Legislation Proposed Requiring Say-on-Pay, Independence Standards for Compensation Committees and Enhanced Federal Regulation of Incentive-Based Compensation Arrangements

On July 21, 2009, Congressman Barney Frank, D-Mass., introduced a bill, the "Corporate and Financial Institution Compensation Fairness Act of 2009" (the "Compensation Fairness Act") for Congressional approval.[1] The proposed legislation incorporates and adds an additional section to a proposal covering the same subject matter which the Treasury submitted to Congress on July 16, 2009.[2] If adopted in its current form, the legislation, like the Treasury's proposal, would require publicly traded companies to provide for a non-binding, advisory "say-on-pay" shareholder vote on certain executive compensation arrangements at the companies' annual meetings and in the context of transactions that result in a change of corporate control, and impose more exacting independence standards upon publicly traded companies' compensation committees. The legislation goes beyond the Treasury's proposal, however, to also require enhanced Federal regulation of incentive-based compensation arrangements for officers and employees of certain financial institutions.

I. "Say-on-Pay" Voting

Background

"Say-on-pay" provisions, which allow a company's shareholders to vote on the company's executive compensation packages, originated internationally and have recently gained growing acceptance in the United States. In 2002, the United Kingdom enacted legislation requiring companies to conduct an annual *non-binding*, advisory shareholder vote on executive compensation. Some European states subsequently followed the United Kingdom's model, while others, like Norway, went further and required a *binding* shareholder vote.

Since 2006, United States corporations have seen steady growth in the number of shareholder proposals calling upon companies to enact advisory "say-on-pay" voting provisions. Shareholders have largely rejected these proposals, however, with Blockbuster Inc. and Verizon Communications Inc. as notable exceptions. In 2008, shareholders of insurer Aflac Inc. became the first shareholders of a publicly held United States corporation to cast an advisory vote on their executives' compensation.

Recently, with the declining economy and growing popular frustration with allegedly improper executive compensation practices, legislators have taken a keen interest in passing "say-on-pay" legislation. Notably, as part of the American Recovery and Reinvestment Act of 2009, Congress required all recipients of Troubled Asset Relief Program ("TARP") funds to provide their shareholders with an annual non-binding vote on executive compensation during the period in which any obligation arising from such financial assistance remained outstanding.[3]

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1 Corporate and Financial Institution Compensation Fairness Act of 2009, H.R. 3269, 111th Cong. (2009), *available at*: http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h3269ih.txt.pdf

2 Investor Protection Act of 2009, 111th Cong. § 941 (2009) (proposed), *available at*: http://www.ustreas.gov/press/releases/docs/tg205071009.pdf

3 American Recovery and Reinvestment Act of 2009. H.R 1, 111th Cong. § 7001 (2009), *available at*: http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h1enr.pdf:

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The Proposed Legislation

The Compensation Fairness Act, if adopted in its current form, would amend Section 14 of the Securities Exchange Act of 1934, as amended ("the "Exchange Act"), to require all publicly traded companies (not only TARP recipients) to provide for the following:

- Annual "Say-on-Pay" Vote. As part of its proxy or consent or authorization for an annual meeting of shareholders (or a special meeting in lieu of the annual meeting), each company would need to provide for an advisory shareholder vote to approve the compensation packages of the company's executives, as disclosed pursuant to the SEC's compensation disclosure rules.
- Change-in-Control "Say-on-Pay" Vote on "Golden Parachutes". In any proxy or consent solicitation material for a meeting of shareholders concerning a merger, acquisition or sale or other disposition of all or substantially all of a company's assets, the soliciting party would need to disclose any "golden parachute" agreements or understandings between the soliciting party and the principal executive officers of the company (or the principal executive officers of the acquirer, if it is not the soliciting party) for compensation packages related to the proposed transaction, that have not been previously approved by shareholders, and provide for a nonbinding shareholder vote to approve such arrangements.

The legislation would require the SEC to issue regulations within six months of the Compensation Fairness Act's enactment. The above-described requirements would apply to any annual meeting (or special meeting held in lieu of the annual meeting) held on or after a date six months after the SEC issues its final rules and regulations.

Previous "Say-on-pay" Provisions

A survey of ten TARP recipients' recent proxy statements[4]—which were statutorily required to include "say-on-pay" voting provisions—may offer some general guidance on how such provisions should be designed.

- Structure: The surveyed companies' proxy statements contained a separate section discussing the non-binding advisory resolution regarding the company's executive compensation. The section was generally located towards the end of the companies' proxy statements, after the company's compensation discussion and analysis but before any shareholder resolutions, and contained the resolution's text and a short accompanying discussion, followed by the board's recommendation that shareholders vote in favor of the company's compensation arrangements.
- Resolution: The surveyed companies' "say-on-pay" resolutions generally read as follows: "*Resolved, that the shareholders approve the compensation of executives, as disclosed pursuant to the compensation disclosure rules of the Securities and Exchange Commission (which disclosure includes the Compensation Discussion and Analysis and the accompanying compensation tables and related narrative in this proxy statement)*.
- Discussion:
  - ❖ CD&A Reference. Each of the surveyed companies' discussions specifically referred readers to the proxy statement's compensation disclosure section for a discussion of the company's executive compensation packages and compensation standards.

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4 The surveyed companies include: Bank of America Corp., The Bank of New York Mellon Corporation, Capital One Financial Corp., Citigroup Inc., Comerica Inc., Morgan Stanley, The PNC Financial Services Group Inc., State Street Corporation, SunTrust Banks Inc., and Wells Fargo & Co.

- Compensation Discussion. Most of the surveyed companies provided a short discussion justifying the company's compensation decisions in light of current market conditions and/or the company's performance.
- Voting Discussion. Most of the surveyed companies provided a brief discussion emphasizing the "say-on-pay" vote's non-binding nature. These companies also generally noted that they would nevertheless consider the vote's outcome when considering future compensation arrangements.

II. Compensation Committee Independence Standards

The Proposed Legislation

The Compensation Fairness Act also takes steps to ensure that all publicly traded companies' compensation committees are "independent in fact, not just in name."[5] Specifically, if adopted in its current form, the legislation would amend the Exchange Act to provide for the following:

- Compensation Committee Member Independence. Members of any publicly traded company's compensation committee could not, other than in their capacity as members of the company's compensation committee, board of directors, or other board committee, accept any consulting, advisory, or other compensatory fee from the company or be otherwise affiliated with the company or its subsidiaries.
- Compensation Consultant and other Compensation Committee Advisor Independence. Any compensation consultant, counsel, or other advisor to a company's compensation committee would have to meet independence standards to be promulgated by the SEC.
- Compensation Committee Retention of Compensation Consultants. A company's compensation committee could, in its sole discretion, retain and obtain the advice of an independent compensation consultant, and have sole responsibility over that consultant. The company would have to disclose in its proxy or consent material, in accordance with regulations to be promulgated by the SEC, whether its compensation committee retained such a consultant and, if it did not, why its compensation committee determined that retaining such a consultant was not in the shareholders' best interest.
- Compensation Committee Retention of Counsel and Other Advisors. A company's compensation committee could, in its sole discretion, retain and obtain the advice of an independent counsel or other advisors, and have direct responsibility over them.
- Funding for Compensation Consultants, Legal Counsel and Other Advisors. A company would be responsible for compensating any independent compensation consultants, counsel, or other advisors selected by the company's compensation committee, in accordance with the compensation committee's determination, in its capacity as a committee of the board of directors.

These requirements would be effective no later than 270 days after the date of the Compensation Fairness Act's enactment. In the event that a company does not have a compensation committee, these requirements would apply to the independent members of the company's entire board of directors. A company's failure to

[5] Fact Sheet, United States Department of the Treasury, Administration's Regulatory Reform Agenda Moves Forward: New Independence for Compensation Committees (July 16, 2009), *available at*: http://www.ustreas.gov/press/releases/tg218.htm

abide by any of these requirements, that is not exempted by the SEC or cured by the company in accordance with provisions to be established by the SEC, could result in the SEC directing national securities exchanges and national securities associations to prohibit the listing of the company's securities.

III. Enhanced Regulation of Incentive-Based Compensation Arrangements

The Proposed Legislation

Finally, the Compensation Fairness Act would provide for enhanced Federal regulation of incentive-based compensation arrangements for officers and employees of certain financial institutions to ensure that such institutions' compensation arrangements are aligned with sound risk management, account for the time horizon of risks, do not threaten the institutions' stability or have serious adverse affects on economic conditions or financial stability. Specifically, if adopted in its current form, the legislation would amend the Exchange Act to require the following:

- Enhanced Disclosure of Incentive-Based Compensation Arrangements. The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Board of Directors of the FDIC, the Director of the Office of Thrift Supervision, the National Credit Union Administration Board and the SEC (the "Federal Regulators") would need to jointly prescribe regulations requiring depository institutions and depositors institutions' holding companies, broker-dealers, credit unions, investment advisors, and any other financial institution such regulators jointly deem necessary to include (the "Financial Institutions") to disclose the Institution's incentive-based compensation arrangements to the Financial Institution's appropriate Federal Regulators.
- Prohibition of Certain Compensation Structures. The Federal Regulators would need to jointly prescribe regulations prohibiting compensation structures or incentive-based payment arrangements, or any feature of such financial arrangements that the Regulators determine encourages inappropriate risks by the Financial Institutions or the Institutions' officers that could threaten the Institutions' safety and soundness or have serious adverse effects on economic conditions or financial stability.

The Federal Regulators would be required to promulgate the above-described regulations within 270 days of the Compensation Fairness Act's enactment. The regulations would be enforced under section 505 of the Gramm-Leach-Bliley Act[6] ("GLBA") and, for the purposes of such section, a violation of these regulations would be treated as a violation of subtitle A of Title V of GLBA.

It is important to emphasize that it is uncertain if the legislation will be adopted in its current form. Moreover, in the absence of specific regulations by the Federal Regulators, the legislation itself leaves several issues unresolved.

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6 Gramm-Leach-Bliley Act of 1999, *available at*: http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=106_cong_public_laws&docid=f:publ102.106

If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; or John Schuster at 212.701.3323 or jschuster@cahill.com.