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Client Alert

A report for clients and friends of the Firm

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Treasury and the SEC Comment on Executive Compensation

In light of the increasing scrutiny on executive compensation, there no doubt will be changes in the rules on executive compensation for all public companies prior to next year's proxy season. The extent and breadth of the changes remain uncertain, but the momentum in proposals and speeches by the Treasury, Securities and Exchange Commission ("SEC"), members of Congress and others make changes inevitable. These will be in addition to the special rules established for Troubled Asset Relief Program ("TARP") recipients, the experience with which will likely influence the new rules for all public companies. Recent remarks made by Timothy Geithner, the Secretary of the Treasury, and Mary Schapiro, Chair of the SEC, are instructive and indicate the administration's current thinking. Of course, there is no assurance that any of the suggestions made will become law, or that another alternative will not be advanced and adopted at the last moment.

On June 10, Secretary Geithner cited executive compensation as a contributing factor to the current financial crisis and announced broad-based principles that the Treasury believed should govern compensation practices, with a goal toward bringing them more tightly in line with shareholder interests and reinforcing the stability of the employer. They are:

- Compensation plans should properly measure and reward performance based on creation of long-term value.
- Compensation should be structured to account for the time horizon of risks.
- Compensation practices should be aligned with sound risk management.
- Whether golden parachutes and supplemental retirement packages align the interests of executives and shareholders should be reexamined.
- Transparency and accountability in the process of setting compensation should be promoted.

He also announced two specific areas in which the administration will work with Congress to pass new legislation:

- "Say on Pay" legislation giving shareholders a nonbinding vote on executive compensation packages (including an annual non-binding vote on golden parachutes).
- Giving the SEC the power to ensure that compensation committees are more independent, utilizing standards similar to those for audit committees under the Sarbanes-Oxley Act and giving compensation committees the responsibility and resources to retain independent compensation consultants and outside counsel that satisfy new criteria for independence.

Equally notable, especially considering some of the pending legislation described below, Secretary Geithner stressed that the administration does not want to cap pay or set forth precise prescriptions on how companies should set compensation. Instead, he stated that it will continue the effort to develop standards that reward innovation and prudent risk-taking, without creating misaligned incentives. On June 10, the Treasury also released long awaited interim final rules interpreting the rules on executive compensation for certain entities receiving assistance under TARP.

SEC Chair Mary Schapiro at the same time announced that the Commission is considering new proxy disclosure rules requiring greater disclosure as to:

- How the company and board manage risk.

- The overall compensation approach of a company, especially compensation programs that reward short-term risk-taking without taking into account the potential long-term effects.

- Compensation consultants' conflicts of interests.

- The experience and qualifications of director nominees.

- Why the Board has or has not a separate chairman and chief executive officer, and the rationale for a particular leadership structure.

Consistent with Secretary Geithner's statement, she also emphasized that the Commission's goal is to "provide further sunshine on compensation decisions" and "not dictate particular compensation decisions." Ms. Schapiro noted specifically that the Commission's role has not been to set pay scales or cap compensation. On July 1, the Commission proposed new rules implementing the "Say on Pay" requirement for TARP recipients and enhancing the information included in proxy statements. These proposals require enhanced disclosure about the relationship of a company's overall compensation policies to risk and potential conflicts of interest of compensation consultants.

Congress also has been active with regard to executive compensation. The United States House of Representatives Committee on Financial Services, chaired by Representative Barney Frank, has continued its long-term interest in the topic by conducting extensive hearings on executive compensation. Similar hearings are being held in the Senate. The bills that have been introduced include the following:

- **Shareholder Bill of Rights Acts of 2009**, introduced by Senator Charles Schumer. Among other provisions, it provides for a nonbinding annual shareholder vote on executive compensation and a similar nonbinding vote on any compensation arrangements with principal executive officers in connection with any merger or other transaction.

- **Shareholder Empowerment Act of 2009**, introduced by Representative Gary Peters. Among other provisions, it would: require an independent chairman who is not and was not an executive officer of the company; require a nonbinding annual shareholder vote on the compensation of executive officers; require that advisory firms that assist the board or committee in negotiating employment contracts or compensation agreements with the company's executives be independent of the company, its executives and directors and report solely to the board or the applicable committee, and that the company not be allowed to agree to indemnify or limit the liability of such advisors; require that the boards of companies develop and disclose a claw-back policy for unearned bonus payments, incentive payments and equity payments that were awarded to officers owing to fraud, financial results that require restatement or some other cause; and prohibit severance payments to a senior executive officer who is terminated because of poor performance as determined by the board, and require additional disclosure of specific performance targets used for compensation purposes.

- **Excessive Pay Shareholder Approval Act**, introduced by Senator Richard Durbin. Among other things, it limits compensation to any employee to 100 times the average compensation for services performed by all employees of the company unless at least 60 percent of the shareholders have voted in favor of such compensation in the prior 18 months.

- **Executive Pay Capped Deduction Act**, also introduced by Senator Richard Durbin. Among other things, it limits company deductions for compensation in excess of 100 times the amount of the average compensation for services performed by all employees of the company.

We expect to see additional legislation passed or regulatory action taken this year with regard to executive compensation. This legislation will likely include some version of "Say on Pay" and require the "Compensation Disclosure and Analysis" discussion in proxy statements to include enhanced analysis and disclosure concerning risk assessment and management as well as enhanced disclosure and analysis of performance targets.

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