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House Backs Bill on Say on Pay and Compensation Committee Independence Requirements for All Public Companies

Includes Provisions for Compensation Regulation in the Financial Sector

A major step towards mandatory Say on Pay votes at all public companies was taken on July 31, 2009, when the House of Representatives approved the Corporate and Financial Institution Compensation Fairness Act of 2009. The legislation introduced by Rep. Barney Frank would require an annual, non-binding advisory shareholder vote on pay, as well as heightening regulatory standards related to Compensation Committee independence at all public companies. Additional provisions, which would apply only to certain financial institutions, are intended to discourage excessive risks by imposing significant new restrictions on the use of compensation incentives.

The effective dates vary for each provision (see chart at end summarizing important dates) but in its current form, Say on Pay would likely take effect in the 2011 proxy season – a year later than proposed by Treasury in its own draft legislation attached to the Investor Protection Act of 2009, which also was introduced in July.

Key provisions of the House-approved bill are summarized below.

Say on Pay

- Annual Shareholder Approval of Executive Compensation: All public companies must give their shareholders an annual, non-binding vote on executive compensation matters disclosed in the proxy statement for named executive officers, including the Compensation Committee Report, the CD&A, the compensation tables and any related materials.

> ***PM&P Observation:*** Congressional opponents of this provision unsuccessfully sought to replace it with a *triennial* shareholder vote, rather than an annual vote – a concept originally proposed by the pension fund of the United Brotherhood of Carpenters and Joiners.

- Shareholder Approval of Golden Parachute Arrangements: In the event of a change-in-control transaction (i.e., acquisition, merger or asset sale), shareholders of public companies must be given a non-binding vote on any compensation agreements related to the transaction with named executive officers. This information must be provided in the transaction's proxy statement in a "clear and simple form."

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- Disclosure of Institutional Shareholder Votes: Any institutional investment manager owning at least $100 million of equity at some point during the preceding 12 months must annually report any vote it cast on an executive compensation or parachute arrangement, unless such vote would be publicly reported elsewhere.

- Potential Exceptions: The SEC has discretion to exempt certain filers. As an example, the Act cites the potential impact on smaller reporting issuers (historically defined by the SEC as companies with a public float of less than $75 million).

- Effective Date: The SEC must issue rules within six months of the Act becoming law. Shareholder votes would be required to be included in any proxies *filed* on or after six months following the promulgation of the rules.

> ***PM&P Observation:*** Importantly, mandatory Say on Pay for most public companies may well be pushed into the 2011 proxy season, unless the dates are amended as the bill is considered in the Senate.

Compensation Committee Independence

- Stricter Standards of Independence for Members: To be considered independent, Committee members cannot accept any consulting, advisory, or other fees outside of pay received for their Board service.

- Compensation Consultants: Any compensation consultant retained by the Committee must be independent within standards to be established by SEC regulation. Importantly, such regulations must be "competitively neutral among categories of consultants" and preserve the Committee's ability to retain the services of members of any such category.

- Disclosure: Companies must disclose in their proxy materials whether the Committee retained and obtained the advice of a compensation consultant meeting SEC standards for independence. Interestingly, the final Act does not include language from an earlier draft that would have required an additional potentially awkward disclosure as to why a Committee chose not to hire an independent consultant.

- Authority of Committee Relating to Compensation Consultants, Counsel and Advisors: The Committee retains sole authority (but not the obligation) to hire, compensate and oversee the work of independent compensation consultants, counsel and other advisors. However, the Act is clear that the Committee is free to accept or reject the individual's advice, and members remain obligated to exercise their own judgment in fulfillment of their duties.

- Potential Exceptions: As with Say on Pay, the SEC can exempt certain filers from these requirements as it deems appropriate, giving consideration to, as in the earlier example, smaller reporting issuers.

- Committee Funding: Companies must provide adequate funding, as determined by their Compensation Committee, for the hiring of independent compensation consultants, counsel or other outside advisors.

- Study and Review: The SEC will conduct a two-year study, to be submitted to Congress, examining the use of independent consultants by Compensation Committees.

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- Effective Dates: Companies must meet the member and outside advisor independence standards within nine months of the passage of the Act, or risk delisting from the respective stock exchange. The disclosure requirements are effective for proxies filed on or after the first anniversary of the passage of the Act (in most cases, the 2011 proxy season).

Enhanced Reporting and Regulation of Compensation Incentives at Financial Institutions

- Applicability and Definitions: This requirement only applies to **"covered financial institutions,"** defined as any depository institution, registered broker-dealers, credit unions, investment advisors, Fannie Mae, Freddie Mac and other institutions that the Federal regulator determines should be subject to this section. The Act defines a **"Federal regulator"** as the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Board of the FDIC, the Directors of the Office of Thrift Supervision, the National Credit Union Administration Board, the SEC and the Federal Housing Finance Agency.

- Disclosure of Incentive Programs: Covered financial institutions must disclose to the appropriate Federal regulator the structures of all incentive-based compensation arrangements sufficient to determine whether they: (i) are aligned with sound risk management; (ii) account for the time horizon of risk; and (iii) meet other criteria deemed appropriate by the Federal regulator to discourage overly risky employee behavior that could threaten the safety and soundness of the company or seriously adversely affect economic conditions or financial stability.

- Prohibition on Certain Incentive Arrangements: The appropriate Federal regulator will issue regulations prohibiting *any* incentive arrangements or features determined to encourage risks that could threaten the safety and soundness of the company or have serious adverse effects on economic conditions or financial stability. There is a limited grandfathering rule that would protect from government recovery any incentive compensation paid under an arrangement that is in place when the Act is passed and does not extend for more than 24 months.

- Exceptions/Clarifications: Covered financial institutions with assets of less than $1 billion are exempt from the disclosure/prohibition requirements. The Act specifically states that companies are *not* required to report compensation provided to any individual employee, and also clarifies that companies do not need to make disclosures under this section if they do not have incentive-based payment arrangements.

- Study: The Comptroller General will study the relationship between compensation structures and excessive risk taking, focusing on: (i) compensation structures used between 2000 and 2008; and (ii) a comparison of companies that failed, or nearly failed, to companies that remained viable throughout 2007 and 2008, including the compensation practices of such companies. The Act defines companies that "**failed or nearly failed"** as those that received "exceptional assistance" under the TARP (AIG, Citigroup, Bank of America, Chrysler, GM, GMAC and Chrysler Financial), and companies that participated in the AIFP, TIP, AGP and SSFI Programs. It also includes Fannie Mae, Freddie Mac and companies that participated in the SEC's Consolidated Supervised Entities Program as of January 1, 2008.

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- Effective Dates: Federal regulators will complete regulations for these requirements within nine months of the Act's passage, and the study of incentive use will be completed within one year of passage.

Conclusion

A battle is anticipated over the details of this House-passed bill, particularly the regulation of financial sector compensation incentives, when it is considered by the Senate this fall. While Say on Pay is not a new concept, having passed the House by a substantial margin two years ago, the regulation of compensation incentives in the financial sector – especially for those companies that did not receive government assistance – is expected to be a significant stumbling block. Government interference in private contracts (as in the recent AIG saga) remains a highly controversial issue and one the Treasury chose not to attach to its own draft of Say on Pay legislation. We will continue to closely monitor and update the status of this legislation.

Summary of Effective Dates

The following chart summarizes effective dates for each of the provisions discussed above:

Requirement	***Applicability***
Say on Pay/Golden Parachute Approval	Proxies filed on or after ***six months*** from the date of rule publication (which will be within six months of the Act's passage), with the practical impact of mandatory Say on Pay generally coming in the 2011 proxy season
Compensation Committee Independence	***Nine months*** after Act's passage
Disclosure Regarding Independence	For proxies filed ***one year*** or more after the Act's passage
Study of Consultant Independence	SEC to complete within ***two years*** of Act's passage
Disclosure and Prohibition of Incentives (for financial institutions only)	Federal regulators to issue guidance within ***nine months*** of Act's passage
Financial Incentive Compensation Incentive Study	Comptroller General to complete within ***one year*** of Act's passage

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