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April 10, 2006

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-9303

By Internet comment form

Re: File No. S7-03-06; Proposed Rules on Executive Compensation and Related Party Disclosure, Items 402 (b) and 407 (e) of Regulation S-K

Dear Ms. Morris,

This letter is a comment on the Securities and Exchange Commission's proposed rules on executive compensation and related party disclosure, Item 402 (b) and Item 407 (e) of Regulation S-K ("the Proposal"). I am the Alfred W. Bressler of Law at Columbia Law School and co-director of its Center for Law and Economic Studies. I write as a legal academic who has studied and written on the problem of executive compensation, in particular, *Executive Compensation: If There is a Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis,"* 30 J. Corp. Law -- forthcoming 2005), cited in the Commission's proposing release and incorporated by reference into this file.

High levels of executive compensation have become a matter of significant concern both to shareholders and to the public at large, and I think the SEC should be commended for taking on this problem. There is unlikely to be a consensus on the "right" level of executive compensation. Even today some would argue that CEO compensation is mostly right, on the view that the major determinant of pay is a competitive market for the scarce executive talent capable of running huge economic enterprises. Nevertheless, well-publicized instances of very high compensation divorced from performance and evidence of a general trend in which executive compensation consumes an increasing fraction of corporate profits raise questions of genuine public concern. Yet efforts to regulate executive compensation in a substantive way are likely to be unwise. Among other things, the differences among firms are too vast to admit of a "one size fits all" solution. Thus I think the best approach combines disclosure and accountability.

Suggested Changes

1. *Compensation Committee Signature.* I think the Proposal does a very good job on disclosure,¹ but a much less good job on accountability. The basic problem is that the Proposal places responsibility for the explanation and justification of executive compensation on management when it ought to be placed on the board, specifically, the compensation committee. Thus I think the compensation committee should be tasked with responsibility for the Compensation Discussion and Analysis (“CD&A”) section of the compensation disclosure, reflected by a signature requirement for members of the committee.

2. *Shareholder Shaping of CD&A.* Moreover, since accountability to shareholders is a critical element of compensation legitimacy, the Commission should indicate that it will favorably receive shareholder proposals under Rule 14a-8 under the Securities Exchange Act that call for the compensation committee to address particular matters in the CD&A. Since CD&A disclosure is for their benefit, shareholders should be able to request (or mandate, depending on whether the proposal is presented as a by-law amendment) the committee to consider particular matters. This will augment the Commission’s own efforts to assure that CD&A does not degenerate into boilerplate (see 71 FR at 6545, 6546) and will facilitate the tailoring of CD&A disclosure to fit specific firms.

3. *Process Disclosure including Advisors.* Finally, I think the CD&A should include disclosure of the process by which the compensation committee came to approve the compensation in question, in particular the committee’s use of outside advisors. The committee’s independence-in-fact will often be enhanced by the use of outside advisors (as we have learned in the “special committee” process more generally), and thus disclosure should be made as to whether such advisors have been engaged. Because of the potential for disabling conflicts of interest, however, it is material to such disclosure whether the advisors (including compensation consultants, lawyers, and accountants) had other fee-generating relationships with the company in the covered year, the preceding year, or currently. If so, disclosure should be made of fees received from the issuer for such other work and for work for the compensation committee and of the reasons why the compensation committee believed the advisors were capable of providing independent advice.

Discussion

Particularly because executive compensation is very high in absolute and historical terms, the compensation-setting process has become a legitimate area of concern for shareholders and the public. In the market for senior executive services, where there are no posted prices and relationships are complex, legitimacy requires a bargaining process in which shareholder interests are represented by an independent party accountable to shareholders. This needs to be the board, and, for public firms, the compensation committee. There really is no one else. Moreover, as a matter of state law, at least in the case of a senior office who sits on the board, action by disinterested directors is ordinarily the way to address the inherent conflict in a compensation contract between a director and the corporation. (See, e.g., Del. Gen. Corp. L. §144.) For the typical public firm, the compensation committee will already be responsible (at least formally) for vetting and approving compensation for senior executives. Thus it is entirely appropriate for the compensation committee to take charge of the CD&A.

¹ I think the proposed disclosure would be made clearer by a breakdown of the “All Other Compensation” column as per the supplemental table discussed at 71 FR 6555.

Executive compensation has become a heated issue in part because of a widespread belief that senior executives have significant control over their own compensation and that directors are insufficiently independent from the CEO for these purposes. Requiring the compensation committee to take ownership of the CD&A would enhance the independence-in-fact of directors. Under my proposal, a specific group of named directors would be required to step up to explain and justify the compensation amounts and types that the issuer has disclosed. A signature requirement would enhance the compensation committee's sense of ownership, as the SEC and then the Congress in the Sarbanes-Oxley legislation recognized in requiring CEO/CFO certification of the issuer's financial disclosure. The compensation committee might reasonably rely on outside advisors in shaping compensation packages, but then it is important for the committee to explain why it believes that these advisors can provide independent advice.

A relevant analogy is the 1934 Act requirement in going private transactions for the independent directors to disclose whether they had retained "an unaffiliated representative to act solely on behalf of unaffiliated securities holders for purposes of negotiating the terms of the Rule 13e-3 transaction and/or preparing a report concerning the fairness of the transaction." Regulation M-A, Item 1014(d). This requirement, in combination with required disclosure of whether a majority of independent directors approved the transaction [id., Item 1014(e)], including director dissents or abstentions [id., Item 1014(a)], has as a practical matter made the independent directors accountable for the negotiation of the terms of the transaction including explanation and justification of the transaction as "fair" [id., Item 1014 (a)]. The rule also produces disclosure of the process used by the independent directors, in particular the retention of outside advisors.

As in the going private transaction, the negotiation of executive compensation may involve a trade-off of the interests of shareholders and managers. Unlike the going private case, shareholders have no approval rights over compensation contracts. It is thus particularly important both to empower the compensation committee and to hold it accountable.

I would regard it as undesirable for the CD&A, even if signed, to increase monetary liability exposure for compensation committee members. The point of the CD&A is to buttress the independence-in-fact of directors and thus the legitimacy of the compensation-setting process. In this regard, the directors should face pressure through reputation markets and the mechanisms of corporate governance and shareholder democracy. If shareholders are unhappy with performance of the compensation committee, the proportionate response is through the board election mechanism, not litigation. In this regard I believe that it appropriate for the issuer to be responsible for the accuracy of the specifics of compensation disclosure, the actual amounts and the specific elements, all as spelled out in the description and tables in the Proposal. The issuer should also be responsible for disclosure relating to fees received by compensation committee advisors. Disclosure that is incorporated into the Form 10-K should be covered by the CEO/CFO certification. But the compensation committee should be responsible only for stating honestly its explanation and justification for the compensation paid, including the various material factors it considered. If designating the CD&A as signed by the compensation committee as "furnished" rather than "filed" would allay litigation concerns, then I would favor it.

If the Commission decides to have public hearing on this issue, I would be willing to participate.

Very truly yours,

s/ Jeffrey N. Gordon

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