary at the American Express Company. Prior to that I practiced law at Weil, Gotshal & Manges in the Securities Litigation department.

The Society is honored to give testimony before this Committee.

Background

The Committee has asked for the Society's views on the likely effects of the implementation of the compensation-related provisions of the Dodd-Frank Act, particularly with respect to whether they will be effective in correcting incentive compensation structures that can lead to excessive risk taking. You also asked for our views on the considerations that Federal regulators should take into account during their rulemaking to implement the compensation-related provisions of the Act. The majority of my testimony will be focused on the latter of these two requests, with some very specific suggestions for the Securities and Exchange Commission relating to the relevant provisions of the Dodd-Frank Act.

The Society is uniquely positioned to provide insight into the practical implications of the statute and the implementing rules, and the potential unintended consequences of them, because our members serve the boards of directors of their companies, including their compensation and risk committees, are familiar with executive compensation practices and risk management policies at their companies and are involved in the development of public disclosures of compensation practices and risk. In addition, a number of our members serve as Compliance Officers at their companies, in addition to performing the role of Corporate Secretary.

Without taking a position on the impact of the Act specific to financial services companies (since all companies are covered by Dodd-Frank), we do believe that the governance changes required under Dodd-Frank, along with the other SEC rules implemented since the financial crisis of 2008 generally will facilitate public companies' efforts to manage and oversee risk. More specifically, however, we note our concerns below with the implementation of the rules based on our perceptions of Congress' intent.

Our comments focus on five executive compensation sections, and the whistleblower provision in Section 922, of the Dodd-Frank Act.

1. Say-on-Pay

Section 951 of the Act requires public companies to provide their shareholders periodically (at least once every 3 years) with a non-binding vote ("say-on-pay") on the compensation of their executives, based on the compensation paid to the company's executive officers named in the proxy statement for the annual meeting, which includes the compensation committee report, compensation discussion and analysis, executive compensation tables and related disclosures. Say-on-pay is required for all shareholder meetings after January 21, 2011. The Act also requires public companies to provide their shareholders a non-binding vote on how frequently the shareholders would be presented with a say-on-pay vote ("say-when-on-pay") (discussed below).

Comments

SEC Final Rules and Guidance Needed Before January 21, 2010

The most recently published SEC implementation schedule targets adoption of say-on-pay and say-when-on-pay rules sometime between January and March of 2011. We respectfully submit that such a schedule is too late to afford public companies sufficient time to comply with the new rules in the upcoming 2011 proxy season, as required by the Act. We urge the SEC to propose these rules in early October so they can be adopted prior to January 21. This is because companies must soon begin to develop their executive compensation disclosures and say-on-pay (and say-when-on-pay) proposals. Most Boards meet in December, January or February to make final decisions on the executive compensation to be disclosed in that year's proxy statement. Many proxy statements are printed and distributed to shareholders in February and March for annual meetings taking place in April and May. In order for public companies to implement the new rules this proxy season, we respectfully submit that the SEC should propose formal rules in early October so that they can be adopted prior to January 2011.

Suggest Using TARP Model

Given the short time frame, we also suggest that the SEC follow the approach similar to that taken for the TARP companies last year which allowed companies flexibility to discuss in the text of the proposal why shareholders should approve the resolution. Indeed, if the SEC were to make clear that in 2011, companies could model their proposals on those used by TARP companies, it would reduce current uncertainty.

In addition, companies still subject to the Emergency Economic Stabilization Act of 2008 (the "Stabilization Act") should be able to satisfy the provisions in Dodd-Frank with a single say-on-pay resolution, including a resolution previously used under the Stabilization Act.

Proxy Advisory Firm Influence Should be Considered

Finally, we ask that the SEC carefully consider the influence of proxy advisory firms and their "one-size-fits-all" policy application in the area of executive compensation when writing these rules.

Almost half of Society members responding to a recent survey indicated that 30% or more of their companies' shares are voted in line with proxy advisory firm recommendations. And over 60% of those responding noted that proxy advisory firm recommendations had been based on materially inaccurate or incomplete information at least once, and of those recommendations, 60% were not corrected. This data indicates that proxy advisory firms frequently make mistakes when analyzing individual company's compensation plans.

Clarify that Preliminary Proxies Will Not Be Required as a Result of the Say-on-Pay Vote

We note that the SEC has informally indicated that preliminary proxies will not be required as a result of the say-on-pay vote, as was the case with TARP companies that were required to provide say-on-pay votes. We respectfully request the SEC to formalize its position and specifically exempt companies from the requirement to file preliminary proxies as a result of providing the say-on-pay vote, and also clarify that the exemption also will apply to those companies still subject to the TARP say-on-pay requirements.

2. Say on Pay Vote Frequency (or "Say When on Pay")

In addition to the vote on executive compensation, companies must also ask shareholders to cast a non-binding vote on whether the company should hold shareholder advisory votes on executive compensation every one, two or three years. After the first "say-when-on-pay" vote, shareholders must be asked at least once every six years whether they prefer an annual, biennial or triennial advisory vote. Finally, the say-on-pay votes will not preclude shareholder proposals "related to executive compensation."

Comments

Company Choice Regarding the Type of Resolution for "Say When on Pay"

Companies will need to determine the preference of their shareholders as to the frequency of say-on-pay votes, and many are canvassing investors at this time to get a sense of their preferences. The SEC rule making on this provision should provide boards a choice whether to offer a resolution with a single recommended choice (e.g. every two years), or a resolution that would give the board's preference but ask for a vote on a one, two or three year frequency in a multiple-choice fashion.

Without elaborating on the rationales for the different frequencies, we submit that this vote should be influenced by a board recommendation. Some boards whose companies have multi-year incentive compensation plans may be well-positioned to recommend a biennial or triennial approach, while others may recommend an annual vote based on its understanding of the interests of shareholders. Boards are in the best position to recommend the frequency of the vote, to ensure that the timing of the vote is aligned with the compensation program and the duration of the incentive structure. It will be up to the shareholders of each company to indicate their views under either type of vote.

The Rules Should Not Allow Shareholder Proposals on Alternative Frequency for Say-on-Pay Votes

The Society believes the SEC in its rulemaking should clarify that a shareholder proposal seeking an alternative one, two or three year scheme would be excluded to avoid unnecessary uncertainty, confusion or conflict with the company's proposal. The Dodd-Frank Act provides that the say-on-pay votes will not preclude shareholder proposals "related to executive compensation." This text means that shareholders should and will be able to continue to submit proposals relating to substantive aspects of executive compensation policies or practices, but not relating to the frequency of a say on pay vote, which we believe is procedural and not "related to executive compensation." Moreover, the statute clearly specifies that the frequency vote should be taken at least every six years, which would be meaningless if the statute were interpreted to allow proposals in any year on any frequency. With that interpretation, a company could be faced with three shareholder proposals each year for a one, two or three year frequency. We don't believe this was the intent of Congress, as it would provide no benefit to shareholders while consuming management time and resources.

3. Pay versus Performance Disclosure

Section 953(a) of the Act requires that companies disclose "information that shows the relationship between executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the shares of stock and dividends of the issuer and any distributions." The definition of "executive compensation actually paid" will need to be determined and could differ from "total compensation" disclosed in the Summary Compensation Table today.

Comments

SEC Should Allow Flexibility to Make Disclosure Meaningful

We urge the SEC to implement rules with enough flexibility to allow compensation committees to explain their decisions, to explain when compensation is "actually paid," over which period performance is measured, and how performance is measured.

We believe there is a potential here for a comparison of compensation paid to financial performance to be based on a timing mismatch. For example, a graphical comparison of the total compensation figure as required to be disclosed in the Summary Compensation Table of the proxy statement to the company's stock price on a particular date would not capture the fluctuation in value of equity-based awards held by executives that were awarded in prior years as long-term compensation. This type of comparison would not accurately reflect the change in value (up or down) of the executive's compensation over time in the same way the change in value of an equity investment in the company would be shown on the same graph. While this would be a simple way of using data currently disclosed in the proxy statement, it would not tell the entire story of how the value of the executive's compensation relates to the company's performance over time. As there is a range of views about what type of depiction would tell the entire story, the SEC should allow those views to play out and not dictate one single method for companies to use when attempting in good faith to tell the full story.

4. Internal Pay Ratio

Section 953(b) of the Act states that companies must disclose the median of the annual total compensation of all employees of the company (other than the CEO) as well as the annual total compensation of the CEO, and then provide a ratio comparing those two figures. Calculation of "annual total compensation" of an employee for purposes of this provision must be determined in accordance with the rules for named executive officers in Item 402 of Regulation S-K, e.g., "the total compensation of an employee of the issuer shall be determined in accordance with section 229.402(c)(2)(x) of title 17, Code of Federal Regulations, as in effect on the day before the date of enactment of the Act." Furthermore, this disclosure will be required in any filings "described in Section 10(a)," which covers much more than proxy statements and annual reports on Form 10-K.

Comments

The SEC implementation schedule contemplates these rules will be in place for the 2012 proxy season. The Society supports a later implementation for this provision given the broad scope of the statute and the many technical clarifications that will be needed before companies can start gathering the data necessary to comply, some of which data could be particularly time-consuming and costly to produce depending on what those clarifications say. We believe the clarifications should be driven both by Congress' intent for the statute and the practical realities of collecting the data needed to comply. We believe that it was Congress' intent to have companies show a rough comparison of the compensation of the average or median laborer in the United States to the compensation of corporate CEOs.

However, a plain reading of the statute would lead most regulators and companies to conclude that the comparison must be one of the median worker in the company's entire global workforce to that of the CEO. This latter interpretation would necessitate a much different and more involved exercise in gathering data from around the world. It would also involve issues of how to value certain unique types of compensation given only in certain countries, what exchange rates to use, and differences in accounting for benefits such as pensions in different counties. We don't believe it was Congress' intent to introduce these types of cross-border issues. Also, we believe that a comparison of the compensation of the average or median U.S. worker to that of the CEO would be a more relevant and meaningful comparison for the investing public than a comparison of the compensation of the average or median worker worldwide to that of the CEO. Based on this understanding of Congress' intent, we would suggest the following:

Clarify that the Scope Includes Only U.S.-Based Full-Time Workers

We believe the statute, either through SEC rule-making or technical amendment, should be clarified to provide that "all employees of the issuer" means only U.S.-based, full-time employees. This change alone will greatly clarify Congress' intent and at the same time will reduce many of the data-gathering challenges for companies with significant operations in other markets.

Limit Total Compensation to Total Direct Compensation—Exclude Pension Accrual

We believe the statue should be clarified to provide that "total compensation" be interpreted broadly to include total direct compensation, that is, all cash compensation (base salary and cash bonuses) and equity-based compensation, but <u>exclude</u> pension accruals, benefits and other non-cash items. Alternatively, we would request that the SEC allow companies to identify the median worker without including pension accrual, benefits and other non-cash items. Thereafter, once the median worker is identified, a single calculation for that worker, including pension accrual, benefits and other non-cash items, could be done and added into total compensation for purposes of determining the ratio.

Require the Ratio Only in a Company's Annual Meeting Proxy

We believe the statue should be clarified to require that this ratio be disclosed only in an annual meeting proxy, rather than in all publicly filed documents. We have reason to believe this was Congress' intent.

Clarify that the "total compensation" takes into consideration future changes in Section 402 of Regulation S-K

We believe that the statute should be clarified to provide that the SEC has authority to implement rules that define "total compensation" under the executive compensation disclosure rules set forth in section 229.402 of title 17, Code of Federal Regulations, **or any successor thereto**, so that the computation of "total compensation" keeps pace with any future changes to the SEC's rules. Further, the SEC should be given express authority to interpret the terms used in Section 953(b) and promulgate rules as it believes is in the best interest of investors and companies.

Allow Issuers to Make Reasonable Estimates

We believe that issuers should be permitted to make reasonable estimates and assumptions when determining their median employee for purposes of identifying the median of the annual total compensation of all of their employees, so long as those estimates and assumptions are adequately explained as part of the required disclosure.

5. Clawbacks

Section 954 of the Act creates a new Section 10D of the Exchange Act requiring listed companies to develop and implement policies to recapture—or "clawback"—incentive compensation "based on financial information required to be reported under the securities laws" that is "erroneously awarded" to executives that would not otherwise have been received in the event of a restatement of the company's financial statements. This requirement is mandatory, provides a Board no explicit discretion as to whether or how much to recoup, covers all present and former executive officers, and does not require misconduct by the company or any officer as a condition to invoking the clawback. Given its broad application and relatively expansive scope, the clawback provision may be one of the most significant aspects of the Act.

The clawback provisions of the Dodd-Frank Act go well beyond existing law and practice. The Act requires a listed company in the case of an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement, to recover:

• from all present and former "executive officers" (not just the executives named in the proxy statement)
• any incentive-based compensation (including stock options) received in excess of what would have been paid under the accounting restatement
• for three years preceding the date on which the company is required to prepare the restatement

• regardless of whether there was any fraud or misconduct involved (that is, the policy must apply to any accounting errors, intentional or not, resulting in a material restatement).[1]

Comments

Boards Should Have Discretion to Determine Whether to Claw Back

Because some incentive compensation (especially the annual incentive) is awarded based in part on achievement of certain metrics and in part based on the compensation committee's judgment, the committee or full board must be able to determine under what circumstances to recoup such compensation. The board should be given the same amount of discretion in recouping awards as was used in the original grant of an award. In addition, the Board must be allowed to determine if recoupment would cost more than the expected recovery amount is worth—and that is whether it would have to pursue litigation to recoup, the likelihood of recovery and any violation of existing contract or state law prohibitions. It would be perverse to require a clawback in every instance even where the recovery would be result in a higher cost to recover than is the amount being recouped. We do not believe that was the intent of Congress, and the SEC should interpret the statute to allow such discretion for the board in the exercise of its fiduciary duties to determine what is in the collective best interest of the company and its shareholders.

Boards Should Have Discretion to Determine How to Recoup Funds

Similarly, Boards or compensation committees should have the ability to make the company whole by canceling unvested awards, setting off amounts owed from existing deferred compensation accounts if applicable, or any other method that would result in recovery of the value owed by the executive.

SEC Must Clarify Which Compensation is Subject to Recoupment

The no-fault clawback provision will have a significant impact on all executive officers who have received pay tied to metrics based on financial measures. The SEC should make clear which compensation will be subject to recoupment and which will not. Reported financial information includes revenue, net income and earnings per share. Incentive compensation, however, is sometimes granted based on metrics such as stock price, total shareholder return, and market share and/or customer satisfaction.

A Clawback Provision Which Is Less Prescriptive Would Support the Intent of Congress

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[1] The Society acknowledges comments submitted by the Center on Executive Compensation to the SEC, dated September 1, 2010, and recommends them to the Committee, particularly Section IV regarding the many unique incentive compensation plan structures, and how the recouped amount would be determined under each of several different scenarios.

The House provisions on compensation recovery accommodated many of these concerns. The proposed Shareholder Empowerment Act of 2009 appropriately balanced the policy objective of requiring clawback while giving the board the responsibility to develop the policy and recognizing that recoupment would occur where it is feasible and practical to do so.

6. Whistleblower Rewards

Section 922(a) of the Act provides that the SEC "shall pay an award" to whistleblowers cash rewards of between 10% and 30% of any monetary sanctions exceeding $1 million that either the SEC or the US Attorney General, or any other self regulatory organization or state attorney general recovers as a result of the whistleblower's assistance. Rulemaking must be done in 270 days.

Comments

> *The Whistleblower Provision Will Encourage Employees to Bypass the Company's Existing Compliance Programs and Prevent a Company from Taking Prompt Corrective Action When Necessary*

The Society is concerned that the whistleblower provision will so significantly incentivize and encourage employees to report concerns of potentially improper conduct directly to the SEC that employees will bypass the extensive compliance programs that companies already have in place, and thus undermine their effectiveness. In short, the unintended consequence of the Act may be that companies will have a more difficult time detecting and investigating misconduct and taking prompt corrective action when violations are found.

The 10-30% award could be worth millions of dollars to an employee. Unfortunately, however, to be eligible to collect an award an employee must provide "original information" to the SEC, that is, information that is not already known to the SEC from the company or another tip. Thus, if an employee is aware of a potential violation of law or company policy and wants to report the issue, in order to ensure that he or she is eligible to receive an award under the statute, he or she will have to choose whether to raise it to a superior or directly with the SEC. Employees have long been trained to raise an issue first with a superior, or alternatively with an ombudsman or "ethics hotline", or even to the Chair of the company's audit committee. Under new whistleblower provisions, an employee will now have a significant financial incentive to bypass raising the issue with the company at all for fear of losing a potential multi-million-dollar award. Such a result, we believe, would be unintended, and contrary to long-established public policy and the principles found in the Federal Sentencing Guidelines.

We believe that Section 922 should be considered carefully by the SEC with particular reference to the defense and health care industries which have long had to deal with False Claims Act cases. To implement Congress' intent to provide more tips to the SEC for potential company abuses, we suggest that the statute grant awards, but not when the person making the report has bypassed the company and its Audit Committee's internal concerns reporting processes.

Conclusion

The Society supports good governance practices -- those which are desired by all shareholders and those which foster long-term success and shareholder return. The executive compensation provisions of Dodd-Frank, coupled with risk disclosure and the intense media and Congressional focus on pay and governance practices, have increased shareholder rights and generally encourage greater corporate accountability. We respectfully offer these suggestions with regard to implementation of the Act to avoid negative unintended consequences and to effect the intent of Congress.

Respectfully submitted,

Darla C. Stuckey

Society of Corporate Secretaries and Governance Professionals