

The SEC Approves New Executive Disclosure Rules

In-House News:

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By Amy E. Wong

"With more than 20,000 comments, and counting, it is now official that no issue in the 72 years of the Commission's history has generated such interest," said Securities and Exchange Commission Chairman Christopher Cox on July 26 in Washington, DC.

Cox was referring to his January proposal to mandate Compensation Disclosure & Analysis (CD&A), a proposal that was unanimously approved by the Securities and Exchange Commission (SEC) in a 5-0 vote. The public's response, which was overwhelmingly supportive, clearly marks the government's continuing desire to control and prevent corporate malfeasance.

Effective Dec. 15, chief executive officers, chief financial officers, and the next three highest-paid executives at public companies will be required to provide investors with their total annual compensation.

In addition to this figure, top executives will have to detail the various components of and the reasons for obtaining their compensation packages. The various components that they will have to take into account include future payments made after an executive's termination, an explanation of stock option

compensation, and new protections against undisclosed backdating or spring loading of options.

All of this should be explained in tabular format and plain English for the general public to understand. Cox was quick to explain at his press conference that the SEC's goal is not to judge or limit the amount that executives are paid, but to "advance the interests of shareholders through better disclosure."

This is a reasonable concern, considering the innumerable wrongs perpetrated against American investors in the past few years by companies such as Enron, Kmart, and, most recently, Brocade Communications Systems.

All of these companies provided their decision-making executives top compensation, while deceiving investors about their financial health. Cases like these, in which investors suffer from plummeting stock prices, highlight the unreliability of current corporate disclosure.

Alan L. Beller, Director of the SEC's Division of Corporate Finance, criticized current corporate disclosure, saying, "Too much executive compensation disclosure has become an example of the kind of disclosure companies should disavow—disclosure that says as little as possible while seeking to avoid liability, rather than disclosure that seeks to inform." In short, disclosure was obscure and unhelpful.

The new CD&A law is the SEC's attempt to prevent scandals before they can adversely affect America's economic market, especially scandals such as the backdating and spring loading of stock options—both recurring problems that the SEC has been contending with.

In a press conference regarding Brocade Communications Systems on July 20, Cox responded to an alleged four-year scheme in which executives knowingly falsified stock option documents in order to obtain an earlier date and lower market price on their grant.

Cox said, "[Backdating] is important because it goes to the heart of the relationship between a corporation and its shareholders. In order for our system of public ownership to work, the interests of shareholders, and not the personal interests of the company's management or its directors, must be paramount."

While stock options serve as an important incentive to attract and retain talent, they are often abused by corporate executives. This abuse, according to Cox, "is poisonous to an efficient marketplace."

In the year 2000, when Brocade's ex-CEO Gregory L. Reyes took home a staggering \$556 million (most of which came from selling options), the company inflated its annual revenue by approximately \$1 billion.

Because the law did not require executives to disclose detailed stock option compensation, they were allowed to reap large monetary rewards while their companies suffered.

Cox continued, "Options backdating strikes at the heart of investor confidence in our capital markets. It deceives investors and the market as a whole about the financial health of companies that cheat in this way. It understates a company's compensation expenses and overstates the company's income. In many cases, it makes a hash of the financial statements."

True to his word, Cox has led the SEC in an effort to bring an end to backdating. A major portion of the new law directly addresses the disclosure of stock option information. Cox commented, "Options are a perfectly legitimate form of compensation as long as it is fully and fairly disclosed to shareholders and properly accounted for."

By making accurate executive compensation publicly available and comprehensible, the SEC hopes to eliminate corporate transgression. Ideally, it will transfer knowledge and power from corporate executives to shareholders.

Cox expressed hopes that both shareholders and boards of directors "will make better decisions about the appropriate amount to pay the men and women entrusted with running their companies."

He continued, "At the end of the day, it will be up to shareholders, directors, investors, and the market to decide how they will use this improved disclosure. But I am absolutely certain that this new information will benefit our markets and the nation's economy."

The SEC expresses its stance clearly: "By taking up these critical issues and addressing them in record time, the Commission has once again shown its responsiveness to the continually evolving needs of American investors."