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Financial Reform Addresses Executive Compensation and Corporate Governance

Proposed financial reform provisions move to address the perceived link between executive compensation and systemic risk by including substantive and procedural executive compensation requirements and imposing additional corporate governance and disclosure requirements.

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In response to the severe and prolonged recession, a major financial crisis, the near collapse of our banking system, and increased corporate and financial scrutiny by regulators and the public, both houses of Congress have undertaken the ambitious goal of sweeping financial reform. On December 12, 2009, the U.S. House of Representatives passed the Wall Street Reform and Consumer Protection Act of 2009, and on May 20, 2010, the U.S. Senate passed the Restoring American Financial Stability Act of 2010.

Among other objectives, the bills focus on systemic regulation, creation of a financial stability oversight council, enhanced resolution authority, and increased regulation. In addition, because of the perceived link between increased systemic risk and excessive and poorly designed executive compensation programs, both bills also contain significant changes to executive compensation and corporate governance that would, if enacted, directly and significantly affect executives, directors, companies, and shareholders, and continue the federalization of corporate governance that largely began with Sarbanes-Oxley. In addition to new disclosure requirements, the legislation would impose on public companies significant new substantive and procedural executive compensation requirements. We discuss below some of the key provisions that affect all listed companies, as well as provisions relating solely to financial institutions.

Say on Pay

Both bills would require companies to include, in any proxy containing executive compensation disclosures, a nonbinding shareholder resolution to approve the executive compensation as disclosed. TARP recipients are already required to include "say on pay" resolutions and other companies have begun including them voluntarily. Although both bills provide for nonbinding resolutions, there are reasons why companies should pay careful attention to shareholder votes. In particular, the RiskMetrics proxy voting guidelines suggest that a failure to respond to shareholder concerns regarding executive compensation may result in future adverse voting recommendations for members of a company's compensation committee. At least three companies have had shareholders vote against management "say on pay" proposals so far this year. Because the Senate bill would also require the SEC to issue rules directing exchanges to prohibit broker discretionary votes on executive compensation matters, obtaining a favorable vote for "say on pay" may become more difficult.

The House bill would also require companies to provide shareholders with a nonbinding vote to approve

golden parachute compensation at any meeting at which they are also asked to approve a merger or acquisition.

Clawback Policies

The Senate bill would require the exchanges to include the adoption of a clawback policy as a listing requirement. Specifically, a company would need to adopt a clawback policy allowing recovery, from both current and former executive officers, of a portion of any incentive-based compensation paid during the three-year period preceding the date on which the company must restate its financials because of material noncompliance with any financial reporting requirement. The amount recovered would be the excess over the amount of incentive compensation that would have been paid based on the restated financials.

In several significant respects, this provision is broader than Section 304 of Sarbanes-Oxley, currently applicable to all public companies. In addition to the company's CEO and CFO, this provision would apply to anyone who served as an executive officer during the relevant three-year period and would require recovery even in the absence of misconduct. Although some companies have adopted clawback policies, relatively few existing policies would satisfy the requirements of the Senate bill.

Compensation Committees

Independence

Both bills would require listed companies to have compensation committees composed entirely of independent directors. To determine independence, companies would take into account all relevant factors, specifically including:

(i) The specific sources of compensation of a member, including any consulting, advisory, or other compensatory fees paid by the issuer to the member

(ii) Whether the member is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer

The exchanges would have discretion to exempt certain relationships as they determine appropriate, based on relevant factors, including the company's size.

Although not mandated by Sarbanes-Oxley, the corporate governance listing criteria of both the New York Stock Exchange and the NASDAQ Stock Market already require that executive compensation be reviewed and administered either by a compensation committee composed of independent directors (NYSE) or by such a committee or a majority of the independent directors (NASDAQ). The principal additions proposed by the Senate bill are that, in determining a director's independence, consideration be given to the sources and nature (apart from the amount) of any compensation the director receives and to whether a director is "affiliated" with the public company or its subsidiaries. Affiliate status (in this context, meaning share ownership) is currently not an "independence" criteria in either exchange's listing rules, although it is a criterion for eligibility to serve on an audit committee under the Sarbanes-Oxley Act and the related SEC rules.

The provision fails to address the "outside director" requirement of Section 162(m) of the Internal Revenue Code or the "nonemployee director" requirement of SEC Rule 16b-3. As a result, if this provision is included in any final legislation, companies may still need to comply with at least three

differing sets of requirements regarding the composition of their compensation committees.

Use of Advisors

Both bills require that compensation committees have the authority and the funding necessary to retain their own compensation consultants, independent counsel, and other advisors to assist them with compensation-related duties and obligations. The compensation committees would be responsible for hiring, paying, and overseeing the consultants and other advisors. Before hiring any counsel, consultant, or advisor, compensation committees would be required to evaluate the advisor's independence, taking into account several factors to be described in rules issued by the SEC, including whether the advisor's employer provides other services to the issuer, the relative amount of fees it receives from the issuer, and whether it has conflict-of-interest policies and procedures, as well as any relationship between the advisor and members of the issuer's compensation committee and any equity ownership in the issuer the advisor may have.

Consultant Disclosures

Both bills would also require companies to disclose whether their compensation committees obtained advice from a compensation consultant, whether the consultant's services created any conflict of interest, and, if so, the nature of the conflict and how the conflict is being addressed.

Additional Company Disclosure Requirements

Comparison of CEO Compensation and Company Performance

The Senate bill requires the SEC to issue rules requiring disclosure of the relationship between compensation actually paid to a company's executives and the company's financial performance, determined by taking into account any change in share value, dividends, and any other distributions.

Although this requirement is consistent with the approach used by RiskMetrics when evaluating a company's pay practices, at least with respect to companies that have underperformed their peers, it is inconsistent with the views expressed by the SEC when it revised the disclosure rules in 2006. At that time, the SEC moved the prior performance graph from the proxy to the annual report, in part because it felt that including the performance graph as part of the compensation disclosures could weaken the primary objective of encouraging a broader discussion of compensation principles.

Internal Pay Equity

The Senate bill would also require internal pay equity information in registration statements, 34 Act periodic reports and proxy statements showing the CEO's annual total compensation, the median compensation for *all* other company employees, and the ratio of the two amounts. Total compensation is to be calculated on the same basis as it is for the Summary Compensation Table appearing in proxy statements or annual reports and registration statements—ostensibly requiring such a computation for *all* employees.

A number of compensation consultants and investor groups have been advocating for some form of internal pay equity disclosure over the last few years. This provision would certainly draw more attention to the issue.

Hedging Activities

The Senate bill would also require proxy disclosure of whether a company permits any of its employees or directors to hedge any direct or indirect positions in any company equity securities, whether or not those positions were acquired from the company as compensation. When adopting the current executive compensation disclosure rules, the SEC specifically declined to require disclosure of hedging policies, but it did include hedging policies on the list of issues that companies might address if appropriate.

Compensation Provisions Limited to Financial Institutions

The Senate bill would amend the Bank Holding Company Act to require the Federal Reserve Board of Governors, in consultation with the Comptroller of the Currency and the Federal Deposit Insurance Corporation (FDIC), to establish standards prohibiting, as an unsafe and unsound practice, any bank holding company compensation plan (i) that provides an executive officer, employee, director, or principal shareholder of the bank holding company with excessive compensation, fees, or benefits; or (ii) that could lead to material financial loss to the bank holding company. In establishing these standards, the Board of Governors must consider the compensation standards described in the Federal Deposit Insurance Act and the views and recommendations of the Comptroller of the Currency and the FDIC.

The House bill would require financial institutions with at least $1 billion in assets to disclose the structures of all incentive-based compensation arrangements to the appropriate federal regulator, which may include the Board of Governors, 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, the SEC, and the Federal Housing Finance Agency. The disclosures would be designed to provide sufficient information for the appropriate regulator to determine whether the incentive compensation arrangements are appropriately aligned with sound risk-management objectives, are structured to account for the time horizon of risks, and are designed to satisfy any other criteria that the regulators determine are appropriate to reduce incentives for employees to take undue risks, threatening the safety and soundness of the covered financial institutions.

The appropriate federal regulators would also be required to prescribe regulations effectively prohibiting any incentive-based payment arrangement, or any feature of any such an arrangement, that the regulators determine encourages inappropriate risks. Since 1995, the federal bank regulatory agencies have had interagency standards in place that prohibit as an unsafe and unsound practice both excessive compensation and any compensation that can lead to material financial loss to the insured bank.

The House bill also expressly requires the Comptroller General of the United States to conduct a study to determine whether there is any correlation between certain incentive-based compensation structures and the likelihood of excessive risk taking.

We will continue to monitor the ongoing developments of Financial Regulatory Reform. If you have any questions or would like more information on the issues discussed in this LawFlash, please contact the authors, **Benjamin I. Delancy** (202.739.5608; bdelancy@morganlewis.com), **Gary S. Rothstein** (212.309.6360; grothstein@morganlewis.com), and **Marc D. Leone** (215.963.5559; mleone@morganlewis.com), or any of the following Morgan Lewis attorneys:

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In addition, Morgan Lewis's multidisciplinary Financial Regulatory Reform resource team is available to assist with a wide range of issues and areas of concern related to the reform effort. You can access a complete collection of the firm's updates and alerts on the subject on our website's Financial Regulatory Reform page.

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