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The State of Regulation of Executive Compensation—How Did We Get Here?

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The issue of executive compensation, and in particular how much executives are paid, is not a new issue. There have been various attempts throughout the years to regulate the amounts of executive compensation paid to CEOs and other executives. These attempts were largely reactive to down economic periods that resulted with many rank and file individuals losing their jobs whether as a result of mass layoffs or companies becoming insolvent, all the while executives of such companies seemed to continue to receive high salaries and even performance bonuses. Out of the 2008-2009 economic downturn came the Dodd Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which included many provisions specifically to regulate executive compensation. While most of the mandates of Dodd-Frank relate to regulation through disclosure of pay, the attempt to regulate pay itself has come to fruition this summer. In July, the Securities and Exchange Commission (SEC) and five banking regulators released a comprehensive set of proposed rules (incentive-based compensation arrangements) that not only impose specific pay parameters on incentive-based compensation paid, but also limit pay that financial institutions may provide their executives. It is curious to see how we got to a place where executive pay can be regulated so.

Prior to the release of the proposed rules, executive compensation has been regulated in different ways through the tax code. For example, in the early 1980s, Congress added to the tax code Sections 280(G) and 4999 to regulate "golden parachute" compensation payments. Section 280(G) prohibits company deductions of golden-parachute payments where such payments exceeded three times an executive's base compensation amount. Section 4999 imposes a 20 percent excise tax on the executives who receive these golden-parachute payments. In the 1990s Section 162(m) was added to the tax code to limit executive compensation deductions by a public company to only $1 million, not including "performance-based" compensation. As a result of Section 162(m), many public companies began to compensate their executives with "performance-based" compensation through applicable equity awards (e.g., stock options and stock awards, etc.) and other bonus arrangements where such compensation is dependent on satisfying certain financial metrics. While Section 162(m) was intended to reduce the amounts of compensation paid to certain executives, it arguably led to an increase in executive compensation paid and, some would argue, an increase in payment structures that incentivize executives to engage in riskier activities that could be harmful to a company's long-term financial health.

The use of the tax code to regulate compensation continued into the millennium. In the early to mid-2000s, Section 409A was added to the tax code to directly address the practice by which mid-level and senior executives were deferring portions of their salaries and bonuses through "nonqualified deferred compensation" plans. This practice was highlighted in the Enron bankruptcy. Deferred compensation arrangements allowed a small number of Enron executives to withdraw millions of dollars from the company's accounts immediately prior to the company declaring bankruptcy. In general, Section 409A provides strict limits of when an individual may elect to have their deferred compensation paid to them and limits the types of severance-related pay schedules provided to executives. The intent of Section 409A was to prevent another Enron-like situation where executives were able to avoid tax on earned compensation and essentially strip the company of financial assets when it needed such assets the most. At first glance, it appeared that Section 409A would only impact a relatively small group of highly paid executives, but it turned out that the broad definition of "deferred compensation" captured many compensation-related payments that were traditionally not viewed as deferred compensation. It has been argued that Section 409A has not effectively halted such deferred compensation arrangements, nor helped lower executive compensation pay.

After the 2008-2009 financial crisis, Congress passed the Dodd-Frank Act to address the problems that led to the financial crisis. Executive compensation was again in the spotlight as the public could not understand how certain -executives were still paid millions of dollars despite having to lay off large work forces and leading companies that were arguably responsible for the poor economy. As a result, the Dodd Frank Act includes mandates for certain regulatory authorities to issue rules relating to pay for performance; clawback rules, pay-ratio disclosure, and prohibition of incentive-based compensation arrangements that encouraged inappropriate risks by certain individuals employed by financial institutions. When viewed as a set of rules, the Dodd-Frank Act seeks to regulate executive compensation through increased disclosure, providing clawback mechanisms, and setting prescriptive rules on how and when to pay executive compensation.

The pay ratio rule requires disclosure by public companies of the median of annual total compensation of all employees (other than the CEO), the annual total compensation of the CEO and the ratio of these two amounts. The rule specifies how to determine the median employee and the annual total compensation. The pay for performance rule requires inclusion of a new pay for performance table in public companies' proxy statements. The table would require disclosure of the total compensation of a company's principal executive officer and the average of the total compensation of the company's other named executive officers. The clawback rule requires that incentive-based compensation received by executives as the result of materially noncompliant financial statements be subject to a clawback policy that would require executives to repay compensation that was based on metrics/information in the noncompliant financial statement. These three rules generally do not require major changes in how a company pays its executives—the reason is largely because the first two rules relate to increase disclosure of specific metrics, and the third rule is only triggered when there is a financial restatement based on a material noncompliance.

More recently, however, five different banking regulators, and the SEC, have released proposed rules that provide for more prescriptive rules on incentive-based compensation paid by financial institutions to certain applicable executives and individuals. These rules have received substantial pushback from the financial institutions as they are expected to place large burdens on financial institutions in monitoring and designing compliant incentive-based compensation arrangements. The proposed rules replace less prescriptive rules issued by the agencies in 2011. While the proposed rules only apply to certain financial institutions, many have questioned whether they will turn into best practices for all companies.

Unlike compensation rules in the past, these rules provide for specific limits and rules on how incentive-based compensation may be paid, and also provide specific rules in connection with governance and risk management relating to how a company monitors its incentive compensation programs. For example, these new incentive-based compensation rules would apply to most key executive officers, and other individuals considered to be "significant risk-takers" under a particular "relative compensation test" or "exposure test." These rules distinguish between "long-term" incentive compensation plans and "other" incentive compensation plans. These different types of incentive-based compensation plans are subject to different mandatory deferral rules and maximum limits on how much incentive compensation can be paid. Furthermore, these rules require that financial institutions consider forfeiture and downward adjustments of incentive-based compensation amounts upon certain "triggering events" identified under the rules. These rules also require a mandatory clawback provision to permit the recovery of compensation up to seven years, post vesting, when a current or former covered person is found to engage in certain misconduct, fraud, or intentional misrepresentation of information used to determine such individual's incentive compensation paid. Finally, these proposed rules require that financial institutions provide for "effective risk management and controls," as well as compliance with specific obligations to maintain records and documents that document the company's incentive-based compensation arrangements.

As one can see, these new proposed rules for incentive-based compensation will require financial institutions to assess their entire risk and control environment in order to comply with the new rules. If these rules are finalized, financial institutions will have to go beyond simply revising plan documents, but also have to put systems and controls in place to continually monitor to whom incentive-based compensation is paid, how it is paid, and when it is paid. Financial institutions will also have to be cognizant that these new rules are in addition to all other existing tax and SEC rules relating to executive compensation. Is it possible that these rules will find their ways to other companies beside financial institutions? Only time can tell. The first hurdle will be with the financial institutions first.

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