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Congressional Watch: Corporate Governance Initiatives Emphasize Concerns Regarding Executive Compensation

Last week, Treasury Secretary Timothy Geithner announced that the Obama Administration will work with Congress to pass "say-on-pay" legislation to give shareholders an advisory vote on executive compensation, as well as legislation to impose requirements on compensation committees intended to strengthen their independence. Recent congressional interest in corporate governance issues has been considerable. In just the last few weeks, four significant pieces of legislation have been introduced in Congress: the Shareholder Empowerment Act, the Shareholder Bill of Rights Act, the Excessive Pay Shareholder Approval Act and the Excessive Pay Capped Deduction Act. Additionally, the House Financial Services Committee has held a hearing on the link between excessive risk in compensation structures and the current financial crisis.

Senior management and directors at public companies should follow these developments closely. Given the level of Congressional interest, and the current political and economic climate, it is likely that we will see elements of these bills become enacted, with potential for the most significant governance reform since the Sarbanes-Oxley Act of 2002.

Obama Administration Proposals

In his statement,[1] Secretary Geithner outlined a "set of broad based principles" intended to "begin the process of bringing compensation practices more tightly in line with the interests of shareholders and reinforcing the stability of firms and the financial system." These five principles are intended to apply to all public companies and not just those in the financial sector:

- Compensation plans should properly measure and reward performance;
- Compensation should be structured to account for the time horizon of risks;
- Compensation practices should be aligned with sound risk management;
- Golden parachutes and supplemental retirement packages should be examined to determine whether they align the interests of executives and shareholders; and
- Transparency and accountability should be promoted in the process of setting compensation.

Secretary Geithner clarified that the Administration does *not* intend to support pay caps or prescribe how companies should set compensation, which he admitted "can often be counterproductive." Rather, the Administration intends to "work to develop standards that reward innovation and prudent risk taking, without creating misaligned incentives." The President's Working Group on Financial Markets will provide an annual review on whether compensation practices are creating excessive risks. Secretary Geithner called on academics, business leaders

and shareholders "to conduct their own reviews to identify best practices, emerging positive and negative trends and call attention to risks that might otherwise go unseen."

The Administration is making these proposals at a time when Congress and regulators are under pressure to address perceived corporate governance failures which some believe contributed to the current financial crisis. Congress has already embraced certain executive compensation standards for recipient companies of the Troubled Asset Relief Program ("TARP")[2] and last week the Treasury Department issued its Interim Final Rule on TARP Standards for Compensation and Corporate Governance.[3] Also last week, the House Financial Services Committee held a hearing on "Compensation Structure and Systemic Risk"[4] and SEC Chairman Mary Schapiro announced that the SEC is considering new proxy disclosure rules "that will provide further sunshine on compensation decisions."[5]

Legislation on "Say-on-Pay"

According to Secretary Geithner, the Administration favors "say-on-pay" legislation as a means to "improve board accountability and better align compensation with long term value creation for shareholders."[6] The Administration is calling for legislation that will give the SEC authority to require non-binding say-on-pay votes for all public companies and will include the following provisions:

- Shareholders in public companies will have the right to cast a non-binding vote each year approving or disapproving executive pay packages;
- Shareholders will have the right to vote on annual compensation, including salary, bonus and other forms of compensation (including those items disclosed in the Summary Compensation Table) for the company's top five named executive officers;
- Companies will have the opportunity to include in their proxy statement additional resolutions on specific compensation decisions, including decisions related to various aspects or categories of pay; and
- Shareholders will also have the right to cast a non-binding vote to approve or disapprove "golden parachute compensation" disclosed in proxy materials relating to a merger, acquisition, or other transaction that may involve a change in control of the company.

Representative Barney Frank (D-MA), Chairman of the House Committee on Financial Services, supports the Administration's call for "say-on-pay" legislation and in a press release stated that he is "optimistic that with the support of the President we will be able to enact this important principle into law."[7]

Legislation on Compensation Committee Independence

The Obama Administration will propose legislation on compensation committee independence to "give compensation committees greater independence, just as Sarbanes-Oxley did for audit committees."[8] This legislation will direct the SEC to:

- Issue rules requiring that compensation committee members meet independence standards similar to audit committee members under the Sarbanes-Oxley Act, in addition to the current independence standards of the major exchanges. Independence for audit committee members is defined in Section 301 of the Sarbanes-Oxley Act to have two principal components: (i) a

director must not accept any consulting, advisory or other compensatory fee from the listed company other than compensation for service as a director and (ii) a director must not be affiliated with the company or its subsidiaries;

- Issue rules requiring that: (i) the compensation committee be directly responsible for the appointment, compensation, retention and oversight of the work of any compensation consultant that the committee retains, and that such consultants report directly to the compensation committee; (ii) the compensation committee has the authority to engage counsel and other advisors, as it deems necessary to carry out its duties; and (iii) each company provide appropriate funding, as determined by the compensation committee, to enable the committee to engage and adequately compensate compensation consultants, outside counsel and any other advisors employed by the compensation committee; and
- Establish standards for ensuring the independence of compensation consultants and outside counsel used by compensation committees.

According to Representative Frank, "given the inherently close relationship that exists between CEOs and other top executives on the one hand, and boards of directors on the other, it is very unlikely that you will ever get the degree of independence that will allow the boards of directors to be left completely on their own to set compensation. That is part of the reason for say-on-pay. But it is also the reason why legislation should be adopted that instructs the Securities and Exchange Commission to set principles which prevent boards from providing compensation systems that lead to excessive risk taking."[9]

The Shareholder Bill of Rights Act of 2009

On May 19, 2009, Senators Charles Schumer (D-NY) and Maria Cantwell (D-WA) introduced the Shareholders Bill of Rights Act of 2009 (the "Shareholder Bill of Rights Act").[10] The stated purpose of the Shareholder Bill of Rights Act is to "provide shareholders with enhanced authority over the nomination, election and compensation of public company executives." Senator Schumer noted that the Shareholder Bill of Rights Act would provide "a permanent change in the balance of power" between shareholders and boards of directors.

The Shareholder Bill of Rights Act, if enacted, would amend the Securities Exchange Act of 1934 by including the following provisions:

- *Non-Binding Shareholder Vote on Executive Compensation*: The Shareholder Bill of Rights Act would require public corporations to provide shareholders with an opportunity for an advisory vote on executive officer compensation (as disclosed pursuant to the SEC's rules) and for an advisory vote on any agreements or understandings concerning compensation for executives of the issuer related to the acquisition, merger, consolidation or proposed sale or other disposition of substantially all of the assets of the issuer (if not already subject to an advisory shareholder vote).[11] This appears consistent with the Administration's position on "say-on-pay."
- *Shareholder Input in Board Elections*: The Act would require the SEC to establish rules for shareholder access to corporate proxy materials for nominations to the board, on the rationale that "it has always been the intent of Congress that the Securities and Exchange Commission

should have full authority to determine the use of the issuer proxy with regards to the nomination and election of directors by shareholders." This provision would provide a stronger foundation for the SEC's authority to issue proxy access rules.[12] The Shareholder Bill of Rights Act also would set the standard for such proxy access (proxy access shall only be given to a shareholder (or groups of shareholders acting by agreement) that has beneficially owned, in aggregate, at least one percent of the voting shares of the issuer, directly or indirectly, for a minimum of two years preceding the date of the next scheduled annual meeting of the issuer). This standard is not consistent with the proxy access rule as proposed by the SEC on May 20, 2009.[13] As proposed, the SEC would, among other things, require a shareholder or shareholder groups to own a certain minimum percentage of the shares entitled to be voted in the election of directors ranging from 1% to 5% depending on the size and reporting status of the company and would require the shareholder or shareholder group to own the voting securities for one year (rather than two years).

- *Corporate Governance Standards*: The Shareholder Bill of Rights Act would also require that the SEC direct the national securities exchanges and national securities associations to generally prohibit the listing of any security of an issuer that is not in compliance with the following corporate governance standards (with exceptions to be made for companies of a certain size, market capitalization, public float, number of shareholders of record, or other criteria that the SEC considers appropriate):
  - *Elimination of Staggered Boards*: Each member of the board must be elected annually.
  - *Majority Voting*: In uncontested elections, each director must be elected by a majority of the votes cast, and if a current director is not reelected under such a standard, that director must tender his or her resignation to the board, *and the board must accept the resignation,* determine the date on which such resignation will take effect (which shall be within a reasonable period of time, as established by the SEC) and make such date public within a reasonable period of time.
  - *Independent Chairperson*: The issuer must include in its governing documents or in a public statement of corporate policy that (i) the board chair must meet the director independence requirements of the exchange on which the issuer's securities are listed and (ii) the board chair may not have previously served as an executive officer of the issuer.
  - *Risk Committee*: The board must create a separate risk committee, comprised entirely of independent directors, responsible for the establishment and evaluation of the risk management practices of the issuer.

The Shareholder Empowerment Act of 2009

On June 12, 2009, Representative Gary Peters (D-MI) introduced the Shareholder Empowerment Act of 2009 (the "Shareholder Empowerment Act").[14] In introducing this legislation, Representative Peters stated that "ensuring executives act in investors' long-term interest rather than for their own short-term gain is critical to prevent a similar economic collapse in the future."[15]

The Shareholder Empowerment Act, if enacted, would amend the Securities Exchange Act of 1934 by adding new governance and executive compensation requirements (and would require the SEC to establish related rules):

Election of Directors:

- *Broker Discretionary Voting in Uncontested Director Elections*: The Shareholder Empowerment Act would prohibit brokers from voting securities in an uncontested election of directors of an issuer if that broker has not received specific voting instructions from the beneficial owner of those securities.[16]
- *Majority Voting*: Similar to the Shareholder Bill of Rights Act, the Shareholder Empowerment Act would require that directors in uncontested elections be elected by a majority of the votes cast, and if a director is not elected under this standard to submit his or her resignation to the board of directors. Unlike the Shareholder Bill of Rights Act, this legislation does not require the board of directors to accept the resignation. Rather, the board of directors would be required to determine what action should be taken with regard to the director's resignation and to publicly disclose its decision and the rationale for that decision.
- *Shareholder Access to the Proxy in Director Elections*: Like the Shareholder Bill of Rights Act, this legislation would require shareholder access to corporate proxy statements in director elections for those holders who have owned in the aggregate at least one percent of the issuer's voting securities for at least two years prior to a record date established by the issuer for a meeting of security holders.
- *Independent Chairman of the Board of Directors*: Like the Shareholder Bill of Rights Act, the Shareholder Empowerment Act would direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that does not provide in its governing documents or in a public statement of corporate policy that the chairman of the board of directors be an independent director who has not previously served as an executive officer of the issuer. Although the Shareholder Bill of Rights Act provides that the chairman of the board must meet the director independence requirements of the exchange on which the issuer's securities are listed, the Shareholder Empowerment Act provides its own definition of independence. A chairman will not qualify as independent if such director, within the preceding five years,[17] has been:
  - employed by the issuer in an executive capacity;
  - an employee, director or owner of greater than 20 percent of the beneficial shares of a firm that is a paid adviser or consultant to the issuer;
  - employed by a significant customer or supplier of the issuer;
  - a party to a personal services contract with the issuer, the issuer's Chair, CEO, or other senior executive officer;
  - an employee, officer or director of a non-profit organization that receives the greater of $100,000 or one percent of its total annual donations from the issuer;
  - a relative of an executive of the issuer;
  - part of an interlocking directorate in which the issuer's CEO or another executive of the issuer serves on the board of another issuer employing that director; or

- engaged in any other relationship with the issuer or senior executives of the issuer that the SEC determines would not render that director independent.

Executive Compensation Requirements:

- *Improved Disclosure of Compensation Targets*: The Shareholder Empowerment Act would require additional disclosure of specific performance targets used by issuers in determining a senior executive officer's eligibility for bonuses, equity and incentive compensation. It would also direct the SEC to consider methods to improve disclosure by issuers who claim that disclosing such targets would result in competitive harm to the issuer, including requiring the issuer to (i) describe its past experience with similar target levels; (ii) disclose any inconsistencies between compensation targets and targets set in other contexts; (iii) submit a request for confidential treatment of the performance targets under SEC rules; or (iv) disclose the data once disclosure would no longer be considered competitively harmful.[18]
- *Severance Agreements Tied to Performance*: The Shareholder Empowerment Act would require that the SEC direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer whose board of directors (or a committee thereof) has entered into agreements that provide for severance payments to a senior executive officer who is terminated because of poor performance as an executive (as determined by the board of directors).
- *Clawbacks of Unearned Performance-Based Pay*: The Shareholder Empowerment Act would require that the SEC direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer whose board has not adopted and disclosed a policy for reviewing unearned bonus payments, incentive payments or equity payments that were awarded to executive officers due to fraud, financial results that require restatement, or other similar causes.
- *Shareholder Approval of Executive Compensation*: Like the Obama Administration's proposal and the Shareholder Bill of Rights Act, the Shareholder Empowerment Act provides for a non-binding shareholder vote on executive compensation.
- *Independent Compensation Advisors*: Like the Obama Administration's proposal, the Shareholder Empowerment Act would require that compensation advisors be independent and report solely to the board of directors. The Shareholder Empowerment Act states that in determining the independence of compensation advisors, the SEC should consider the extent to which an advisor provides services in conjunction with negotiating employment or compensation agreements with the issuer as compared to other services that the advisor provides to the issuer or the issuer's executives, whether individual advisors are permitted to hold equity in the issuer (and whether they do so) and whether an advisory firm's own incentive compensation plan links the compensation of individual advisors to the firm's provision of other services to the issuer.

The Excessive Pay Shareholder Approval Act and the Excessive Pay Capped Deduction Act

On May 7, 2009, Senator Richard Durbin (D-Illinois), Assistant Majority Leader, introduced two pieces of legislation: the Excessive Pay Shareholder Approval Act and the Excessive Pay Capped Deduction Act of 2009.

The Excessive Pay Shareholder Approval Act,[19] if enacted, would amend the Securities Exchange Act of 1934 by requiring a supermajority shareholder vote (60%) to approve the compensation of an employee who receives compensation in any taxable year exceeding 100 times the average compensation of all employees of the issuer during that taxable year. The proxy materials for shareholders to vote upon would be required to include the following information: the amount of compensation paid to the lowest paid employee and the highest paid employee; the average amount of compensation paid to all employees; the number of employees who are paid more than 100 times the average amount of compensation for all employees; and the total amount of compensation paid to employees who are paid more than 100 times the average amount of compensation for all employees.

The Excessive Pay Capped Deduction Act of 2009,[20] if enacted, would amend Section 162 of the Internal Revenue Code of 1986 to deny a deduction for any excessive compensation for any employee of the taxpayer. "Excessive compensation" would include any compensation for an employee in excess of 100 times the amount of the average compensation of all employees of the taxpayer during the taxable year. An employer providing "excessive compensation" to any employee during a taxable year would be required to file a report to the Treasury Secretary including the following information: the amount of compensation paid to the lowest paid employee and the highest paid employee; the average amount of compensation paid to all employees; the number of employees who are paid more than 100 times the average amount of compensation for all employees; and the total amount of compensation paid to employees who are paid more than 100 times the average amount of compensation for all employees.

Debate Over Proposed Corporate Governance and Executive Compensation Legislation

Many of the proposed changes contained in these drafts of legislation relating to corporate governance and executive compensation have been hotly debated by corporate governance advocates, investors and boards of directors in recent years, but until now have remained the subject of private ordering between shareholders and directors. The debate has been framed as follows: supporters of federally mandated corporate governance and executive compensation rules contend such mandates are necessary to hold boards of directors accountable to shareholders; those opposed believe that federal mandates represent an ill-advised departure from the flexible state law-based corporate governance system that has prevailed in our country for more than a century. However, given the attention that these issues have received from the media and general public, as well as the strong support for the proposed changes demonstrated by the Obama Administration, Congress and regulators, it appears likely that some significant federal corporate governance mandates are on the way.

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If you have any questions on these matters, please do not hesitate to speak with your regular contact at Weil, Gotshal & Manges LLP or members of the Firm's Public Company Advisory Group: Howard B. Dicker, howard.dicker@weil.com, 212-310-8858; Cathy Dixon, cathy.dixon@weil.com, 202-682-7147; Holly J. Gregory, holly.gregory@weil.com, 212-310-8038; P.J. Himelfarb, pj.himelfarb@weil.com, 202-682-7197; Robert L. Messineo, robert.messineo@weil.com, 212-310-8835; and Ellen J. Odoner, ellen.odoner@weil.com, 212-310-8438.

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[1] Secretary Geithner's press release is available at http://www.ustreas.gov/press/releases/tg163.htm.

[2] For example, Section 7001 of the American Recovery and Reinvestment Act of 2009 requires TARP recipients to "permit a separate shareholder vote to approve the compensation of executives, as disclosed pursuant to the compensation disclosure rules of the [Securities and Exchange] Commission."

[3] The Department of the Treasury's press release announcing the interim final rule is available at http://www.ustreas.gov/press/releases/tg165.htm. The regulations are available at http://www.treas.gov/press/releases/reports/ec%20ifr%20fr%20web%206.9.09tg164.pdf. The interim final rule sets limits on executive compensation for certain executives and highly compensated employees at companies receiving TARP funds, appoints a special master to review compensation plans at firms receiving exceptional assistance, implements and extends upon key provisions of the Department of the Treasury's February 4, 2009 proposals regarding restrictions on executive compensation for financial institutions that are receiving government assistance, and sets additional compensation and governance standards to improve accountability and disclosure.

[4] An archived webcast of this hearing is available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/hrfc_061109.shtml.

[5] On June 10, 2009, Chairman Schapiro stated that the SEC is considering proposals requiring greater disclosure relating to a company's risk management, overall compensation approach, conflicts of interest of compensation consultants, the experience and qualifications of director nominees and why a board has chosen its particular leadership structure. Her statement is available at http://www.sec.gov/news/press/2009/2009-133.htm.

[6] The "Say-on-Pay" Fact Sheet linked to Secretary Geithner's press release is available at http://www.treas.gov/press/releases/reports/fact_sheet_say%20on%20pay.pdf.

[7] Representative Frank's statement is available at http://www.house.gov/apps/list/press/financialsvcs_dem/press_061009.shtml.

[8] The "Providing Compensation Committees with New Independence" Fact Sheet linked to Secretary Geithner's press release is available at http://www.treas.gov/press/releases/reports/fact_sheet_indepcompcmte.pdf.

[9] At a June 11, 2009 hearing before the House Financial Services Committee, Representative Frank stated that he plans for the committee to mark-up and present to the House of Representatives before the summer recess a set of new financial regulations to put in place rules derived from lessons learned from the economic crisis.

[10] S. 1074, 111th Cong. (1st Sess. 2009).

[11] The text of the Shareholder Bill of Rights Act states that these shareholder advisory votes on executive compensation shall not be binding on the board of directors and shall not be construed "(1) as overruling a decision by such board; (2) to create or imply any change to the current fiduciary duties of such board; (3) to create or imply any additional fiduciary duty by such board; or (4) to restrict or limit the ability of shareholders to make proposals for inclusion in such proxy materials related to executive compensation."

[12] In their press release announcing the Shareholder Bill of Rights Act, Senators Schumer and Cantwell acknowledged that the introduction of the Shareholder Bill of Rights Act comes as the SEC considers giving shareholders access to corporate proxy materials. The press release states "Even though such action would represent a lawful exercise of the SEC's authority, the business community is already threatening lawsuits if any steps are taken. Schumer and Cantwell's legislation would give this proposed change the force of law and eliminate any debates over the agency's authority." Press Release, Senators Charles E. Schumer and Maria Cantwell, Schumer, Cantwell Announce 'Shareholder Bill of Rights' to Impose Greater Accountability on Corporate America (May 19, 2009).

[13] On May 20, 2009 the SEC voted in favor of adopting a new proxy rule that would provide shareholders meeting certain eligibility standards with access to corporate proxy materials to nominate their own directors where otherwise not prohibited by applicable state law and/or the company's governing documents. For a detailed discussion of the SEC's proposed rules see our Weil Briefing "SEC Proposes New Rule Mandating Proxy Access" (May 21, 2009) available at http://www.weil.com/news/pubdetail.aspx?pub=9483. The SEC released its proposed proxy access rules on June 10, 2009 (available at http://www.sec.gov/rules/proposed/2009/33-9046.pdf). The proposed rules were published in the Federal Register on June 18, 2009 (74 Fed. Reg. 116).

[14] H.R. 2861, 11th Cong. (1st Sess. 2009).

[15] Representative Peters' statement is available at http://peters.house.gov/?sectionid=22§iontree=21,22&itemid=148.

[16] On February 26, 2009 the NYSE filed with the SEC an amendment to NYSE Rule 452 that would eliminate broker discretionary voting in director elections. The NYSE proposal is available at http://www.sec.gov/rules/sro/nyse/2009/34-59464.pdf. The SEC has solicited comments on this proposed rule change which are available at http://www.sec.gov/comments/sr-nyse-2006-92/nyse200692.shtml.

[17] Unlike NYSE and NASDAQ listing rules, the Shareholder Empowerment Act provides for a five-year, rather than a three-year, look-back period for determining independence.

[18] Under the current proxy disclosure rules, an issuer may be required to disclose target levels with respect to specific quantitative or qualitative performance-related factors used in setting executive compensation. Instruction 4 to Regulation S-K Item 402(b) states that registrants are not required to disclose such target levels or any other factors or criteria involving confidential trade secrets or confidential commercial or financial information "the disclosure of which would result in competitive harm for the registrant." In determining whether to omit performance levels, the registrant must first consider the materiality of the performance targets. If performance targets are determined to be material to the company's executive compensation policies or decisions, a company may omit targets involving confidential trade secrets or confidential commercial or financial information only if disclosure would result in competitive harm. (Division of Corporation Finance, Compliance and Disclosure Interpretations – Regulation S-K CDI 118.04 available at http://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm).

[19] S.1006 , 111th Cong. (1st Sess. 2009).

[20] S.1007 , 111th Cong. (1st Sess. 2009).