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New Principles and Proposals on Executive Compensation Likely to Serve as the Basis for New Requirements for All U.S. Public Companies

Those following the flow of press releases and other announcements from the U.S. Treasury Department in recent months may be surprised to see that, on June 10, just before Treasury announced its interim final rule on TARP standards for compensation and corporate governance, Treasury Secretary Geithner issued a statement setting forth five broad executive compensation principles and supporting legislation that would require annual non-binding "say-on-pay" shareholder votes and impose stricter compensation committee independence standards. These initiatives would apply to all U.S. public companies, not only those subject to TARP rules. Separately, SEC Chairman Schapiro also issued a statement on executive compensation, reiterating the SEC's intention to enhance its executive compensation disclosure requirements, in particular to address how a company's compensation structure may be related to its risk structure.

The announcements on executive compensation come at a time of significant focus on corporate governance matters and risk management. There is some overlap between these announcements and the proposed Shareholder Bill of Rights Act of 2009 (the former go beyond the proposed compensation provisions in the latter), and the SEC's recent proposals on proxy access for director nominations can also be expected to have an impact on the corporate governance.

Secretary Geithner's Principles

Noting that executive compensation was a contributing factor to the financial crisis, Secretary Geithner outlined five broad principles as a starting point for consideration of executive compensation reform intended to more tightly align compensation practices with the interests of shareholders and reinforce company and financial system stability. The Secretary did not detail how the principles would be implemented, but we expect they will serve as the basis and framework for new requirements in the coming weeks and months.

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The principles outlined in the announcement are:

1. compensation plans should properly measure and reward performance;

2. compensation should be structured to account for the time horizon of risks;

3. compensation practices should be aligned with sound risk management;

4. golden parachutes and supplemental retirement packages should be re-examined to determine whether they properly align the interests of shareholders and executives; and

5. transparency and accountability should be promoted in the process of setting compensation.

The Secretary announced that Treasury intends to work with Congress to pass legislation in two specific areas. First, the Secretary stated that Treasury will support Congressional efforts to adopt "say-on-pay" legislation that would give the SEC authority to require listed companies to give shareholders a non-binding vote on executive compensation packages. Second, Treasury will propose legislation giving the SEC authority to ensure that compensation committees of listed companies are more independent, satisfying requirements similar to those now applicable to audit committees of listed companies. The legislation would provide that compensation committees be given the responsibility and the resources to hire their own independent compensation consultants and outside counsel.

The announcement was accompanied by two fact sheets: one relating to "say-on-pay" and one relating to increasing compensation committee independence.

The "say-on-pay" fact sheet calls for granting the SEC authority to require non-binding shareholder votes in respect of the following:

- a company's overall executive compensation as disclosed in the annual proxy statement (including the narrative description of the board's compensation decisions in the CD&A and the quantitative disclosure of amounts executives are entitled to receive);

- annual compensation, including salary, bonus and other forms of compensation (as described in the CD&A) for the top five named executive offices as disclosed in the annual proxy statement; and

- golden parachute compensation disclosed in proxy materials for shareholder meetings to approve mergers, acquisitions or other changes of control.

Companies would also have the opportunity to include additional resolutions on specific compensation decisions, so long as shareholders have a vote on all compensation disclosed in the annual proxy statement.

The compensation committee fact sheet states that Treasury will propose legislation directing the SEC to promulgate rules requiring listed companies to meet new standards for independence. The SEC would be directed to:

- require that each member of the compensation committee, in addition to meeting the general standards of independence of the relevant stock exchange, meet independence requirements similar to those applicable to audit committee members (Exchange Act Rule 10A-3, which applies through stock exchange listing standards, prohibits receipt of consulting, advisory or other compensation by audit committee members and precludes affiliates from serving on the audit committee);

- issue rules enabling compensation committees to use outside advisers in the pay-setting process by giving committees authority to retain advisers and requiring the companies to provide for appropriate funding to compensate them; and

- establish standards for independence of compensation consultants and outside legal counsel used by compensation committees.

Secretary Geithner emphasized that the principles and proposals do not cap executive compensation or mandate precise rules as to how compensation should be set. Rather, Treasury intends to work toward developing standards that reward innovation and prudent risk-taking without creating “misaligned incentives.”

The announcement stated that the President’s Working Group on Financial Markets will provide an annual review of compensation practices to monitor whether such practices are creating excessive risks.

In a statement issued following the announcement of these principles and proposals, House Financial Services Committee Chairman Barney Frank supported the Administration’s proposals, but was skeptical that the proposed goals could be achieved by strengthening compensation committee independence. He expressed the view that legislation should go beyond Treasury’s proposals and should direct the SEC to “set principles which prevent boards from providing compensation systems that lead to excessive risk taking.”

While the “say-on-pay” provisions are likely to only impact domestic SEC registrants (i.e., those that are required to issue proxy statements), it is unclear how the compensation committee independence provisions will be applied. The analogous independence provisions applicable to audit committees apply to foreign private issuers as well as domestic registrants (though with various carve outs).

Likely SEC Initiatives

In her June 10th statement, Chairman Schapiro announced that the SEC staff is actively considering a package of proxy statement disclosure rules that would require greater disclosure concerning executive compensation decisions. According to the announcement, the proposals would not dictate particular compensation decisions, but, rather, would require companies to better analyze both how compensation decisions impact risk-taking and the implications for the long term health of the company. These proposals had been raised before, including in a speech given by Chairman Schapiro in early April to the Council of Institutional Investors.

The disclosure proposals being considered by the SEC staff would cover:

- how a company and its board of directors manage risks;
- the overall compensation approach taken by the company, in particular as it relates to the company's risk management and risk-taking;
- potential conflicts of interest of compensation consultants, including disclosure of relationships between the consultants and the company and their affiliates;
- the experience, qualifications and skills of director nominees; and
- why a board has chosen its particular leadership structure, such as whether the structure includes an independent chairman or combines the position of chairman and chief executive officer.

The SEC proposals are expected to be taken up in July, according to the June 11th testimony of Brian Breheny, Deputy Director of the SEC's Division of Corporation Finance, before the House Committee on Financial Services.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content.