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Paying Up

By Stephen Barlas

Tom Lehner, the director of public policy for the **Business Roundtable**, recalled a recent conversation with the chief executive of a Fortune 500 company. The CEO's company, like 350 others, received a letter from the **Securities and Exchange Commission** during the second half of 2007 voicing unhappiness with the company's disclosure in its 2007 proxy about how the pay levels of top executives are determined.

This company, like all public companies filing proxies, for the first time in 2007 had to comply with rules the SEC published in 2006 requiring companies to spell out in their compensation discussion and analysis the "metrics" used in determining the pay of the CEO, its chief financial officer and the next three most highly compensated executives.

The SEC's division of corporation finance had looked at this Fortune 500 company's 2007 proxy and noticed a significant disparity between the pay for two vice presidents. The regulators complained to the company that it had not spelled out why one compensation package was heavyweight and the other lightweight.

"One of them is doing a much better job," explained the CEO to Lehner, with a touch of exasperation, "but we can't put that in the proxy."

Exasperation is, in fact, the principal reaction these days among corporate executives whose pockets Washington players are, if not exactly picking, pulling out and examining with all the fervor of a crime scene investigator looking for evidence of crimes.

Even before the disclosures about the severance packages given to former **Merrill Lynch** CEO **Stan O'Neal** and **Countrywide Financial** founder **Angelo Mozilo** (which led to a Congressional committee hearing on February 28) and the bonuses paid to top executives at **Bear Stearns** and **Morgan Stanley** - seen as big rewards for floundering performances - at least two congressmen had been on the war path against lavish pay packages. Even the Internal Revenue Service is getting in on the action.

Congressional Democrats certainly sense a political opportunity in an anti-corporate executive comp campaign, especially given a looming recession and middle-class economic angst. When he released his economic plan on February 13, Sen. **Barack Obama** (D-Ill.) criticized executives who "are making more in a day than the average worker makes in a year," according to *The Wall Street Journal*.

Not that Sen. **John McCain** (R-Ariz.) evidently feels much differently. When he discusses his health plan, he disdains any federal program as a solution and instead opts for a nationwide private insurance market that ensures broad and vigorous competition - which, he adds, "will wring out excess costs, overhead and bloated executive compensation."

Waxman questions consultant usage

While the rhetoric is flowing on the campaign trail, Rep. **Henry Waxman** (D-Calif.), the leading House hit man on executive compensation, sent a letter to Fortune 250 companies on January 31 asking them to provide information about how executive compensation consultants are utilized in determining senior executives' pay packages. Waxman has held a year's worth of hearings and issued a report last December that exposed alleged conflicts of interest when compensation consultants do salary advising and other consulting, be it tax, human resources or auditing, for the same company.

Waxman's House Oversight & Investigations Committee, which he chairs, has no legislative authority. So, even if Waxman were to propose some type of **Sarbanes-Oxley** anti-conflict-of-interest legislation aimed at corporate use of compensation consultants, it would have to go through the Financial Services Committee chaired by Rep. **Barney Frank** (D-Mass.). Waxman has not declared his intentions.

Brent Longnecker, a compensation consultant who represented **Enron** plaintiffs and today works with seven large corporations, says having consultants sign an affidavit attesting to the lack of pressure from management would be a good idea. Longnecker says that very occasionally a board may ask him after he makes salary recommendations to give them any ideas for improvements in that process, and his comments may go into the board's minutes, which may or may not be public. But that appears to be as far as the corporate internal policing of compensation consultants goes today.

Ira Millstein, senior partner at **Weil, Gotshal & Manges** and dean of the National Association of Corporate Directors, says, "Waxman has raised the right question. It should be clear to boards that this is a hot enough issue that if they don't do something, they are risking legislation."

One piece of legislation aimed at making boards think twice about questionable pay packages has already passed the House. That would be "*The Shareholder Vote on Executive Compensation Act*" (H.R. 1257), sponsored by Rep. Frank. The bill would require that public companies ensure that shareholders have: 1) an annual nonbinding advisory vote on their company's executive compensation plans; and 2) an additional nonbinding advisory vote if the company awards a new golden parachute package while simultaneously negotiating the purchase or sale of the company.

A number of companies have already adopted this proposal voluntarily, so it isn't the most radical notion to come down the pike. Nonetheless, the Business Roundtable and other trade business groups oppose it.

Despite that opposition, the House passed it by a vote of 269-134 on April 20, 2007. That is about 20 votes short of a veto-proof majority, which is important since the Bush Administration opposes the bill. That could lead to a veto if the legislation is passed by Congress. At the moment, however, there appears to be little chance of that.

After it came over from the House, the bill sat in the Senate Banking, Housing and Urban Affairs Committee for the rest of 2007 as Sen. **Chris Dodd** (D-Conn.), the chairman there, ran for the Democratic presidential nomination. Some would say Dodd was too busy to take up the Frank bill, which is sponsored in the Senate by Sen. Obama.

But one lobbyist for a shareholders' group says the rumor is that Dodd declined to take it up last year because he was loathe to give a legislative gift to Obama while Dodd was competing with him for the Democratic nomination. Dodd has continued to sit on the bill now that he is off the campaign trail.

Voluntary advisory votes seen

"In a legislative year shortened by the elections, the prospects for moving the Frank/Obama bill are unclear," says Lehner of the Business Roundtable. Moreover, he doesn't think the bill is necessary because nearly 100 companies have already said they would voluntarily allow an advisory shareholder vote on pay, so the Fortune 500 is moving on its own in that direction.

Companies already are disclosing more information about how they come up with the pay packages for their top five executives as a result of the 2006 SEC rules, which came into play for the first time for 2007 proxies. But **John White**, director of corporation finance for the SEC, made it clear in speeches during the second half of 2007 that companies made good-faith efforts to comply with the rules, but needed to do better on manner of presentation and analysis.

As it happens, the SEC took no action against any of the 350 companies whose disclosures it examined in 2007. But as companies prepare their 2008 proxies, there is palpable fear that the SEC will not be so understanding this year. SEC spokesman **John Nester** says the agency will have "the full range" of enforcement options on the table in 2008, including forcing companies to restate their proxies or taking enforcement action if companies balk at that request.

With regard to Lehner's anecdote about the exasperated CEO, Nester says that if a metric a company uses to determine pay is "material," then it must be disclosed. "If performance is one of those metrics the board looks at when approving pay, most observers would consider it material," he states.

The SEC isn't the only federal burr under the corporate salary saddle. The IRS issued a letter ruling last September - which became public and controversial on February 8 - reversing its long-standing position on the effect of standard severance arrangements on the deductibility of performance-based compensation under Section 162(m) of the IRS

Code. That part of the code explains when companies can take more than a \$1 million deduction for the pay of any of its top five executives.

This \$1 million cap does not apply to qualified performance-based compensation. But, there is a raft of considerations that go into determining whether the \$1 million-plus exception is available to any company. For example, the pay is still considered "performance-based" even if the plan allows the compensation to be payable on death, disability or a change of control or ownership.

During a February 14 webcast on *CompensationStandards.com*, **Ken Griffin**, associate chief counsel, executive compensation branch at the IRS, acknowledged the uproar caused by publication of the September private-letter ruling. "Much of the thunder that we're hearing is focused on the financial accounting ramifications from this ruling, and it's from every direction we're getting it. We hear it more and more," he said.

"It appears pretty likely that some further guidance will be out soon from the IRS, at least regarding the possible retroactive application of the private-letter ruling's conclusion," said **Broc Romanek**, editor of *CompensationStandards.com*, "since otherwise, the position could cause thousands of companies to adjust their tax reserves significantly."

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